

**BUSINESS**

SMALL BUSINESS

GUIDE

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**Australian Government**

**Australian Taxation Office**

# Income tax and deductions for small business

How to calculate assessable income and allowable deductions, and lodge an annual income tax return.



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## ! ABOUT THIS GUIDE

You pay income tax on your taxable income, which is your assessable income minus your allowable deductions.

This guide explains how small businesses:

- calculate their assessable income
- calculate their allowable deductions, and
- lodge an annual income tax return.

When we refer to 'you' or 'your business' in this guide we are referring to you as a small business entity, for example, a sole trader, a partnership, a company or a trust that conducts a business.

We use examples of two businesses throughout this guide to show how a sole trader and a company calculate and report their income tax.

You may want to discuss what you include as income and your allowable deductions with your tax adviser.

## ! IMPORTANT – THE MATERIAL IN THIS GUIDE ASSUMES:

- you are in business and not running a not-for-profit activity or merely conducting a hobby, and
- have chosen the structure (sole trader, partnership, company or trust) through which to operate your business.

This guide is designed as a companion booklet to *Tax basics for small business* (NAT 1908). If you are completely new to business, we recommend that you read that publication first as it covers the range of 'getting started' issues. Other publications that are useful for new small businesses include

*Recordkeeping for small business* (NAT 3029)

*GST for small business* (NAT 3014)

*Carrying on a business at or from your home* (NAT 10709)

*PAYG withholding for small business* (NAT 8075) – a guide for employers.

See page 2 for information on how to view these publications online or to order these booklets.

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# HOW TO ACCESS TAX OFFICE PUBLICATIONS

The Tax Office produces a range of publications designed to help small business. Relevant publications are listed in the 'More information' boxes throughout this guide.

## TO VIEW PUBLICATIONS

The quickest way to access our publications (including forms) is by going to our website at [www.ato.gov.au](http://www.ato.gov.au) and typing the name of the publication into the search box.

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- for individuals – **13 28 65** (if you don't yet have an ABN).

This automated service is available 24 hours a day, 7 days a week. It is for people who know the **name** of the publication they want to order and have no other queries.

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- the name of the publication and number of copies required.

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- a name and address for delivery purposes.

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## How to access other useful products

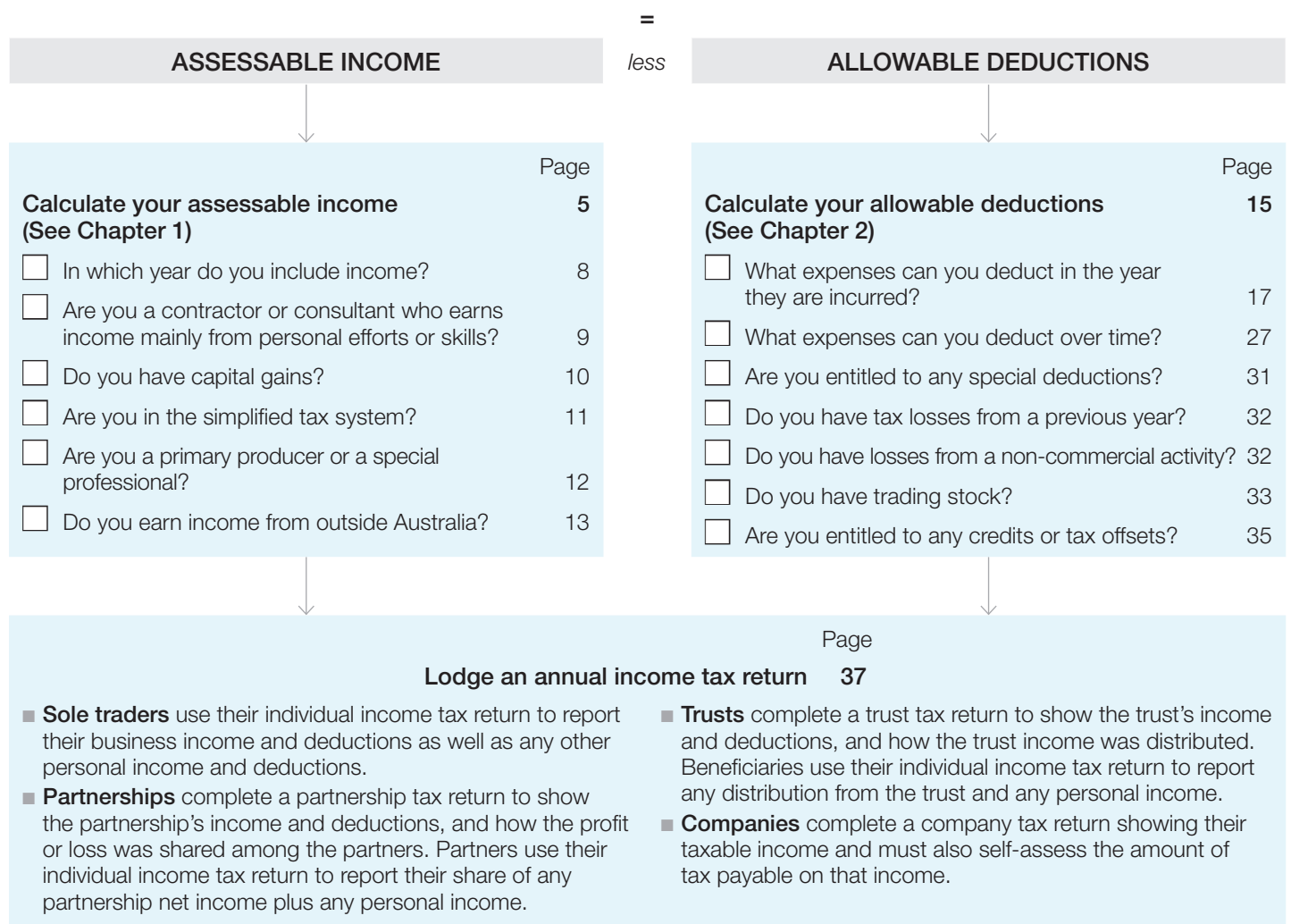
Item	Description	How to access
<b>Business Portal</b>	A secure website that is available 24 hours a day, 7 days a week. You can use the portal to: <ul style="list-style-type: none"> <li>■ lodge activity statements online</li> <li>■ revise previous activity statements</li> <li>■ check your tax accounts</li> <li>■ view and update most of your business registration details, and</li> <li>■ send us secure messages.</li> </ul> You may be eligible for a two-week deferral if you use the Business Portal to lodge and pay your activity statement online (subject to terms and conditions).	You will need an ABN, internet access and minimum computer requirements, and a free ATO digital certificate to identify yourself.  For more information visit <a href="http://www.ato.gov.au/onlineservices">www.ato.gov.au/onlineservices</a>
<b>e-Record</b>	Our free electronic record keeping software designed to help small businesses keep good business records. It is available in both PC and Macintosh versions and is suitable for businesses that operate on a cash basis of accounting, currently keep paper records and have one bank account.	You can download a copy from <a href="http://www.ato.gov.au/erecord">www.ato.gov.au/erecord</a> or phone <b>13 72 26</b> to order a CD-ROM.
<b>Record-keeping evaluation tool</b>	Helps you understand what records you need to keep and evaluate whether your record-keeping practices are adequate. It provides a list of records tailored specifically for your business, a report on how well your business is keeping its records, and suggested improvements where appropriate. You can use it for an existing business or if you are thinking about starting a business.	You can download a free copy from <a href="http://www.ato.gov.au">www.ato.gov.au</a>
<b>e-tax</b>	Allows you to complete your <i>Tax return for individuals</i> electronically.	You can download a copy from <a href="http://www.ato.gov.au">www.ato.gov.au</a>
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<b>Electronic calculators</b>	We also have a range of electronic calculators such as the tax withheld calculator, fringe benefits tax (FBT) car calculator and home office expenses calculator.	You can access the calculators at <a href="http://www.ato.gov.au">www.ato.gov.au</a>

# QUICK GUIDE TO INCOME TAX AND DEDUCTIONS FOR BUSINESS

What you need to do:

- calculate your assessable business income
- calculate your allowable business deductions
- lodge an annual income tax return, and
- keep the necessary records.

## YOUR TAXABLE INCOME



## RECORDS YOU NEED TO KEEP

Keeping appropriate records is an essential part of calculating the assessable income and allowable deductions for your business.

You must keep records of your business transactions for five years after they are prepared, obtained or the transactions completed, whichever occurs later. These records include:

- sales and expense invoices
- sales and expense receipts
- cash register tapes
- credit card statements
- bank deposit books and cheque books
- bank account statements, and
- records relating to employees, such as your copies of tax file number declarations, wages books and time sheets.

You may also need to keep the following specific income tax records for each financial year:

- motor vehicle expenses, including logbooks
- debtors and creditors lists
- records of depreciating assets
- stocktake records, and
- records relating to assets for capital gains tax purposes.

If you use any business purchases for private use, you must have records that show how you calculated any private use component.

You can store records in either paper or electronic form. However, all your business records should be readily accessible and available in English.

You may want to talk to a bookkeeper about setting up a good record keeping system to help keep track of your business records.

### MORE INFORMATION

- *Record keeping for small business (NAT 3029)*

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# CALCULATE YOUR ASSESSABLE INCOME

# 01

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## HOW TO USE THIS SECTION

Work out what business income you include in your assessable income. Then work out if your taxable income is affected by whether:

- you account on a cash or accruals basis (see page 8)
- you receive income from contracting or consulting (see page 9)
- you have any net capital gains (see page 10)
- you are in the simplified tax system (see page 11)
- you can access the small business concessions (see page 11)
- you are a primary producer or a special professional (see page 12)
- you have income from outside Australia (see page 13).

## WHAT BUSINESS INCOME DO YOU INCLUDE IN YOUR ASSESSABLE INCOME?

Income that is subject to tax is called assessable income. When calculating assessable income for your business, you generally include the amounts listed in the following table.

- amounts received in the ordinary course of carrying on your business, for example, from selling trading stock or providing services
- amounts received from isolated transactions outside the ordinary course of your business, if you intend to make a profit
- amounts received to replace something that would have had the character of income, for example, a payment for loss of earnings
- amounts received from the sale of depreciating assets – if in excess of their written down value
- amounts received as compensation, such as workers' compensation or payments for trading stock losses, interruption to business or cancellation of contracts
- amounts received from fuel tax credits
- amounts recovered for a bad debt for which you have received a tax deduction
- commission income
- dividends and franking credits earned on business investments
- fees for services
- where fringe benefits are provided, most employee contributions will be considered assessable income
- grants you receive, for example, under the new apprenticeship incentives program
- incentive payments, for example, a cash payment to enter into a lease of business premises
- income earned outside Australia (if you're an Australian resident for tax purposes)
- interest on business investments, and interest on overpayment or early payment of tax
- lease payments, including hire charges for plant
- market value of any transactions not involving money, for example, barter transactions
- net capital gains from the sale of certain capital assets, such as land or buildings
- payments for selling know-how
- prizes or awards related to your business, for example, a cash prize for being the best business in your region
- profit on disposal of leased cars and other equipment
- profit on the sale or lease of a business
- refunds of rates, taxes and other items
- rental income from property owned by the business
- royalties, for example, for the use of a patent
- subsidies for carrying on a business
- value of goods taken from trading stock for your own private use
- value of trading stock on hand at the end of the income year if it is more than at the start of the year

### ! GROSS EARNINGS VERSUS GROSS PROFIT

Make sure you include your gross earnings or proceeds, not your gross profit.

**WHAT AMOUNTS DON'T YOU INCLUDE?**

Don't include the following in your assessable income because these amounts are not assessable:

- amounts earned from a hobby
- gifts or amounts bequeathed to you
- lottery winnings
- prizes, as long as they're not related to your business
- betting and gambling wins (unless you carry on a business of betting or gambling)
- GST you are liable for
- any money you've borrowed
- maintenance and child support payments, and
- exempt government pensions, allowances and payments, such as family tax benefit payments.

**! GST AMOUNTS**

If you are registered for GST and you have charged GST to your clients, you do not include the amount of GST you collected in your gross earnings figure. The GST you collected is not your income and you are required to send it on to the Tax Office.

**! CAPITAL ASSETS**

Remember, if you make a taxable sale (supply) of a capital asset, such as a computer, or a hairdryer from your salon, you are liable for GST on the sale and will be required to remit it to the Tax Office. You may also have to include the net gain or loss in your tax return.

**GOODS TAKEN FROM STOCK FOR YOUR PRIVATE USE**

Where you take an item of trading stock for your private use, it is treated as if it had been sold and you have to include the value of the item in your assessable income.

