TR 2011/6 - Income tax: business related capital expenditure - section 40-880 of the Income Tax Assessment Act 1997 core issues

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Taxation Ruling

Income tax: business related capital expenditure – section 40-880 of the *Income Tax Assessment Act 1997* core issues

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What this Ruling is about

1. This Ruling sets out the Commissioner's views on the interpretation of the operation and scope of section 40-880 of the *Income Tax Assessment Act 1997* (ITAA 1997).

2. It considers aspects of section 40-880 of the ITAA 1997 by identifying the key issues which need to be resolved to establish entitlement to a deduction under the provision.

3. All references in this Ruling are to the ITAA 1997 unless otherwise indicated.

4. This Ruling specifically considers:

- the type of expenditure to which section 40-880 applies;
- the nexus required for capital expenditure to be 'in relation to' a current, former or proposed business;
- the requirement that the business be carried on for a taxable purpose; and
- limitations and exceptions to a deduction.

Background

5. Prior to 1 July 2001, a range of business related capital expenditures, referred to as 'blackhole expenditure' had not been recognised appropriately for tax purposes.

6. The former section 40-880 was introduced to allow a five-year, straight-line write-off for a number of specific types of business related capital expenditure which had not previously received relief in the tax system (such as the costs of raising equity, of establishing, converting or winding up a business structure and of defending against takeovers).

7. It applied to costs incurred on or after 1 July 2001 and on or before 30 June 2005. Capital expenditure which was not one of the seven types specified in the former section 40-880 remained unrecognised by the tax system.

8. *Tax Laws Amendment (2006 Measures No. 1) Act 2006* repealed the former section 40-880 and replaced it with the current provision which applies to business related capital expenditure incurred on or after 1 July 2005.

9. In contrast to the former section 40-880, the current provision is expressed in more general terms. It includes and extends the types of expenditure specified in the former section 40-880.

10. The following key concepts apply in relation to the current section 40-880:

- It is a provision of last resort. In other words, section 40-880 only applies to expenditure if no other provision allows or denies a deduction or otherwise takes the expenditure into account.
- The expenditure must be capital expenditure which is business related. This excludes revenue expenditure and non-business expenditure such as expenditure relating to occupation as an employee or to passive investment.
- The expenditure must be incurred on or after 1 July 2005.
- If the expenditure relates to an existing business then the entity that incurs the expenditure is only entitled to a deduction if they are carrying on that business.
- The business in relation to which the taxpayer incurs the expenditure is not limited to the taxpayer's existing business. The expenditure may relate to a former or proposed business, or to the liquidation, deregistration or winding up of a company, partnership or trust that

carried on a business and of which the taxpayer was a member, a partner or a beneficiary.

- The expenditure which the taxpayer incurs must relate to a business to the extent to which that business is carried on for a 'taxable purpose'.
- The eligibility for a deduction is determined, once and for all, as at the time the expenditure is incurred. There is no need to test in subsequent years whether that expenditure is eligible.
- The expenditure is allowed as a straight-line write-off over five years and the expenditure is not apportioned if it is incurred part way through the year.
- A deduction of more than one fifth of the expenditure cannot be claimed in any particular income year.
- Only the entity that incurs the expenditure qualifies for the deduction.
- Once eligibility is established a number of limitations and exceptions may apply to limit the amount deductible or to deny a deduction.

11. Further, other provisions in the tax laws may operate to defer or deny a section 40-880 deduction, for example, Divisions 35 and 85.

Ruling

The expenditure must be incurred on or after 1 July 2005 and must be business related capital expenditure

12. There is no statutory definition of the term 'incurred' however the principles established by case law regarding the meaning of the word 'incurred' in section 8-1 also apply to section 40-880. In other words, a taxpayer incurs expenditure at the time they owe a present money debt that they cannot avoid paying.

13. The expression 'capital expenditure' is also not a defined term. Whether expenditure is capital in nature is determined on the facts of each particular case having regard to the principles established by case law. Merely because expenditure fails the positive limbs of section 8-1 does not necessarily mean that it will be capital expenditure.

