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DEDUCTIONS FOR PREPAID EXPENSES —INDIVIDUALS

2000–01

TAXPACK REFERRED PUBLICATION

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AUSTRALIAN TAXATION OFFICE

www.ato.gov.au

How self-assessment affects most individuals

Self-assessment means the Australian Taxation Office (ATO) uses the information you give in 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 computers 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 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 a copy of the publication *Business and professional items* (NAT 2543—6.2001) referred to in this booklet:

- visit our Internet site 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.

Feedback

Reader feedback helps us to improve the information we provide. If you have any comments to make about this book, please write to:

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CIVIC SQUARE ACT 2608

As this is a publications area only, any tax matters will be passed on to a technical area. Otherwise you can ring our Personal Tax Infoline on **13 2861** for help.

Deductions for prepaid expenses—individuals

Australian Taxation Office
Canberra

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Instructions to complete P10 *2001 business and professional items schedule*

This publication is for individuals who have prepaid a deductible expense for things to be done within 13 months and which will be done in whole or in part after the income year in which the expenditure was incurred.

It has been prepared to help you complete item **P10** on your *2001 business and professional items schedule*. It covers:

- the 13 month prepayment measure including the transitional rules
- how to complete **A**, **B** and **C** item **P10** on the *2001 business and professional items schedule*. The information to be shown at item **P10** relates only to the 13 month prepayment measure and not to tax shelter prepayments
- the tax shelter prepayment rules
- how to work out your deduction for the 2000–01 income year.

Note: These instructions apply to individuals who have a 1 July–30 June income year. If you have a substituted accounting period (SAP), ring the Personal Tax Infoline on **13 2861** for assistance to complete your schedule.

13 month prepayment measure

The prepaid expenses measure introduced in the *New Business Tax System (Integrity and Other Measures) Act 1999* has changed the rules that allow immediate deductibility for expenditure incurred in respect of things to be done within 13 months of the expenditure being incurred. For many businesses, most prepaid expenditure —that would otherwise be a general deduction in the expenditure year—incurred after 11.45 a.m. [by legal time in the Australian Capital Territory (ACT)] on 21 September 1999 must be apportioned over the period the prepayment covers. This is consistent with the treatment of prepayments for periods exceeding 13 months.

Transitional rules—which are explained in part B on page 2 —apply to reduce the initial impact of this measure.

Note: The transitional rules do not apply to prepaid expenses incurred under a tax shelter arrangement after 1.00 p.m. (by legal time in the ACT) on 11 November 1999—see part F on page 4.

Small business taxpayers

The 13 month prepayment measure does not apply to small business taxpayers or non-business expenses. Small business taxpayers may be able to claim an immediate deduction for prepaid expenditure—other than under a tax shelter agreement which is explained in part F on page 4—where the benefits for which the payment is made are provided within 13 months. It is intended that this entitlement will continue until the introduction of the proposed Simplified Tax System on 1 July 2001.

You are a small business taxpayer if you carry on a business during the income year and either:

- your average turnover for the year is less than $1 million or
- you choose to recalculate your average turnover for an income year before the 2001–02 income year, based on your group turnover for that year and a reasonable estimate for the following 2 years, and it is less than $1 million.

Your average turnover for an income year is the average of your group turnovers for that year and the preceding 2 years, if any. However, you can only average your turnover for the years in which you carried on a business. For example, if you have carried on a business for the current and previous year only, you would average only the sum of 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.

Your group turnover for an income year is the sum of the values of all supplies of goods and services that you and your controlling or controlled entities made during the year to third parties in the ordinary course of carrying on a business, exclusive of goods and services tax (GST) payable on supplies.

If you are a small business taxpayer *write* **N** for **NO** at **A** item **P10** on your schedule. Do not complete **B** and **C**. However, you need to read part F on page 4 to find out whether the tax shelter rules apply to your prepayment.

PART A—When does the 13 month prepayment measure apply?

