Deductions for prepaid expenses

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Australian Taxation Office

How self-assessment affects most individuals

Self-assessment means the Australian Taxation Office (ATO) uses the information you give on your tax return to work out your refund or tax bill. You are required by law to make sure you have shown all your assessable income and claimed only the deductions and tax offsets to which you are entitled.

What are your responsibilities?

Even if someone else—including a tax agent—helps you to prepare your tax return, you are still legally responsible for the accuracy of the information.

What if you lodge an incorrect tax return?

Our systems continually check for missing or wrong information. We have audit programs designed to detect where taxpayers have not declared all of their assessable income or where they have incorrectly claimed deductions or tax offsets. If you become aware that your tax return is incorrect, you must contact us straightaway.

Initiatives to complement self-assessment

There are a number of initiatives administered by the ATO which complement self-assessment. Examples include:

- a change in penalty provisions so that if you take reasonable care with your tax affairs, you will not receive a penalty for honest mistakes but please note that interest on omitted income or overclaimed deductions and tax offsets could still be payable
- the process for applying for a private ruling
- your entitlement to interest on early payment or overpayment of a tax debt
- the process for applying for an amendment if you find you left something out of your tax return.

Do you need to ask for a private ruling?

If you have a concern about the way a tax law applies to your personal tax affairs, you may want to ask for a private ruling. A private ruling will relate just to your situation. Write to the ATO describing your situation in detail and ask for advice. Include your tax file number.
If you lodge your tax return before you receive your private ruling, be aware that the ruling may alter the accuracy of your tax return.

You can ask for a review of a private ruling decision if you disagree with it, even if you have not received your assessment. The ATO can give you more information about review procedures.

Copies of publications

To get any publication referred to in this booklet:

- visit the ATO website at <**www.ato.gov.au**>
- ring our Publications Distribution Service on **1300 720 092** for the cost of a local call or
- visit an ATO office.

Publications referred to in this booklet include:

- *Business and professional items* (NAT 2543—6.2002)
- *Partnership and trust tax returns instructions* (NAT 2297—6.2002)
- *Company tax return instructions* (NAT 0669—6.2002).

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Deductions for prepaid expenses 2001–02

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Chapter 1 General information about prepaid expenses

What is a prepaid expense?

A prepaid expense is expenditure you incur for things to be done (in whole or in part) in a later income year. If expenditure is incurred for something to be done in full within the same income year, it is not a prepaid expense to which the prepayment rules apply.

EXAMPLE—Expenditure not constituting a prepayment

Jasmin is a solicitor. On 1 July 2001, she paid $1500 annual subscription for the monthly provision of a professional journal. The subscription covers the period 1 July 2001 to 30 June 2002. Because the thing to be done under the agreement—the provision of the professional publication—will be completed wholly within the expenditure year the prepayment rules will not apply.

What is the eligible service period?

The eligible service period is the period during which the thing is to be done under the agreement in return for the expenditure. The eligible service period begins on the day the thing under the agreement commences to be done or on the day the expenditure is incurred, whichever is later. The eligible service period continues until the end of the last day the thing under the agreement ceases to be done or 10 years, whichever is earlier.

EXAMPLE—Eligible service period

Mike runs a delicatessen from leased premises. On 1 December 2001, Mike made a lease payment to cover the period 1 December 2001 to 30 November 2002. The eligible service period for this expenditure therefore commenced on 1 December 2001 and will end on 30 November 2002, a period of 365 days.

Mike's income year ends on 30 June of each year. As the thing to be done under the agreement (the provision of premises by the lessor) is not wholly done within the expenditure year the prepayment rules will apply.

Expenditure must be deductible under the general deduction provisions or the research and development provisions

The prepayment rules only apply to expenditure which would otherwise qualify for immediate deduction under the general deduction provisions of section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) or, for eligible companies, under the research and development provisions in sections 73B, 73BA, 73BH or 73Y of the *Income Tax Assessment Act 1936* (ITAA 1936).

The general deduction provisions generally allow you to deduct from your assessable income any loss or outgoing to the extent that it is either incurred in gaining or producing your assessable income, or is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income. Expenditure of a capital, private or domestic nature, or expenditure incurred in gaining exempt income, is specifically excluded from being deductible under these provisions. The prepayment rules do not apply if the expenditure is deductible under a specific deduction provision of the tax law other than those for research and development referred to in the previous paragraph.

NOTE Unless specifically stated otherwise, the terms 'expense' and 'expenditure' used throughout this guide refer to expenditure that is only allowable as a deduction under the general deduction provisions of section 8-1 of ITAA 1997 or, for eligible companies, under the research and development provisions in section 73B 73BA, 73BH or 73Y of ITAA 1936.

What is excluded expenditure?

Certain types of expenditure are excluded from the prepayment rules. These are:

- amounts of less than $1000
- amounts required to be paid by a Commonwealth, State or Territory law or by a court order
- payments of salary or wages (under a contract of service)
- amounts that are capital, private or domestic in nature.

EXAMPLE—Amount required to be paid under a State law

John operates a cartage business and paid $1200 on 31 December 2001 to register his truck for 12 months from 1 January 2002 to 31 December 2002. The truck is used exclusively for business purposes. Although the registration fee is in excess of $1000 and it covers a period spreading across more than one income year, it is excluded expenditure. This is because the registration fee is required to be paid under a State or Territory law. The prepayment rules do not apply to this type of expenditure and the fee is deductible in the year it is paid.

What is a pre-RBT obligation?

A pre-RBT obligation is any contractual obligation that:

- exists under an agreement at or before 11.45 a.m. [by legal time in the Australian Capital Territory (ACT)] on 21 September 1999—the date of the Government's release of the Review of Business Taxation (RBT)
- requires you to make a prepayment in return for something to be done under the agreement
- cannot be avoided by your own actions.

The rules for deducting prepaid expenses incurred under a pre-RBT obligation are the same as those explained for taxpayers who are in the Simplified Tax System (STS), see page 7 chapter 5.

What are the prepayment rules?

Generally, a prepaid expense is deductible over the eligible service period, or 10 years if that is less, rather than being immediately deductible. For more information about the eligible service period, see page 1.