14. Subject to the specified limitations and exceptions, paragraphs 40-880(2)(a) to 40-880(2)(c) allow a taxpayer to deduct capital expenditure they incur if it is 'in relation to' a business:

- currently carried on by them;
- formerly carried on by them or by another entity; or

- proposed to be carried on by them or by another entity.

15. The expression 'in relation to' denotes the proximity required between the expenditure on the one hand and the former, current or proposed business on the other. For capital expenditure to be 'in relation to' a business, there must be a sufficient and relevant connection between the expenditure and the business.

16. The closeness of the association or connection must objectively support the conclusion that the capital expenditure is a business expense of the particular business.

17. Whether capital expenditure is truly business expenditure is determined by the facts. If the facts show that the expenditure satisfies the ends of the relevant business, it will have the character of business expenditure.

18. Capital expenditure that has the essential character of business expenditure also includes expenditure on activities that prepare for the commencement of the business.

19. Business related capital expenditure does not include expenditure relating to non-business activities such as passive investment. Occupation as an employee is generally a non-business activity (although earning income under a contract of employment can, in limited circumstances, form part of a business).

The relevant business

20. Subsection 40-880(2) requires identification of the business in relation to which the relevant capital expenditure was incurred. The word 'business', as defined at subsection 995-1(1), is used throughout section 40-880. The nature and scope of a business for the purposes of the section is a question of fact in each case.

21. The reference in paragraph 40-880(2)(a) to 'your business' is a reference to the taxpayer's overall business rather than a particular undertaking or enterprise within the overall business. Similarly, where the taxpayer is the head company of a consolidated group, 'your business' refers to the overall business of the head company.

22. In contrast, paragraphs 40-880(2)(b) and 40-880(2)(c), which concern a former business and a proposed business, could refer to an overall business or a business activity which is an element or aspect of the taxpayer's overall business. This is also the case with the head company of a consolidated group.

Expenditure which serves more than one purpose or object

23. Determining the amount allowable as a deduction under section 40-880 is a multi-step process. The first step is to determine initial entitlement under subsection 40-880(2). Once entitlement is established, the limitations in subsections 40-880(3) and 40-880(4) and the exceptions in subsection 40-880(5) must be considered.

24. The use of the expression 'to the extent that' in subsections 40-880(3), 40-880(4) and 40-880(5) indicates that an apportionment may be required when applying those subsections. In contrast, subsection 40-880(2) does not contain the expression 'to the extent that'. However, in the Commissioner's view the absence of the expression 'to the extent that' in subsection 40-880(2) does not prevent an apportionment of expenditure on a single thing or service which serves more than one purpose or object. This is equally so whether the thing or service serves distinct and separate purposes or objects, or whether the thing or service serves two or more purposes or objects indifferently.

25. The basis for any such apportionment must be fair and reasonable.

The deduction is limited by the extent to which the taxpayer's current business is, a former business was or a proposed business is to be carried on for a taxable purpose

26. Subsections 40-880(3) and 40-880(4) both contain a 'taxable purpose test' which applies to the expenditure identified in subsection 40-880(2) by reference to the extent to which it relates to carrying on the business for a taxable purpose. In other words, *the* expenditure identified in subsection 40-880(2) is deductible only to the extent that it relates to so much of the business that is, was or will be, carried on for a taxable purpose.

27. If the expenditure relates to the whole of the business but part of the business is carried on to derive exempt income or non-assessable non-exempt income then to that extent the expenditure will not be deductible. If the expenditure relates solely to that part of the business carried on to derive assessable income, however, the whole of the expenditure will be deductible. On the other hand, if the business is carried on to derive exempt income or non-assessable non-exempt income only then none of the expenditure is deductible under subsection 40-880(2).

