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*

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. 4-10(3)*

*Taxable income is **assessable income** minus allowable deductions*

Our concern is not with the tax rates nor 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 difference between a person's assessable income and deductions (reduced by losses made in prior years). So it is a two-step process – looking first at what amounts fall into assessable income, and then looking at what amounts are deductions. *s. 4-15*

These are the two critical concepts that we want to examine:
1. Which receipts and other amounts form part of a person's assessable income?
2. Which payments and other amounts are allowed as deductions?

If we know the answers to these questions, we then know how much is the person's taxable income.

2. The first part of taxable income: assessable income

You will find this rule in …

*Assessable income is **ordinary income***

Section 6-5 of the Tax Law says that a person's assessable income includes all their "ordinary income" derived during the year. *s. 6-5*

*Plus **statutory income***

Section 6-10 then says that a person's assessable income also includes other amounts (that are not ordinary income) but which are "included in your assessable income by provisions [in Tax Law] about assessable income." In the Tax Law, this is called "statutory income." *s. 6-10*

So the basic idea of "assessable income" is that it is made up of two amounts:
- amounts which are "income" within the ordinary meaning of that word; and
- amounts which aren't ordinarily thought of as income, but which Tax Law says will be taxed as if the amount is income (statutory income).

I will pause here to let you look at sections 6-5 and 6-10 in the Tax Law. They are on pages 1 and 2.

3. Ordinary income

You will find this rule in …

Ordinary income is not defined

It may seem odd, but the Tax Law does not give us any written definition of what is "ordinary income." So, in the absence of a written definition, it is the opinions of judges deciding cases and interpreting the word "income" that tells us what is the "ordinary income" made assessable by s. 6-5 of the Tax Law. The cases give the meaning that taxpayers and their advisers later rely on.

But it has a generally accepted meaning

In general terms, the concept of ordinary income means three broad types of receipts:
1. amounts that a person receives as a reward for performing services (eg, the wages received by an employee)
2. amounts that a person receives which are profits from carrying on a business, and
3. amounts that a person receives which are a return on the person's investments (eg, dividends on shares, interest on term deposits, rent on investment properties, royalties paid for allowing someone to use a patent, and so on).

EXAMPLE

Bob earns $1,280 per week working in the warehouse at Coles' major warehouse in Carlton. The $1,280 he receives is ordinary income because it is payment for performing services.

+ Ordinary income	$1,280
- Deductions	nil
Taxable income	$1,280

The meaning is found in decided cases

These three classes are not written in the Tax Law nor can they be found in this compiled form in any decided Court cases – the categories are largely the result of classifications applied to the results of individual cases. The classes emerge as the principles in the decided cases. Nowhere does the Tax Law ever say "interest is taxable" or "rent is taxable." These transactions are, instead, understood as being part of the "ordinary income" of a person.

Many amounts are not ordinary income

If a receipt does not fall within one of these ideas, it is not ordinary income.

Some common omissions from ordinary income are:
- gifts received (sometimes) – the qualification arises because gifts received by employees or by a business owner may in some cases be regarded as connected to the employment or business, and so form part of the employment income or business profits,
- inheritances,
- windfalls,
- treasure trove, such as money found buried under a house,
- prizes (sometimes) – again the qualification arises because some prizes received by an employee or by a business owner may be regarded as connected to the employment or business, and so form part of the employment income or business profits,

- gambling winnings (sometimes) – here the qualification arises because gambling winnings are business profits for some “professional gamblers” such as the so-called “high-rollers”, and prizes also form a major part of the remuneration of racehorse trainers,
- the amount received by a company when issuing shares to shareholders
- the amount received as the principal of a loan.

*A **capital receipt** is not ordinary income*

One of the most important omissions from a person’s “ordinary income” is the proceeds of sale of a capital asset, owned by an individual or company. The profit made on selling a capital asset (say, vacant land or shares on the stock exchange) is typically called a “capital gain.” We will come back to this idea of a capital gain later in the session.

4. Statutory income

You will find this rule in …

*Tax Law supplements ordinary income with **statutory income***

This distinction between an ordinary income receipt and a capital gain is fundamental to “ordinary income.” Because a capital gain is not “ordinary income” we have an extensive capital gains tax regime in the Tax Law: those rules exist to overturn the effect of the distinction that the gain made on the sale of a capital asset is not income, and thus not within the scope of a tax on “income.” The taxation of capital gains is one of the most important examples of statutory income.