However, if you are an STS taxpayer, or an individual incurring deductible non-business expenditure, you can claim an immediate deduction under the 12-month rule for prepaid expenditure where the payment is incurred for an eligible service period not exceeding 12 months and the eligible service period ends in the next income year.

For more information on STS taxpayers, see page 7 chapter 5 and on deductible non-business expenditure incurred by individuals, see page 6 chapter 4.

If you are not an STS taxpayer and you

- incur prepaid expenditure in carrying on a business or
- incur prepaid non-business expenditure and you are not an individual,

transitional arrangements may apply to the expenditure where the eligible service period ends not more than 13 months after you incur the expenditure.

The transitional treatment isolates the part of the payment that relates to a later year and allows a specified percentage to be immediately deductible instead of being apportioned over the eligible service period. There is a limit (cap) on the amount that is subject to transitional treatment unless you are:

- a small business taxpayer and are not an STS taxpayer or
- a non-individual taxpayer incurring deductible non-business expenditure.

For more information on the transitional rules that apply to small business taxpayers who are not in the STS, see page 9 chapter 6 and on the rules that apply to other taxpayers, see page 11 chapter 7 and page 14 chapter 8.

Prepaid expenditure incurred under certain managed investments ('tax shelter' arrangements) is not eligible for the 12-month rule or transitional treatment. For more information about tax shelter arrangements, see page 3 chapter 2.

Certain prepaid expenditure incurred under an investment in a plantation forestry managed agreement is eligible for the 12-month rule. For more information see page 5 chapter 3.

If the 12-month rule or the transitional provisions do not apply, your deduction for prepaid expenditure is apportioned over the eligible service period or 10 years, whichever is less.

What is a tax shelter arrangement?

You have a tax shelter arrangement in the income year in which you incur prepaid expenditure if:

- your allowable deductions attributable to the arrangement for the expenditure year exceed your assessable income from the arrangement for that year
- you do not have day-to-day control over the operation of the arrangement
- at least one of the following is met:
  - more than one taxpayer participates as an investor in the arrangement or
  - the manager, arranger or promoter of the arrangement, or an associate, carries out similar activities for other taxpayers.

What expenditure is excluded from the tax shelter rules?

The following prepaid expenditure is excluded from the application of the tax shelter rules:

- premiums for building insurance, contents insurance or rent protection insurance
- interest on money borrowed to acquire:
  - real property or an interest in real property
  - shares listed on an approved stock exchange or
  - units in a widely held unit trust which has at least 300 beneficiaries

provided the arrangement is conducted at arm's length and that you have or can reasonably expect to obtain rent, dividends or trust income. Additionally, you must not have obtained and will not obtain any other kind of assessable income (except a capital gain or insurance receipt) from the arrangement.

Also specifically excluded from the application of the tax shelter rules are:

- certain expenditure that is an allowable deduction under the infrastructure borrowing rules
- expenditure incurred under a contract (requiring prepayment for something to be done under the agreement) entered into before 1.00 p.m. (by legal time in the ACT) on 11 November 1999 that you cannot avoid by your own actions
- expenditure under an agreement which, before 1.00 p.m. (by legal time in the ACT) on 11 November 1999, had obtained or had applied for and later obtained a favourable ATO product ruling or
- any prepaid expenditure which is excluded expenditure; that is, an amount below $1000, an amount required to be incurred by a law or a court order, or an amount of salary or wages.

NOTE If you incur prepaid expenditure that is not subject to the tax shelter rules because of one of the above exceptions, your deduction must be determined in accordance with the other rules explained in this publication.

Summary of rules

- Certain prepaid expenditure incurred under a plantation forestry managed agreement is subject to a 12-month rule. For more information, see page 5 chapter 3.
- If you invest in a tax shelter arrangement, you need to be aware that the tax shelter rules for prepayments may apply to limit your immediate deductions. **The tax shelter rules apply in the same way to all taxpayers.**
- If you prepaid expenditure under a tax shelter agreement for a thing that will not be wholly done within the expenditure year and it is not covered by one of the exceptions listed above, you cannot deduct all of the expenditure in the income year in which it was incurred. The deduction must be apportioned over the eligible service period or 10 years, whichever is less.
- An agreement in respect of a tax shelter arrangement is one that covers any activities that relate to the arrangement, including those that give rise to deductions or assessable income. For example, if you invest in a tax shelter arrangement and prepay interest on a loan from a 3rd party to pay management fees for the tax shelter, the prepaid interest on the loan would also be subject to the tax shelter rules.

Calculating your deduction for a prepayment made under a tax shelter arrangement

Use the following formula to work out your deduction for prepaid expenditure that is affected by the tax shelter rules:

$$\text{Expenditure} \times \frac{\text{number of days of eligible service period in the income year}}{\text{total number of days of eligible service period}}$$

EXAMPLE—Investment in a tax shelter arrangement

On 30 April 2002, Marian invested in an olive grove venture. The investment has all the characteristics of a tax shelter arrangement and is not subject to any of the exceptions.

Under the terms of the agreement, Marian was required to pay an initial management fee of $10 000 on 1 May 2002 to cover the provision of services over the period 1 May 2002 to 30 April 2003 (a period of 365 days). Marian made this payment on 1 May 2002. Marian is required to apportion her deduction over the 2002 and 2003 income years.

Marian's deductions are calculated as follows:

2001–02

$$\$10\,000 \times \frac{61}{365}\ (\text{1 May 2002 to 30 June 2002}) = \$1671$$

2002–03

$$\$10\,000 \times \frac{304}{365}\ (\text{1 July 2002 to 30 April 2003}) = \$8329$$

Over the 2002 and 2003 income years, Marian is entitled to a total deduction of $10 000.

Chapter 3 Investments in plantation forestry managed agreements

What is a plantation forestry managed agreement?

You have a plantation forestry managed agreement in the year in which you incur prepaid expenditure if:

- the arrangement entered into is for the planting and tending of trees for felling
- you do not have day-to-day control over the operation of the agreement
- at least one of the following is met:
  - more than one taxpayer participates in the agreement or
  - the manager, arranger or promoter of the agreement, or an associate, carries out similar activities for other taxpayers.

