Computing Taxable Income

1. Tax Payable

You will find this rule in …

*Tax is payable on a person's **taxable income***

Australia's Tax Law decrees that every year ending 30 June, most people in Australia (and this includes companies) have to pay tax on an amount which the Tax Law calls the person's "taxable income." *s. 4-1* *s. 4-10*

This amount – the person's "taxable income" for that year – is the end result of a much longer series of steps which the Tax Law prescribes in detail.

*Tax payable = taxable income **x. tax rate***

Once the amount of taxable income has been calculated, the Tax Law then applies a scale of Tax Rates to this amount in order to work out exactly how much tax the person has to pay for this year. *s. 5-10*

*Taxable income is **net income** with some adjustments*

Our concern is not with the tax rates or the amount of tax payable, but rather with the steps that lead up to finding the amount of taxable income earned during the year.

Taxable income is defined in the Tax Law to be the amount of a person's net income with some adjustments and reduced by losses made in prior years. *s. 6-15*

The critical part of this definition that we want to examine is the first one – how much is a person's net income for that year?

2. The first part of net income: cash flows

You will find this rule in …

Net income starts with: receipts – payments

The concept of net income is defined in the Tax Law. It says, net income is made up of two elements: *s. 6-55*

- one involves cash flows that have occurred during the year, and
- the other involves measuring changes to assets and liabilities over the year.

I will pause here to let you look at s. 6-55 in the Tax Law. It is on pages 1 and 2. Read Steps 1 and 2. *s. 6-55, Steps 1, 2*

We will begin with the first element: cash flows. As you saw, the Tax Law says the first part of net income is the difference between all amounts received during a year, and all amounts spent during a year.

EXAMPLE

Bob earns $1,280 per week working in the warehouse at Coles' major warehouse in Carlton. The $1,280 he receives is part of his net income

+ Receipts	$1,280
- Payments	nil
Net income	$1,280

but not private receipts or

This rule is subject to a very important qualification if the taxpayer is a person, rather than a company. The Tax Law says that a receipt by a person is excluded if the receipt is "private or domestic." Similarly, a *s. 222-5* *s. 222-25*

private payments, for individuals

payment made by a person is excluded if it is "private or domestic." *s. 222-10*

So for example, a taxpayer cannot deduct a gift to family members, the interest on a home mortgage interest, or amounts paid for groceries at the supermarket – these are all private matters.

EXAMPLE

Alison earns $1,200 per week. She spends $250 per week on rent and $150 per week on her share of the groceries, phone, gas and electricity bill. None of these amounts is deductible as they are private expenditures.

+ (Non-private) Receipts	$1,200
- (Non-private) Payments	nil
Net income	$1,200

Companies do not have private payments and so do not have to worry about this rule. *s. 222-5*

Tax Law can deem amounts to be received / paid

This basic framework is supplemented in the Tax Law by rules which deem amounts to be received or paid when no cash has actually changed hands.

One example is the rules dealing with the sale of goods or services on credit. If I sell goods on credit I don't receive a payment for them and the buyer doesn't make a payment at the time of the sale, but Tax Law will create both a receipt and a payment. We will look at credit sales in more detail a bit later. *s.16-15(2)*

Another example is when assets just appear "out of thin air." The Tax Law says, if I get an asset without having paid for it, I am deemed to receive an amount of money equal to the value of the asset and then spent that amount buying the asset. And the system is the same for the person who gave me the asset. He or she is deemed by Tax Law to have paid me the amount of money and then received that amount back as the proceeds for the asset. No money has actually changed hands, but the Tax Law re-creates the cash flows to create a receipt and a payment for each side to the deal. *s. 16-55* *s. 16-60*

3. The second part of net income: changes to assets and liabilities

You can find this rule in …

*Plus changes during the year to **assets** and **liabilities***

The second element of the net income calculation concerns assets and liabilities held by a taxpayer at the end of the tax year – that is, what assets and liabilities does the person have at midnight on 30 June?