Some of the most important examples of transactions that the Tax Law deals with are:

- the profit made on the sale of interest-bearing investments (called “traditional securities”) is added to statutory income — *s. 26BB*
- special rules exist for gains made on redeeming interest-bearing liabilities — *s.245-105*
- it adds net capital gains as statutory income — *s. 102-5*

s. 26BB

The proceeds of selling an interest-bearing security (say a corporate bond) are one example of “statutory income.” The amount received on selling the bond would not be ordinary income to an individual who bought the bond to hold as an investment. But the Tax Law provides that if the person sells the bond for a profit, the profit is included in their assessable income as “statutory income.”

s.245-105

The treatment of gains made on discharging liabilities is a bit more obscure. The kind of transaction that the rules apply to is this: assume a company owes $100,000 which is not due for another 2 years. Assume also that the lender desperately needs the money back sooner. The lender may be willing to accept a smaller amount, say $95,000 if the company repays the money today. If this is the case, the company has made a gain of $5,000. Tax Law says this amount will reduce the company’s (ie, the borrower’s) tax losses and other attributes.

s. 102-5

We will return to capital gains in more detail later.

The important point to note at this stage is that the Tax Law often adds amounts made into “statutory income” to a person’s ordinary income to get to the total – which is their “assessable income.”

5. The second part of taxable income: deductions

You will find this rule in …

Expenses incurred in earning income are allowable deductions

The second step in determining a taxpayer's taxable income involves subtracting some payments and other amounts from the taxpayer's assessable income. We said above that Tax Law allows a taxpayer to deduct from assessable income all of the "deductions" for the year, so that tax is paid on the net amount – their "taxable income." *s. 8-1*

So, what is a "deduction"? The answer comes in two parts (and with several qualifications that we will get to shortly).

First, Tax Law says, a person can deduct from assessable income any payment (or a loss suffered) that is made in order to gain or produce assessable income – these are called "general deductions." *s. 8-1(1)*

Plus amounts that are made allowable deductions

Next, s. 8-5 of the Tax Law says that a person can also deduct amounts that "a provision [of the Tax Law] allows you to deduct" – these are called "specific deductions." *s. 8-5(1)*

So the basic idea of "deductions" is that it is made up of two types of amounts:

- amounts which are "general deductions"; and
- amounts which are "specific deductions" – amounts which aren't general deductions but which Tax Law specifically says can be deducted from assessable income.

I will pause here to let you look at sections 8-1 and 8-5 in the Tax Law. They are on page 2.

But not amounts that are private or domestic

You will see there are two important exclusions from the amounts which will qualify as general deductions.

The first qualification is that no deduction is allowed for a payment or other amount that is "private or domestic." 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. *s. 8-1(2)(b)*

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.

+ Ordinary income	$1,200
- Deductions	nil
Taxable income	$1,200

Nor amounts that are capital in nature

The second important exclusion is that no deduction can be claimed for a payment or other amount that is "capital" in nature. One example of a payment that is "capital" in nature is a payment for an enduring asset, like a machine or a building or a block of land. *s. 8-1(2)(a)*

EXAMPLE

Julie invests $200,000 for 50,000 shares in a company listed on the Australian Stock Exchange. The $200,000 is not deductible in the year it is spent as it is a capital payment. (Instead, it will form one part of the cost of the shares and will

be relevant when she sells them.)

+ Ordinary income	nil
- Deductions	nil
Taxable income	nil

But amounts which are capital in nature will usually not just disappear from the tax system altogether. While the Tax Law says they are not deducted in this year, these amounts will often be subtracted later – either in parts over ensuing years, or all in one lump in some future year.

To take one example, a capital payment to buy a block of land as an investment is not deducted in the year when the land is bought because the payment is "capital" in nature. Instead, the payment is subtracted from the proceeds of sale in the year when the land is sold. This is the way capital gains are taxed – the cost of the asset is not deducted from income in the year in which the asset is bought. Rather, it is subtracted from the proceeds of sale when the land is sold.