Agreements entered into where trees are planted for the purpose of obtaining harvest from fruit or other produce are not plantation forestry managed agreements.

What prepaid expenses are covered by these rules?

These rules apply where, under an agreement, the following requirements are satisfied:

- the prepaid expenditure is incurred on or after 2 October 2001 and on or before 30 June 2006
- the eligible service period for the expenditure is 12 months or less and the 12-month period ends on or before the last day of the income year following the year in which the expenditure was incurred
- the expenditure is for seasonally dependent agronomic activities undertaken during the establishment period.

What are seasonally dependent agronomic activities?

Seasonally dependent agronomic activities include:

- ripping and mounding a plantation site
- applying fertiliser, herbicides or pesticides in conjunction with the planting
- tending seedlings prior to planting
- planting.

They do not include any incidental activities of an administrative nature carried out by the manager.

NOTE A Taxation Determination addressing the meaning of the term 'seasonally dependent agronomic activities' is being prepared.

What is the establishment period?

The establishment period for the planting of trees starts on the day when the first seasonally dependent agronomic activity is done and ends on the later of:

- the day when the last seedling is planted under that planting program
- the day when any fertiliser, herbicide or pesticide is applied to seedlings under that planting program.

Summary of rules

- If your prepaid expense is incurred in respect of seasonally dependent agronomic activities that occur during the establishment period it is immediately deductible under the 12-month rule where:
  - the eligible service period for the expenditure is 12 months or less
  - the 12-month period ends no later than the last day of the income year following the year in which the prepayment was incurred.
- If your prepaid expense is not incurred in respect of seasonally dependent agronomic activities that occur during the establishment period, or the 12-month rule is not satisfied, your deduction for the expenditure is determined in accordance with either the tax shelter or general prepayment rules discussed elsewhere in this publication.

EXAMPLE—Deduction for expenditure in a plantation forestry managed agreement

Donald made a prepaid investment of $10 000 in a plantation forestry managed agreement on 1 June 2002. The prepaid activities are carried out within 12 months of the expenditure being incurred. An amount of $4000 is for seasonally dependent agronomic activities that occur within the establishment period. This component of the prepaid expense is deductible in the 2001–02 income year.

The remaining $6000 continues to be subject to the other prepayment rules. For example, under the rules applicable to tax shelter arrangements the deduction for that expenditure will need to be apportioned over the eligible service period.

Chapter 4 Individual taxpayers incurring deductible non-business expenditure

What is non-business expenditure?

Non-business expenditure is any expenditure you incur in gaining assessable income from activities that do not relate to the carrying on of a business. The most common forms of non-business expenditure are amounts incurred by individual taxpayers in gaining their assessable salary and wage income. Other examples include certain expenditure made in respect of a rental property or shares held purely as a passive investment.

EXAMPLE—Non-business expenditure

Ian is employed as a bank manager and the primary source of his income is the salary received from his employer. Ian also owns a rental property from which he receives assessable income. Ian's rental property activities do not constitute the carrying on of a business. Prepaid expenditure incurred by Ian in respect of the rental property or for work related expenses will be subject to the prepayment rules that apply to deductible non-business expenditure incurred by an individual.

Summary of rules including the 12-month rule

- Prepaid expenditure that is subject to the tax shelter rules is apportioned over the eligible service period or 10 years, whichever is less. For more information, see page 3 chapter 2.
- If you are an individual, your prepaid non-business expenditure is immediately deductible under the 12-month rule where:
  - the eligible service period for the expenditure is 12 months or less
  - the 12-month period ends no later than the last day of the income year following the year in which the payment was incurred.
- If you are an individual, your deduction for prepaid non-business expenditure is apportioned over the eligible service period or 10 years, whichever is less, where the eligible service period is more than 12 months or it ends after the last day of the next income year.

Calculating your deduction where the 12-month rule is satisfied

If you incur prepaid non-business expenditure and its eligible service period is 12 months or less, and it ends on or before the last day of the next income year, you are entitled to deduct that expenditure in the income year it was incurred.

EXAMPLE—Deduction for non-business expenditure with an eligible service period of 12 months or less

On 1 June 2002, Jasmin, an employed solicitor, paid $1500 subscription for the provision of a monthly professional journal for the period 1 June 2002 to 31 May 2003. Because the thing to be done under the agreement is wholly provided within a 12-month period ending before the last day of the next income year, Jasmin is entitled to a deduction for the expenditure in 2001–02.

Calculating your deduction where the 12-month rule is not satisfied

Where you incur non-business expenditure and the eligible service period is more than 12 months or it ends after the last day of the next income year, you must use the following formula to work out your deduction:

$$\text{Expenditure} \times \frac{\text{number of days of eligible service period in the income year}}{\text{total number of days of eligible service period}}$$

EXAMPLE—Deduction for non-business expenditure with an eligible service period of more than 12 months

On 1 January 2002, Martin, a senior clerk employed by a legal firm, paid $1250 subscription for the monthly provision of a professional journal to cover the period 1 January 2002 to 31 January 2003. As the eligible service period is more than 12 months, Martin must apportion his deduction over the 2002 and 2003 income years. Martin's deductions are:

2001–02

$$\$1250 \times \frac{181\ \text{(1 January 2002 to 30 June 2002)}}{396} = \$571$$

2002–03

$$\$1250 \times \frac{215\ \text{(1 July 2002 to 31 January 2003)}}{396} = \$679$$

Over the 2002 and 2003 income years, Martin will get a total deduction of $1250.

Are you in the Simplified Tax System?

Participation in the STS is optional. Broadly, you are eligible to enter the STS for an income year if:

- you carry on business in that year
- the STS average turnover of your business and related businesses for that year is less than $1 million
- your business and related businesses have depreciating assets with a total adjustable value of less than $3 million at the end of that year.

If you are eligible to enter the STS and wish to do so, you should make an election to that effect on your 2002 income tax return. For more information, see *Business and professional items, Partnership and trust tax returns instructions* or *Company tax return instructions*.