Here the rules are trying to capture the difference between the assets owned at the beginning of the year and the assets owned at the end of the year. The rules also look at liabilities, and compare the liabilities owed at the beginning of the year to the liabilities owed at the end of the year. *s. 6-55, Steps 3-6*

The idea is this: if my assets have increased over the year or my liabilities have diminished, this difference adds to my net income. On the other hand, if my assets have diminished or my liabilities have increased during the year, this diminishes my net income.

So, the second element of net income is:

- the closing assets *minus* the opening assets

minus

- the closing liabilities *minus* the opening liabilities.

s. 6-55, Step 3,4

I will pause here to let you look again at section 6-55 in the Tax Law. It is on pages 1 and 2.

s. 6-55, Steps 5,6

This calculation compares two snapshots – my assets and liabilities at the beginning of the year, and my assets and liabilities at the end of the year. And it looks at the difference between them.

EXAMPLE

John has 1 asset (a truck) and 1 liability (the money he borrowed to buy it) and he holds both throughout the year. The tax value of the truck decreases from $12,000 to $10,000 during the year. The tax value of the liability does not change. He collects $12,000 from clients and pays $12,000 interest on the loan. His net income would be:

+ Receipts	+ $12,000
- Payments	- $12,000
+ Change to tax value of asset	- $ 2,000
- Change to tax value of liability	nil
Net income (loss)	-$2,000

In many cases, this add back of assets will serve to reverse the effect of making the payment.

EXAMPLE

Julie pay $200,000 for 50,000 shares in a company listed on the Australian Stock Exchange. The amount spent is deducted as a payment, but it is then added back because she now holds an asset as a result of making the payment:.

- Payments	$200,000
+ Closing tax value of shares ($200,000) – opening tax value of shares (0)	200,000
Net income	nil

Assets and liabilities are broadly defined

s. 10-15

Tax Law defines an asset in very general terms. It says an asset is "anything that embodies future economic benefits." This would include tangible things like land, buildings, and machinery. It would also include intangible things like shares, the right to interest on my bank account, and rights under other contracts, like the warranty on a machine I purchased or the right to receive goods that I have paid for.

s. 12-15

Tax Law defines a liability in similarly general terms. It defines a liability as "one or more obligations to provide future economic benefits." This includes for example, the obligation pay interest and to repay money I have borrowed. It would include other obligations like the obligation to repair goods I sold with a warranty or to deliver goods I have been paid for.

*The change is calculated by reference to **tax value***

s. 10-40

There is an important aspect to the rules that deal with this second element of net income: the calculation of the change to the assets and liabilities during the year is made by reference to their "*tax value*." Tax value is usually measured at the end of the year of income year – 30 June

Tax value varies for classes of asset / liability

This label, “Tax Value” is a defined term in the Tax Law and it has different meaning for different kinds of assets and liabilities. (It will usually not be the same as the market value of the asset.)

The Table in section 10-40 of the Tax Law gives 6 different classes of assets and a corresponding tax value for each class.

I will pause here to let you look at section 10-40 in the Tax Law.

Assets with a tax value of ***zero***

s. 10-40, Item 1

Item 1 of the Table says that some assets are given a tax value of zero. These full list is in Division 68. Office supplies and spare parts are two examples of assets with a zero tax value.

If I hold one of these assets, its tax value at the beginning of the year and the end of the year will be zero. So, when I subtract the opening tax value of 0 from the closing tax value of 0, the difference is 0 and so my net income would be just the first part of the net income calculation – the cash inflows less (non-private) cash outflows.

EXAMPLE

John repairs radios and receives $43,200 during the year from his clients. During the year he spends $13,200 for spare parts. At 30 June, he still holds some of the spare parts. His net income for the year is:

+ Receipts	$43,200
- Payments	-13,200
+ Closing tax value of spare parts (nil) – opening tax value (nil)	nil
Net income	$30,000

And notice that priority is given to the zero-value rule as some assets could potentially fall within that Item and another Item in the Table which would imply a positive tax value.