And the amounts must relate to an income-earning activity

One final part of the basic idea of a general deduction is that the amount must be relevant to earning assessable income or to carrying on a business which produces assessable income. *s. 8-1*

This will create a difficulty if a taxpayer does not have any income or does not operate a business at that time. For example, if I spend money on commissioning a feasibility study to ascertain whether there will be a market for the products of the business I want to start, I will not be able to deduct the amount – there is no current business to connect the amount to. The same logic applies to interest on money that I borrowed to buy a vacant block of land – if the land is vacant, there is no rental income from which to deduct the interest. So the interest can't be deducted as I pay it to the bank.

These are both areas where Tax Law then steps in to provide a specific rule to overcome this idea:

- A special deduction spread over 5 years is created for feasibility studies. *s. 40-880*
- The interest on the vacant land is added to the cost of the land and recovered when the land is sold. *s. 110-25(4)*

The qualifications are often removed in the rules about specific deductions

These 2 qualifications (about private and capital amounts) are important if the person wants to claim a general deduction. But they are often overturned by the rules in the Tax Law which create specific deductions.

Some examples of amounts that would not be deductions under the ordinary rules but which are made specific deductions include:

- losses made on selling interest-bearing securities (in some cases) *s. 70B(2)*
- the deduction for making gifts to charities.

The treatment of losses on interest-bearing securities ("traditional securities") is just the reverse of the rules we looked at above (which taxes the profits made on selling these securities). If an investor buys a $10,000 bond and then sells it for $9,875, the loss would be a capital loss. The Tax Law will overturn this to allow a taxpayer to deduct the loss, but the specific deduction is subject to its own limits: the loss must not be because the borrower is unable to pay the debt (although this *s. 70B(4)*

limitation is ignored if the securities are traded on a securities market).

6. 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 the difference between a person's assessable income and their deductions
3. Assessable income is made up of amounts that are ordinary income plus statutory income (ie, amounts which are included in income by the Tax Law)
4. Deductions are made up of amounts that are general deductions and specific deductions (ie, amounts that are made deductible by the Tax Law).

7. Receipts in more detail

You will find this rule in …

We have said already that "ordinary income" has a core idea - some amounts are included in the idea of ordinary income: wages, rent, dividends, and so on.

We have also said that some amounts (capital receipts) fall outside the idea of ordinary income: borrowed money, money that is found, the proceeds of selling some kinds of assets.

Of "fruit and trees"

A common way of conveying the notion of ordinary income uses the metaphor of "fruit and trees." It is often said that income is the fruit of a tree, while the taxpayer's capital is the tree.

This conveys the idea that ordinary income is what comes to the taxpayer from his or her "tree" – wages from an employment contract; interest on bank deposits; rent from a home unit; dividends on shares, and so on. But when the taxpayer sells the "tree" – sells the home unit or the shares, for example – the proceeds of selling the tree are a capital receipt.

Capital and income receipts in a business context

This metaphor may help explain why we just said that "the proceeds of selling some kinds of assets" are capital receipts. Whether the proceeds of sale are capital or income depends on what part the asset plays in the taxpayer's activities.

For example:
- the proceeds of selling the head office of a business would be capital – it is selling the tree; it is selling the structure through which the taxpayer operates
- similarly, the proceeds of selling the taxpayer's machinery and equipment would be capital – it is selling the tree; it is selling part of the structure through which the taxpayer operates
- but selling the taxpayer's trading stock is regarded as generating income and is not regarded as capital – the items were bought in order to be sold. They are not part of the taxpayer's business structure.

Including

These examples all used tangible assets – buildings, machines, and so

intangible assets

on. But the same type of analysis would also hold true for intangible assets and liabilities, like contracts.

EXAMPLE

In 1999, Botanical Plants won a valuable contract to provide and maintain indoor plants to all Victorian Government offices in exchange for an annual payment of $2.4 million. This one contract occupies almost all of Plants' staff and now generates 85% of all Plants' income. The Victorian Government has decided it wants to terminate the contract. The parties agree to if the Government pays Plants $1.25 million. The amount would be a capital receipt as the contract represents the majority of Plants' business operations.

Some gaps will be plugged by the Tax Law

As we will see later, where there are gaps in the ordinary income idea, the Tax Law (especially the rules about depreciating assets and the capital gains tax) has specific rules which will sometimes add these amounts as statutory income

8. Deductions in more detail

You will find this rule in … s. 8-1(2)

The idea of a capital amount …

We saw above that capital amounts are not deductible when they are made. We said that, instead, many capital amounts will be dealt with under various statutory regimes which will recognise the amounts later.