Summary of rules including the 12-month rule

- Prepaid expenditure that is subject to the tax shelter rules is apportioned over the eligible service period or 10 years, whichever is less. For more information, see page 3 chapter 2.
- However, certain prepaid expenditure incurred under a plantation forestry managed agreement is deductible under the 12-month rule where:
  - the eligible service period for the expenditure is 12 months or less
  - the 12-month period ends on or before the last day of the income year following the year in which the payment was incurred.

  For more information, see page 5 chapter 3.
- Prepaid expenditure incurred by an STS taxpayer is immediately deductible under the 12-month rule where:
  - the eligible service period for the expenditure is 12 months or less
  - the 12-month period ends no later than the last day of the income year following the year in which the payment was made.

  This 12-month rule applies to both deductible business and deductible non-business expenditure made by an STS taxpayer. It applies to years of income commencing after 30 June 2001.
- A deduction for prepaid expenditure incurred by an STS taxpayer, whether incurred in carrying on a business or not, is apportioned over the eligible service period or 10 years, whichever is less, where the eligible service period is more than 12 months or it ends after the last day of the income year following the year in which the payment was made.

NOTE For an STS taxpayer, the expenditure must have been *paid* before a deduction can be claimed.

Calculating your deduction where the 12-month rule is satisfied

EXAMPLE—Prepaid expense that is immediately deductible

The ABC Trust is an STS taxpayer. On 1 June 2002, it made a payment of $24 000 to cover the lease of its business premises for a 12-month period commencing on 1 July 2002 and ending on 30 June 2003.

As the eligible service period for the expenditure does not exceed 12 months and ends on or before the last day of the income year following the year in which the payment was made the prepayment satisfies the 12-month rule. The ABC Trust can therefore claim an immediate deduction of $24 000 in the 2001–02 income year.

Calculating your deduction where the 12-month rule is not satisfied

If you make a prepayment which does not satisfy the 12-month rule an immediate deduction is not available. As an STS taxpayer, you must apportion the deduction over the eligible service period or 10 years, whichever is less, using the following formula:

$$\text{Expenditure} \times \frac{\text{number of days of eligible service period in the income year}}{\text{total number of days of eligible service period}}$$

Example—Prepaid expense where eligible service period is greater than 12 months

Tom Pty Ltd is an STS taxpayer. On 31 May 2002, it paid $15 000 for business advertising to cover the period 1 June 2002 to 30 June 2003 (395 days). Because the eligible service period is longer than 12 months, the prepayment does not satisfy the 12-month rule. Tom Pty Ltd cannot claim an immediate deduction for the prepayment. Instead, the deduction for the expenditure must be apportioned over the eligible service period as follows:

2001–02

$$\$15\,000 \times \frac{30}{395} \text{ (1 June 2002 to 30 June 2002)} = \$1139$$

2002–03

$$\$15\,000 \times \frac{365}{395} \text{ (1 July 2002 to 31 June 2003)} = \$13\,861$$

The total deduction allowed proportionately over the 2002 and 2003 income years will be $15 000.

EXAMPLE—Prepaid expense where the eligible service period is 12 months or less but ends after the last day of the next income year

Noel Pty Ltd, an STS taxpayer, was offered a 15 per cent discount on advertising to cover the period 15 July 2002 to 14 July 2003 providing payment was made by 30 June 2002. Noel Pty Ltd accepted these conditions and paid $10 200 for these services on 30 June 2002.

Although the eligible service period is for a period of 12 months or less, the 12-month rule has not been satisfied. This is because the eligible service period does not end before the last day of the income year following the one in which the expenditure was incurred. The deduction for the expenditure must be apportioned over the eligible service period as follows:

2001–02

Nil. No part of the eligible service period occurred in this income year.

2002–03

$$\$10\,200 \times \frac{351\ \text{(15 July 2002 to 30 June 2003)}}{365} = \$9809$$

2003–04

$$\$10\,200 \times \frac{14\ \text{(1 July 2003 to 14 July 2003)}}{365} = \$391$$

The total deduction allowed proportionately over the 2003 and 2004 income years will be $10 200.

Chapter 6 Small business taxpayers who do not enter the Simplified Tax System

Are you a small business taxpayer?

You are a small business taxpayer if you carry on a business during the income year and your average turnover for that year is less than $1 million. Your average turnover for an income year is the average of your group turnovers for that year and the previous 2 years, if any. However, you can only average the years in which you carried on a business. For example, if you carried on a business for the current and previous year only, you would average only the sum of the group turnovers for those 2 years.

You are taken to be carrying on a business in an income year if you are winding up a business you formerly carried on and you were a small business taxpayer at the time that you stopped carrying on the business.

In working out group turnover for an income year, you must group your turnover with the turnover of each entity you control or are controlled by.

Summary of rules

- Prepaid expenditure that is subject to the tax shelter rules is apportioned over the eligible service period or 10 years, whichever is less. For more information, see page 3 chapter 2.
- However, certain prepaid expenditure incurred under a plantation forestry managed agreement is deductible under the 12-month rule where:
  - the eligible service period for the expenditure is 12 months or less
  - the 12-month period ends on or before the last day of the income year following the year in which the payment was incurred.

  For more information, see page 5 chapter 3.
- If you are a small business taxpayer and are not participating in the STS, your deduction for prepaid business expenditure is spread over the eligible service period or 10 years, whichever is less. However, where the eligible service period ends not more than 13 months after you incur the expenditure, transitional rules apply to allow part of the expenditure that would otherwise be deductible in a future year to be deductible in the expenditure year.
- If you are not an individual and are a small business taxpayer not participating in the STS, your deduction for prepaid non-business expenditure is treated in the same way as your prepaid business expenditure.
- If you are an individual, your prepaid non-business expenditure is immediately deductible under the 12-month rule where:
  - the eligible service period for the expenditure is 12 months or less
  - the 12-month period ends no later than the last day of the income year following the year in which the payment is made.

  For more information, see page 6 chapter 4.
- If you are an individual your deduction for prepaid non-business expenditure is apportioned over the eligible service period or 10 years, whichever is less, where the eligible service period is more than 12 months or it ends after the last day of the next income year. For more information, see page 6 chapter 4.