The 13 month prepayment measure requires your deduction for the prepayment to be apportioned where all of the following apply:

- you were not a small business taxpayer
- the prepayment was made after 11.45 a.m. (by legal time in the ACT) on 21 September 1999—and was not made under a contract entered into before that time (that you cannot avoid by your own actions)
- the prepayment was for things to be done within 13 months of the expenditure being incurred and would not be wholly done in the income year in which the amount was incurred (the expenditure year)
- the prepayment was $1000 or more, and was not an amount of salary or wages or an amount required to be incurred by a law or a court order
- the prepayment was made in carrying on a business and
- the prepayment was not apportionable under the tax shelter rules—see part F on page 4.

Completing label A item P10 on your schedule

Did you make a prepayment of an expense in the 1999–2000 or 2000–01 income year where all of the above applied?

NO ☐ ▶ *Write* **N** at A item **P10** on your schedule. Do not complete B and C. However, you need to read part F on page 4 to find out whether the tax shelter rules apply to your prepayment.

YES ☐ ▶ *Write* **Y** at A item **P10** on your schedule. You must complete B and C in relation to the affected prepayments. Go to part B.

PART B—Transitional rules

Transitional rules apply to prepaid expenses affected by this measure. These prepayments can be divided into 2 parts:

- the part relating to something to be done within the income year in which the prepayment was made. This is the expenditure year amount which is worked out using the following formula:

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

  (The eligible service period is the period during which the thing is to be done under the agreement.) and
- the part relating to something to be done in future income years. This is the later year amount which is the difference between the expenditure and the expenditure year amount.

The expenditure year amount is immediately deductible in the income year in which it is incurred and should be included at the appropriate expense label at item **P8—Business income and expenses** on your schedule. Later year amounts may be eligible for concessional treatment under the transitional rules which allow a proportion of your later year amounts to be brought forward and deducted in the expenditure year. The proportion of your later year amount you are able to deduct (subject to a cap—see part E on page 3) is summarised in the following table:

Proportion of your later year amount you are able to deduct

Year	*Year that 13 month prepaid expenses incurred (expenditure year)*	*% of later year amount deductible in expenditure year*	*% of later year amount deductible in the year following the expenditure year*
1st	Income year including 21 September 1999	80	20
2nd	Income year following the 1st year	60	40
3rd	Income year following the 2nd year	40	60
4th	Income year following the 3rd year	20	80

Note: For expenditure prepaid in the 2nd, 3rd and 4th years there is a cap on the later year amount that is eligible for transitional treatment. The cap is the total of later year amounts for expenditure that was subject to the measure in the initial year—1999–2000 income year for most taxpayers. You are required to show the amount of your cap at B item **P10** on your schedule.

PART C—Completing B item P10 on your schedule

Show at B item **P10** on your schedule, the total of your later year amounts for prepaid expenditure that was subject to the measure in 1999–2000.

Note: Prepaid expenses incurred before 11.45 a.m. (by legal time in the ACT) on 21 September 1999 or under a tax shelter arrangement after 1.00 p.m. (by legal time in the ACT) on 11 November 1999 must not be included in this amount. This is explained in part F on page 4.

Work out your amount to show at B on your schedule as follows:

Step 1

$$\text{Initial year prepayment (refer to part A)} \times \frac{\text{number of days of eligible service period in the 1999–2000 income year}}{\text{total number of days of eligible service period}}$$

(The initial year prepayment is the prepayment made in the 1999–2000 income year that is subject to the measure. The eligible service period is the period during which the thing is to be done under the agreement.)

Step 2

Deduct the amount at step 1 from your initial year prepayment.

Step 3

Write this amount at B on your schedule.

Under the transitional rules, 80% of the amount at B is deductible in the 1999–2000 income year and the remaining 20% is deductible in the 2000–01 income year. Ensure that you have shown your 20% deduction as a subtraction at H **Expense reconciliation adjustments** item **P8** on your schedule if the prepayment relates to your business income at **P8** and you have not included the amount at any other label.