Example 1

28. *D Coy carries on a manufacturing business in Australia and is also the holding company of a number of overseas subsidiaries. The income it derives from manufacturing is assessable income. It also derives dividends, which are non-assessable non-exempt income under section 23AJ of the Income Tax Assessment Act 1936 (ITAA 1936), from its overseas subsidiaries. The proportion of its assessable income to total income for all foreseeable years is 50%.*

29. *D Coy decides to cease manufacturing in Australia. Prior to terminating its manufacturing activities, it incurs capital expenditure to close down those activities.*

30. *D Coy's business, for the purposes of subsection 40-880(2), is its overall business of being a holding company and a manufacturer.*

31. *As the expenditure is incurred exclusively for a part of D Coy's business that was carried on for a taxable purpose, pursuant to subsection 40-880(3), it is fully deductible under subsection 40-880(2).*

Example 2

32. *A Coy and B Coy decide to establish a retail business to be carried on in partnership. A Coy (but not B Coy) incurs capital expenditure in relation to the proposed business. When the expenditure is incurred, it is proposed that, for the foreseeable future, the business will be carried on wholly for a taxable purpose.*

33. *No apportionment of A Coy's expenditure is required under subsection 40-880(3) as the business is proposed to be carried on wholly for a taxable purpose.*

34. Neither the legislation nor the extrinsic material sets out a particular methodology to determine the extent to which a business is carried on for a taxable purpose or not. In the absence of a prescribed method, however, the Commissioner will accept an apportionment made on a fair and reasonable basis.

35. As a general rule, the extent to which a business is, was or is proposed to be, carried on for a taxable purpose is determined by comparing the amount of any exempt income and non-assessable non-exempt income the business has derived or will derive with total income (that is, assessable income plus exempt income plus non-assessable non-exempt income). This percentage is then applied to the amount of expenditure to reduce the deduction.

Example 3

36. *J Coy is a holding company and manufacturer which incurs capital expenditure to remove a disruptive board member. The expenditure relates indifferently to all its business activities.*

37. *J Coy's relevant business for the purposes of applying the taxable purpose test in subsection 40-880(3) is its overall business.*

38. *For the foreseeable future, 50% of its income will be assessable income derived from a business activity in Australia. The other 50% of its income will be non-assessable non-exempt income.*

39. *As the expenditure relates to the whole of the business indifferently, pursuant to subsection 40-880(3), only 50% of the expenditure will be deductible under subsection 40-880(2).*

40. However, a comparison of non-assessable non-exempt and exempt income with total income may not always be the most relevant method of apportionment – particularly, if an integral part of the business activities is not for the purpose of gaining or producing any income, assessable or otherwise.

41. The taxable purpose of the business is tested as at the time the expenditure is incurred. Where expenditure is incurred for an existing or proposed business, the test takes into account all known and predictable facts about the taxable purpose of the business in future years – not just in the year the expenditure is incurred or the years for which a deduction under section 40-880 is sought.

Example 4

42. *M Coy, a resident taxpayer incurs capital expenditure to raise equity to acquire a discrete off-shore enterprise from which M Coy will derive only non-assessable non-exempt income by way of dividends. However, the acquisition is delayed for two years during which M Coy invests the equity on-shore in return for assessable interest income.*

43. *In circumstances such as these, where dividends would be a discretionary matter for the directors of the off-shore enterprise, a fair and reasonable approach to determine the extent to which the capital expenditure is deductible would be to apportion it on a temporal basis. That is, to compare the two years of the on-shore investment against the anticipated duration of M Coy's investment in the off-shore enterprise.*

44. In contrast to the taxable purpose test for current and proposed businesses, the taxable purpose test for a former business is applied to the period which reasonably reflects the taxable purpose of the former business. Generally, the Commissioner will accept that a period of five years before the taxpayer permanently ceased operating the business will give a reasonable reflection.