Assets with a ***moving*** *tax value*

Items 2 – 5 give the tax values for some other kinds of assets. These assets have a tax value that (a) is not zero and (b) which changes during the course of the year.

s. 10-40, Item 3

s. 72-30

So consider an asset to which Item 3 applies. A depreciating asset is one which has a limited life and so declines in value as I use it – say a truck that I buy to deliver goods to my customers, or a building that I construct on vacant land. Its tax value will decline during the year under these rules and this decline will reduce my net income

EXAMPLE

John has 1 asset (a truck) and he holds it throughout the year. He collects $42,000 from his courier work. The tax value of the truck decreases from $12,000 to $10,000 during the year. His net income would be:

+ Receipts	+ $42,000
+ Closing tax value of truck ($10,000) - opening tax value of truck ($12,000)	- $ 2,000
Net income	$40,000

Assets with a ***fixed*** *(positive) tax value*

s. 10-40, Item 6

Where none of these special rules applies, Item 6 applies. It applies to “any other asset.” The name given to any other asset is an “investment asset.” Common examples would land and shares. Item 6 says that the tax value of this kind of asset is its cost.

EXAMPLE

Julie holds a parcel of 50,000 shares in a company listed on the Australian Stock Exchange for the entire year. The shares are an investment asset – their tax value is set at cost and does not change during the year

+ Closing tax value of shares ($200,000) – opening tax value of shares (200,0000)	nil
Net income	nil

*(but not **private assets** or private liabilities, for individuals)*

This process for all types of assets is subject to a qualification if the taxpayer is a person, rather than a company. The Tax Law says that an asset held by a person is ignored if the asset is a private asset. Similarly, a liability owed by a person is ignored if it is a private liability. So private assets and liabilities are not counted.

s.222-40

s. 222-80

s. 222-45

Notice that there is a special rule that land is never a private asset (unless it is my home).

Companies do not have any private assets. So they are not subject to this rule and all of their assets and liabilities are counted.

*And only assets and liabilities that are **held** by someone*

There is another qualification to this process. This happens through a rule which says that only assets and liabilities which are ***held*** by someone are counted. The Tax Law says only 3 kinds of assets can be held: property (meaning both tangible things like land and machinery and intangible things like shares and options), plus rights that are recognised at law plus purchased secret information. If the asset does not meet this test, it is not counted.

s. 10-20

So, my good idea about how to build a better mousetrap, while it might one day prove to be valuable, is not held because a good idea is not (yet) property or a right. It does not have to be given a tax value. But if I bought someone else's idea for a better mousetrap, it would be counted as an asset – it would be purchased secret information.

s. 12-20

Similarly for liabilities, a person only has a liability if the person has a legal or equitable obligation that currently exists.

EXAMPLE

Rosebery Cellars Ltd started business in 1998 and employs 12 full-time staff. Under State law, employees are entitled to receive long service leave, but only after they have completed 10 years' employment. In the current year, none of the employees has completed 10 years service with the company. Rosebery Cellars will probably enter a note in its accounts for this to reflect some of the likely cost of the long service leave.

But in this year, no amount is recognised as a liability under tax law because the liability has not yet arisen.

And not money

There is one qualification to mention at this stage. The rules do not require a person to value one important asset - "money" - which is defined to mean cash in hand. This rule exists to prevent double counting – the money would be taxable (or not) as a receipt and so there is no need to value it again as an asset if the taxpayer is still holding it at the end of the year.

s. 6-55 Steps 3, 4

But bank accounts are valued as assets

Money in bank accounts is a little more complicated. Bank accounts are viewed as financial assets for Tax Law. So if I deposited $1,200 into my bank account, there is both a payment to the Bank, and that payment

procures a non-private asset (my bank account) which I hold and which has a tax value for me at the end of the year.

