Week 8 – Topic 5: Specific Deductions, Capital Allowances and Trading Stock

Main concepts:
- Specific Deductions
- Capital Allowances
- Trading Stock

4-15 **How to work out your taxable income**

(1) Work out your ***taxable income*** for the income year like this:

Taxable income = Assessable income – Deductions

… (If the deductions equal or exceed the assessable income, you don't have a taxable income.)

Note: If the deductions exceed the assessable income, you may have a tax loss which you may be able to deduct in a later income year: see Division 36.

Specific Deductions

8-5 **Specific deductions**

(1) You can also ***deduct*** from your assessable income an amount that a provision of this Act (outside this Division) allows you to deduct.

(2) Some provisions of this Act prevent you from deducting an amount that you could otherwise deduct or limit the amount you can deduct.

(3) An amount that you can deduct under a provision of this Act (outside this Division) is called a ***specific deduction***.

For a summary list of provisions about deductions, see section 12-5.

8-10 **No double deductions**

If 2 or more provisions of this Act allow you deductions in respect of the same amount (whether for the same income year or different income years), you can deduct only under the provision that is most appropriate.
- Statutory interpretation - The more specific provision will prevail over the general.

Specific deduction provisions in ITAA 1997

Specific deductions under the 1997 Act
- Some amounts that can be deducted: Div 25
- Car expenses: Div 28
- Gifts or contributions: Div 30
- Tax losses of earlier income years: Div 36
- Capital allowances: deductibility of capital expenditure: Div 40
- Excess of opening value over closing value of trading stock on hand: s70-35(3)

Specific deduction provisions in ITAA 1997 – Div 25

- 25.5. Tax-related expenses
- 25.10. Repairs
- 25.15. Amount paid for lease obligation to repair
- 25.20. Lease document expenses
- 25.25. Borrowing expenses
- 25.30. Expenses of discharging a mortgage
- 25.35. Bad debts
- 25.40. Loss from profit-making undertaking or plan
- 25.45. Loss by theft etc.
- 25.47. Misappropriation where a balancing adjustment event occurs
- 25.50. Payments of pensions, gratuities or retiring allowances
- 25.55. Payments to associations
- 25.60. Parliament election expenses
- 25.65. Local government election expenses
- 25.70. Deduction for election expenses does not extend to entertainment
- 25.75. Rates and land taxes on premises used to produce mutual receipts
- 25.85. Certain returns in respect of debt interests
- 25.90. Deduction relating to foreign non-assessable non-exempt income
- 25.95. Deduction for work in progress amounts
- 25.105. Deductions for United Medical Protection Limited support payments
- 25.100. Travel between workplaces
- 25.110. Capital expenditure to terminate lease etc.

25-5 Tax-related expenses:

- Section 25-5 ITAA97 allows a deduction for expenditure incurred on managing tax affairs.
- Expenses allowed would include costs incurred for using a *registered tax agent (s25-5(2)(e) ITAA97 AND s995-1 ITAA97)* to prepare an income tax return; or to attend to an objection with the Australian Taxation Office; or to prepare and lodge a business activity statement.
- Deductions *not permitted* under this provision include payments of income tax; expenditure excluded from s8-1(1) ITAA97 such as penalties and fines; or expenditure of a capital nature such as tax advice regarding the acquisition of a new business.
- This provision only relates to tax affairs. Tax is a defined term (s995-1) and means 'income tax'. This doesn't include other taxes such as GST and fringe benefits tax.

25-10 Repairs

(1) You can deduct expenditure you incur for repairs to premises (or part of premises) or a *depreciating asset that you held or used *solely* for the *purpose of producing assessable income.

Property held or used partly for that purpose

(2) If you held or used the property only partly for that purpose, you can deduct so much of the expenditure as is reasonable in the circumstances.

No deduction for capital expenditure

(3) You cannot deduct capital expenditure under this section.

- The word **'repairs'** is not defined in the Act.
- The courts developed the following six principles for interpreting the word:
    1. A repair restores an item to its previous condition without changing its function
    2. An item must need restoration before it can be repaired
    3. A repair replaces part of an item rather than the entire item
    4. Functional approach
    5. Capital repairs are not deductible
    6. Property held or used partly for an income-producing purpose

Repairs - Functional approach

***Lindsay v FCT* (1961) 106 CLR 377**

Facts: The taxpayer repaired ships in its premises, which included two slipways. A timber slipway was replaced with concrete because timber was not available. The new slipway was longer than the old one, although the greater length produced no greater efficiency.