Expenditure which forms part of the cost of land

45. Paragraph 40-880(5)(c) provides that the taxpayer cannot deduct expenditure they incur to the extent that it forms part of the cost of land. This paragraph excludes from deductibility expenditure incurred to acquire land in the relatively uncommon situation where the cost of acquiring land does not form part of the cost base or reduced cost base of the land. This can occur if the amount is incurred to acquire the freehold title to land for someone other than the taxpayer.

Expenditure in relation to a lease or other legal or equitable right

46. Paragraph 40-880(5)(d) provides that the taxpayer cannot deduct expenditure they incur to the extent that it is in relation to a lease or other legal or equitable right.

47. The existence of paragraphs 40-880(5)(a) and 40-880(5)(f) and section 25-110 mean that paragraph 40-880(5)(d) has limited practical application. It applies to expenditure incurred on or after 1 July 2005 that has a sufficient and relevant connection to a lease or right held by an entity other than the taxpayer. The 'rights' in question do not include all legal rights but only those similar to leases in that they give the taxpayer a right to exploit the asset with which the right is associated. In other words, the right is carved out of an asset but falls short of full ownership of the asset. Examples of such rights include profits à prendre, easements and other rights of access to land. The rights however are not limited to rights associated with land.

Expenditure that could be taken into account in working out the amount of a capital gain or capital loss from a CGT event

48. In most cases, capital proceeds and cost base (or reduced cost base) are taken into account in working out the amount of a capital gain or capital loss from a CGT event. Therefore, capital expenditure which reduces capital proceeds from a CGT event or forms part of the cost base (or reduced cost base) of a CGT asset could be taken into account in working out the amount of a capital gain or capital loss from a CGT event for the purposes of paragraph 40-880(5)(f).

49. Where the expenditure is not reflected in the net capital gain included in the taxpayer's assessable income for the income year in which the CGT event happened because, for example, the amendment period under section 170 of the ITAA 1936 has expired without the expenditure actually having been taken into account, this does not mean that the expenditure could not be taken into account.

50. In the context of section 40-880 the words of paragraph 40-880(5)(f) do not require that the capital expenditure be actually taken into account in working out a capital gain or capital loss, or that the capital gain or capital loss worked out be actually taken into account in working out the net capital gain included in the taxpayer's assessable income – that is a separate process. If the words were interpreted otherwise expenditure which should receive CGT treatment could inappropriately become a revenue deduction.

Expenditure incurred in relation to gaining or producing exempt income or non-assessable non-exempt income

51. Where expenditure is incurred in relation to gaining or producing exempt income or non-assessable non-exempt income and an apportionment is required under subsection 40-880(3) or 40-880(4) (because the relevant business or aspect of the business was not carried on wholly for a taxable purpose) this does not mean that the section 40-880 deduction is reduced twice.

52. The interaction of subsection 40-880(3) or 40-880(4) and paragraph 40-880(5)(j) results in only one reduction (under these respective provisions) to the amount that a taxpayer can deduct under section 40-880.

Other provisions that may affect the taxpayer's section 40-880 deduction

Non-commercial losses

53. If the taxpayer is an individual taxpayer (operating either alone or in partnership) the non-commercial loss provisions in Division 35 may apply to defer deductions for expenditure they incur in relation to a business they carry on or propose to carry on.

54. Where the taxpayer has incurred business capital expenditure in relation to a former business and the activity does not satisfy the commerciality tests or the Commissioner does not exercise his discretion not to apply the rule in subsection 35-10(2), the section 40-880 deduction will be denied rather than deferred.[1]

Personal services income

55. Under the personal services income rules, an individual carrying on a business which generates personal services income but does not meet the 'personal services business tests' and does not have a 'personal services business determination' from the Commissioner, will not be regarded as conducting a personal services business. Therefore, under section 85-10, they will be prevented from deducting any amount under the Act, including section 40-880, that an employee could not deduct in relation to their personal services income.

56. However, a taxpayer that is a 'personal services entity' (company, partnership or trust) which carries on business and is in receipt of personal services income may be entitled to a deduction under section 40-880, even though it does not meet any of the 'personal services business tests' and has not received a 'personal services business determination'.