EXAMPLE

Alice receives $1,200 in salary from her employer for. She deposits this into her bank account:

+ Receipts	+ $1,200
- Payments	- $1,200
+ Closing tax value of bank account ($1,200) - opening tax value (nil)	+ $1,200
Net income	$1,200

4. Summary

Summary, so far

So far the presentation has made four main points:

1. Tax is payable on a person's taxable income
2. Taxable income is based (in part) on a person's net income
3. The first element of net income is the cash received *minus* cash paid (but not cash that arises from private transactions)
4. The second element of net income is the changes to the tax value of assets and liabilities during the year, including bank accounts (but not cash in hand, nor assets or liabilities that are private). The change is measured by looking at the tax value at the beginning and at the end of the year – 1 July to 30 June.

5. Assets and liabilities in more detail

You will find this rule in …

Individuals will have private assets and liabilities and other assets and liabilities

We will now revisit the treatment of assets and liabilities to fill in some more of the detail.

We have seen already that the exclusion of private assets and liabilities will mean that many assets and liabilities held by individuals are ignored. But individuals will have other assets and liabilities that will have to be taken into account. *Division 222*

So, individuals will need to be concerned about assets like:

- Term deposits, bank accounts and other financial investments (which are called financial assets in the Tax Law) *s. 10-40, Item 5*
- Houses and home units that are rented out to tenants (which are called depreciating assets in Tax Law) *s. 10-40, Item 3*
- Vacant land, shares, units in managed funds (which are called investment assets in the Tax Law). *s. 10-40, Item 6*

And individuals will also have to be concerned about their non-private liabilities like the obligation to pay interest and to repay the money they borrowed to buy these investments (financial liabilities) *s. 12-40, Item 4*

We have seen already that whoever holds a non-private asset, whether an individual or a business, will have to calculate an opening and closing tax value, and that the tax value of an asset depends on the type of asset in question.

The Table in section 10-40 identifies 6 different classes. We will look at a few of the more common types in more detail.

***Financial assets** are one type of asset*

Item 5 deals with financial assets. A financial asset is defined as the right to receive an amount of money – say, the credit balance in your savings account with the NAB, or the last payment owed to you by the person who bought your car.

s. 10-40, Item 5

As we will see, Tax Law divides this world into several different kinds of rights to receive an amount of money.

s. 76-10

- a right to receive an amount

The Tax Law says that the tax value of the right to receive an amount of money that is due and payable to you – we would usually call this a "debt" – is the amount you have the right to receive.

s. 76-15, Item 1

EXAMPLE

A builder orders some roof tiles from the manufacturer and promises to pay COD. The courier company delivers the goods and delivers an invoice for $12,000 to the builder but fails to collect the payment.

The manufacturer would be holding a financial asset because the price is due and payable. The tax value of the financial asset would be the amount which the manufacturer is entitled to receive.

+ Closing tax value of asset ($12,000)	
- opening tax value of asset (nil)	+ $12,000
Net income	+ $12,000

If money is owed eventually, but it is not due and payable at that time, then tax law says the tax value is zero, provided it must be paid within 12 months.

s. 76-15, Item 2

EXAMPLE

A builder orders some roof tiles from the manufacturer. The builder has an established line of credit with the manufacturer and has 60 days to pay. The courier company delivers the goods and gives an invoice to the builder for the price.

The manufacturer would be holding a financial asset. The tax value of the asset would be zero because the amount is not yet due and payable, but is payable with 12 months.