The table on this page shows the amounts the Commissioner will accept as estimates of the value of goods taken from trading stock for private use by taxpayers in selected industries for 2006–07. The amounts are updated annually.

Alternatively, you can keep records of the actual value of goods you take from trading stock for your own use and report that amount.

Practice Statement PS LA 2004/3 (GA) sets out the approach the Commissioner will accept for valuing trading stock that is taken for private use by sole traders or partners in a partnership.

**Value of goods taken for own use for 2006–07**

Type of business	Amount (excluding GST) for adult/child over 16 years (\$)	Amount (excluding GST) for child 4–16 years (\$)
Bakery	980	490
Butcher	660	330
Licensed restaurant/cafe	3,380	1,340
Unlicensed restaurant/cafe	2,680	1,340
Caterer	2,930	1,465
Delicatessen	2,680	1,340
Fruiterer/greengrocer	710	355
Takeaway food shop	2,550	1,275
Mixed business (including milk bar, general store and convenience store)	3,220	1,610

**> MORE INFORMATION**

There is an explanation of how the amounts are determined in Taxation Determination TD 2006/55 *Income tax: value of goods taken from stock for private use for the 2006–2007 income year*.

## SEPARATING YOUR BUSINESS AND OTHER INCOME

If you also have other assessable income, such as salary and wages, or interest, dividends and rental income from personal investments, you need to record it separately for accounting purposes. How you treat your business and non-business income depends on your business structure, as shown in the following table.

Structure	How to treat non-business income
<b>Sole trader</b>	Your assessable income includes all your business and non-business income and must be shown on your personal tax return. An example is shown on page 14.
<b>Partner in a partnership/beneficiary of a trust</b>	Your assessable income includes any distribution of income to you (from a partnership or trust) as well as your non-business income and must be shown on your personal tax return.
<b>Company</b>	The income earned by the company is shown by the company in its own tax return. If the company has paid you wages, director's fees or dividends, these must be included together with any other assessable income shown on your personal tax return.

### ! SEPARATE BUSINESS BANK ACCOUNT

It's a good idea to have a separate business bank account. This means you can keep your business income separate from any other assessable income, such as dividends from shares or income from a rental property. If you have a company or trust, it is a legal requirement to have a separate account.

## IN WHICH YEAR DO YOU INCLUDE INCOME?

The amounts you include as assessable income in any particular income year depend on how you account for your taxable income, as shown in the following table.

If you account on...	You include in your assessable income...
a <b>cash basis</b>	only income received in that income year
an <b>accruals basis</b>	all amounts you have issued an invoice for in the income year, even if you haven't received the payment. For example, if you sent out an invoice for \$724 in June but weren't paid by the end of the income year, you'd include the \$724 (less any GST) in your assessable income for that year.

## ARE YOU A CONTRACTOR OR CONSULTANT?

If your business income is mainly payment for your personal efforts or skills (called personal services income), this may affect what amounts you have to include in your assessable income. Income such as consultancy fees and commissions may be personal services income.

Income is not personal services income if it is mainly:

- for supplying or selling goods
- for granting a right to use property
- generated by an income producing asset, such as income derived from the use of a truck, or
- generated by a business structure, for example, a large accounting firm.

Even if you carry on a business through a company, partnership or trust and the income is paid to the company, partnership or trust and not directly to you, you may have to include personal services income in your individual assessable income and be taxed at your individual tax rate.

### WHERE YOU'RE CONSIDERED TO BE CONDUCTING A PERSONAL SERVICES BUSINESS

Your personal services income is *not* affected by these rules if you're conducting a personal services business, either on your own or through a company, partnership or trust. You qualify as a personal services business if:

- you meet the results test
- less than 80% of your personal services income in an income year comes from each client and you meet one of the other three tests (the unrelated clients test, employment test or business premises test), or
- you obtain a determination from the Tax Office confirming that you are a personal services business.

Even if you are a personal services business, the general anti-avoidance tax rules may apply where the dominant purpose is to reduce your income tax liability (for example, by income splitting).

### WHERE YOU'RE NOT CONSIDERED TO BE CONDUCTING A PERSONAL SERVICES BUSINESS

Where you are a sole trader and don't qualify as a personal services business, there are limits on the deductions you can claim in relation to your personal services income (see page 25).

Where your company, partnership or trust is receiving your personal services income, does not qualify as a personal services business and does not promptly pay the income to you as salary or wages:

- this income (less allowable deductions) is regarded as your income for tax purposes and must be included in your individual assessable income as attributed personal services income
- your company, partnership or trust has to calculate the amount of personal services income to be attributed to you and it may have additional PAYG withholding obligations in relation to the attributed income amount, and
- there are limits on the deductions that can be claimed in relation to this income. For more information about how deductions are affected, see page 25.

If your company, partnership or trust makes a net personal services income loss, only you personally can deduct the loss (see page 25).

#### ➤ MORE INFORMATION

- *Alienation of personal services income: contractors and consultants* (NAT 4788)
- *Alienation of personal services income: additional pay as you go withholding obligations* (NAT 3517)

## HAVE YOU MADE A CAPITAL GAIN?

There is no separate capital gains tax. However, making a capital gain affects your income tax liability because you have to include any net capital gain you made for the income year in your assessable income.

Your net capital gain is the total of your capital gains (not just those you made from your business) for the year, reduced by your total capital losses for the year or earlier years, and any relevant concessions.

As a small business operator, one of the most common ways of making a capital gain or loss is if you sell one of your business assets – for example, your business premises or goodwill. If you conduct your business through a company or trust, you may make a capital gain or loss if you sell your shares or trust interest.

If you have a net capital loss at the end of the income year, you can't use it to reduce other income. Instead, you can carry it forward until the next year you have a capital gain and offset it against that gain.

If you are:

- an individual or trust and hold an asset for at least 12 months before disposing of it, you qualify for the 50% discount. This means you include only 50% of the capital gain in your assessable income
- a company, you are not entitled to a discount
- a partnership, the partnership doesn't pay tax on capital gains – instead, the individual partners include their share of the capital gain when calculating their net capital gain to include in their assessable income.

### CAPITAL GAINS TAX CONCESSIONS FOR SMALL BUSINESS

There are four capital gains tax concessions that reduce capital gains made by eligible small business operators when they dispose of business assets or their interest in an entity that carries on the business. The concessions are subject to certain conditions, but basically they are:

- 1 the 15-year exemption, which provides a full exemption from a capital gain on the disposal of business assets held continuously for 15 years, where the relevant individual is aged 55 or over and retiring, or is permanently disabled
- 2 the 50% active asset exemption, available to companies, trusts and individuals, which reduces the capital gain by 50%
- 3 the small business retirement exemption, which is available to individuals and, provided certain conditions are met, companies and trusts. It provides an exemption from tax on capital gains to individuals and the capital gains tax concessional stakeholders of the companies and trusts up to a lifetime limit of \$500,000 for each stakeholder. If the relevant individual is under 55 years of age, the amount must be paid into a superannuation (or similar) fund, and
- 4 the small business rollover, which defers a capital gain, provided a replacement asset is acquired.

! Changes from the 2007–08 income year have made it easier to access these concessions (see Small business concessions on page 11). More information is available at [www.ato.gov.au/SBconcessions](http://www.ato.gov.au/SBconcessions)

### WHEN DOES THE CAPITAL GAIN OR LOSS OCCUR?

The tax law specifies when a capital gain or loss occurs for each capital gains tax event. For example, if there is a contract for the sale of an asset, the capital gain or loss occurs when the contract is entered into (not when the contract is settled).

### EXEMPTIONS

Some assets are exempt from capital gains tax. These include:

- assets acquired before 20 September 1985
- your main residence (except if you are carrying on your business from home)
- trading stock, and
- cars and motorcycles.

Capital gains tax generally doesn't apply to depreciating assets (such as tools or motor vehicles) used in your business.

### ! KEEPING RECORDS FOR CAPITAL GAINS TAX

You must keep records of any act, transaction, event or circumstance that might reasonably be expected to be relevant to working out a capital gain or loss, even if the capital gain or capital loss hasn't yet happened. Otherwise, you may incur extra expense to reconstruct the information later. Sometimes gaps in your record keeping result in you paying more tax.

### > MORE INFORMATION

- *Guide to capital gains tax* (NAT 4151)
- *Guide to capital gains tax concessions for small business* (NAT 8384)

## HAVE YOU JOINED THE SIMPLIFIED TAX SYSTEM?

**!** The simplified tax system (STS) ceases to exist after the 2006–07 income tax year. You will still be able to access the individual STS concessions if your turnover is less than \$2 million (See Small business concessions on this page).

The simplified tax system is an alternative method of determining taxable income for eligible small businesses with straightforward financial affairs. Joining the simplified tax system may affect what amount you include in your assessable income in an income year.

The simplified tax system began on 1 July 2001 and has two main elements:

- 1 simplified trading stock rules** whereby businesses only need to conduct a stocktake and account for changes in the value of trading stock in limited circumstances, and
- 2 simpler capital allowances (depreciation) rules** whereby most depreciating assets costing less than \$1,000 each are written off immediately. Most other depreciating assets are pooled and deducted at a rate of either 30% or 5%, depending on their effective life.

In addition, taxpayers in the simplified tax system can claim an immediate deduction for certain prepaid expenses.

### ➤ MORE INFORMATION

*Deductions for prepaid expenses* (NAT 4170) explains how prepayment rules apply to small businesses.

For income years up to and including 2004–05, taxpayers in the simplified tax system also had to use a specific accounting method (the ‘STS accounting method’).

From the first income year starting on or after 1 July 2005, this is no longer the case. If you are in the simplified tax system, you can now calculate your taxable income using the accounting method that is most appropriate to your circumstances. However, a business that was already a simplified tax system taxpayer in the income year that started immediately before 1 July 2005 may continue to use the STS accounting method for as long as it remains in the simplified tax system.

If you do join the simplified tax system, you must use both the simplified trading stock rules and simplified capital allowances (depreciation) rules where they apply.

Broadly, you are eligible to join for an income year if:

- you carry on a business in that year
- your simplified tax system average turnover for that year is less than \$1 million (excluding GST), and
- you have depreciating assets with a total adjustable value of less than \$3 million at the end of that year.

If you are grouped with any other entities under the simplified tax system grouping rules, their turnover and depreciating assets must be taken into account in determining your eligibility.

Participation is voluntary. If you want to join, all you have to do is complete the simplified tax system election on your income tax return for that year. You then remain in the simplified tax system until you notify the Tax Office, or until your business is no longer eligible.

**!** If you leave the simplified tax system because you are no longer eligible, you can rejoin in the year you again become eligible, up to the 2006–07 income year.

Taxpayers who chose to leave the simplified tax system in an income year beginning before 1 July 2005 can rejoin in the 2005–06 or 2006–07 income years.

Taxpayers who chose to leave the simplified tax system in the 2005–06 income year cannot re-enter the system in the 2006–07 year.

### ➤ MORE INFORMATION

- *What is the simplified tax system?* (NAT 3956)
- *The simplified tax system – a guide for tax agents and small businesses* (NAT 6459)

## SMALL BUSINESS CONCESSIONS

Applicable from the 2007–08 income year, small businesses with an annual turnover of less than \$2 million may be eligible to pick and choose from a range of concessions, including the CGT concessions and the STS concessions. The following concessions may affect your assessable income:

- the CGT concessions for small business
- the simplified trading stock rules, and
- the simpler depreciation rules.

Choosing one of these concessions will affect what amounts you include in your assessable income.

### ➤ MORE INFORMATION

[www.ato.gov.au/SBconcessions](http://www.ato.gov.au/SBconcessions)

## ARE YOU A PRIMARY PRODUCER OR A SPECIAL PROFESSIONAL?

If you're a primary producer or a special professional, there are special tax concessions that may affect what amounts you include in your assessable income in an income year.

### PRIMARY PRODUCERS

To use the special concessions for primary producers, you must meet the Tax Office's definition of 'carrying on a business of primary production'. Some of the factors we may consider in deciding whether you're a primary producer include:

- the size or scale of your activity
- whether your activity is profitable or, if not, whether you genuinely believe the activity will be profitable, and
- whether your activity is carried on in the same manner as that type of activity is ordinarily carried on.

Examples of primary production activities include farming, fishing and aquaculture.

#### ➤ MORE INFORMATION

There is more information about what constitutes a primary production business in Taxation Ruling TR 97/11 *Am I carrying on a business of primary production?*

If you're a primary producer, you have to include in your assessable income:

- any expenditure you recoup on primary production depreciating assets. Where the expenditure is deductible over more than one income year, there are special rules to calculate the amount to be included in assessable income in the year you recoup it and in later income years, and
- any withdrawals of farm management deposits to the extent that you have previously claimed them as a deduction.