Court held: Not a deductible repair as the slipway was an entirety.

Repairs - Capital repairs are not deductible

1. *Additions:* An addition to a capital asset will not be deductible. For example, where an extra wing is added to a cement factory.
2. *Improvements:* Repair restores an item to its former condition while improvement makes the item functionally better. It does not matter that modern materials are used, provided the materials do not improve functional efficiency.

***FCT v Western Suburbs Cinemas Ltd* (1952) 86 CLR 102**

Facts: The taxpayer replaced the tin roof of a cinema with fibro sheeting which had advantages over the tin ceiling.

Court held: Expenses not deductible, an improvement. The work would significantly reduce future repairs. Also, the work which had been carried out, was different in kind as well as degree from the type of repairs which are properly allowed as working expenditures for cinemas.

Initial repairs: Where you acquire a property and fix up the defects, such initial repairs are not deductible.

***Law Shipping Co v IR Commrs* (1924) 12 TC 621**

Facts: The taxpayer bought a ship for £97,000, but the ship needed work before it could gain permission to sail with freight. It cost £51,558 to get it seaworthy.

Court held: The costs were not deductible; they were capital as:

1. the purchase price was substantially less than it would have been if the ship was in good repair;
2. at the time of purchase the ship was not in a profit-earning state; and
3. there was no evidence that the expenses were properly chargeable to revenue.

However, in *Odeon Associated Theatres Ltd v Jones* things were viewed differently.

***Odeon Associated Theatres Ltd v Jones* [1972] 1 All ER 681**

Facts: The taxpayer incurred expenses in repairing a cinema immediately after it was purchased.

Court held: Deductible because:

1. the purchase price was not affected by state of disrepair;
2. at the time of purchase the cinema was in a profit-earning state and could be used to produce income; and
3. there was ample evidence that expenses incurred could be properly charged to revenue account in accordance with accounting principles.

The Australian Tax Office (ATO) takes the *Law Shipping Co* view: see TR 97/23.

Repairs - *Taxation Ruling* TR 97/23

- An asset will be an entirety of an asset if it:
  - Is separately identifiable as capital equipment
  - Provides a function on its own
  - Is a distinct item of plant, or
  - Is a 'unit of property' as per the depreciation rules
- Initial repairs are capital and not deductible if the defect:
  - Existed at the time of purchase
  - Did not arise from the operations of the person who incurs the expenditure

25-20 Preparation of Leases

- Section 25-20 ITAA97 allows a deduction for expenditure incurred for the preparation, registration and stamping of a lease or an assignment or surrender of a lease of property, that has been, or will be used for income producing purposes .
- The deduction will need to be apportioned where the property is only used partly for income-producing purposes (s25-20(2) ITAA97).

25-25 Borrowing Expenses

- Section 25-25 ITAA97 allows a deduction for expenditure incurred for borrowing money *and* the purpose of the money is to produce assessable income *(Ure v FC of T 81 ATC 4100).*
- These costs refer to the "cost" of borrowing and include valuation fees, survey fees, stamp duty, and legal costs.
- Interest paid on loans is excluded from borrowing costs. They are deductible under s8-1 ITAA97.
- Borrowing expenses which are $100 or less are fully deductible in the year the expense was incurred: s25-25(6) ITAA97

Example: Lesley obtained a three-year loan of $150,000 on 12 January 2023, which she used solely for income-producing purposes throughout the period of the loan. Borrowing expenses incurred in relation to the loan are $2000. The total period of the loan is three years, ie 1,095 days. The borrowing expenses would be allowed as follows:

2022-23: $ 312.30 ($2000 x 171/1,095 days)
2023-24: $ 666.65 ($2000 x 365/1,095 days)
2024-25: $ 666.65 ($2000 x 365/1,095 days)
2025-26: $ 354.30 ($2000 x 194/1,095 days)
$2000.00

25-30 Expenses of discharging a mortgage

- You can deduct the expenditure you incur to discharge a mortgage that you gave as security for the repayment of money that you borrowed if you used the borrowed money solely for the purpose of producing assessable income. If the expenditure relates only partly to the production of assessable income, the borrowing costs are only partially deductible. You cannot deduct payments of principal or interest under this provision: s 25-30(4).