[1] Subsection 35-10(2A).

Date of effect

57. This Ruling applies to arrangements begun to be carried out from 1 July 2005 except insofar as a view in this Ruling differs from that in an Australian Taxation Office Interpretative Decision (ATO ID) mentioned in the following paragraph. Where a view in this Ruling differs from that in the ATO ID, the Ruling applies from 8 December 2010.

58. The ATO view on most of the matters covered by this Ruling was stated in a number of ATO IDs. This Ruling is consistent with those ATO IDs in most respects. However, when this Ruling issued as a draft, the views in ATO ID 2007/94, ATO ID 2009/37 and ATO ID 2009/84 were altered.[2] Accordingly, those particular ATO IDs were withdrawn with effect from the date of issue of the draft Ruling. In addition, this Ruling is not consistent with the view expressed in ATO ID 2003/788 (withdrawn) about capital expenditure incurred to restore leased premises to the condition they were in at the start of the lease. That ATO ID and the reason for its withdrawal could reasonably have conveyed a view of the law contrary to the view expressed in this Ruling. Therefore, to the extent that this Ruling differs from the view in ATO ID 2003/788 (withdrawn) this Ruling applies from 8 December 2010. The remaining ATO IDs on matters covered by this Ruling are withdrawn with effect from the date of release of this Ruling as they are redundant.

Commissioner of Taxation
30 November 2011

[2] The ATO view in ATO ID 2009/37 (withdrawn) is altered by paragraph 45 of this Ruling. The ATO view in ATO ID 2007/94 (withdrawn) and ATO ID 2009/84 (withdrawn) is altered by paragraphs 23 to 25 of this Ruling.

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

59. The object of section 40-880 is to allow a deduction over five years for certain business capital expenditure, incurred on or after 1 July 2005, if:

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

60. A number of tests about the expenditure must be satisfied to initially establish an entitlement to a deduction. The provision then limits and excludes the amount of expenditure the taxpayer can deduct by imposing further tests on the expenditure and the business itself.

The expenditure must be incurred by the taxpayer on or after 1 July 2005

61. The current section 40-880 only applies to business related capital expenditure which is incurred on or after 1 July 2005.

62. There is no statutory definition of the term 'incurred'. As a broad guide, the taxpayer incurs an outgoing at the time they owe a present money debt that they cannot avoid paying.

63. The courts have been reluctant to attempt an exhaustive definition of a term such as incurred. However, Taxation Ruling TR 97/7 *Income tax: section 8-1 – meaning of 'incurred' – timing of deductions* sets out the following principles developed by case law to help determine whether and when expenditure has been incurred:

(a) a taxpayer need not actually have paid any money to have incurred expenditure provided they are definitively committed. Accordingly, expenditure may be incurred even though it remains unpaid, provided the taxpayer is 'completely subjected' to the obligation to pay. That is, subject to the principles set out below, it is not sufficient if the liability is merely contingent or no more than pending, threatened or expected, no matter how certain it is that the expenditure will be incurred in the future. It must be a presently existing liability to pay a pecuniary sum;

(b) a taxpayer may have a presently existing liability, even though the liability may be defeasible by others;

(c) a taxpayer may have a presently existing liability, even though the amount of the liability cannot be precisely ascertained, provided it is capable of reasonable estimation (based on probabilities);

(d) whether there is a presently existing liability is a legal question in each case, having regard to the circumstances under which the liability is claimed to arise; and

(e) in the case of a payment made in the absence of a presently existing liability (where the money ceases to be the taxpayer's funds) the expense is incurred when the money is paid.

The expenditure must be capital in nature

64. The expression 'capital expenditure' is not a defined term. Whether expenditure is capital in nature is determined on the facts of each particular case having regard to the principles established by the case law.

65. Merely because expenditure fails the positive limbs of section 8-1 will not necessarily mean that it will be capital expenditure.