Special tax concessions that may affect what primary production income you include in your assessable income in an income year include the following.

- Under certain circumstances, you can choose to spread profit from the forced disposal or death of livestock over five years (or 10 years if the disposal was related to controlling bovine tuberculosis). Alternatively, you can defer the profit and use it to reduce the cost of replacement stock in the disposal year or in any of the next five income years. You include any unused part of the profit in your assessable income in the fifth income year.
- Where you have an assessable insurance recovery for loss of livestock or for loss by fire of trees that were assets of a primary production business carried on in Australia, you can choose to include the amount in assessable income in equal instalments over five years.

- Where you sell two wool clips in an income year because of an early shearing caused by drought, fire or flood, you can choose to defer the profit on the sale of the clip from the advanced shearing to the next year.
- You may be able to average your income over a number of years (see below).

The special concessions also affect when you have to pay your income tax as you may be able to make your PAYG payments in two instalments each year, instead of four.

The non-commercial business losses may also not apply to primary producers (see page 31).

### Income averaging

If you're a primary producer, tax averaging enables you to even out your income and tax payable over a maximum of five years to allow for good and bad years. The averaging can commence only when your income in the current year is not less than your income in the immediate preceding year.

When your average income is:

- less than your taxable income (excluding capital gains), you may receive an averaging tax offset, and
- more than your taxable income (excluding capital gains), you may be required to pay a complementary amount of tax, which is included in the tax assessed.

You don't need to register to be a primary producer. Averaging of income will apply automatically when your primary production income is shown at the primary production item on your tax return, unless you notify the Tax Office in writing. If you choose to opt out of the averaging system, you can't reverse your decision.

### Farm management deposits scheme

The farm management deposits scheme can help primary producers deal with uneven income streams. The scheme allows you to claim a deduction for farm management deposits made in the year you deposit.

If you withdraw a farm management deposit, you have to include the amount of the deduction previously allowed in your assessable income in the year you withdraw it.

#### ➤ MORE INFORMATION

For more information about primary production income, visit [www.ato.gov.au/primaryproducers](http://www.ato.gov.au/primaryproducers) or see:

- *Information for primary producers* (NAT 1712)
- *Tax averaging for primary producers* (NAT 8914)
- *Farm management deposits scheme* (NAT 8776)

**SPECIAL PROFESSIONALS**

If you're one of the following 'special professionals', in certain circumstances you may also qualify for income averaging (see the previous page):

- artist
- author
- composer
- computer programmer
- inventor
- performing artist
- production associate, or
- sportsperson.

You may also be able to make your PAYG payments in two instalments each year, instead of four.

**➤ MORE INFORMATION**

You can find information about when a person is considered to be carrying on a professional arts business in Taxation Ruling TR 2005/1 *Carrying on a business as a professional artist*, or see:

- *Income averaging for special professionals 2005* (NAT 2475)
- *PAYG instalments for primary producers and special professionals* (NAT 4352)

## DO YOU EARN INCOME OUTSIDE AUSTRALIA?

If you are an Australian resident, you include income from all sources in your assessable income, regardless of whether you earned the income in Australia or in another country.

You must:

- include your assessable foreign income even if tax was taken out in the country from which the income came. In some cases, foreign income that is exempt from Australian tax may still be taken into account to work out the amount of tax you have to pay on your other income, and
- convert (translate) your income and deductions to Australian dollars.

Deductions are generally converted at the exchange rate when you incur or pay the deductible expense, whichever occurs first.

Income is generally converted at the exchange rate that applies at the earlier of when you derived or received it.

Where an average exchange rate is a reasonable approximation of the exchange rates you otherwise would have had to use, you may use an average exchange rate to translate both your income and deductions into Australian dollars.

You receive a foreign tax credit in your income tax assessment for any creditable taxes you paid in another country on income you earned there (see page 35).

**➤ MORE INFORMATION**

- *Forex – the general translation rule* (NAT 9339)
- *Forex – general information on average rates* (NAT 13434)
- *Foreign source income – other than employment, pensions and annuities* (NAT 9382)

**Example of calculation of assessable income****Sole trader**

During the income year Bill, a sole trader, has received the following:

*Assessable income*

Sale of toys (excluding GST)	\$110,405
Interest on business bank account	\$45
<b>Total assessable business income</b>	<b>\$110,450</b>

*Other assessable income*

Income from rental property	\$13,000
Franked dividends	\$980
<b>Total assessable income</b>	<b>\$124,430</b>

*Non-assessable income*

Hobby income (home-baked bread)	\$1,200
Lotto win	\$3,280

In calculating his assessable income Bill doesn't include the \$1,200 from the sale of his home-baked bread and the \$3,280 he won in lotto as these amounts are not assessable.

While the \$13,000 from his rental property and the \$980 from franked dividends are not business income, as a sole trader Bill must include all these amounts in his assessable income on his tax return (however, he records the amounts separately for accounting purposes).

Bill is not affected by the personal services income rules as he doesn't earn income from providing his personal services and skills.

He did not make any capital gains, is not entitled to any of the special concessions for primary producers and special professionals, nor did he earn any income from outside of Australia.

His total assessable income is therefore \$124,430.

Remember: Bill is not taxed on his income, but on his taxable income, which is calculated as all his assessable income less his allowable deductions.

**Company**

During the income year Maria's company has received the following income:

*Assessable income*

Graphic design services	\$90,710 (excluding GST)
Interest	\$748
<b>Total assessable income</b>	<b>\$91,458</b>

The company also received \$480 from the sale of a computer and printer which had been used 100% for business. However, this is not assessable income because the company is in the simplified tax system and so uses the simpler depreciation rules that allow easier depreciation calculations. It then uses the \$480 to reduce the closing balance of its pool of depreciating assets. Note: for the 2007–08 income year, the company can choose to use the simpler depreciation rules without having to be in the simplified tax system (see page 11).

The company has a number of unrelated clients and it does not earn more than 80% of the graphic design services income from any single client. The income is mainly a reward for Maria's personal efforts or skills.

The company isn't affected by the personal services income rules because it is conducting a personal services business.

Maria also received \$18,540 in dividends from her personal investment portfolio. However, this is not included in her company's tax return as it is her personal income and is quite separate from her company's income.

If Maria was paid wages or dividends by her company, these amounts would also need to be declared by her on her tax return.

# CALCULATE YOUR ALLOWABLE DEDUCTIONS

# 02

## HOW TO USE THIS SECTION

Work out what you can do to reduce your assessable income:

- you can generally claim a deduction for expenses in the same income year they are incurred for the everyday running of your business (see page 17)
- you can claim a deduction over a number of years for the decline in value of capital assets such as machinery, tools and computers (see page 27)
- if you have personal services income you may be limited in the deductions you can claim (see page 25)
- you may be entitled to special deductions if you're a primary producer or involved in research and development (see page 31)
- you can generally offset tax losses carried forward from previous years (see page 32)
- only in certain circumstances can you offset losses from a non-commercial activity against other income (see page 33)
- if the value of your trading stock at the end of the year is less than at the beginning of the year, you can claim a deduction for the difference (see page 33)
- if you are in the simplified tax system this may affect what you can claim as deductions in an income year (see page 34)
- if you choose to use one or more of the small business concessions this may affect what you can claim as deductions in an income year (see page 34)
- you may be entitled to certain credits and tax offsets on your income (see page 35).

## WHAT EXPENSES CAN YOU DEDUCT?

If you run a business, you know only too well that there are expenses involved in earning your income. These expenses are called 'losses and outgoings' and you may be able to use them to reduce your assessable income (and therefore the amount of tax you pay).

For deduction purposes, expenses can be divided into three main groups:

- expenses you can deduct in the income year in which they are incurred
- expenses you can deduct over a number of years, and
- expenses you can never deduct.

### EXPENSES YOU CAN DEDUCT IN THE INCOME YEAR IN WHICH THEY ARE INCURRED

Working or operating expenses that relate to the everyday running of your business, for example, office stationery, rent of office premises, salary and wages, are called revenue expenses. You can generally claim a deduction for these expenses in the income year in which they are incurred.

Some expenses may not be deductible if you earn personal services income and are not a personal services business (see page 25).

### EXPENSES YOU CAN DEDUCT OVER A NUMBER OF YEARS

The cost of assets that have a longer life (usually more than the income year in which they are purchased) and relate more to establishing, replacing, enlarging or improving the structure of your business are called capital expenses. You have a capital expense when you buy capital assets such as computers and office furniture.

Generally, you can't deduct the total expense for a capital asset in the income year in which you incur the expense. Instead, you can deduct an amount for the decline in value of the asset each year over a number of years. These assets are called depreciating assets.

Some capital assets, such as land and the goodwill in a business, may not qualify for depreciation but may give rise to a capital gain or capital loss when sold. However, there is no capital gains tax on depreciating assets used solely in your business or depreciating assets that have been deducted under the simpler depreciation rules.

If a depreciating asset has also been used for private purposes, capital gains tax applies to the private portion of any capital gain or loss.

### EXPENSES YOU CAN NEVER DEDUCT

You can't deduct:

- private or domestic expenses, for example, childcare fees, clothes for your family
- expenses relating to income that is not taxable, for example, money you earn from a hobby, or
- expenses that are specifically non-deductible under the tax law, for example, parking fines.

### NON-BUSINESS OR PART-YEAR USE

You can't claim a deduction for an expense relating solely to private use. If an expense relates to both business and private use, you have to work out what proportion of the expense is related to your business and claim only that amount.

This applies also to deductions for the decline in value of depreciating assets. You don't get a deduction for the decline in value of a depreciating asset that is used solely for private purposes. If an asset is used partly for private purposes and partly for business, you can deduct an amount only for the decline in value of the business use proportion of the asset.

Where you use an item in your business for only part of a year, you may not be able to claim a deduction for the full amount.

### WHEN DO YOU INCUR AN EXPENSE?

You can claim a deduction for revenue expenses incurred by your business in an income year, as follows:

- if you account on a cash basis, you incur an expense when you actually make a payment, and
- if you account on an accruals basis, you incur an expense once you receive an invoice. This means you can claim a deduction if you have the invoice in the income year, even if you haven't paid it.

While deductions must generally be incurred in the income year, there are different rules for prepayments.

An immediate deduction may not be allowed if expenditure incurred in carrying on a business is for something that is not wholly provided within 12 months.

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

### Concession for prepayments

There are different rules for small business taxpayers in the simplified tax system or, for the 2007–08 income year and later years, for those with an annual turnover of less than \$2 million (see page 11). Eligible taxpayers can claim an immediate deduction for prepaid business expenses where the payment is for a period of service of less than 12 months that ends in the next income year.

#### ➤ INFORMATION

*Deductions for prepaid expenses* (NAT 4170) explains how prepayment rules apply to small businesses.

## WHAT EXPENSES CAN YOU GENERALLY DEDUCT IN THE YEAR THEY ARE INCURRED?

You can claim a deduction for most revenue expenses necessary for the everyday running of your business, in the same income year in which you incur the expenses. The following list shows some expenses that are generally deductible.

**!** An expense must be directly related to earning assessable income to be deductible. There may also be limits on the amount that can be claimed for a specific deduction.

Primary producers can also claim a deduction for a range of primary production expenses. For information about what primary production expenses are deductible, see *Information for primary producers* (NAT 1712).

- advertising/sponsorship expenses
- bad debts
- bank fees and charges
- business motor vehicle expenses
- business operating expenses
- business travel expenses
- clothing (corporate wardrobes and uniforms, occupation-specific clothing, protective clothing)
- education, technical or professional qualification expenses
- electricity costs
- fringe benefits – cost of any fringe benefit provided and fringe benefits tax on the benefit
- glasses, sunhats and sunscreen
- home office expenses, where the home is used as business premises
- insurance premiums, including payment of workers' compensation, accident or disability insurance, fire, burglary, professional indemnity, public risk, motor vehicle, loss of profits
- interest on money borrowed for income tax, employer superannuation contributions, late payment or lodgment of tax, to produce assessable income or purchase income producing assets
- land tax on business premises
- legal expenses, for example, incurred in defending future income earning, borrowing money, discharging a mortgage, or obtaining tax advice
- losses from previous year
- luxury car lease expenses
- office stationery
- operating a commercial website, for example, site maintenance, content updating, internet service provider fees
- parking fees
- payments – advertising or public relations
- phone expenses
- rates on business premises
- registered tax agent/accountant fees
- rent or lease of business premises
- repairs and maintenance of income-producing property
- replacement of income producing property costing \$300 or less
- salary or wages, bonuses or allowances paid
- software
- subscriptions to business or professional journals, information services, newspapers and magazines
- sunglasses, sunhats and sunscreen where your activities entail working outside
- superannuation contributions, up to age-based limits
- tax preparation costs – income tax, GST
- tender costs (even if the tender is unsuccessful)
- trading stock, including delivery charges
- transport and freight
- travel expenses related to relocation of employees
- union dues and periodical subscriptions to trade, business or professional associations
- water rates on business premises

### **!** GST AND INCOME TAX DEDUCTIONS

You can't claim an income tax deduction for the GST included in the price of something you purchased if you are entitled to claim it as a GST credit on your activity statement.