25-35 Bad Debts

Four conditions must be satisfied to get a bad debt deduction:

1. there must be an existing debt
   - If the debt has been waived or a lesser amount has been accepted in satisfaction of the debt, there is no longer an existing debt to write off
   - *Point v FCT* (1970) 119 CLR 453; 70 ATC 4021
2. the debt must be bad
   - Debt will be bad if the taxpayer makes a bona fide commercial decision that the debt is unlikely to be paid
   - Debt must 'bad', not merely doubtful
3. the debt must be written off as bad during the year of income in which the deduction is claimed
   - Written record evidencing decision to write the debt off is sufficient
4. the debt must have been included in the taxpayer's income for the income year or earlier income year, or the debt must be in respect of money lent in the ordinary course of a money lending business.

25-40 Loss from profit-making undertaking or plan

- You can deduct a loss arising from carrying on or carrying out of a profit-making undertaking or plan if any profit from that plan would have been included in your assessable income by s 15-15 (profit-making undertakings and plans). If the undertaking or plan relates to property, then the property must be acquired before 20 September 1985. A loss will not be deductible under s 25-40 unless the Commissioner is notified that the property was acquired for a profit-making purpose in the relevant income tax year.

25-100 Travel between workplaces

- Travel between workplaces is travel directly between two places, to the extent that:
  - the individual at the first place was engaged in activities to gain or produce their assessable income; or engaged in activities in the course of carrying on a business for the purpose of gaining or producing their assessable income; and
  - the purpose of their travel to the second place was to engage in activities to gain or produce their assessable income; or engage in activities in the course of carrying on a business for the purpose of gaining or producing their assessable income; and
  - they engaged in those activities while they were at the second place.
- Travel between two places is not travel between workplaces if one of the places the individual is travelling between is a place at which they reside: **s 25-100(3)**
- No deduction for capital expenditure

__**Other specific deductions in Div 25**__

- **25-45 Losses by theft**
  - You can deduct a loss if the loss was caused by theft, stealing, embezzlement, larceny, defalcation or misappropriation by your employee or agent (other than an individual you employ solely for private purposes) provided that the money was included in your assessable income.
- **25-47 Misappropriation where a balancing adjustment event occurs**
  - A deduction is available if a balancing adjustment event occurs for a depreciating asset held by a taxpayer and the taxpayer's employee or agent misappropriated the amount (whether by theft, embezzlement, larceny or otherwise).
- **25-50 Payments of pensions, gratuities or retiring allowances**
  - You can deduct a payment of a pension, gratuity or retiring allowance that you make to an employee or a former employee or a dependant of an employee or a former employee, to the extent that it is made in good faith in consideration of the past services of the employee, or former employee, in any business that you carried on for the purpose of gaining or producing assessable income. These payments will also usually be deductible under s 8-1. If they are then s 25-50 would not apply (s 25-50(3)): see *Magna Alloys*, although see also *Union Trustee Co of Australia Ltd* below.
- **25-55 Payments to associations**
  - You can deduct a payment you make for membership of a trade, business or professional association up to a maximum of $42. But this section will have a limited operation as there is no limit if the payment is deductible under s 8-1. For example, s 25-55 will apply where a retired person continues their professional body membership and it is not deductible under s 8-1 because the retired person is not producing assessable income from that professional activity.

- **25-60, 25-65, 25-70   Election expenses**
  - You can deduct expenditure you incur in contesting an election for membership of the Parliament of the Commonwealth or the Parliament of a state or the Legislative Assembly for the Australian Capital Territory or the Legislative Assembly of the Northern Territory of Australia. Local government candidates can deduct up to $1000: s 25-65.
- **25-75   Rates and taxes — mutual receipts**
  - Rates and taxes on premises used to produce mutual receipts or to produce amounts to which s 59-35 applies are deductible.
- **25-90   Deduction — foreign non-assessable non-exempt income**
  - Section 25-90 provides deductions for Australian entities in respect to devising certain foreign non-assessable non-exempt income.
- **25-95   Work in progress payments**
  - Payments made to acquire work in progress (other than goods) are deductible under s25-95.
- **25-105   Deductions — United Medical Protection**
  - Section 25-105 provides deductions for contributions to United Medical Protection support payments.
- **25-110   Capital expenditure to terminate lease**
  - Capital expenditure incurred to terminate a lease or license is deductible over five years (20 per cent per annum).