PART D—Completing C item P10 on your schedule

The amount to show at C item **P10** on your schedule is your later year amount for prepayments made in the 2000–01 income year.

Work out your later year amount as follows:

Step 1

$$\text{2000–01 income year prepayment (refer to part A)} \times \frac{\text{number of days of eligible service period in the 2000–01 income year}}{\text{total number of days of eligible service period}}$$

This is your expenditure year amount and is deductible in 2000–01.

Step 2

Deduct the amount at step 1 from your 2000–01 income year prepayment.

Step 3

Write this amount at C item **P10** of your schedule. This is your later year amount which may be eligible for transitional treatment.

Note: Prepaid expenses incurred under a tax shelter arrangement after 1.00 p.m. (by legal time in the ACT) on 11 November 1999 must not be included in this total of later year amounts. This is explained in more detail on page 4.

PART E—Working out the extent to which transitional treatment applies to your later year amount shown at C item P10 on your schedule

Under the transitional rules there is a cap on the later year amount that is eligible for concessional treatment. The cap is the amount shown at B item **P10** on your schedule. If the amount at B is nil, no part of the amount at C is eligible for concessional treatment.

If the later year amount at C is equal to or less than the amount at B item P10 on your schedule

The transitional rules allow you to deduct 60% of the later year amount (shown at C) in the 2000–01 income year. The remaining 40% is deductible in the 2001–02 income year. Ensure that you have made the correct expense reconciliation adjustment at H item **P8** on your schedule if the prepayment shown as an expense at item **P8** differs from the deductible amount for 2000–01.

If the later year amount at C is more than the amount at B item P10 on your schedule

The transitional rules restrict the portion of the later year amount you can deduct in the 2000–01 income year. Your deduction in the 2000–01 income year for the later year amount is limited to 60% of the amount of the cap shown at **B**. The remaining 40% of the cap amount is deductible in 2001–02.

A deduction is not allowable in the 2000–01 income year for the excess of the later year amount shown at **C** over the amount of the cap at **B**. Instead the excess is deductible in 2001–02 (and 2002–03 if the eligible service period continues into that income year) to the extent of:

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

Ensure that you have made the correct expense reconciliation adjustment at **H** item **P8** on your schedule if the prepayment shown as an expense at item **P8** differs from the deductible amount for 2000–01.

Example 1 of transitional rule

Sue is a non-small business taxpayer who has a 1 July–30 June income year. She did not incur any prepaid expenses in the 1999–2000 income year which related to things to be done in the following year.

Sue enters into a contract on 1 February 2001 to purchase carpet cleaning services over the next 12 months and for these services pays $100 000. Under this contract, services are to be provided over the next 365 days, 150 of which relate to the 2000–01 income year and 215 of which relate to the 2001–02 income year.

Sue is entitled to immediately deduct the part of this expenditure that relates to the current income year. This is calculated as follows:

$$\$100\,000 \times \frac{150}{365} = \$41\,096$$

and as the services purchased in this example relates to contractor expenses, this amount should be included at **F** **Contractor, sub-contractor and commission expenses**, item **P8**.

The remaining amount of the expenditure which relates to the following income year is calculated as follows:

$$\$100\,000 - \$41\,096 = \$58\,904$$

This is the later year amount and must be written at **C** item **P10**. As Sue did not incur any prepaid expenses in the previous income year she has a cap of 0 and would need to write **0** at **B** item **P10** and must not claim any of the later year amount as a deduction in the current year under the transitional rules. This amount is deductible in the following year.

Example 2 of transitional rule

Ron is a non-small business taxpayer who has a 1 July–30 June income year. He incurred prepaid expenses of $15 000 in the 1999–2000 year. The amount of $5000 of this related to services to be provided in the 2000–01 income year and therefore sets the cap at $5000 under the transitional rules.