**SOME COMMON DEDUCTIONS**

Here is more detailed information about some common deductions for business expenses.

**Expenses related to a home work area**

If you do work relating to your business at home, you may be able to claim a deduction for:

- **occupancy expenses**, which are expenses associated with occupying your home, namely, rent, mortgage interest, rates, land taxes and house insurance premiums, and
- **running expenses**, which include phone rental and business calls, internet fees, decline in value of office furniture and equipment, and any additional heating, cooling, lighting and cleaning expenses.

Whether you can claim both running expenses and occupancy expenses depends on the nature of your home work area.

Basically, there are three ways you can operate at home:

- home is your place of business and you have an area set aside exclusively for business activities
- home is not your place of business but you have an area set aside exclusively for business activities, and
- you work at home but have no home work area. You work when others are not present in a living area or garage but your home is not your place of business and you don't have an area set aside primarily or exclusively for business activities.

Where your home is your place of business and you have an area set aside exclusively for business activities, you may be able to claim both running and occupancy expenses. But if you carry on your business elsewhere and also do some work at home, you can't claim occupancy expenses, regardless of whether or not you have a home work area set aside. The table below summarises the allowable deductions for the three ways you can work at home.

**Expenses you may be able to claim for working at home**

What you can claim	How you operate your business		
	Home is your place of business and you have a home work area	Home is not your place of business but you have a home work area	You work at home but don't have a home work area
<b>Occupancy expenses*</b> Cost of owning or renting the house (rent, mortgage interest, insurance, rates)	Yes	No	No
<b>Running expenses</b> Cost of using a room (utilities such as gas and electricity)	Yes	Yes	Yes
Business phone costs	Yes	Yes	Yes
Decline in value of office plant and equipment (eg, desks, chairs, computers)	Yes	Yes	Yes
Decline in value of curtains, carpets, light fittings etc.	Yes	Yes	No

\* If your income includes personal services income, you may not be able to claim a deduction for occupancy expenses (see page 25).

You can keep a diary to work out how much of your running expenses relate to working at home. All you have to do to substantiate your claims is to keep a diary during a representative period of about four weeks each income year.

Alternatively, for home work area expenses for heating, cooling, lighting and the decline in value of furniture, you can claim a fixed rate of 26 cents an hour instead of keeping details of actual expenses.

**➤ MORE INFORMATION**

- *Carrying on a business at or from your home* (NAT 10709)
- *Taxation Ruling TR 93/30 Income tax: deductions for home office expenses*
- *Practice Statement PS LA 2001/6 Home office expenses*

**⚠ CAPITAL GAINS TAX AND YOUR HOME**

If your home is your place of business, there may be capital gains tax implications when you sell your home.

See:

- *Guide to capital gains tax* (NAT 4151)
- *Main residence exemption – the effect of using your home to produce income* (NAT 10255)

**Plant and equipment**

If you use plant and equipment solely for business purposes, you can claim the full decline in value (depreciation) deduction. But if these are also partly used for non-business purposes, you have to reduce the decline in value deduction by an amount that reflects this non-business use.

If you are using the simpler depreciation rules when calculating the decline in value of depreciating assets, you can claim an immediate deduction for most depreciating plant and equipment costing less than \$1,000 each.

**Phones**

If you use a phone exclusively for business, you can claim a deduction for the phone rental and calls, but not for installation costs.

If you use a phone for both business and private calls, you can claim a deduction for business calls and part of the rental costs. You use the following formula to calculate the percentage of phone rental expenses you can claim:

$$\frac{\text{Number of business calls made and received} \times 100}{\text{Number of total calls}}$$

You can identify business calls from an itemised phone account. If you don't have an itemised account, you can keep a record for a representative four-week period to establish a pattern of business calls for the entire year, provided you have a regular pattern of use throughout the year.

**Motor vehicle expenses**

The rules for claiming expenses associated with running a motor vehicle for your business vary according to your business structure.

If your income includes personal services income, you may be able to claim a deduction for only one car used for private purposes (see page 25).

**Company**

If you run your business through a company, you can claim a full deduction for expenses involved in running a motor vehicle owned or leased by your company. If the vehicle is also used for private purposes you may have to pay fringe benefits tax (but this is also a deduction). There is a fringe benefit tax (FBT) car calculator available at [www.ato.gov.au](http://www.ato.gov.au)

**Sole trader or partnership**

If you operate as a sole trader, or a partnership that includes at least one individual, there are special substantiation rules about claims for motor vehicle expenses. You must own, lease or hire the vehicle under a hire purchase agreement, and it must have a carrying capacity of less than one tonne or fewer than nine passengers (this may include certain panel vans and utility trucks).

There are two main categories of vehicles:

- Business purpose vehicles, including:
  - larger trucks or vans, and
  - smaller vehicles (for example, utes, wagons or panel vans) that have been heavily modified for business use, or where private use is restricted to home-to-work travel and very minor other use.

You usually get a deduction for all business purpose vehicle running costs.

- Other vehicles, including:
  - ordinary cars, station wagons or four-wheel drives
  - most other vehicles designed to carry less than one tonne or fewer than nine passengers, and
  - utes and panel vans where private use is not strictly limited.

For these other vehicles, you have a choice of four methods for working out your deduction, each providing a different way of treating the private use of vehicles.

**! TRAVELLING BETWEEN HOME AND WORK**

Except in certain limited situations, travel between your home and place of business is not deductible. However, if your home is your place of business, you can claim the cost of trips between your home and other places, provided the cost is incurred in the course of carrying on your business.

In choosing a claim method:

- choose the method that will give you the best result
- you can use different methods for different vehicles
- you can change methods from year to year, and
- remember to keep appropriate records.

The claim methods available to you depend on whether you travel more or less than 5,000 business kilometres a year in the vehicle.

5,000 business km or less	More than 5,000 business km
---------------------------	-----------------------------

- |  |   |
|--|---|
| <ul style="list-style-type: none"> <li>■ cents-per-kilometre method</li> <li>■ logbook method</li> </ul> | <ul style="list-style-type: none"> <li>■ cents-per-kilometre method (claim limited to 5,000 km)</li> <li>■ logbook method</li> <li>■ 1/3 of actual expenses method</li> <li>■ 12% of original value method</li> </ul> |
|--|---|

**METHOD 1 – Cents per kilometre**

- Your claim is based on a set rate for each business kilometre.
- You can claim a maximum of 5,000 business kilometres.
- You do not need written evidence.

You can use this method to claim up to a maximum of 5,000 business kilometres per car even if you have travelled more than 5,000 business kilometres. For example, if you travelled 5,085 business kilometres, you can only claim the cost of travelling 5,000 kilometres with this method. You cannot claim for the extra 85 kilometres.

You do not need written evidence but you may need to be able to show how you worked out your business kilometres.

You multiply the total business kilometres travelled (a maximum of 5,000 for each car) by the number of cents allowed for your car’s engine capacity (from the Rates per business kilometre table below). Divide your answer by 100 to work out the amount in dollars that you can claim.

The figure you have calculated takes into account all the running expenses; you can not make a separate claim for decline in value.

The rates are adjusted each year and are contained in *TaxPack* (NAT 0976) and at [www.ato.gov.au](http://www.ato.gov.au)

Here are the rates per business kilometre for the year ended 30 June 2007:

Ordinary car – engine capacity	Rotary engine car – engine capacity	Cents per kilometre
1600cc (1.6 litre) or less	800cc (0.8 litre) or less	58 cents
1601–2600cc (1.601–2.6 litre)	801–1300cc (0.801–1.3 litre)	69 cents
2601cc (2.601 litre) and over	1301cc (1.301 litre) and over	70 cents

**EXAMPLE**

Jane used her car for 3000 business kilometres during the year ended 30 June 2006. Her car had a 1800cc engine (1.8litre).

Her claim was therefore calculated as  
 3000kms × 69 cents per km = 207,000 cents  
 207,000 cents ÷ 100 = \$2070 claim for motor vehicle expenses.

**METHOD 2 – 12% of original value**

- Your claim is based on 12% of the original value of your car. If you bought the car, you can claim 12% of the cost. If you leased the car, you can claim 12% of its market value at the time that you first leased it  
This method does not allow you to make a separate claim for decline in value on the vehicle  
The value is subject to luxury car limits (in 2007 this was set at \$57,009) – the figures are updated each year in *TaxPack* (NAT 0976)
- Your car must have (or would have) travelled more than 5,000 business kilometres in the income year.

**EXAMPLE**

If your vehicle cost \$20,000 and you held the vehicle for the full year and met the requirements to make a claim under this method, your claim for motor vehicle expenses would be:  
 $12\% \times \$20,000 = \$2,400$

- You do not need written evidence to use this method but you may need to be able to show how you worked out your business kilometres.

**METHOD 3 – One-third of actual expenses**

- You claim one-third of your car’s expenses
- Your car must have (or would have) travelled more than 5,000 business kilometres in the income year
- You need written evidence or odometer records for fuel and oil costs
- You need written evidence for all the other expenses for the car.

There are two ways to work out your fuel and oil costs:

- use your fuel and oil receipts, if you have them
- keep odometer records and make a reasonable estimate based on those records

You also need to keep records which show

- odometer readings of the car at the start and end of the period that you owned or leased the car during the income tax year
- the car’s engine capacity, make, model and registration number
- show how you worked out your business kilometres and any reasonable estimate you made.

**EXAMPLE**

If the expenses for costs such as

- fuel and oil
- registration and insurance
- Interest on a loan to buy the vehicle
- repairs and maintenance
- the decline in value or lease payments

totalled \$9,000 and the other requirements for claiming under this method were met, the calculation would be  
 $\$9,000 \div 3 = \$3,000$  motor vehicle expenses under this method.

#### **METHOD 4 – Logbook**

Your claim is based on the business use percentage of each car expense, based on your logbook record.

You need a logbook so you can work out the percentage.

You can claim fuel and oil costs based on odometer records (see example above).

You need written evidence for all the other expenses for the car.

#### **EXAMPLE**

At the end of the logbook period, Tim's logbook shows that he travelled a total of 11,000 kilometres of which 6,600 were business kilometres.

Tim would work out his business use percentage like this:

$$\frac{6,600}{11,000} \times 100 = 60\%$$

This is the business use percentage Tim would use to work out his car expenses claim.

If his total expenses, including decline in value, were \$9,000, the calculation would be

$$\$9,000 \times 60\% = \$5,400.$$

#### *Your logbook*

Your logbook is valid for five years.

If this is the first year you are using this method, you must have kept a logbook during the income tax year.

The logbook must cover at least 12 continuous weeks. If you started to use your car for business purposes less than 12 weeks before the end of the income tax year, you are able to continue to keep a logbook into the next year so that your logbook covers the required 12 weeks. If you want to use the logbook method for two or more cars, the logbook for each car must cover the same period.

Where you have kept a logbook it must contain the following information:

- when the logbook period begins and ends
- the car's odometer readings at the start and end of the logbook period
- the total number of kilometres that the car travelled during the logbook period
- the number of kilometres travelled for work activities based on journeys recorded in the logbook. If you made two or more journeys in a row on the same day, you can record them as a single journey
- the business use percentage for the logbook period.

If you established your business use percentage using a logbook from an earlier year you need to retain that logbook and maintain odometer records in the following years.

Pre-printed logbooks are available from stationery suppliers or you can draw up your own.

Here is an example of a blank logbook, showing the information that is needed:

**SAMPLE: Car logbook**

<b>Vehicle registration no</b>					
<b>Period covered by logbook</b>		from:		to:	
<b>Odometer readings for period</b>		start:		end:	
<b>Odometer readings per journey</b>		<b>Date of travel</b>		<b>Kilometres travelled</b>	<b>Reason for journey</b>
start	end	start	end		
Total km for period:		Total business km:		km	%

<b>Odometer record</b>			
Make:	Model:	Engine capacity:	Registration no:
Odometer reading at start of year/period:			
Odometer reading at end of year/period:			
<b>Replacement vehicle</b>			
Make:	Model:	Engine capacity:	Registration no:
Odometer reading of replacement vehicle at start of year/period:			
Odometer reading of replacement vehicle at end of year/period:			
Estimated business use is:		km	%

*Odometer records*

You must keep written odometer records for the period you owned or leased the car during each year for which you are making a claim. You need to record:

- the car's odometer readings at the start and end of the period, and
- the make, model, engine capacity and registration number of the car.