Deducting prepaid business expenditure

If you are a small business taxpayer and you do not enter the STS, you must apportion your deduction for prepaid business expenditure over the eligible service period or 10 years, whichever is less. However, transitional rules phase in the initial impact of this measure for certain prepaid expenditure incurred in the 2002 and 2003 income years.

Transitional rules

If you are a small business taxpayer and you do not enter the STS, transitional rules apply to prepaid business expenditure where the eligible service period ends not more than 13 months after you incur the expenditure. Your prepaid business expenditure is divided into 2 parts:

- the current year amount
- the later year amount.

Current year amount

The current year amount is that part of your prepayment that relates to the thing to be done within the income year in which you incur the expenditure (the expenditure year). This amount is calculated as follows:

$$\text{Expenditure} \times \frac{\text{number of days of eligible service period in the expenditure year}}{\text{total number of days of eligible service period}}$$

The current year amount is immediately deductible in the income year in which the prepayment is incurred.

Later year amount

The later year amount is that part of your prepayment that relates to the thing to be done in future income years. This amount is the difference between the total amount of prepaid expenditure incurred and the current year amount.

If you are a small business taxpayer and do not enter the STS, the transitional rules provide a concession by enabling you to deduct, in the year in which you incur the prepaid business expenditure, the sum of the current year amount plus part of the later year amount. The balance of the later year amount is deductible in the income year after the expenditure year.

The concessional treatment applies to the later year amount for prepaid expenditure incurred in the 2002 and 2003 income years. These rules allow:

- 40 per cent of the later year amount for prepaid business expenditure incurred in the 2002 income year to be deducted in the 2002 income year, the balance (60 per cent) will be deductible in the 2003 income year
- 20 per cent of the later year amount for prepaid business expenditure incurred in the 2003 income year can to be deducted in the 2003 income year, the balance (80 per cent) will be deductible in the 2004 income year.

The transitional rules will cease to apply to prepaid business expenditure incurred after the 2003 income year.

Deductions for prepaid business expenditure, where the eligible service period ends more than 13 months after you incur the expenditure, continue to be apportioned over the eligible service period or 10 years, whichever is less. Transitional treatment does not apply to prepaid expenditure of this nature.

EXAMPLE—Transitional rules for a prepayment made in the 2002 income year

Bill is a small business taxpayer who does not enter the STS. On 31 December 2001, Bill prepaid rent of $5000 for the use of his business premises for the 12-month period covering 1 January 2002 to 31 December 2002. As Bill incurred prepaid business expenditure in an income year which commenced after 30 June 2001 he is not entitled to an immediate deduction for the expenditure incurred.

Bill's current year amount and the later year amount are calculated as follows:

Current year amount

$$\$5000 \times \frac{181 \text{ (1 January 2002 to 30 June 2002)}}{365} = \$2479$$

This amount is immediately deductible in the 2002 income year.

Later year amount

$5000 – $2479 = $2521

Applying the transitional rules, Bill is entitled to deduct 40 per cent of this later year amount in the 2002 income year. The balance (60 per cent) will be deductible in the 2003 income year. Bill is entitled to the following deductions:

2001–02

Current year amount	$2 479
40% of later year amount ($2521 × 0.40)	$1 008
Total deduction	$3 487

2002–03

60% of later year amount ($2521 × 0.60)	$1 513

The total deduction allowed proportionately over the 2002 and 2003 income years will be $5000.

Eligible service period ending more than 13 months later

If you are a small business taxpayer and you are not participating in the STS, your deduction for prepaid business expenditure (and prepaid non-business expenditure if you are not an individual) is apportioned over the eligible service period where the eligible service period ends more than 13 months after the expenditure has been incurred. Transitional rules do not apply in these situations. For each year of income containing the eligible service period, the deduction must be worked out using the following formula:

$$\text{Expenditure} \times \frac{\text{number of days of eligible service period in the income year}}{\text{total number of days of eligible service period}}$$

EXAMPLE—Deduction for expenditure where the eligible service period is more than 13 months

Roger is a small business taxpayer who does not enter the STS. On 31 December 2002, Roger pays $15 000 rental for the use of business premises covering the period 1 January 2002 to 31 March 2003.

Because the eligible service period is longer than 13 months, Roger cannot claim an immediate deduction for the prepayment nor do the transitional rules apply. Instead, the deduction must be apportioned over the eligible service period. Roger is entitled to the following deductions:

2001–02

$$\$15\,000 \times \frac{181 \text{ (1 January 2002 to 30 June 2002)}}{455} = \$5967$$

2002–03

$$\$15\,000 \times \frac{274 \text{ (1 July 2002 to 31 March 2003)}}{455} = \$9033$$

The total deduction allowed proportionately over the 2002 and 2003 income years will be $15 000.

Non-business expenditure

Non-business expenditure is any expenditure you incur in respect of activities that do not amount to a business activity. For a small business taxpayer, circumstances can arise where you may incur deductible non-business expenditure. A common example is expenditure made in respect of a rental property held as a passive investment.

Prepaid non-business expenditure

The prepayment rules for non-business expenditure differ depending on whether you are an individual taxpayer or a non-individual taxpayer such as a company or trust.

If you are not an individual—for example, a company, superannuation fund or a trust—calculate the deduction for prepaid non-business expenditure in the same manner as your deduction for prepaid business expenditure as explained on page 9.

However, if you are an individual, you are entitled to an immediate deduction for prepaid non-business expenditure where the payment is incurred for a period of service not exceeding 12 months and the eligible service period ends on or before the last day of the next year of income. Where the eligible service period is more than 12 months or ends after the next year of income, your deduction for the expenditure must be apportioned over the eligible service period or 10 years, whichever is less. Transitional rules do not apply in these circumstances. For more information, see page 6 chapter 4.

Chapter 7 Taxpayers carrying on a business, other than small business taxpayers or Simplified Tax System taxpayers

To find out if you are a small business taxpayer, see chapter 6 and if you are an STS taxpayer, see chapter 5.