- bank accounts

The tax value of other kinds of financial assets is found in Division 76. The most common example would be a bank account, either a cheque account or a savings account

The rule giving for the tax value of bank accounts is the "cost" of the account. A deposit to that account will add to the "cost" and a withdrawal from the account will reduce its "cost" and thus its tax value.

s. 76-15, Item 5

Depreciating assets

Depreciating assets are another class of asset. The idea of a depreciating asset is something that deteriorates over time, like a machine. It can also refer to an intangible such as the right to occupy land or payment to use a patent over a process for a limited time. Buildings that are rented out to tenants are another example of a depreciating asset.

s. 10-40, Item 3

s. 72-30

EXAMPLE

Home Architects Ltd buys a 12-month subscription to *Architectural Digest* for $1,200. It takes out the subscription in May and the subscription starts with the June issue. The amount spent is a payment which buys a depreciating asset.

Home Architects would claim the payment and then add back the closing tax value of the asset it procured:

- Payment	- $1,200
+ Closing tax value of asset ($1,100)	
- opening tax value (nil)	+ $1,100
Net income (loss)	- $100

We will look at depreciating assets more fully in the last part of the presentation because they arise most commonly for businesses

Other assets

Item 6 is the catch-all for any other asset and uses the term investment assets. It provides that the tax value of an investment asset is its cost.

s. 10-40, Item 6 Division 78

EXAMPLE

Andrew bought a vacant block of land in March for $225,000. He sells the land 10 months later in the next tax year for $240,000. He pays tax on the $15,000 profit in the year of sale:

Year 1

- Payment	- $ 225,000
+ Closing tax value of land (cost $225,000)	
- opening tax value (nil)	+ $225,000
Net income	nil

Year 2

+ Receipt	+ $240,000
+ Closing tax value of land (nil)	
- opening tax value of land ($225,000)	- $225,000
Net income	+ $15,000

Individuals will have private and non-private liabilities

Individuals will also have to find the tax value of their non-private liabilities.

s. 6-55, Steps 5, 6

Division 222

For many individuals, their principal liabilities will be the rent for their home or the principal and interest on their mortgage, the payments on their car, personal loans or credit cards. Many of these liabilities could be entirely private liabilities and so ignored.

But some individuals will have other liabilities that are not private. If an individual has borrowed to buy a home unit and they rent the home unit to tenants, this liability will likely not be private.

Tax value of liabilities

The rules in Division 12 mirror to a large extent some of the rules we have seen for assets. There is a Table which sets out the tax value for various kinds of liabilities.

s. 12-40

Some liabilities will have a zero-tax value: Item 1. These are listed.

Liabilities that depreciate over time will have a tax value that declines: Item 2. An example would be a liability to perform repairs under a warranty that gradually expires.

s. 72-45

EXAMPLE

Architectural Productions Ltd publishes *Architectural Digest* and sells annual subscriptions for $1,200, payable in full at the time of taking the subscription. Reader takes out a subscription in May and the subscription starts with the June issue. The amount received is ordinary income, but it is spread over the period of the subscription.

Architectural Productions Ltd would report 1/12th of the payment in its return for the year ending 30 June:

+ Receipts	+ $1,200
- Closing tax value of liability ($1,100) - opening tax value of liability (nil)	- $1,100
Net income	+ $ 100

Financial liabilities will have a tax value that is worked out in any one of four ways: Items 3-5

Any other liability had by someone will have a tax value which is the amount received when the liability was assumed: Item 7.

6. Routine rights and liabilities

You will find this rule in …

Routine rights and liabilities are given a zero tax value

We have already briefly mentioned the rule that some assets and liabilities are given a tax value of zero. We will now examine one important type of assets and liabilities with a tax value of zero.

s. 10-40, Item 1 Division 68

"Routine rights" are one class of asset that is afforded a zero tax value. A "routine liability" is also afforded a zero tax value.

Routine right

Tax Law carves out from all the rights that a person holds one class of rights and defines them as "routine rights." The conditions which define the right as being a routine right are:

s. 68-45(1)

1. The right must arise under a contract.
2. The person must also have a liability under that contract.
3. Either,

   Neither party to the contract has yet started to perform their obligations under the contract, or *s. 68-45(2)*

   The person has paid some proportion of the contract price and has got about that proportion of the total contract delivered. *s. 68-45(3)*

The kind of transaction to which these rules apply would be things like arrangements where neither party has yet started work on the project.