In choosing a claim method:

- choose the method that will give you the best result
- you can use different methods for different vehicles
- you can change methods from year to year, and
- remember to keep the appropriate records.

 **MORE INFORMATION**

See *TaxPack* (NAT 0976) for information about motor vehicle expenses and how each claim method works.

**Superannuation contributions**

Superannuation contributions made by the self employed or employers on behalf of employees to a complying superannuation fund or retirement savings account are fully deductible from 1 July 2007. There may be tax consequences for individuals where concessional contributions exceed \$50,000 for those under 50 and \$100,000 for those who are 50 and over for the financial years 2007–08 to 2011–2012.

Note that the deductibility of superannuation contributions may be affected where income is personal services income (see page 25).

**Salary and wages**

If you run your business through a company, any salary and wages paid to you and any other employees are deductible. If your business is run through a partnership or trust, salary and wages are deductible provided they are not paid to a partner of the partnership. If your income includes personal services income, your entitlement to deductions for payments to associates may be affected (see page 25).

The situation is different for a sole trader. As a sole trader you can't employ yourself and get a deduction for salary and wages. This means that you don't get a deduction for any drawings you take from your business income for private purposes, either regularly or irregularly.

**Fringe benefits tax**

As a general rule, the cost incurred in providing a fringe benefit and the amount of fringe benefits tax paid by an employer are deductible. However, any employee contributions towards the cost of the fringe benefit provided may be assessable income of the employer.

**Tax-related expenses**

Expenses related to managing business taxes are deductible. Such expenses include having tax returns and activity statements prepared and lodged, objecting or appealing against an assessment, or attending a Tax Office audit. The cost of obtaining tax advice about the everyday running of your business may be deductible as an ordinary business expense.

### Repairs, maintenance and replacement

To repair something generally means to fix defects, including renewing parts, but it doesn't mean to totally reconstruct something.

You can deduct non-capital expenses for repairs to machinery, tools or premises that are used to produce business income. You don't have to own the property or item that is repaired.

Generally, the costs of painting, conditioning gutters, maintaining plumbing, repairing electrical appliances, mending leaks, replacing broken parts of fences or broken glass in windows, and repairing machinery are deductible.

The following are not considered to be repairs:

- substantial improvements to an item or property, such as replacing a dilapidated ceiling with an entirely new and better ceiling (such expenditure may be eligible to be included in the cost base of the asset when working out capital gains), and
- repairs made to machinery, tools or property immediately after you acquire them. This is because the price you paid for the items is taken to reflect their condition and any repairs to such items are considered to be capital in nature.

### Advertising

Most advertising expenses are deductible, for example, where you incur these expenses for the purpose of selling trading stock, letting rental properties, hiring employees, or gaining publicity for a business name. Sponsorship fees are deductible on the same basis as advertising fees.

### Business travel expenses

Business travel expenses are deductible only if you have:

- written evidence of all expenses (this is not required if there is no overnight stay away from home), and
- travel records, if the business travel is for six or more consecutive nights away from home.

The travel record must record the particulars of each business activity before it ends, or as soon as possible afterwards, in a diary or similar document. The particulars that must be specified are:

- the nature of the activity
- the day and approximate time it began
- how long it lasted, and
- where (the place) you engaged in it.

#### ⚠ KEEP YOUR PLANE TICKET

A plane ticket may show all the details required to substantiate your expenses relating to air fares.

For expenses incurred on or after 1 July 1994 you need to keep the records for five years.

Where travel is for both business and private purposes, exclude the private expenses from your claim. If you run your business through a company or trust, you may have to pay fringe benefits tax if the travel includes private activities.

#### ➔ MORE INFORMATION

See *TaxPack* (NAT 0976) for information about business expenses and deductions.

### PERSONAL SERVICES INCOME

If you earn personal services income and are not conducting a personal services business (see page 9), the deductions available against this income may be limited. The following table is a guide to what deductions you can claim against personal services income.

If you operate through a company, partnership or trust that has a net personal services income loss, only you personally are entitled to claim the loss as a deduction on your individual tax return. As you are entitled to claim the loss, the total amount of deductions the company, partnership or trust is entitled to claim in the income year is reduced by the amount you are entitled to claim.

Deduction	Can you claim it if you are not a personal services business? <sup>1</sup>	Can you claim it if you are a personal services business? <sup>1</sup>
Premiums for workers' compensation, public liability and professional indemnity insurance	Yes	Yes
Bank and other account keeping fees and charges	Yes	Yes
Tax-related expenses, such as the cost of preparing and lodging tax returns or activity statements	Yes	Yes
Registration or licensing fees	Yes	Yes
Expenses for advertising, tendering and quoting for work	Yes	Yes
Decline in value (depreciation)	Yes	Yes
Running expenses for your home office (not including rent, mortgage interest, rates or land taxes – see below)	Yes	Yes
Occupancy expenses – rent, mortgage interest, rates or land tax for an area of your home that is a place of business	No	Yes
If you are a company, partnership or trust – expenses or fringe benefits tax for more than one car that is used partly or solely for private purposes	No	Yes
Salary and wages for an arm's length employee (not an associate)	Yes	Yes
Salary and wages paid to the principal worker within 14 days of the end of each PAYG withholding payment period	Yes	Yes
Contributions to a superannuation fund on behalf of the principal worker or an arm's length employee (not an associate)	Yes <sup>2</sup>	Yes <sup>2</sup>
Reasonable amounts paid to an associate for principal work	Yes	Yes
Contributions up to the superannuation guarantee amount for an associate doing up to, but less than, 20% of the principal work	Yes	Yes
Reasonable amounts paid to an associate for non-principal work	No	Yes
Reasonable contributions to a superannuation fund for an associate doing solely non-principal work	No	Yes

1 This table is a guide only. You may need more information to determine whether a specific deduction is available to you in your circumstances. Remember, you can claim a deduction for an amount you have paid or incurred only if it relates to gaining or producing your assessable income. This applies if you are an individual or an entity.

2 You may not necessarily be entitled to a deduction for personal superannuation contributions. For example, an individual generally cannot deduct their personal superannuation contributions if they are entitled to superannuation support from their employer. A person who enters into a contract wholly or principally for their labour will be an employee for the purposes of the superannuation guarantee and therefore entitled to superannuation support from the contracting entity. For help in determining your entitlement to a deduction for your personal superannuation contributions, phone **13 10 20**.

 MORE INFORMATION

See *Alienation of personal services income – Deductions* Fact sheet (NAT4774).

## WHAT EXPENSES CAN YOU GENERALLY DEDUCT OVER TIME?

Generally you can't claim a deduction for the cost of a capital asset in the income year you purchase the asset. Instead, you can deduct part of the cost of the asset each year over a number of years. The part you can deduct each year represents the decline in value of the asset for that year.

These assets are called depreciating assets. They have a limited life expectancy (effective life) and can reasonably be expected to decline in value over the time they are used. Depreciating assets include items such as computers, electrical tools, furniture, carpet and curtains, and motor vehicles.

Land and items of trading stock are never treated as depreciating assets. But improvements to land and fixtures on land (for example, windmills and fences) are treated as separate from the land and may be depreciating assets.

**!** A deduction for the decline in value of a depreciating asset is generally available only to the asset's holder, who is usually its economic owner. In most cases, the legal owner is also the economic owner and, therefore, the holder. In hire purchase arrangements, the hirer is the economic owner of the asset.

The amount you can claim will be reduced if

- you only hold the asset for part of a year, or
- it is only used partly for business (eg if it used 60% for business purposes, you may only claim 60% of the actual decline in value for that year – the asset still declines each year by the full amount of the decline in value)
- the asset was held for some time before you commenced business (in which case you will need to calculate how much the asset declined in value before you commenced business and use the reduced value at that time as your starting base value for the asset).

### **!** DECLINE IN VALUE OF A CAR

You can't deduct any amount for the decline in value of a car where you use the cents-per-kilometre or 12% of original value method to calculate deductions for car expenses.

**➤** In most cases, it will be clear whether something is a depreciating asset. If you're not sure, contact your tax adviser or the Tax Office.

There are two sets of rules for working out your deductions for depreciating assets:

- a the simpler depreciation rules, and
- b the uniform capital allowances rules.

### **SIMPLER DEPRECIATION RULES CONCESSION**

This small business concession is available if you are in the simplified tax system or, for the 2007–08 income year and later years, if your annual turnover is less than \$2 million.

Under these rules, an eligible small business can:

- write off depreciating assets costing less than \$1,000 each immediately
- pool other depreciating assets with an effective life of less than 25 years in a general pool and deduct at the rate of 30%
- pool depreciating assets with an effective life of 25 years or more in a long-life pool and deduct at the rate of 5%
- deduct newly acquired assets at either 15% or 2.5% in the first year, regardless of when you acquired them during the year.

**!** For certain depreciating assets, the uniform capital allowance rules have to be used, rather than the concessional rules.

### **➤ MORE INFORMATION**

*Simplified tax system: simplified depreciation rules* (NAT 4824). Visit [www.ato.gov.au/SBconcessions](http://www.ato.gov.au/SBconcessions)

## UNIFORM CAPITAL ALLOWANCES RULES

Under these rules you can:

- work out the decline in value of business assets using one of two methods, or
- work out the decline in value of certain depreciating business assets that cost or are written down to less than \$1,000 through a low-value pool.

You can claim an immediate deduction for certain assets costing \$300 or less if the assets are used predominantly to produce assessable income that is not income from carrying on a business (for example, income from a rental property). For more information see the fact sheet *Uniform capital allowance system: \$300 immediate deduction* (NAT 4813).

A deduction for the decline in value of a depreciating asset is generally available only to the asset's holder, who is usually its economic owner. In most cases, the legal owner is also the economic owner and, therefore, the holder. In hire purchase arrangements, the hirer is the economic owner of the asset.

### Determine the effective life of the asset

Firstly, you need to know how much the asset cost you and its effective life (that is, how many years you expect it to last). The effective life of a depreciating asset is how long it can be used to produce income, taking into account reasonable wear and tear under the circumstances in which you expect to use it, and assuming reasonable levels of maintenance.

For most depreciating assets, you can work out what the effective life will be or use the number of years determined by the Commissioner – examples are shown in the following table (these are published every year and are available at [www.ato.gov.au](http://www.ato.gov.au)).

Depreciating asset	Effective life in years (at 1 January 2006)
Carpets	
■ in commercial office buildings	8
■ in tenpin bowling centres	4
Cash registers	10
Computers	
■ generally	4
■ laptops	3
Curtains and drapes	6
Fire extinguishers	15
Floor coverings (linoleum and vinyl)	10
Desks	20
Chairs	10
Hot water installations	15
Lawnmower	
■ motor	6 <sup>2</sup> / <sub>3</sub>
■ self-propelled	5
Library (professional)	10
Motor vehicles, etc.	
Cars	
Generally	8
■ hire and travellers' cars	5
■ taxis	4
■ motorcycles and scooters	6 <sup>2</sup> / <sub>3</sub>
Photocopying machines	5
Power tools (hand-operated)	5
Refrigerators	10
Television receivers (not used for hire)	10
Tools (loose)	5
Vacuum cleaners (electric)	10
Washing machines	6 <sup>2</sup> / <sub>3</sub>
For houses and flats let furnished only:	
■ window blinds	10
■ electric clock	10
■ electric heater	15
■ garbage units (compacting)	6 <sup>2</sup> / <sub>3</sub>
■ refrigerators	12
■ stoves	12

**MORE INFORMATION**

- *Guide to depreciating assets* (NAT 1996)
- *Uniform capital allowance system: calculating the decline in value of a depreciating asset* (NAT 4814)
- Taxation Ruling TR 2006/15 *Income tax: effective life of depreciating assets* (applicable from 1 January 2007)

The decline in value of a depreciating asset starts when you first use it, or install it ready for use, for any purpose (including a private purpose). This is known as a depreciating asset's start time. However, you can deduct an amount for the decline in value only for the time you used the asset to produce assessable income.

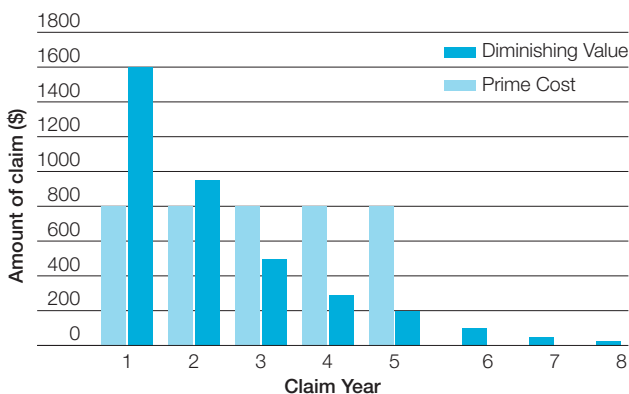
**Working out the decline in value**

Secondly, you can generally choose one of the two methods in the following table to work out the decline in value of a depreciating asset.