Ron enters into a contract on 31 March 2001 to rent business premises for the next 5 months and pays $50 000 as rent for this period in advance. Under the contract, the business premises is to be used for the next 153 days, 92 of which relate to the 2000–01 income year and 61 of which relate to the 2001–02 income year.

Ron is entitled to immediately deduct the amount of the expenditure which relates to the current income year. This is the current year amount and is calculated as follows:

$$\$50\,000 \times \frac{92}{153} = \$30\,065$$

and as the services purchased relate to rent expenses, this amount would need to be added to **K** **Rent expenses**, item **P8**.

The remaining amount of the expenditure which relates to the following income year is calculated as follows:

$$\$50\,000 - \$30\,065 = \$19\,935$$

This is the later year amount and must be written at **C** item **P10**. Ron is entitled to deduct a total of 60% of the lesser of his cap amount $5000 and his later year amount ($19 935). This is equal to

$$\$5000 \times 60\% = \$3000$$

which needs to be added to **K** **Rent expenses**, item **P8**, making the total amount of rent expenditure claimed in the current year in this example equal to $33 065 ($30 065 + $3000). The remaining rent expenditure of $16 935 must not be claimed in the current year and should be added to any rent deductions in the following year.

PART F—Prepayments and tax shelter arrangements

The transitional rules which phase in the effects of removing the 13 month immediate deduction rule for prepaid expenditure incurred by business other than small business, do not apply to prepayments made in relation to tax shelter arrangements. Tax shelter prepayments are required to be spread over the eligible service period. The tax shelter rules apply to all taxpayers including small business taxpayers.

If you have prepaid expenditure under a tax shelter agreement for a thing to be done within 13 months and it is not covered by one of the exclusions, you cannot deduct all of the expenditure this income year. Instead the deduction must be apportioned over the eligible service period. (The eligible service period is the period during which the thing is to be done under the agreement.) This is consistent with the treatment of prepayments where the period exceeds 13 months.

An agreement covered by the tax shelter rules includes all related activities, including those that give rise to deductions or assessable income. For example, if a taxpayer invests in a tax shelter, and prepays interest on a loan used to fund management fees of the manager, the prepaid interest would also be subject to these rules.

The apportionment rules apply if you made a prepayment of expenditure under an agreement for something that was not wholly done in the expenditure year and:

- the expenditure was incurred for doing the thing within 13 months
- the expenditure was incurred after 1 p.m. (by legal time in the ACT) on 11 November 1999—and was not made under a contractual obligation entered into before that time (that you cannot avoid by your own actions)
- your allowable deductions attributable to the agreement for the expenditure year exceed your assessable income attributable to the agreement for that year
- you do not have day-to-day control over the operation of the agreement and
- at least one of the following is met:
  - more than one taxpayer participates as an investor in the agreement or
  - the manager, arranger or promoter of the agreement, or an associate, carries out similar activities for other taxpayers.

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

- premiums for building insurance, contents insurance or rent protection insurance or
- 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 which has at least 300 beneficiaries

provided the agreement 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 agreement.

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 and
- 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.

PART G—Working out your deduction for a prepayment under a tax shelter agreement

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

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

If the prepayment shown as an expense at item **P8** on your schedule differs from the deductible amount for 2000–01 worked out using the above formula, ensure that you make an expense reconciliation adjustment at **H** item **P8** on your schedule. If the prepayment relates to a partnership or trust distribution at item **12** on your tax return, ensure that the deduction claimed at **X** or **Y** item **12** on your tax return is the amount worked out using the above formula.

If you made a tax shelter prepayment in the 1999–2000 income year and you did not claim a deduction for all of the expenditure because some of the eligible service period is within the 2000–01 income year, use the above formula to work out the amount of your deduction for the 2000–01 income year. Show the amount as a subtraction at **H** **Expense reconciliation adjustments**, item **P8** on your schedule if the prepayment relates to your business income at **P8**. If the prepayment relates to a partnership or trust distribution at item **12** on your tax return, ensure that the amount is shown as a deduction at **X** or **Y** item **12**.