<u>Car expenses: Div 28</u>

- ***car*** means a *motor vehicle (except a motor cycle or similar vehicle) designed to carry a load of less than 1 tonne and fewer than 9 passengers: s995-1(1).
- ***car expense*** has the meaning given by section 28-13: s995-1(1).

28-13 Meaning of *car expense*

(1) A *car expense* is a loss or outgoing to do with a *car.

(2) In addition, any of the following is a car expense:

(a) a loss or outgoing to do with operating a *car;

(b) decline in value of a *car.

(3) None of the following is a car expense

(a) a loss or outgoing incurred, or a payment made, in respect of travel outside Australia;

(b) a taxi fare or similar loss or outgoing

Two methods to work out car expenses:

1. **“Cents per kilometre” method: s28-25**
   - Flat rate of 88c per “business km” (income producing) travelled and capped at 5,000 kms (excess is disregarded) for 2024-25 income year.
   - Expenses do not need to be substantiated: **s28-35.**

2. **"Log book" method: s28-90**
   - Total expenses are apportioned by the "business use percentage" determined by keeping a log book for 12 weeks.
   - Expenses must be substantiated: **s28-100.**

<u>**Gifts or contributions: Div 30**</u>

- Table of gifts or contributions that are deductible: **s30-15**
- Testamentary gifts or contributions are not deductible under **Div 30: s30-15(2)**
- Tables of recipients of deductible gifts or contributions: **Subdiv 30-B**.
- A deduction for gifts made to nominated funds or institutions is allowed provided:-
  - the gift is not made by a will unless it is made under the Cultural Bequests Program;
  - each gift is $2 or more in either money or value of property;
  - if the gift consists of property other than money, the property must have been purchased by the taxpayer within twelve months immediately preceding the making of the gift or be valued by the Commission at more than $5,000; and
  - the fund, authority or institute to which the gifts are made is in Australia.
- The gift must be a real gift
  - *FCT v McPhail* (1968) 117 CLR 111
  - You must have a receipt from the "deductible gift recipient".
- The gift must be voluntarily given and without any material benefit or advantage being received by the giver in return **(s30-220 ITAA97).**
- A Tax Loss cannot be added to or created by a deduction for a gift or donation **(s26-55 ITAA97).**

Tax losses of earlier income years: Div 36

- Under Div 36 taxpayers can carry forward tax losses from earlier years and claim these as a deduction. There are different rules for non-corporates and corporates. (Corporates are dealt with in **Chapter 14**.)
- Taxpayers (that are not corporate entities) may be entitled to carry forward tax losses of earlier years to assessable income of future years: **s 36-15(1).**

Capital allowances – deductibility of capital expenditure: Div 40

- Deduction for "decline in value" of a depreciating asset held for a taxable purpose**: s 40-25.**
- Balancing adjustment deduction if a depreciating asset's termination value is less than its adjustable value: **s 40-285(2).**
- Deduction for certain types of business capital expenditure – "blackhole" expenses: **s 40-80**

40-25 Deducting amounts for depreciating assets

You deduct the decline in value

(1) You can deduct an amount equal to the decline in value for an income year (as worked out under this Division) of a *depreciating asset that you *held for any time during the year

Note 1: Sections 40-70, 40-72 and 40-75 show you how to work out the decline for most depreciating assets. There is a limit on the decline: see subsections 40-70(3), 40-70(3) and 40-75(7).

Note 2: Small business entities can choose to both deduct and work out the amount they can deduct under Division 328.

(2) You must reduce your deduction by the part of the asset's decline in value that is attributable to your use of the asset, or your having it *installed ready for use, for a purpose other than a *taxable purpose.