Method	How it works
<b>Prime cost method</b>	Assumes that the value of a depreciating asset decreases uniformly over its effective life.
<b>Diminishing value method</b>	Assumes that the value of a depreciating asset decreases more in the early years of its effective life.

You can choose either method for each depreciating asset you hold. But once you have chosen a method for a particular asset, you can't change to the other method for that asset.

**Comparing prime cost and diminishing value methods**



This graph shows the two methods for an asset costing \$4,000 with an effective life of 5 years – (we have assumed it was bought on the first day of the first claim year and is used exclusively for business purposes).

Under the prime cost method, you would claim a fixed amount each year – this would mean claiming 20% of its cost for each of the five years, so the deduction would be for \$800 in each of the five years.

The formula for the prime cost method is:

$$\text{Asset's cost} \times \frac{\text{days held}^1}{365} \times \frac{100\%}{\text{asset's effective life}}$$

1 can be 366 in a leap year

$$\$4,000 \times \frac{365}{365} \times \frac{100\%}{5} = \frac{\$4,000}{5} = \$800^2$$

2 \$800 per year for decline in value.

Under the diminishing value method, the formula is:

$$\text{Base value} \times \frac{\text{days held}^1}{365} \times \frac{200\%}{\text{asset's effective life}}$$

1 can be 366 in a leap year

$$\$4,000 \times \frac{365}{365} \times \frac{200\%}{5} = \frac{\$8,000}{5} = \$1,600^3$$

3 \$1,600 for decline in value in the first year.

The base value reduces each year by the decline in value of the asset.

Therefore – the base value for the second year will be \$2,400 (\$4,000 minus the \$1,600 decline in value in the first year).

ie \$4,000 – \$1,600 = \$2,400 reduced base value

The claim for the second year will be

$$\$2,400 \times \frac{365}{365} \times \frac{200\%}{5} = \frac{\$8,000}{5} = \$960^4$$

4 \$960 for decline in value in the second year.

Both methods give you the same total deduction for the decline in value, but the prime cost method does so over a shorter time. The diminishing value gives you a larger deduction early in the asset's life and smaller deductions later on, eg:

- 40% in first year = \$1,600 deduction in the first claim year
- 40% of remaining value (\$2,400) = \$960 claim for the second year
- In the third year, 40% of remaining value (\$1440) = \$576
- In the fourth year, 40% of the remaining value (\$864) = \$346
- and so on

Once the value of the asset drops below \$1,000, the remaining value can be transferred to a low-value pool (see page 34), where it is pooled with any other low-value assets, rather than continuing to require its own separate claim calculation.

### Use a low-value pool

Under the uniform capital allowance rules, specific rules provide that the decline in value of certain depreciating assets can be worked out by:

- allocating low-cost assets and low-value assets you hold to a low-value pool (see table below), and
- depreciating them at a set annual rate.

<b>Low-cost asset</b>	A low-cost asset is a depreciating asset whose cost as at the end of the year in which you start to use it or have it installed for a taxable purpose is less than \$1,000 (excluding GST credits).
<b>Low-value asset</b>	A low-value asset is a depreciating asset that is not a low-cost asset but has an opening adjustable value of less than \$1,000, and for which you used the diminishing value method to work out the decline in value for a previous income year.

You can't allocate the following depreciating assets to a low-value pool:

- low-value assets for which you have calculated any available deductions from a decline in value using the prime cost method
- horticultural plants (including grapevines)
- assets for which you can deduct amounts under the small business concessions
- assets costing \$300 or less that you can claim an immediate deduction for, or
- certain depreciating assets used in carrying on research and development activities.

A low-value pool is created when you first choose to allocate a low-cost or low-value asset to the pool.

Once you choose to create a low-value pool and a low-cost asset is allocated to the pool, you must pool all other low-cost assets you start to hold in that income year and in later income years. You can decide whether to allocate low-value assets to the pool on an asset-by-asset basis.

Once you've allocated an asset to the pool, it remains in the pool. You then need to do only one annual calculation for the decline in value for all the depreciating assets in the pool using an annual diminishing value rate of 37.5%. This rate is equivalent to an effective life of four years.

If you acquire an asset and allocate it to the pool during an income year, the deduction is worked out at a rate of 18.75%, or half the pool rate. This deduction is available, no matter when in the year you acquire the asset.

#### MORE INFORMATION

- *Uniform capital allowance system: low-value pools* (NAT 4514)

### Other capital expenditure

The uniform capital allowance system provides a deduction for certain business-related capital costs that are not denied a deduction or taken into account by some other provision of the tax law.

The following expenses may qualify for a deduction:

- business-related capital expenditure you incur in relation to your existing business that is carried on for a taxable purpose, and
- pre- and post-business-related capital expenditure (such as the costs of establishing a business entity or costs incurred to stop carrying on a business) you incur for a business which is proposed to be, or was formerly, carried on for a taxable purpose.

You deduct 20% of the expenditure in the year you incur it and in each of the following four years.

You can also get a deduction for certain capital expenditure directly connected with a project. The expenditure, known as a project amount, can be allocated to a pool and written off over the effective life of the project using the diminishing value method. The expenditure must not be otherwise deductible or form part of the cost of a depreciating asset. Examples of project amounts are feasibility studies or environmental assessments for a project.

#### MORE INFORMATION

- *Uniform capital allowance system: business-related costs technical information* (NAT 5477)

## ARE YOU ENTITLED TO ANY SPECIAL DEDUCTIONS?

If you're a primary producer or a company involved in research and development (R&D), you may be able to reduce your assessable income using special tax concessions.

### TAX CONCESSIONS FOR PRIMARY PRODUCERS

If you're a primary producer, you use the general uniform capital allowance system rules (see page 28) to work out the decline in value of most of your depreciating assets. However:

- there are special rules you must use to work out the decline in value of:
  - water facilities
  - horticultural plants
  - grapevines owned and planted on or before 30 September 2004, and
- you may also be able to claim deductions for capital expenditure on landcare operations, electricity and phone line connections.

If you're carrying on a primary production business, you may claim the special deduction even if you're only a lessee of the land.

These deductions are not available to a partnership. Expenses incurred by a partnership for water facilities, to establish horticultural plants or grapevines, for landcare operations, or mains electricity supply or phone lines, are allocated to each partner. The partners then claim a deduction according to their share of the expenditure.

The farm management deposits scheme allows you to claim a deduction for farm management deposits made in the year you deposit.

#### ➤ MORE INFORMATION

For more information about deductions for primary producers, visit [www.ato.gov.au/primaryproducers](http://www.ato.gov.au/primaryproducers) or see:

- *Information for primary producers* (NAT 1712)
- *Farm management deposits scheme* (NAT 8776)

### RESEARCH AND DEVELOPMENT TAX CONCESSION

If you're a company and incur expenditure on R&D, you may be eligible to claim a tax offset or a tax deduction to reduce your assessable income. The concession includes increased rates of deduction.

The tax concession is available only for expenditure on eligible R&D activities. The IR&D Board and AusIndustry determine whether activities carried out are eligible R&D activities. You must be registered with the IR&D Board through AusIndustry for each year you want to claim the concession.

#### ➤ MORE INFORMATION

For more information about R&D expenditure and claiming the concession, visit [www.ato.gov.au/randd](http://www.ato.gov.au/randd) or phone the Tax Office on **13 28 66**.

The *Research and development tax concession schedule* (NAT 6708) and the *Guide to the R&D tax concession* are available at [www.ato.gov.au/randd](http://www.ato.gov.au/randd)

### DID YOUR BUSINESS RUN AT A LOSS?

If you're in business, you may have income from more than one source, for example, from your business and from salary or wages.

You can claim that business loss against other assessable income only if:

- the activity is being run by a company or trust, rather than by you as a sole trader or a partner in a partnership
- you are undertaking a primary production business or a professional arts business and you make less than \$40,000 (excluding any net capital gains) in an income year from other sources
- the losses arise from passive investments in shares, rental property or infrastructure bonds (unless your investment activity is really a business, rather than a passive investment). This means you can still negatively gear these passive investments
- you have assessable income from the activity of at least \$20,000
- the activity has produced a profit in three out of the past five years (including the current year)
- the activity uses real property or an interest in real property worth at least \$500,000, on a continuing basis (this excludes a dwelling and adjacent land)
- the activity uses other assets worth at least \$100,000, on a continuing basis, or
- the Commissioner exercises a discretion to allow the loss to be offset against other income.

Otherwise, you can't offset a loss from that business activity against any of your other assessable income for that income year, but must defer the loss. If your business activity makes a profit in a following year, you can offset the deferred loss against this profit, but only to the extent of that profit.

#### ➤ MORE INFORMATION

- *Non-commercial losses: overview* (NAT 3379)

## DO YOU HAVE TAX LOSSES IN PREVIOUS YEARS TO OFFSET?

If your business made tax losses in previous years, you may be able to reduce your assessable income by those tax losses from earlier years. However, if you're an individual (alone or in a partnership), it is only in certain circumstances that you can offset losses from a non-commercial business activity against assessable income in the year in which the loss is incurred.

A tax loss is incurred when the total of your allowable deductions for an income year (excluding tax losses from earlier income years) is more than your total assessable income and net exempt income.

There are some deductions you cannot use to create or increase a tax loss, including donations or gifts, and superannuation contributions by eligible persons.

### TAX LOSSES FROM EARLIER YEARS

You may carry forward a tax loss you incur in one income year and, in certain circumstances, deduct the tax loss from your assessable income in a later year.

In carrying forward tax losses:

- where you have tax losses from more than one previous year, you must fully deduct the tax loss from the earliest year before deducting a tax loss, or part of a tax loss, from a later year
- your tax losses from earlier income years can reduce your Australian source income only to zero. If your tax losses from earlier income years are more than your Australian source income, you'll need to keep a record of the tax losses to claim next year, and
- you can now carry forward tax losses indefinitely, but non-primary production losses made before 1989–90 can no longer be deducted from income.

Before you can deduct tax losses from earlier income years, you must first reduce them by any current year net exempt income. To calculate your net exempt income, deduct any non-capital expenses you have incurred in earning your exempt income and any foreign tax paid on that income.

Generally, a tax loss is not allowable as a deduction from assessable foreign income. However, you can make an election to use some or all of your tax losses incurred in earning Australian source income to reduce your assessable foreign income.

### Sole traders and partnerships

If you operate your business as a sole trader or a partnership, you cannot choose the year or years in which to deduct a tax loss from an earlier year. You must carry the tax loss forward from one year to the next until it is absorbed.

### Trusts

If a trust makes a tax loss, the loss cannot be distributed to beneficiaries. The trust cannot choose the year or years in which to deduct a tax loss, but must carry the tax loss forward from one year to the next until it is absorbed.

#### ! TRUSTS AND LOSSES

There are special rules in the tax law that restrict the circumstances where a trust can claim a deduction for a tax loss. You should seek further advice if you operate your business through a trust that has tax losses.

### Companies

If a company makes a tax loss, the loss cannot be distributed to shareholders. The company must carry the tax loss forward until it can be offset against assessable income in a later year.

For the year in which 1 July 2002 falls and later years, a company may (subject to certain limitations):

- choose the amount of a previous year tax loss it wants to deduct (after first deducting the tax loss from any net exempt income), and
- carry forward to a later year a tax loss that it would have incurred in a particular year but for the receipt of franked dividend income.

A company cannot deduct a tax loss unless:

- it has the same owners and the same control throughout the period from the start of the loss year to the end of the income year, or
- it carried on the same business throughout a specified period.

## DO YOU HAVE TRADING STOCK?

Trading stock is anything you produce, manufacture, acquire or purchase for manufacture, sale or exchange by your business. Livestock is considered to be trading stock. You are considered to have trading stock on hand if you have the power to dispose of that stock (see Taxation Ruling No. IT 2670 *Income tax: meaning of 'trading stock on hand'*).

If you operate a business, the value of all trading stock you have on hand at the beginning of the income year (generally 1 July) and at the end of the income year (generally 30 June) is taken into account in working out your taxable income for the year.

This is worked out as follows:

- if the value of your trading stock at the end of the income year is more than at the beginning of the year, you must include the difference in your assessable income, or
- if the value of stock at the end of the year is less than at the beginning of the year, you can claim a deduction for the difference.