66. The classic test for determining whether expenditure is of a capital or revenue nature is explained in the following passage from the judgment of Dixon J in *Sun Newspapers Ltd. and Associated Newspapers Ltd. v. Federal Commissioner of Taxation* (1938) 61 CLR 337; (1938) 5 ATD 23; (1938)1 AITR 403 (*Sun Newspapers*):

> There are, I think, three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay…

67. The character of the advantage sought provides important direction. It provides the best guidance as to the nature of the expenditure as it says the most about the essential character of the expenditure itself. This was emphasised in the decision of the High Court in *G.P. International Pipecoaters v. Federal Commissioner of Taxation* (1990) 170 CLR 124; 90 ATC 4413; (1990) 21 ATR 1.

68. If expenditure produces some asset or advantage of a lasting character for the benefit of the business it will be considered to be capital expenditure. As stated in *Sun Newspapers* at 355 per Latham J, an enduring benefit does not require that the taxpayer obtain an actual asset, it may be a benefit which endures, in the way that fixed capital endures. Menzies J in *John Fairfax & Sons Pty Ltd v. Federal Commissioner of Taxation* (1959) 101 CLR 30; (1959) 11 ATD 510; (1959) 7 AITR 346 concluded that a capital expense can also result in the reduction of capital. In *Foley Brothers Pty Ltd v. FC of T* (1965) 13 ATD 562; (1965) 9 AITR 635, outgoings incurred for the purpose of altering the organisation or structure of the profit-yielding subject (including its demise) were considered to be of a capital nature.

The capital expenditure must be business related

69. Under paragraphs 40-880(2)(a), 40-880(2)(b) and 40-880(2)(c), the taxpayer can deduct capital expenditure they incur if it is in relation to their business, or in relation to a business that used to be carried on or is proposed to be carried on.

70. The expression 'in relation to' denotes the proximity required between the expenditure on the one hand and the former, current or proposed business on the other. Establishing that the expenditure is in relation to the relevant business is the threshold step in determining whether the expenditure can be deducted under one of these paragraphs.

71. Subsection 40-880(1) describes the object of section 40-880 to make certain business capital expenditure deductible over five years. The expression 'business capital expenditure' connotes capital expenditure that has the essential character of business expenditure. This is confirmed by paragraph 2.25 of the Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No. 1) Bill 2006 ('2006 Explanatory Memorandum') which notes:

> The provision is concerned with expenditure that has the character of a business expense because it is relevantly related to the business.

72. The use of the expression 'in relation to' in subsection 40-880(2) rather than 'in carrying on' or the preposition 'on' to qualify the closeness of the required connection indicates that Parliament intended there to be greater latitude in the connection that needs to exist.

73. In contrast, for expenditure to be deducted under the second positive limb of section 8-1, it must be incurred in carrying on a business. To satisfy this requirement, the outgoing must have the character of a working or operating expense of the entity's business or be an essential part of the cost of its business operations. In *John Fairfax & Sons Pty Ltd v. FC of T* (1958-9) 101 CLR 30 Menzies J stated at page 49:

> …there must, if an outgoing is going to fall within its terms, be found (i) that it was necessarily incurred in carrying on a business; and (ii) that the carrying on of the business was for the purpose of gaining assessable income. The element that I think is necessary to emphasise here is that the outlay must have been incurred in the carrying on of a business, that is, it must be part of the cost of trading operations.

74. The test under the second positive limb of section 8-1 is therefore a more demanding test requiring a more immediate or direct link between the expenditure and the process of operating the business than a connection that qualifies the expenditure as being 'in relation to' a business.

75. The words 'in relation to', whilst positing a test that is not as strict as 'in carrying on' however indicate that the expenditure in question is sufficiently relevant to the business to impress on it the character of a business expense of that business.