If you are carrying on a business and are not a small business taxpayer or an STS taxpayer, the following rules apply to your prepaid expenditure.

Summary of rules

- Prepaid expenditure that is subject to the tax shelter rules is apportioned over the eligible service period or 10 years, whichever is less. For more information, see page 3 chapter 2.
- However, certain prepaid expenditure incurred under a plantation forestry managed agreement is deductible under the 12-month rule where:
  - the eligible service period for the expenditure is 12 months or less
  - the 12-month period ends on or before the last day of the income year following the year in which the payment was incurred.

  For more information, see page 5 chapter 3.
- If you are carrying on a business and are not a small business taxpayer or an STS taxpayer, you must apportion your deduction for prepaid business expenditure over the eligible service period or 10 years, whichever is less. However, where the eligible service period ends not more than 13 months after you incur the expenditure, transitional rules may apply to allow part of the expenditure that would otherwise be deductible in a future year to be deductible in the expenditure year. There is an upper limit (cap) on the amount that is subject to this concessional treatment under the transitional rules.
- If you are not an individual or an STS taxpayer, your deduction for prepaid non-business expenditure is apportioned over the eligible service period or 10 years, whichever is less. However, where the eligible service period ends not more than 13 months after you incur the expenditure, transitional rules may apply to allow part of the expenditure that would otherwise be deductible in a future year to be deductible in the expenditure year. There is no upper limit (cap) on the amount that is subject to this concessional treatment under the transitional rules.

  For more information, see chapter 8.
- If you are an individual, your prepaid non-business expenditure is immediately deductible under the 12-month rule where:
  - the eligible service period for the expenditure is 12 months or less
  - the 12-month period ends no later than the last day of the income year following the year in which the payment is made.

  For more information, see page 6 chapter 4.
- If you are an individual, your deduction for prepaid non-business expenditure is apportioned over the eligible service period or 10 years, whichever is less, where the eligible service period is more than 12 months or it ends after the last day of the next income year. For more information, see page 6 chapter 4.

Calculating your deduction for prepaid business expenditure

If you are carrying on a business and are not a small business taxpayer or an STS taxpayer, you must apportion your deduction for prepaid business expenditure over the eligible service period or 10 years, whichever is less. However, where the eligible service period ends not more than 13 months after you incur the expenditure, transitional rules may apply.

Transitional rules

The transitional rules provide a concession by isolating that part of the payment that relates to a later year and allows a specified percentage to be immediately deductible instead of being apportioned over the eligible service period. There is an upper limit (cap) on the amount that is subject to this concessional treatment under the transitional rules.

The concession provided for under the transitional rules will not apply if:

- the eligible service period for the prepaid expenditure you have incurred ends more than 13 months later or
- your limit on the amount subject to transitional treatment is nil because you did not incur any prepaid expenditure between 11.45 a.m. (by legal time in the ACT) on 21 September 1999 and the end of the income year that included that date (30 June 2000 for most taxpayers).

Under the transitional rules your prepaid business expenditure is divided into 2 parts:

- the current year amount
- the later year amount.

Current year amount

The current year amount is that part of your prepayment that relates to the thing to be done within the income year in which the prepayment was incurred (the expenditure year). This amount is calculated as follows:

$$\text{Expenditure} \times \frac{\text{number of days of eligible service period in the expenditure year}}{\text{total number of days of eligible service period}}$$

The current year amount is immediately deductible in the income year in which the prepayment is incurred.

Later year amount

The later year amount is that part of your prepayment that relates to the thing(s) to be done in future income years. It is the difference between the total prepaid expenditure incurred and the current year amount.

The later year amount may be eligible for concessional treatment under the transitional rules. The treatment is determined by reference to the table below.

NOTE There is a limit or cap on the amount subject to the transitional rules. See explanation of the cap in later paragraphs.

Proportion of your later year amount you are able to deduct

Transitional year	Expenditure year	Amount included in deduction for the expenditure year	Amount of deduction for the year of income straight after the expenditure year
1st	Year of income including 21.9.99	80% of the later year amount	20% of the later year amount
2nd	Year of income following the 1st year	60% of the later year amount	40% of the later year amount
3rd	Year of income following the 2nd year	40% of the later year amount	60% of the later year amount
4th	Year of income following the 3rd year	20% of the later year amount	80% of the later year amount

Cap or limit on the amount subject to the transitional rules

There is a limit on the amount eligible for transitional treatment. This limit is referred to as the cap. The cap is the total of all your later year amounts subject to the transitional rules in the year of income including 21 September 1999. Any prepayments you made which were subject to the tax shelter rules are not included in determining the amount of the cap.

If your later year amount for prepaid expenditure incurred in the 2002 income year exceeds your cap, the later year amount subject to the transitional rules in that year will be limited to the amount of that cap. The amount by which your 2002 later year amount exceeds this cap is allowed as a deduction proportionately over the eligible service period that occurs after the expenditure year.

Calculating your deduction for prepaid business expenditure where the transitional rules apply—later year amount less than cap

EXAMPLE—Prepayment made in 2002 where the later year amount is less than the cap

On 15 December 1999, Black Ltd entered into a 4-year contract for maintenance services to be provided over the period 1 January 2000 to 31 December 2003. On that day, Black Ltd made a payment of $120 000 for the first year's service. The amount of the prepayment that relates to services to be provided over the period 1 January 2000 to 30 June 2000, a period of 182 days in a total eligible service period of 366 days, was $59 672—the current year amount. Black Ltd's later year amount was therefore $60 328 ($120 000 – $59 672)—this amount represents Black Ltd's cap.

On 15 December 2000, Black Ltd paid $110 000 for services to be provided in the 2001 calendar year. Under the transitional rules, this resulted in Black Ltd carrying forward to 2002 an amount of $22 181 being 40 per cent of the later year amount for which a deduction could not be claimed in 2001.