(7) … a ***taxable purpose*** is:

(a) the *purpose of producing assessable income;

40-30 What a *depreciating asset* is

(1) A ***depreciating asset*** is an asset that has a limited *effective life and can reasonably be expected to decline in value over the time it is used, except:

(a) land; or

(b) an item of *trading stock; or

(c) an intangible asset, unless it is mentioned in subsection (2).

(2) These intangible assets are *depreciating assets* if they are not *trading stock:

(c) items of *intellectual property; …

Calculation depreciation

Calculating depreciation can be broken up into five sub steps:

1. Determine the period
2. Choose between diminishing value method or the prime cost method
3. Working out effective life and depreciation rate
4. Determine cost, and
5. Calculate depreciation

(1) Determine the period

- a depreciating asset starts to decline in value when a taxpayer first uses it or has it installed ready for use for any purpose **Section 40-60**. This is known as the start time.
- The period for the depreciation calculation is based on the number of days from the start time to 30 June of the income tax year: **s 40-70(1).**

Example: Harold operates a funeral parlour and purchases a hearse without an engine on 1 July. He has an engine fitted and the hearse is ready to be used for transportation of the dead-on 1 September. He acquires a laptop on 10 July and uses it immediately for private use until 1 December when he uses it 100 per cent for business. The start time for the hearse is 1 September and for the laptop is 1 December.

(2) Choose between diminishing value method or the prime cost method

- There is a choice of two methods to work out the decline in value of a depreciating asset — diminishing value method or prime cost method: s 40-65(1)
- Once a choice is made for an asset, it can't be changed

(3) Work out effective life and depreciation rate

- In determining the applicable depreciation rate, the effective life of the depreciating asset first needs to be determined.
- There are two choices per s 40-95(1):
  - effective life determined by the Commissioner, and
  - taxpayer's estimate.
- Having determined effective life and chosen the diminishing value or prime cost method, the depreciation rate can be calculated. Using the Commissioner's effective life (as set out in the extract in Appendix 2) the table in Appendix 1 provides a conversion table into depreciation rates depending on whether the depreciating asset was acquired before or after 9 May 2006.

(4) Apportionment

Example: Ben holds a depreciating asset that he uses for private purposes for 30% of his total use in the income year. If the asset declines by $1,000 for the year, Ben would have to reduce his deduction by $300 (30% of $1,000).

Other Depreciation Rules

- **Section 40-80** immediate deduction if less than $300.
  Small Business Entities (SBE) - Simplified depreciation rules.
- Aggregated turnover of less than $10 million from 1 July 2016 onwards and $2 million for previous income years.
- Simplified depreciation rules for small business include:
  - an instant asset write-off for assets that cost less than the relevant threshold
  - a general small business pool, which has simplified calculations to work out the depreciation deduction (next slide).

COVID-19 Measures

- The instant asset write-off does not apply for assets you start to hold, and first use (or have installed ready for use) for a taxable purpose, from 6 October 2020 to 30 June 2023. You must immediately deduct the business portion of the asset's cost under temporary full expensing.

Low value pool - Subdivision 40E

- To make things easier, taxpayers can allocate assets a low value asset pool, which for most assets has a higher rate of depreciation, and simplified administration as treated as one single asset.
- There are two types of assets allocated to the pool - low-cost assets and low-value assets.
  - Low costs assets are new assets purchased that are less than $1,000 **s 40-425**
  - Low value assets – assets you already hold whose written down value is now less than $1,000
- Once the low-cost assets are put in a pool, they are pooled together and depreciated under s 40-440 at:
  - 18.75% of the taxable use percentage in the year of entry (timing apportionment is ignored) for new low costs assets and
  - 37.5% of the book value balance from prior years, including low value assets added to the pool.

40-285 Balancing adjustments

(1) An amount is **included in your assessable income** if:

(a) a * balancing adjustment event occurs for a * depreciating asset you * held and:

(i) whose decline in value you worked out under Subdivision 40-B; or

(ii) whose decline in value you would have worked out under that Subdivision if you had used the asset; and

(b) the asset's * termination value is more than its * adjustable value just before the event occurred.

The amount included is the difference between those amounts, and it is included for the income year in which the balancing adjustment event occurred.

Note 1: The most common balancing adjustment event is where you sell the depreciating asset.