A payment which buys my structure / enduring benefit

One part of the idea of a capital amount is one which buys or adds an enduring structure or a long-lasting benefit to a business or investment. Continuing our previous metaphor, it buys a new "tree" or it improves an existing "tree." So,

- the price I pay to buy some shares in a listed company is not deductible to me (it is capital) if the shares are the structure through which I am going to earn dividend income;
- the price I pay to buy a home unit is not deductible to me (it is capital) if the home unit is the structure through which I am going to earn rental income;
- the price I pay for a new set of display shelves for my bookshop is not deductible (it is capital) as it forms part of the premises from which I operate.

Not a payment which just maintains it

On the other hand, there are payments which do not generate a new structure nor add a new and enduring benefit to my business structure – these will usually be deductible:

- the rent I pay to lease my factory for another month is deductible because it does not generate an enduring benefit for the business – it only gets me the premises for another month
- the wages I pay to my workshop staff for another week's work is deductible because they do not generate an enduring benefit for the business – they have already provided me all the labour that my payment will buy
- the cost of repairing a machine that I use is deductible because it does not generate a new enduring benefit for the business – it just gets me my old machine back in a state where I can use it
- the amount I spend to insure the machine is deductible because it does not generate a new enduring benefit for the business – it just gets me some protection for a short period.

Some of

In fact, to avoid doubt, the deductibility of some of these payments is

these ideas are repeated in tax law

made explicit by provisions in the Tax Law. For example:

- the amount paid to repair an asset is deductible
- a retiring allowance paid to former employee is deductible
- this year's dues paid to belong to a professional association is deductible

s. 25-10
s. 25-50
s. 25-55

These amounts would be deductible anyway.

9. Timing rules

You will find this rule in …

Income may be taxed in the year it is received or in the year it is earned

So far, we have looked at ***what*** amounts received by a person might be taxable and what amounts paid by a person might be deductible. We also have to have rules about when those amounts are to be recorded.

Whether an amount of income (or a deduction) belongs in one year rather than another depends on the timing rules – rules which allocate receipts and payments to this year rather than that year.

There are two basic systems for determining when receipts should be reported:

- Cash accounting – income is reported in the year when it is received
- Accrual accounting – income is reported in the year when it is earned

These two ideas are the interpretation that Courts have given to the words "derived."

s. 6-5

Individuals commonly need to report amounts only when received

Most individuals will use cash accounting. They will report their income based on the amounts they have received during the year. So for example,

- An employee would report as income the sum of the wages paid to her (or deposited directly into her bank account) during the year.
- Similarly interest income earned on a bank account would be taxed when the bank credited the interest to the account.

s. 6-5(4)

Businesses commonly report amounts when earned, before receipt

Businesses, on the other hand, are obliged to report their income when it is earned.

EXAMPLE

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

The manufacturer would not yet report the income from the sale of the tiles because the tiles have not yet been delivered to him and until they are, the builder is not yet under an obligation to pay for them. The money has not yet been earned.

But "earning" for businesses will usually be when work is done and an invoice is sent, rather that waiting until cash is received.

EXAMPLE

A builder orders some roof tiles from the manufacturer. The manufacturer delivers the tiles and sends the builder an invoice demanding payment.

The manufacturer would report the income from the sale of the tiles because the tiles have been delivered the builder is not yet under an obligation to pay for them. The money has now been earned.

Earning can occur after receipt as well as before

The previous examples show amounts which are treated as earned by the business before the amount was received. Amounts can also be treated as earned after they are received.

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:

+ Ordinary income ($1,200 / 12)	$100
Taxable income	$100

Similar rules apply to deductions

Similarly, most individuals will report their deductions when they pay them (although strictly Tax Law allows them to claim their deductions when the deductions are "incurred" which the Courts have said can occur before payment).

"Incurred" means the business has an existing liability to make the payment, not just that it will probably have to make a payment in the future.

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 allowed as a deduction under tax law because the liability has not yet been incurred.

Businesses will invariably claim their deductions when they are incurred. This will usually mean, when the business has received the goods or services it has purchased and holds an invoice seeking payment. A business would not need to wait until the time it pays the invoice.

EXAMPLE

A builder orders some roof tiles from the manufacturer. The manufacturer delivers them next month and gives the builder an invoice at the time of delivery.

The builder would be entitled to a deduction for the cost of the tiles because the tiles have been delivered to him and the builder is now under an obligation to pay for them.