EXAMPLE

A builder orders some roof tiles from the manufacturer. The manufacturer promises to deliver them next month (July) and the builder will pay COD.

The manufacturer would have an asset because there is a binding contract which will entitle it to payment when the tiles are delivered. But it is a routine right because the tiles have not yet been delivered nor has the manufacturer received any money yet. The manufacturer's asset would be given a tax value of zero.

Routine liabilities

The conditions which define a liability as being a routine liability are:

1. The person has a liability under a contract.
2. The person also has rights under the contract.
3. Either,

   Neither party to the contract has yet started to perform their obligations under the contract, or

   The person has delivered some proportion of the contract, and has been paid about that proportion of the contract price.

EXAMPLE

A builder orders some roof tiles from the manufacturer. The manufacturer promises to deliver them next month (July) and the builder will pay COD.

The builder has a liability under the contract because there is a binding contract to accept and pay for the tiles when delivered. But it is a routine liability because the tiles have not yet been delivered nor has the builder paid for them. The builder's liability would be given a tax value of zero.

7. The 'cost' of acquiring an asset and the 'proceeds' of selling an asset

You will find this rule in …

Tax Law has rules about cost and proceeds of assets

The Tax Law prescribes rules to determine

- The 'cost' of an asset and — *s. 14-20*
- The 'proceeds' of disposing of the asset. — *s. 14-40*

The cost of an asset is: two inclusions and some exclusions

The rules in Division 14 of the Tax Law give the definition of 'cost.'

Cost is defined to mean the sum of two amounts (and to exclude some other amounts).

- The first inclusion is the amount a person paid to acquire or construct an asset. This includes any incidental costs of buying or constructing the asset. *s. 14-25*
- The second inclusion is any amount that the person has subsequently paid in order to bring the asset to its present condition and location. The idea behind this second element is that some payments add to the value of assets and so should be added to their cost. *s. 14-30*

In addition, the Tax Law says that the cost of an asset does not include interest, or amounts paid to maintain, repair or insure an asset. The exclusion of payments on the maintenance, repair or insurance of an asset expresses the idea that these payments do not add to the value of assets and need not be added to the cost of the repaired asset. *s. 14-35*

Proceeds …

The proceeds of realising an asset is the amount that the person will receive because they stop holding the asset. *s. 14-40*

Special rules exist to deem receipts and payments (for costs and proceeds) rules where no cash

The cost and proceeds of assets and liabilities are relatively clear when a person pays or receives cash for their transaction. But not all transactions happen in cash. Sometimes, people will exchange one asset for another, or for another asset and a bit of cash.

The Tax Law contains special rules to state what happens for transactions that involve payments in kind. These rules give an amount for the costs and proceeds rules, by saying that I paid and received the market value of the assets involved. *s. 16-25*

Credit sales are treated as involving cash payments and receipts

One important area where these rules apply is when there is a transaction involving the promise to pay money in the future. The sale of goods on credit is treated as involving sale of goods in exchange for an asset, not for money.

So if I sell you an asset in exchange for $1,000 which is paid

immediately, I have sold the asset for cash, and the special rules about cost and proceeds do not apply. But if I have sold the asset for $1,000 which is to be paid on delivery of the item, that is not a transaction involving cash and so the special rules apply. This is important if delivery won't happen until the next tax year.

Including short term trade credit

One example of this treatment of credit sales arises for sales on short-term (ie, less than 12-months) credit. The rules create a notional loan of the amount of the credit which is then spent to acquire the asset. *s. 16-15*

EXAMPLE

A builder orders $1,200 worth of goods from a hardware store. The builder has an established line of credit with the store and has 60 days to pay. The builder collects the goods and receives an invoice for the price. At the end of the tax year (90 days later) the amount owed is now due and payable but the builder still has not paid.