(2) You can **deduct an amount** if:

(a) a * balancing adjustment event occurs for a * depreciating asset you * held and:

(i) whose decline in value you worked out under Subdivision 40-B; or

(ii) whose decline in value you would have worked out under that Subdivision if you had used the asset; and

(b) the asset's * termination value is less than its * adjustable value just before the event occurred.

The amount you can deduct is the difference between those amounts, and you can deduct it for the income year in which the balancing adjustment event occurred.

40-295 Meaning of balancing adjustment event

(1) A ***balancing adjustment event*** occurs for a *depreciating asset if:

- (a) you stop *holding the asset; or
- (b) you stop using it, or having it *installed ready for use, for any purpose and you expect never to use it, or have it installed ready for use, again; or
- (c) you have not used it and:
  - (i) if you have had it installed ready for use - you stop having it so installed; and
  - (ii) you decide never to use it.

Note: A balancing adjustment event occurs under paragraph 40-295(1)(a) when you start holding a depreciating asset as trading stock.

Balancing adjustment example

Example: Bridget purchased a cabinet on 1 July 2021. She used the cabinet from that date solely in her work. The cabinet was destroyed by fire on 18 January 2023 and Bridget received an insurance pay-out of which she attributed $1,300 to the cabinet. Its adjustable value at that time was $1,200. As the amount received of $1,300 is more than the adjustable value of the cabinet at the time it was destroyed, the excess of $100 is included in Bridget's assessable income.

40-880 Business related costs

Object

(1) The object of this section is to make certain *business capital expenditure deductible over 5 years if

- (a) the expenditure is not otherwise taken into account; and
- (b) a deduction is not denied by some other provision; and
- (c) the business is, was or is proposed to be *carried on for a *taxable purpose.

Deduction

(2) You can deduct, in equal proportions over a period of 5 income years starting in the year in which you incur it, capital expenditure you incur:

- (a) in relation to your *business; or
- (b) in relation to a business that used to be *carried on; or
- (c) in relation to a business proposed to be carried on; or
- (d) to liquidate or deregister a company of which you were a *member, to wind up a partnership of which you were a partner or to wind up a trust of which you were a beneficiary, that carried on a business.

Limitations and exceptions (See ss 40-880(3)-(9))

Trading stock

70-10 Meaning of trading stock

Trading stock includes:

(a) anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of a *business; and

(b) *livestock.

Acquiring trading stock — deductions: subdiv 70-B

- Trading stock is deductible when incurred: **s 8-1.**
- **Section 70-20** requires that for non-arm's-length transactions you must use market value in working out the deduction.
- **Section 70-25** provides that the cost of trading stock is not capital.
- Pursuant to **s 70-30**, where you bring into trading stock an item you own, you are deemed to have brought the item into trading stock at cost or market value and sold it for the same amount.

Assessable income from trading stock: subdiv 70-D

Dispose within ordinary course of business: **s6-5 & s70-80**

Dispose outside ordinary course of business: **s70-90**

- market value included in assessable income i.e. a gift

Disposal when you stop holding trading stock: **s 70-100**

- market value included in assessable income.

Death of owner: **s 70-105**

- market value included in assessable income, although the legal personal representative can elect to use another value.

Stop holding an item as TS but still own it**: s70-110**

- treated as having sold it in the ordinary course of business and bought it back for the same amount (ie you take an item of your TS for your own consumption)

Compensation for lost trading stock**: s 70-115**

- include as assessable income any insurance or indemnity received for loss of trading stock (see **s 70-115**) unless it is otherwise assessable income: see **s 6-5.**

Trading stock

- **s70-35:** compare the ***value*** of o/s with c/s for the year:

  If c/s > o/s, the difference is AI: **70-35(2)**

  If c/s < o/s, the difference is deductible: **s70-35(3)**

- **s70-45(1):** taxpayers can choose from the following methods for valuing trading stock at the end of the income year:
  - Cost; or
  - Market selling value; or
  - Replacement price.

- **s70-50**: obsolete stock "You may elect to value an item of your trading stock below all the values in **section 70-45** if: (a) that is warranted because of obsolescence or any other special circumstances relating to that item; and (b) the value you elect is reasonable".