And deductions can be delayed

And just like the treatment of income, so too deductions can be delayed even though the person has paid the amount of the invoice in full.

s. 82KZMD

The Tax Law contains rules to deal with prepayments – that is amounts which are incurred now, but which procure benefits which last beyond the current year. Where these rules are triggered, the deduction is claimed over the period to which the payment relates. The period is counted in days.

EXAMPLE

Home Architects Ltd buys a 12-month subscription to *Architectural Digest* for $1,200. It takes out the subscription on 1 June. The amount spent is deductible, but it is spread over the period of the subscription.

Home Architects would claim 30/365th of the payment in its return for the year ending 30 June, $100:

- Deductions $1,200 * 30 / 365	$100
Taxable income (loss)	- $100

10. Capital gains and losses

You will find this rule in …

Capital gains are one form of "statutory income"

We mentioned above that a person's "ordinary income" is supplemented in various ways by the Tax Law. These add-ons are called "statutory income." One of the most significant types of statutory income is the "capital gains tax." *s. 102-5*

I will pause here to let you look at section 102-5 in the Tax Law. It is on page 10.

CGT runs parallel to the rules about income and deductions

The capital gains tax operates as a separate system within the Tax Law. It applies for the most part to amounts which would not be ordinary income and to amounts which would not be general deductions. Many amounts which are not deductions (because they are capital payments) will instead affect the calculation of the amount of a capital gain.

CGT looks at whether there is a profit on each transaction …

For the most part, capital gains tax is concerned with sales of assets at a profit. Capital gains tax works by comparing the amount paid for an asset (called the "cost base of the asset") to the amount received when it is sold or exchanged (called the "capital proceeds"): *Eg, s. 104-10(4)*

- if the proceeds are more than the cost of the asset (in other words, you have made a profit), there is a capital gain
- if the proceeds are less than the cost of the asset, there is a capital loss.

EXAMPLE

Andrew bought a vacant block of land in March for $225,000. He sells the land 10 months later for $240,000.

The cost of the land is not deductible as it is a capital payment. Instead, it is subtracted from the sale proceeds when the land is sold. He pays tax on $15,000 as a capital gain:

+ Statutory income: net capital gain			
	+ proceeds	$240,000	
	- cost base	$225,000	$15,000
- Deductions			nil
Taxable income			$15,000

Then adds the results of all the year's trans-actions

The total of all the individual capital gains and capital losses made on all the taxpayer's assets for the year are then aggregated. *s. 102-5*

If the total is positive (there are more gains than losses) there is a "net capital gain" and this amount forms part of the taxpayer's statutory income for the year. If there is an overall loss, no amount is added into my income. Instead, the loss is carried forward and can be used next year.

The cost of an asset comprises 5 elements

We said above that in order to work out the capital gain or loss made on each transaction, the person has to calculate what the asset cost them. *s. 110-25*

Tax Law provides that the cost of an asset consists of 5 amounts:

- what you paid to buy the asset *s. 110-25(2)*
- incidental costs of buying and selling it - real estate agents' fees, surveyor's fees, lawyers fees, brokerage fees, valuer's fees, stamp duty, advertising costs *s. 110-35*
- certain other costs (interest, rents, insurance premiums, rates) provided you could not deduct them *s. 110-25(4)*
- amounts spent to improve the asset *s. 110-25(5)*
- amounts spent defending your ownership of the asset *s. 110-25(6)*

Proceeds = cash + value of assets received

Tax Law also says that the proceeds of disposing of the asset include any cash received and the value of any asset you receive for the asset. *s. 116-20*

Some-times, CGT also taxes mere receipts

We said above, that capital gains tax was mostly concerned with disposals of assets. But sometimes, capital gains tax is also applied to various receipts that would be ordinary income.

The main example of this – where capital gains tax taxes a receipt that doesn't arise on the sale of an asset – occurs when one person creates rights in another person in exchange for payment. *s. 104-35*

A standard example would be where a person receives money in exchange for giving an option to buy something. The idea is that we have a "one-sided sale" – the person granting the option didn't already own the option, but they created it (the option rights) in the person who paid them for it. Hence we tax the gross payment as a capital gain.

Another example would be where a person undertakes a new commitment (creates "rights") in exchange for a payment.

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 taxable as a capital gain because Jason has created rights in Rival in exchange for a payment.