The first step in the transaction treats the hardware store as receiving $1,200 for the goods. The manufacturer is then treated as lending this amount to the builder and acquiring in exchange a financial asset (being the right to receive the amount due and payable). The tax value of the asset would be the amount lent.

The second leg would involve the goods. They would now be held by the builder and so the hardware store would remove them from its closing assets.

Borrowing leg of the transaction

- Payments	- $1,200
+ Closing tax value of asset ($1,200) – opening tax value (nil)	+ $1,200

Goods leg of the transaction

+ Receipts	+ $1,200
+ Closing tax value of assets (nil) - opening tax value of assets (say 1,000)	- $1,000
	200

8. The 'proceeds' of taking on a liability and the 'cost' of extinguishing it

You will find this rule in …

Tax Law also has rules about proceeds and costs of liabilities

The Tax Law prescribes similar rules to determine

- The 'proceeds' of taking on a liability *s. 14-75*
- The 'cost' of extinguishing the liability. *s. 14-90*

The proceeds rules are important in determining the tax value of a liability. If I borrow $100,000, the proceeds of taking on the liability to repay the amount is the $100,000 I received.

The 'cost' rules prescribe the cost of extinguishing a liability. Again, if I have to pay $100,000 to repay my debt, then the cost of extinguishing it is $100,000.

9. Business assets and liabilities

You will find this rule in …

There are further rules for business assets and liabilities

So far we have been through the basic system once and then looked at some of the rules in more detail.

We will now look at a few of the special rules for businesses. Businesses will still have to apply the rules we have just examined – indeed many of

our examples already have involved businesses – but there are a few further regimes that are relevant principally for businesses. This is because businesses have a few extra classes of assets and liabilities which will require a tax value computation.

The main assets of a business will be: trading stock

One important class of business asset is its trading stock. Trading stock means the assets that a business deals in – the kind of assets that the business buys or manufactures in order to sell. Example are the groceries on the shelves at Coles, the cars in the car showroom, and the shoes in the shoe store window.

The Tax Law says that the tax value of trading stock is its cost.

s. 10-40, Item 2

This means that the payment for trading stock generates an asset with a tax value of cost. When the stock is sold, there is a receipt and the opening tax value of the stock is removed. The profit is taxed when the stock is sold

EXAMPLE

In early June, Malvern Booksellers Ltd buys a shipment of 250 copies of Tim Winton's most recent novel from the publisher for $20 per copy. The books are put into storage until the book's national release on 16 July. All the books are sold in July and August at $45 per copy.

The cost of the books (-$5,000) is deducted in the year ending 30 June, but is added back (+$5,000) because the books are still on hand at 30 June. That amount is then re-deducted in the next year (-$5,000) and the proceeds of sale ($11,250) are taxed in the year of sale. The system has two effects: (a) the cost of the books is deferred until the year of sale and (b) the profit ($6,250) is taxed in the year of sale.

Year 1		
	- Payment	- $5,000
	+ Closing tax value of books ($5,000)	
	- opening tax value of books (nil)	+$5,000
	Net income	nil
Year 2		
	+ Receipts from sale books	$11,250
	+ Closing tax value of books (nil)	
	- opening tax value of books ($5,000)	-$5,000
	Net income	$ 6,250

And depreciating assets

Another important class of business asset is its depreciating assets. Depreciating assets means (a) the assets that a business buys and keeps to carry on its activities and (b) they decline in value as they are used by the business. They are shelves on which the groceries at Coles are displayed, the customer couches and coffee tables in the car showroom, and the cash register used by the shoe store. The cash register may be sold, but it was not bought to be re-sold, unlike the shoes (trading stock) in the window. Rather, it was bought to be used and will probably be owned for a longish period.

s. 10-40, Item 3

s. 72-30

The rules say that the tax value of a depreciating asset is set at its cost and is then reduced each year by the decline in value of the asset. The decline in value is set out using the assumed life of the asset – that every car will last for 7 years, for example, and that a five year licence will last for 5 years. The tax value at the end of each year is the cost reduced by this year's decline in value.