76. The legislation does not define the expression 'in relation to' and so it takes its ordinary meaning. The Macquarie Dictionary, 2005, 4th edition, The Macquarie Library Pty Ltd, NSW, defines 'related' as 'associated; connected'. Accordingly, the expenditure and the business need to be associated or connected for the expenditure to be described as being 'in relation to' the business. Although the phrase 'in relation to' uses wide words of connection, the intended width of the relationship between the two connected subjects must be considered against their legislative context.

77. This principle of interpretation was applied by the High Court in *PMT Partners Pty Ltd (In Liquidation) v. Australian National Parks & Wildlife Service* (1995) 184 CLR 301. Brennan CJ, Gaudron and McHugh JJ observed, in considering the application of the *Commercial Arbitration Act 1985* (NT), at 313:

> Inevitably, the closeness of the relation required by the expression 'in or in relation to' in s 48 of the Act, indeed, in any instrument – must be ascertained by reference to the nature and purpose of the provision in question and the context in which it appears.

78. The legislative context of section 40-880 indicates that the closeness of the association or connection must objectively support the conclusion that the expenditure is a business expense of the particular business. This is the same idea conveyed by the then Treasurer in media release no. 045 on 10 May 2005 that announced a systemic tax treatment for 'legitimate business expenses, known as blackhole expenditures.' The adjective 'legitimate' emphasises that the expenditure in question must be a genuine business expense of a particular business.

79. Whether capital expenditure is truly a business expense turns on the particular facts and circumstances and is a matter of impression and judgement. Determining whether the expenditure has the character of a business expense can be approached by asking what the expenditure is for, in the sense of identifying the need or object that the expenditure serves. If the facts show that the expenditure satisfies the ends of the relevant business then it will have the character of a business expense.

Example 5

80. *Jemima decides to expand her bus charter business by purchasing another bus. She finds a second-hand bus in another State that seems to meet her requirements and buys an airfare so she can inspect it before committing to the purchase. Jemima inspects the bus and concludes that it is not suitable. She does not go ahead with the purchase.*

81. *The expenditure is in relation to Jemima's bus charter business because the object of the expenditure is directed to meeting a need of the business – that is adding to the fleet of buses available for charter. The purpose of the expenditure is to facilitate Jemima's inspection of the bus in order to evaluate whether it met the requirements of the business and is, therefore, in relation to the business for the purpose of paragraph 40-880(2)(a).*

82. In many cases, the description of what the expenditure is for will be enough to demonstrate the relationship with the former, proposed or existing business. The connection will be readily evident. For example, capital expenditure incurred to establish the structure (that is, the entity) that is to carry on a proposed business has a clear connection with that proposed business. Likewise, expenditure on converting an existing business structure to a different structure which is to carry on that business in future, for example, from a sole trader or partnership to a company, demonstrates a relevant connection with the existing business being carried on (as well as with the carrying on of that business in the future).

83. There is an immediate connection between expenditure of this type and the relevant business because establishing the structure by which the business will be owned and operated is an essential prerequisite to the conduct of the business itself. The occasion of the outgoing can only be explained by reference to the business. Of course, expenditure to establish a structure, such as a company, will only be deductible under section 40-880 if there is in fact a business that is proposed to be carried on in that structure. If there is no proposal to carry on a particular business within a reasonable time then it follows that the requisite relationship between the expenditure and a business cannot be satisfied.

84. In contrast, expenditure relating to the ownership of the entity carrying on the business is not business related capital expenditure unless it can be demonstrated that the change of ownership serves an objective of the business.