+ Statutory income: net capital gain		
+ proceeds	$2.5 m	
- cost base	n/a	$ 2.5m
- Deductions		nil
Taxable income		$ 2.5m

But CGT does not tax every receipt

But this rule is unusual – capital gains tax will usually be triggered where an asset is sold and is usually irrelevant if the taxpayer just receives cash that isn't ordinary income.

This is important because it means CGT is not the mirror of "ordinary income" – it doesn't just apply to every receipt that isn't ordinary income. If it did, it would tax many of the examples listed above of amounts that aren't ordinary income – gifts, prizes, gambling winnings and so on.

And there are many exemptions

And in any event, CGT contains many exemptions. Some exemptions exist for policy reasons: there is no capital gains tax on the sale of your car or your own home, for example.

Division 118

Others exist to deal with overlaps. There is no capital gains tax on the sale of trading stock or depreciable assets as these are fully dealt with under the ordinary income rules. The rules also reduce the amount of capital gains tax if the amount is already included in income under another rule.

s. 118-25
s. 118-24
s. 118-20

And some exemptions are for greater caution. There is no capital gains tax on:

- prizes and gambling winnings
- payments as compensation for personal injury

s. 118-37(1)

11. Business assets and liabilities in more detail

You will find this rule in …

There are further rules for business assets

So far we have concentrated on rules that would affect individuals. We will now look at a few special rules for businesses. Businesses will have to apply the rules we have already examined, but there are a few further regimes that are relevant to them. This is because businesses have a few extra classes of assets.

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

Division 70

The treatment of trading stock operates in four steps:

1. The taxpayer deducts the cost of the trading stock in the year in which the stock is purchased. The Tax Law uses the term "on hand" meaning when the stock is delivered to the taxpayer. *s. 70-25, s. 8-1*
2. But if some or all of the trading stock is still on hand at the end of the year, the taxpayer adds back an amount to represent the unsold stock. *s. 70-35(1)*
3. The amount added back at the end of last year is then subtracted as the cost of the stock for the new year. *s. 70-40(1)*
4. The gross proceeds of sale are taxed when the trading stock is sold *s. 6-5*

This process makes sure that the deduction for the cost of trading stock is delayed – it ends up deducted in the year in which the stock is sold; not in the year it was purchased. The process also makes sure that the profit is taxed in the year of sale.

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

+ Statutory income (add back cost of books)	+$5,000
- Deductions (cost of books)	5,000
Taxable income	nil

Year 2

+ Ordinary income (sale books)	$11,250
- Specific deduction (opening cost of books)	- 5,000
Taxable income	$ 6,250

And depreciating assets

Another important class of business asset is depreciating assets. Depreciating assets mean the structural assets that a business uses to carry on its activities which decline in value: 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.

s. 40-30

These rules in Division 40 say that the cost of a depreciating asset is recovered each year by an amount representing the presumed decline in value of the asset during that year. The decline in value is based on the presumed useful life of the asset.

s. 40-25

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 cost of the van is not deductible because it is a capital payment. Instead, the cost is recovered under the depreciation rules.

The truck will have an effective life of 7 years so that $6,000 can be deducted each year. In the first year, Speed Couriers will deduct 91 days' worth of depreciation for the period from 1 April to 30 June $1,500.

- Specific deductions (depreciation)	
$42,000 / 7 x 91 / 365	-$1,500
Taxable income (loss)	-$1,500

And the same rules can also apply to intangible assets like patents and copyrights which also decline in value as the time until they expire runs out.

s. 40-30(2)

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.

- Specific deductions (depreciation)	
$250,000 / 5 x 365 / 365	-$50,000
Taxable income (loss)	-$50,000

And capital assets

Finally, businesses will have other structural assets which are not purchased for re-sale and do not decline in value. A standard example would be the land on which the company operates its factory. The factory building would be depreciable because it deteriorates over time,

but land does not deteriorate and so it is not dealt with under the depreciation rules.

Rather, the structural assets of a business are dealt with in just the same way as the capital assets of anyone else – under the CGT rules discussed above. The cost of the asset is not deducted in the year in which the asset was purchased. Rather, the cost is subtracted from the proceeds of sale in the year that the asset is sold. If there is an overall profit for the year on all the CGT transactions, this is added into statutory income.

s. 8-1(2)

s. 102-5

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.