EXAMPLE

Speed Couriers buys a new delivery van for $42,000 on 1 April. The van is used to deliver parcels for its customers in Melbourne. The tax value of the van declines under the depreciation rules.

The truck will have an effective life of 7 years so that its tax value will decline by $6,000 in each year. In the first year, the decline in tax value will be 91 days for the period from 1 April to 30 June $1,500.

- Payment	- $42,000
+ Closing tax value of truck ($40,500) – opening tax value of truck (nil)	+ $40,500
Net income (loss)	- $1,500

And note that depreciating assets can be both tangible or intangible. *s. 72-30*

EXAMPLE

Kodak Inc. owns a worldwide patent over some valuable technology involved in turning colour photographs into digitised images. On 1 July, it grants a license to Hudson Photographics (Australia) Ltd to use the technology in Australia for 5 years for $250,000. Hudson will use the technology to expand its existing business (which is mostly concerned with film developing and printing) into the new photograph conversion market. The cost of the licence is not deductible to Hudson because it is a capital payment. Instead, the cost is recovered under the depreciation rules. The licence will have an effective life of 5 years so that Hudson can deduct $50,000 in each year of the next 5 years.

- Payment	- $250,000
+ Closing tax value of truck ($200,00) – opening tax value of truck (nil)	+ $200,000
Net income (loss)	- $50,000

And depreciating liabilities

And businesses will also have depreciating liabilities. These are treated in just the same way.

EXAMPLE

Jason Industries operates in New South Wales and Victoria and currently makes 60% of its profits from the Victorian market. It agrees with Rival Ltd to withdraw from the Victorian market for 5 years in exchange for $2.5 million.

The amount received would be included in net income. But the money comes with a liability to Rival and it is a depreciating liability which decline over 5 years. The tax value of the liability will decline each year:

+ Receipt	+ $2.5 m
- Closing tax value of liability ($2m) - opening tax value of liability (nil)	- $ 2 m
Net income	+ $0.5 m

And financial assets

We have already looked at the main rules for financial assets. They are the same for businesses as they are for individuals. *s. 10-40, Items 4, 5*

And some investment assets

Businesses will also own investment assets. The most common would be land (on which the factory stands) or shares in subsidiary companies. Again we have looked at the rules about the tax value of these assets already. The tax value of investment assets will usually be their original cost. *s. 78-10*

EXAMPLE

In 1999, Botanical Plants won a contract to provide and maintain indoor plants to all Victorian Government offices in exchange for an annual payment of $2.4 million. The contract generates 85% of all Plants' income. The Victorian Government has decided it wants to terminate the contract. The parties agree to do so if the Government pays Plants $1.25 million. This contract would be an investment asset.

And some zero tax value assets	Finally, there are a few special rules which give some business assets a zero tax value. These are: ▪ Routine rights (which we have looked at above) ▪ Consumable stores and spare parts, ▪ Office supplies, ▪ An item of intellectual property whose subject matter is advertising material	*s. 10-40, Item 1, Division 68* *s. 68-10*

Thank you for paying attention to the presentation.

We suggest that you now take about 5 minutes to review what you have just heard to get it clear in your own mind. Remember the key point to each paragraph is in the left hand column.

When you have done that, turn to the document marked “Questions” and start working on it.

Remember that I can’t answer any questions so if you have difficulties please just try your best.

When you are answering the questions, feel free to go back to this presentation and to check the legislation you have in front of you.

When you have finished answering all the questions, please -
- write the time in the box on the last page and
- bring the document to me.