You work out the value of your trading stock by doing an annual stocktake. In most cases, you'll need to do a physical count as close as possible to the end of the income year. The value of your stock at the end of an income year will be the same as its value at the start of the next income year (except for the first year you are in business). The value at the start of the year is zero if you do not have an end-of-year value of trading stock on hand at the end of the previous year.

Note that the stocktake rules are different for taxpayers who join the simplified tax system (see the next page).

### ! LIVESTOCK

If you slaughter livestock for your own consumption, you are treated as if you had disposed of the stock at its cost.

## VALUATION

The following table shows the three methods for valuing trading stock.

Method	Valuation basis
<b>Cost</b>	Include all costs associated with bringing the stock into its existing condition and location (this may include cost price plus freight, insurance, customs and excise duties and delivery charges).
<b>Market selling value</b>	Current value of stock if sold in the normal course of business.
<b>Replacement value</b>	What it would cost to obtain a substantially identical item and available in the market on the last day of the income year.

You can use a different method for different items of stock and also from one year to the next.

The closing value for an item of trading stock at the end of one income year automatically becomes its opening value at the beginning of the next income year.

## SIMPLIFIED TRADING STOCK CONCESSION

This is a small business concession that is available to taxpayers in the simplified tax system or, for the 2007–08 income year and later years, for those with an annual turnover of less than \$2 million. Eligible businesses need to conduct a stocktake and account for changes in the value of trading stock only if there is a variation of more than \$5,000 in the value of their stock on hand at the start of the income year and the reasonably estimated value of their stock on hand at the end of that year.

Your estimate would be reasonably based if:

- you maintain a constant level of stock each year and have a reasonable idea of the value of your stock on hand, or
- your stock levels fluctuate, but you can make an estimate based on appropriate records of what stock has been purchased.

### MORE INFORMATION

*Simplified tax system: simplified trading stock rules (NAT 4107)* includes information about how to make a reasonable estimate of the value of your trading stock on hand.

[www.ato.gov.au/sbconcessions](http://www.ato.gov.au/sbconcessions)

If the value varies by more than \$5,000 you must:

- value each item of trading stock on hand at the end of the income year, and
- account for the change in value in your assessable income.

If the value of your trading stock varies by \$5,000 or less, you're not required to account for this difference. The value of trading stock on hand at the end of the year is deemed to be the same as at the start of the year.

## EXAMPLE

At the start of the 2005–06 income year, the opening value of Bill's trading stock is \$53,000. Using his reliable inventory system, he estimates the closing value to be \$56,000.

The closing value for the 2005–06 income year, and the opening value for the 2006–07 income year, will be \$53,000.

However, if the value varies by more than \$5,000, or you choose to account for a change in trading stock, the value at the end of the year will depend on:

- the results of your stocktake, and
- the valuation method you use (that is, cost, market selling value or replacement value).

### CHOOSING TO DO A STOCKTAKE

Even if you do join the simplified tax system, you can still choose to do a stocktake and account for changes in the value of trading stock in any income year.

## ARE YOU ENTITLED TO ANY CREDITS OR TAX OFFSETS?

You may be able to reduce the tax you have to pay by available credits or tax offsets. The Tax Office works out the tax due on your taxable income and then reduces it by the total amount of tax offsets available to you. This means that tax offsets are different from deductions, which are taken off your income before your tax is worked out.

Most tax offsets can reduce the amount of tax you pay only to zero. That is, if your tax offsets are more than your tax due, you do not get a refund of the excess amount. But there are three exceptions, with the three refundable tax offsets being:

- the private health insurance rebate, where any excess is refunded to you
- the baby bonus, where any excess is refunded to you, and
- the franking credits tax offset, where any franking credits that remain once your tax payable has been reduced to zero are refunded to you.

Tax offsets do not generally reduce your Medicare levy. But where you still have excess refundable tax offsets after they have been offset against the tax payable on your taxable income, they can reduce the amount you have to pay for the Medicare levy.

Except in the case of a company, the Tax Office reduces the tax on your taxable income by including the relevant tax offsets and credits you are entitled to. Companies have to work out their tax payable, taking into account any credits or tax offsets they are entitled to.

### 25% ENTREPRENEURS' TAX OFFSET

This small business concession is available if your business has an annual turnover of less than \$75,000. Prior to the 2007–08 income year, taxpayers also needed to be in the simplified tax system to claim this concession. This tax offset allows you to reduce the income tax liability related to your business income by up to 25%.

### FRANKING CREDITS

A dividend is profit distributed by a company to its shareholders. It can be:

- a franked dividend, if it is paid from profits the company has already paid tax on, or
- an unfranked dividend, if it is paid from profit the company has not paid tax on.

Franked dividends have franking credits attached to them. While you include the franking credits in your assessable income, you get a rebate of tax equal to the amount of the franking credits.

Special provisions apply where a trustee or partnership receives a franked dividend.

### FOREIGN TAX CREDITS

You're allowed a foreign tax credit for any creditable taxes you paid in another country on income you earned there. The foreign tax credit cannot be more than the amount of Australian tax payable on that foreign income.

Income earned by a resident from sources outside Australia is subject to Australian tax, but a credit is allowed against the Australian tax for any foreign tax paid on that income.

You will have an excess foreign tax credit for an income year if the amount of foreign tax you have paid in relation to a particular category of foreign income is more than the Australian tax payable on that category of foreign income. You can carry forward this excess credit to another income year for a period of up to five years for offset against foreign income of the same category.

You're entitled to claim a foreign tax credit if you:

- are an Australian resident
- have earned foreign income that is taxable in Australia, and
- have paid foreign tax for which you were personally liable in respect of that income.

If you were refunded any tax in the country where you paid it, you will not be able to claim the foreign tax credit. Also, you're not allowed a credit for penalties, fines or interest paid to a foreign country.

You should keep written evidence of your foreign tax credits with your other tax records. You may need to produce it at a later date to substantiate your claims for a foreign tax credit.

You'll also need written evidence of any foreign tax you've paid, such as:

- a notice of assessment from the foreign tax authority and a receipt for the tax paid
- a statement from the foreign tax authority setting out the particulars that would normally be recorded on a notice of assessment and a receipt for payment, or
- a certificate for tax withheld issued by the person who pays you the interest, dividend or any other income that is subject to foreign tax.

### OTHER TAX OFFSETS

There are several other tax offsets for things like maintaining a dependant or living in a remote area. There are also a range of other tax offsets for such things as heritage conservation work, superannuation contributions on behalf of your spouse, and net medical expenses over the threshold amount.

#### MORE INFORMATION

See *TaxPack* (NAT 0976) for information on what tax offsets are available and whether you're eligible.

**EXAMPLE: Deductions****Sole trader**

Here are Bill's deductions for the income year:

*Allowable deductions*

Brochures for advertising toy sales	\$650
Rent of shop	\$10,000
Electricity for shop	\$1,875
Insurance premiums for his business	\$2,900
Cost of trading stock	\$48,000
Business phone	\$720
Car (business use)	\$1,500
Rental property expenses	\$14,200
<b>Total allowable deductions</b>	<b>\$79,845</b>

Bill's total allowable deductions consist of business deductions of \$65,645 plus rental property deductions of \$14,200.

*Non-allowable deductions*

Parking fines	\$100
Home mortgage	\$12,000
Domestic expenses	\$20,000
Flour for bread making	\$270

Bill can claim a deduction for all the expenses related to running his toy shop in the income year in which he incurs the expenses. This means he can claim a deduction for \$65,645. He can also claim the \$14,200 expense related to his rental property.

He can't claim a deduction for parking fines, home mortgage, domestic expenses or flour for his bread making hobby.

**Company**

Here are the deductions Maria's company has for the income year:

*Allowable deductions*

Tender costs	\$5,968
Advertising	\$500
Home office expenses	\$4,620
Decline in value of depreciating assets	\$3,500
Subscription to professional association	\$220
Salary and wages	\$44,585
Superannuation payments	\$4,013
Fringe benefits tax	\$4,000
Motor vehicle expenses	\$11,780
Insurance premiums (business, workers' compensation, professional indemnity)	\$9,000
Stationery	\$1,080
New printer	\$980
Accountant's fees	\$1,500
<b>Total allowable deductions</b>	<b>\$91,746</b>

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# LODGE AN ANNUAL INCOME TAX RETURN

# 03

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Once you've worked out your assessable income and allowable deductions, you're ready to report your income. How and when you do this will vary, depending on your business structure.

## SOLE TRADER, PARTNERSHIP OR TRUST

If you run your business as a **sole trader**, you lodge an *Individual tax return* to report your taxable income or loss, which is:

- your assessable business income minus your allowable business deductions

plus

- any other assessable income, such as salary and wages (shown on a payment summary), dividends and rental income, minus any allowable deductions against this income.

You also have to complete certain other forms and schedules (see the table on page 40).

### MORE INFORMATION

See the *TaxPack supplement* (NAT 2677) for information about lodging an individual return that includes business income.

If you run your business through a **partnership**, the partnership lodges a *Partnership tax return* to show the partnership's net income. This is the partnership's income less expenses and deductions. The partnership may also have to complete certain other forms and schedules (see the table on page 40).

Individual partners report their share of any partnership net income or loss plus any other assessable income, such as salary and wages (shown on a payment summary), dividends and rental income, on an *Individual tax return*.

If you run your business through a **trust**, the trust lodges a *Trust tax return* to show the trust's net income or loss. This is the trust's income less expenses and deductions. The trust may also have to complete certain other forms and schedules (see the table on page 40).

Trust beneficiaries report any distribution from the trust plus any other assessable income, such as salary and wages (shown on a payment summary), dividends and rental income, on an *Individual tax return*.

### ANNUAL ASSESSMENT

If you're an individual (sole trader, partner in a partnership or beneficiary of a trust), once you lodge your tax return the Tax Office will issue you with an annual assessment showing how much tax you have to pay or your refund. The assessment takes into account any PAYG withheld amounts, any PAYG instalments you've been credited with for the income year, and any tax offsets you're entitled to.

### TAX RATES

Individuals who are residents of Australia pay tax at the rates shown in the following tables. Non-residents pay tax on all their taxable income as they don't qualify for the tax-free threshold of \$6,000.

Generally, being able to claim a tax offset depends on things like maintaining a dependant or living in a remote area, or on how much taxable income you earned.

#### Tax rates 2006–07

Taxable income	Tax payable
\$0 – \$6,000	Nil
\$6,001 – \$25,000	15% of amount over \$6,000
\$25,001 – \$75,000	\$2,850 plus 30% of amount over \$25,000
\$75,001 – \$150,000	\$17,850 plus 40% of amount over \$75,000
Over \$150,000	\$47,850 plus 45% of amount over \$150,000

#### Tax rates 2007–08\*

Taxable income	Tax payable
\$0 – \$6,000	Nil
\$6,001 – \$30,000	15% of amount over \$6,000
\$30,001 – \$75,000	\$2,850 plus 30% of amount over \$30,000
\$75,001 – \$150,000	\$17,850 plus 40% of amount over \$75,000
Over \$150,000	\$47,850 plus 45% of amount over \$150,000

\* At the time of printing the table is based on the tax rate changes announced in the 2007 Federal Budget, which are expected to take effect from 1 July 2007.

 The above rates *do not* include the Medicare levy of 1.5%.

### Medicare levy

Most resident individuals also have to pay 1.5% of their taxable income as a Medicare levy if their income is above the low income threshold.

You may also have to pay the 1% Medicare levy surcharge if you don't have adequate private patient hospital cover and your taxable income is more than:


- \$50,000 – if you are single with no dependent children, or
- \$100,000 – if you have a spouse or dependent child, increasing by \$1,500 for each dependent child after the first.

## COMPANY

A company is required to work out its tax liability for the income year and lodge a *Company tax return* showing its taxable income and the tax payable on that income.

The company does this by reducing its assessable income by its allowable deductions to arrive at its taxable income. It then multiplies its taxable income by the company tax rate of 30% to work out its tax payable.

This is different from sole traders, partnerships and trusts which have to report their taxable income or net income or loss, but do not have to work out their tax payable as the Tax Office does this for them.

 Remember, the company's income is separate from your personal income.

## WHICH FORM DO YOU USE TO REPORT?

Your business structure determines which forms you use to report your income and claim your deductions, as shown in the following table.

If you lodge your returns without all the required schedules, you may not be considered to have lodged in the approved form. Also, unless you lodge all required schedules by the due date, you may incur a failure to lodge on time penalty.

The *Individual tax return* (NAT 1371) and *Tax return for individuals (supplementary section)* (NAT 2679) can also be lodged together online using the Tax Office's electronic lodgment facility, e-tax.