Black Ltd made a further payment of $110 000 on 15 December 2001 to cover services to be provided over the period 1 January 2002 to 31 December 2002. Black Ltd's current year amount and later year amount are calculated as follows:

Current year amount

$$\$110\,000 \times \frac{181 \text{ (1 January 2002 to 30 June 2002)}}{365} = \$54\,548$$

Later year amount

$110 000 – $54 548 = $55 452

As the later year amount is *less* than the amount of the cap established in the 2000 income year (that is, $60 328), Black Ltd will be entitled to immediately deduct 40 per cent of the later year amount in the 2002 income year. This is equal to:

$55 452 × 40% = $22 181

The balance of $33 271 ($55 452 – $22 181) will be available as a deduction to Black Ltd in the 2003 income year.

Black Ltd is also entitled to deduct the amount of $22 181 being that part of the previous year's later year amount which was not deductible in that year. Black Ltd's total deduction for prepaid expenditure is therefore:

2001–02

Current year amount	$54 548
40% of later year amount ($55 452 × 0.40)	$22 181
40% of previous year's later year amount carried forward	$22 181
Total deduction	$98 910

The total deduction allowed for the 2002 prepaid expenditure apportioned between the 2002 and 2003 income years is $110 000 made up as follows:

2001–02

Current year amount	$54 548
40% of 2002 later year amount	$22 181
	$76 729

2002–03

60% of 2002 later year amount	$33 271
Total	$110 000

Calculating your deduction for prepaid business expenditure where the transitional rules apply—later year amount exceeds cap

Where the later year amount of your prepaid business expenditure incurred in the 2002 income year exceeds the cap established in the income year including 21 September 1999, the percentage of the later year amount you can claim as a deduction in the 2002 income year is limited to 40 per cent of that cap.

EXAMPLE—Prepayment made in 2002 where the later year amount exceeds the cap

To vary the previous example, assume that on 15 December 2001, Black Ltd's payment under the contract was $130 000.

Black Ltd's current year amount and later year amount are calculated as follows:

Current year amount

$$\$130\,000 \times \frac{181 \text{ (1 January 2002 to 30 June 2002)}}{365} = \$64\,466$$

Later year amount

$130 000 – $64 466 = $65 534

As the later year amount *exceeds* the amount of the cap established in the year including 21 September 1999 (that is $60 328), Black Ltd will only be entitled to deduct 40 per cent of that capped amount in the 2002 income year. The amount by which the later year amount exceeds the cap (that is $5206) will be deductible in the 2003 income year. This is because the eligible service period occurring after the year in which it was incurred falls wholly within the 2003 income year.

In addition to these amounts, Black Ltd is also entitled to deduct the balance (that is 40 per cent) of the later year amount established in the 2001 year. Black Ltd's total deduction for prepaid expenditure is therefore:

2001–02

Current year amount	64 466
40% of later year amount—limited to cap ($60 328 × 0.40)	24 131
40% of previous year's later year amount carried forward	22 181
Total deduction	$110 778

The total deduction allowed for the 2002 prepaid expenditure apportioned between the 2002 and 2003 income years is $130 000 made up as follows:

2001–02		
Current year amount	64 466	
40% of 2002 later year amount—limited to cap	24 131	88 597
2002–03		
60% of 2002 later year amount—limited to cap	36 197	
Excess of 2002 later year amount over cap	5 206	41 403
Total		$130 000

Calculating your deduction for prepaid expenditure where the transitional rules do not apply

If the eligible service period for your prepaid business expenditure ends more than 13 months later or your cap is nil because you did not make a prepayment between 11.45 a.m. (by legal time in the ACT) on 21 September 1999 and the end of your income year including that date (30 June 2000 for most taxpayers), the transitional rules will not apply. Instead, your deduction must be claimed proportionately over each income year containing all or part of the eligible service period. This deduction is calculated using the following formula:

$$\text{Expenditure} \times \frac{\text{number of days of eligible service period in the income year}}{\text{total number of days of eligible service period}}$$

No part of the amount of expenditure relating to the later year can be claimed as a deduction in the 2002 income year.

EXAMPLE—Prepayment made in the 2002 year only

Green Ltd is not a small business taxpayer and its income year ends on 30 June. During the year ended 30 June 2000 (that is, the income year including 21 September 1999), Green Ltd did not incur any prepaid expenditure that was affected by the prepayment rules.

On 31 December 2001, Green Ltd entered into a contract for the supply of maintenance services for the period 1 January 2002 to 31 December 2002. Green Ltd paid $120 000 for these services on 31 December 2001.

Because Green Ltd did not incur any prepaid business expenditure in the 2000 income year the transitional rules do not apply. Green Ltd's deduction must be claimed proportionately over each year that contains all or part of the eligible service period. Green Ltd's total deductions for prepaid expenditure are therefore:

2001–02

$$\$120\,000 \times \frac{181 \text{ (1 January 2002 to 30 June 2002)}}{365} = \$59\,507$$

2002–03

$$\$120\,000 \times \frac{184 \text{ (1 July to 31 December 2002)}}{365} = \$60\,493$$

The total deduction allowed proportionately over the 2002 and 2003 income years is $120 000.

Chapter 8 Taxpayers, other than individuals or Simplified Tax System taxpayers, incurring deductible non-business expenditure

Non-business expenditure

Non-business expenditure is any expenditure you incur in gaining assessable income from activities that do not amount to a business. For an entity carrying on a business, circumstances can arise where you may incur deductible non-business expenditure. A common example is expenditure made in respect of a rental property held as a passive investment.

Summary of rules

- Prepaid non-business expenditure that is subject to the tax shelter rules is apportioned over the eligible service period or 10 years, whichever is less. For more information, see page 3 chapter 2.
- If you are not an individual or an STS taxpayer, your deduction for prepaid non-business expenditure is apportioned over the eligible service period or 10 years, whichever is less. However, where the eligible service period ends not more than 13 months after you incur the expenditure, transitional rules may apply to allow part of the expenditure that would otherwise be deductible in a future year to be deductible in the expenditure year.

Deducting prepaid non-business expenditure

If you incur deductible prepaid non-business expenditure, your deduction must be claimed proportionately over each income year containing all or part of the eligible service period or 10 years, whichever is less. However, transitional rules phase in the initial impact of this measure.

Transitional rules

If you are not an individual or an STS taxpayer, transitional rules apply to your prepaid non-business expenditure where the eligible service period ends not more than 13 months after you incur the expenditure. Your prepaid non-business expenditure is divided into 2 parts:

- the current year amount
- the later year amount.

Current year amount

The current year amount is that part of your prepayment that relates to the thing to be done within the income year in which the expenditure was incurred (the expenditure year). This amount is calculated as follows:

$$\text{Expenditure} \times \frac{\text{number of days of eligible service period in the expenditure year}}{\text{total number of days of eligible service period}}$$

The current year amount is immediately deductible in the income year in which the prepayment is incurred.

Later year amount

The later year amount is that part of your prepayment that relates to the thing to be done in future income years. This amount is the difference between the total amount of prepaid expenditure incurred and the current year amount.

The transitional rules provide a concession by enabling you to deduct, in the year in which you incur the prepaid expenditure, the sum of the current year amount plus a part of the later year amount. The balance of the later year amount is deductible in the income year after the expenditure year. The concessional treatment applies to the later year amount for prepaid expenditure incurred in the 2002 and 2003 income years. These rules allow:

- 40 per cent of the later year amount for prepaid non-business expenditure incurred in the 2002 income year to be deducted in the 2002 income year, the balance (60 per cent) being deductible in the 2003 year
- 20 per cent of the later year amount for prepaid non-business expenditure incurred in the 2003 income year to be deducted in the 2003 income year, the balance (80 per cent) being deductible in the 2004 year.

The transitional rules cease to apply to prepaid non-business expenditure incurred after the 2003 income year.

Deductions for prepaid non-business expenditure where the eligible service period ends more than 13 months after you incur the expenditure, continue to be apportioned over the eligible service period or 10 years, whichever is less. Transitional treatment does not apply to prepaid expenditure of this nature.

Calculating your deduction for prepaid non-business expenditure where the transitional rules apply

EXAMPLE—Transitional rules for a prepayment of non-business expenditure made in the 2002 income year

HIJ Ltd operates a business within the transport industry. It also owns a negatively geared rental property which is purely a passive investment—this activity does not constitute the carrying on of a business. HIJ Ltd's income year ends on 30 June.

On 31 December 2001, HIJ Ltd made an interest-only payment of $8500 in relation to a loan used to finance the acquisition of the property. This payment covers interest incurred during the period 1 January 2002 to 31 December 2002. As HIJ Ltd has incurred prepaid non-business expenditure in an income year which commences after

30 June 2001 it will no longer be entitled to an immediate deduction for the expenditure incurred.

HIJ Ltd's current year amount and later year amount are calculated as follows:

Current year amount

$$\$8500 \times \frac{181}{365}\ \text{(1 January 2002 to 30 June 2002)} = \$4215$$

This amount is immediately deductible in the 2002 income year.

Later year amount

$8500 – $4215 = $4285

Applying the transitional rules, HIJ Ltd is entitled to deduct 40 per cent of this later year amount in the 2002 income year. The balance (60 per cent) will be deductible in the 2003 income year. HIJ Ltd is entitled to the following deductions:

2001–02

Current year amount	$4 215
40% of later year amount ($4285 × 0.40)	$1 714
Total deduction	$5 929

2002–03

60% of later year amount ($4285 × 0.60)	$2 571

The total deduction allowed proportionately over the 2002 and 2003 income years is $8500.

Eligible service period ending more than 13 months later

Your deduction for prepaid non-business expenditure is apportioned over the eligible service period or 10 years, whichever is less, where it ends more than 13 months after the expenditure has been incurred. Transitional rules do not apply to any later year amount in these situations. For each year of income containing the eligible service period, the deduction must be worked out using the following formula:

$$\text{Expenditure} \times \frac{\text{number of days of eligible service period in the income year}}{\text{total number of days of eligible service period}}$$

EXAMPLE—Deduction for expenditure where the eligible service period is more than 13 months

MNO Ltd operates a business within the finance industry. It also owns a negatively geared rental property which is purely a passive investment—this activity does not constitute the carrying on of a business. MNO Ltd's income year ends on 30 June.

On 31 December 2001, MNO Ltd made an interest-only payment of $15 000 in relation to a loan used to finance the acquisition of the property. This payment covers interest incurred during the period 1 January 2002 to 31 March 2003.

Because the eligible service period is longer than 13 months, MNO Ltd cannot claim an immediate deduction for the prepayment nor do the transitional rules apply. Instead, the deduction must be apportioned over the eligible service period. MNO Ltd is entitled to the following deductions:

2001–02

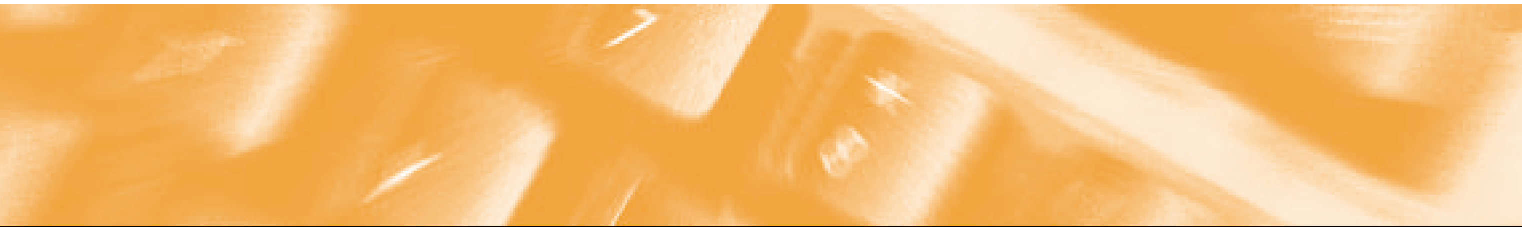
$$\$15\,000 \times \frac{181}{455}\ \text{(1 January 2002 to 30 June 2002)} = \$5967$$

2002–03

$$\$15\,000 \times \frac{274}{455}\ \text{(1 July 2002 to 31 March 2003)} = \$9033$$

The total deduction allowed proportionately over the 2002 and 2003 income years is $15 000.

Deductions for prepaid expenses 2001–02



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