Business structure/ taxpayer	Reporting form	What information to report	When to report*
<b>Sole trader</b>	<ul style="list-style-type: none"> <li>■ <i>Individual tax return</i> (NAT 1371)</li> <li>■ <i>Tax return for individuals (supplementary section)</i> (NAT 2679)</li> <li>■ <i>Business and professional items schedule</i> (NAT 2816)</li> </ul> <p>You may also have to complete a <i>Capital allowances schedule</i> (NAT 4089)</p>	Business income and other assessable income	By 31 October
<b>Partnership</b>	<ul style="list-style-type: none"> <li>■ <i>Partnership tax return</i> (NAT 0659)</li> </ul> <p>The partnership may also have to complete:</p> <ul style="list-style-type: none"> <li>■ <i>Personal services income schedule</i> (NAT 3421)</li> <li>■ <i>Capital allowances schedule</i> (NAT 4089)</li> <li>■ <i>Schedule 25A</i> (NAT 1125)</li> </ul>	Partnership income	By 31 October
<b>Partner</b>	<ul style="list-style-type: none"> <li>■ <i>Individual tax return</i> (NAT 1371)</li> <li>■ <i>Tax return for individuals (supplementary section)</i> (NAT 2679)</li> </ul> <p>You may also have to complete a <i>Business and professional items schedule</i> (NAT 2816)</p>	Share of partnership income and other assessable income	
<b>Trust</b>	<ul style="list-style-type: none"> <li>■ <i>Trust tax return</i> (NAT 0660)</li> </ul> <p>The trust may also have to complete:</p> <ul style="list-style-type: none"> <li>■ <i>Capital allowances schedule</i> (NAT 4089)</li> <li>■ <i>Losses schedule</i> (NAT 3425)</li> <li>■ <i>Capital gains tax schedule</i> (NAT 3423)</li> <li>■ <i>Personal services income schedule</i> (NAT 3421)</li> <li>■ <i>Schedule 25A</i> (NAT 1125)</li> </ul>	Trust income	By 31 October
<b>Beneficiary</b>	<ul style="list-style-type: none"> <li>■ <i>Individual tax return</i> (NAT 1371)</li> <li>■ <i>Tax return for individuals (supplementary section)</i> (NAT 2679)</li> </ul>	Share of trust income and other assessable income	
<b>Company</b>	<ul style="list-style-type: none"> <li>■ <i>Company income tax return</i> (NAT 0656)</li> </ul> <p>The company may also have to complete:</p> <ul style="list-style-type: none"> <li>■ <i>Capital allowances schedule</i> (NAT 4089)</li> <li>■ <i>Losses schedule</i> (NAT 3425)</li> <li>■ <i>Capital gains tax schedule</i> (NAT 3423)</li> <li>■ <i>Personal services income schedule</i> (NAT 3421)</li> <li>■ <i>Schedule 25A</i> (NAT 1125)</li> <li>■ <i>Research and development tax concession schedule</i> (NAT 6708)</li> </ul>	Company income	By the date the Commissioner has advised the company to lodge its return or, where no date has been advised, by 31 October.

\* This may be a later date if you lodge through a tax agent.

## PAYG INSTALMENTS

If you're a sole trader or a company, you probably have to pay instalments towards your expected tax liability for the income year as you earn your income. These pay as you go (PAYG) instalments are credited against your annual income tax liability.

Most partnerships and trusts are not liable to pay PAYG instalments. Instead, individual partners or beneficiaries may be liable to pay PAYG instalments on their share of income from each partnership or trust of which they are a partner or beneficiary.

Most small businesses pay quarterly PAYG instalments for the four quarters ending on the last day of September, December, March and June. However, primary producers and some special professionals may pay only two PAYG instalments a year – 75% of their expected tax liability for the income year after their third quarter, and the remaining 25% after their fourth quarter.

Some small businesses may be able to pay an annual PAYG instalment.

**!** Remember, you still have to lodge an income tax return even if you report your PAYG instalments and any other obligations on an activity statement each quarter.

### EXAMPLE: Taxable income

#### Sole trader

Bill reports assessable business income of \$110,450 and allowable business deductions of \$65,645. He also reports other assessable income of \$13,980 (rent and dividends) and allowable deductions of \$14,200.

So Bill's total assessable income is \$124,430 and total deductions are \$79,845, leaving him with a personal taxable income of \$44,585.

Bill is not entitled to any tax offsets or rebates.

Once Bill lodges his annual tax return, the Tax Office will work out his annual assessment and credit him for the PAYG instalments he has paid during the income year. We will then issue him with an assessment notice to pay any outstanding amount.

#### Company

Maria's company calculates its taxable income by reducing its assessable income by allowable deductions, and then taking into account any PAYG instalments the company has been credited with during the income year.

The company's assessable income is \$91,458 and it has allowable deductions of \$91,746. This means the company has a loss of \$288. It can carry the loss forward and offset it against future taxable income. The company had not actually paid any quarterly PAYG instalments during the year because its instalment rate was 0%.

## DEFINITIONS

### Accruals basis of accounting

If you account on an accruals basis, you include all income you have received and any income you have issued an invoice for in the income year. You include expenses once you have received an invoice or paid for any part of them, whichever occurs first.

### Allowable deductions

These are expenses you can claim a tax deduction for.

### Assessable income

Income that is subject to tax is called assessable income.

### Capital expenses

Capital expenses are expenses of establishing, replacing, enlarging or improving the business structure, as distinct from working or operating expenses. Some capital expenses may be deductible over a period of time, while some may be deductible outright under specific provisions of the tax law.

### Capital gains tax concessions for small business

There are four capital gains tax concessions that reduce capital gains made by eligible small business operators when they dispose of business assets or their interest in an entity that carries on the business.

### Cash basis of accounting

If you use a cash basis of accounting you include in your income only amounts received in that income year. You can generally claim a deduction for expenses in the income year in which they are incurred.

### Company

For tax purposes, a company is an incorporated or unincorporated body or association, but doesn't include a partnership or a non-entity joint venture. An incorporated company is a distinct legal entity and pays tax on the company's income.

### Decline in value

Decline in value is the new term for depreciation.

### Depreciating asset

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. Depreciating assets include such items as computers, electric tools, furniture and motor vehicles.

### Diminishing value method

This is one of the methods you can use to work out the decline in value of a depreciating asset. This method assumes that the decline in value of a depreciating asset each year is a constant proportion of the remaining value and produces a progressively smaller decline over time.

### Low-cost asset

A low-cost asset is a depreciating asset whose cost as at the end of the year in which you start to use it or have it installed for a taxable purpose is less than \$1,000 (excluding GST credits).

### Low-value asset

A low-value asset is a depreciating asset that is not a low-cost asset but has an opening adjustable value of less than \$1,000, and for which you used the diminishing value method to work out the decline in value for a previous income year.

### Low-value pool

An optional low-value pooling arrangement for plant was introduced from 1 July 2001. It applies to certain plant costing less than \$1,000 or having an undeducted cost of less than \$1,000. This plant can be allocated to a low-value pool and depreciated at statutory rates.

### NAT number

Most of our publications have a NAT number (our catalogue number), which we generally show in brackets after the title of the publication, for example, *Tax basics for small business* (NAT 1908).

### Occupancy expenses

Occupancy expenses are expenses associated with occupying your home, namely, rent, mortgage interest, rates, land taxes and house insurance premiums.

### Partnership

For tax purposes, a partnership is an association of people or entities that carry on business as partners or receive income jointly. A partnership is not a separate legal entity and doesn't pay tax on the income earned by the partnership.

### PAYG instalments

PAYG instalments is a system for paying instalments towards your expected tax liability for business and investment income for the income year. Instalments may be paid in four or two instalments during the year or annually, at the end of the income year, subject to you meeting the respective eligibility criteria.

### PAYG withholding

PAYG withholding is the system whereby payers withhold amounts from payments to payees and send the withheld amounts to the Tax Office.

**Personal services business**

You are considered to be conducting a personal services business if you earn personal services income as an individual and meet certain conditions.

If you earn your personal services income through an entity (such as a company, partnership or trust), that entity is considered to be conducting a personal services business if it meets certain conditions.

**Personal services income**

Personal services income is income that is mainly a result of your personal efforts or skills. Whether the personal services income is paid to you as an individual or is channelled through an entity (company, partnership or trust), it remains your personal services income.

Income is not personal services income if it is mainly:

- for supplying or selling goods
- for granting a right to use property
- generated by an income-producing asset, such as income derived from the use of a truck, or
- generated by a business structure, for example, a large accounting firm.

**Prime cost method**

This is one of the methods you can use to work out the decline in value of a depreciating asset. This method assumes that the value of a depreciating asset decreases uniformly over its effective life.

**Repair**

For tax deduction purposes, to repair something means to fix defects, including renewing parts, but it doesn't mean a total reconstruction.

**Revenue expenses**

Working or operating expenses that relate to the everyday running of your business (for example, office stationery, rent of office premises, salary and wages) are called revenue expenses. You can generally claim a deduction for these expenses in the income year in which you incur them.

**Running expenses**

Running expenses include phone rental and business calls, internet fees, decline in value of office furniture and equipment, and any additional heating, cooling, lighting and cleaning expenses.

**Simplified tax system**

The simplified tax system (STS) was a package of measures designed to reduce the compliance costs faced by eligible small businesses. It ceased to exist on 1 July 2007, but its key features (simplified depreciation and trading stock rules) continue to be available as part of a range of concessions available to eligible small businesses (whose annual turnover is less than \$2 million).

**Sole trader**

A sole trader is an individual trading alone. The income of the business is treated as the individual's personal income. Sole traders pay the same tax rate as individual taxpayers.

**Tax offsets**

Tax offsets reduce your tax payable but are not deductions. The sum of all tax offsets you are entitled to cannot exceed the amount of tax otherwise payable and therefore will not give you a refund. Tax offsets generally don't reduce the Medicare levy you have to pay.

**Taxable income**

Your taxable income equals your assessable income minus your allowable deductions.

**Taxable sale**

This term is widely defined to include most sales (goods, services and anything else) you make in your business. A sale is not a taxable sale if it is GST-free, input taxed or otherwise non-taxable. Note that in this document the word 'sale' describes the GST term 'supply'.

**Trading stock**

Trading stock is anything you produce, manufacture, acquire or purchase for manufacture, sale or exchange by your business. Livestock is considered to be trading stock. You are considered to have trading stock on hand if you have the power to dispose of that stock (see Taxation Ruling No. IT 2670 *Income tax: meaning of 'trading stock on hand'*).

**Trust**

A trust is an obligation on a person to hold property for the benefit of others, who are known as 'beneficiaries'. A trust is not a separate legal entity.

**Uniform capital allowance system**

From 1 July 2001 there are new rules for working out deductions for your depreciating assets, such as plant and equipment. These new rules are part of the uniform capital allowance system.

## MORE INFORMATION

### INTERNET

Visit:

- [www.ato.gov.au](http://www.ato.gov.au) for easy access to tax information for small business
- [www.ato.gov.au/onlineservices](http://www.ato.gov.au/onlineservices) to find out about our range of online services, including the Business Portal
- [business.gov.au](http://business.gov.au) for easy access to a range of business information, services and transactions with government. There are links to Tax Office applications to register for an ABN and GST, or to apply for a tax file number.

### PHONE

Phone:

- **13 28 66** (general **business** enquiries) for information about most small business tax matters, including GST, ABN, pay as you go (PAYG) instalments, amounts withheld from wages, business deductions, lodging and paying activity statements, activity statement accounts, wine equalisation tax, luxury car tax, fringe benefits tax, fuel tax credits and matters for non-profit organisations
- **13 10 20** (**superannuation** enquiries) for information about the superannuation guarantee, choice of superannuation fund and the Super Co-contribution
- **13 28 61** (**personal tax** enquiries) for information about individual income tax and general personal tax enquiries
- **1300 720 092** to order Tax Office publications (see page 3).

### FAX

- Phone **13 28 60** to have information faxed to you about a range of tax-related topics.

### BUSINESS SEMINARS AND WORKSHOPS

- We run small business seminars and workshops on a range of topics, including GST, PAYG, activity statements and record keeping. Visit [www.ato.gov.au](http://www.ato.gov.au) or phone **1300 661 104** to find out whether there is a seminar or workshop near you or to make a booking.

### BUSINESS ASSISTANCE VISITS

- If you would like personalised, specialist assistance, or if you are new to business you can organise a business assistance visit by contacting **13 28 66**.

### OTHER SERVICES

- If you do not speak English well and want to talk to a tax officer, phone the Translating and Interpreting Service on **13 14 50** for help with your call.
- If you have a hearing or speech impairment and have access to appropriate TTY or modem equipment, phone **13 36 77**. If you do not have access to TTY or modem equipment, phone the Speech to Speech Relay Service on **1300 555 727**.

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