Example 6

85. *Company B approaches Company A with a merger proposal. To evaluate the proposal Company A incurs capital expenditure on professional fees for legal, corporate and tax advice and for the performance of financial due diligence. The object of the expenditure is to determine the commercial merit of the proposal including the effect on the company's structure and its trading operations. The expenditure is in relation to Company A's business for the purpose of paragraph 40-880(2)(a).*

Example 7

86. *Wayne and Blayne are shareholders in X Pty Ltd. As their personal relationship deteriorates Blayne considers whether or not to sell his shares and incurs capital expenditure on professional advice. The sale does not proceed because they resolve their relationship issues.*

87. *Blayne's expenditure is not in relation to the business for the purpose of paragraph 40-880(2)(a).*

Example 8

88. *XYZ Pty Ltd carries on a medical research and supply business. The shareholders' involvement in the business includes providing medical expertise and services to the company. Because of other commitments one of the shareholders has been and will continue to be unable to devote resources to the business.*

89. *The directors of XYZ Pty Ltd decide that in the interests of the business the ownership of the company should be restructured to replace the inactive shareholder with a private equity investor with the business acumen to push the company forward and inject capital for the purpose of future growth.*

90. *To facilitate the restructure XYZ Pty Ltd paid $200,000 to the shareholder as an incentive to agree to the sale of his shares to the equity investor.*

91. *The expenditure is capital expenditure of the company in relation to the business for the purpose of paragraph 40-880(2)(a).*

92. Capital expenditure that also has the essential character of a business expense includes expenditure on activities that prepare for the commencement of the business. Some typical examples are market research or writing a business plan. This expenditure is directed to meeting the anticipated commercial requirements of the proposed business operations and necessarily satisfies the description of being 'in relation to' the business.

The capital expenditure must relate to the taxpayer's current business, a former business carried on by the taxpayer or another entity or a proposed business to be carried on by the taxpayer or another entity

93. If capital expenditure does not fall under paragraph 40-880(2)(d) then entitlement to a deduction can only arise under paragraph 40-880(2)(a), 40-880(2)(b) or 40-880(2)(c). In other words the expenditure must relate to a business:

- currently carried on by the taxpayer;'
- formerly carried on by the taxpayer or by another entity; or
- proposed to be carried on by the taxpayer or by another entity.

94. 'Business' is defined broadly at subsection 995-1(1) and includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee. Paragraph 40-880(2)(a) refers to 'your business' being the taxpayer's overall business. In contrast, the references in paragraphs 40-880(2)(b) and 40-880(2)(c) to past and future businesses of the taxpayer or another could refer, in the case of the taxpayer's business, to the taxpayer's overall business or a discrete undertaking or enterprise that was or will be a part of the taxpayer's overall business.

95. The table at paragraph 18 of *Taxation Ruling TR 97/11 Income tax: am I carrying on a business of primary production?* sets out the indicators the Commissioner considers relevant in determining whether activities constitute the carrying on of a business.

96. The capital expenditure must be business related. Business related capital expenditure does not include expenditure relating to non-business activities such as passive investment. Occupation as an employee is generally a non-business activity (although earning income under a contract of employment can in limited circumstances form part of a business).[3]

97. What is passive income of an individual will not necessarily be passive income of a company *Brookton Co-Operative Society Limited v Federal Commissioner of Taxation* 81 ATC 4346 per Aickin J at 4363. Whether other entities such as partnerships, trusts or other collective investment vehicles have incurred expenditure on passive investments or in relation to a business will be determined on the individual facts of each case.

Current business

98. Paragraph 40-880(2)(a) gives an entitlement to a deduction for capital expenditure the taxpayer incurs in relation to their business. The expenditure must relate to an existing business the taxpayer is carrying on at the time they incur the expenditure.

99. Under paragraph 40-880(2)(a), only the taxpayer carrying on the business, and no other taxpayer, is entitled to a deduction. If the business is carried on through a company or trust structure then that entity must incur the expenditure to be entitled to a deduction under this paragraph.

100. If the expenditure relates only to a current business an individual may be entitled to a deduction only if the business is carried on by them through a partnership or sole proprietorship structure.

Former business

101. Paragraph 40-880(2)(b) gives an entitlement to a deduction for expenditure incurred in relation to a business that used to be carried on. This means that the taxpayer has permanently ceased operating the business.

102. The use of the words 'a business' means that the business need not have been carried on by the taxpayer for an entitlement to a deduction to arise under this paragraph.

103. Paragraph 40-880(2)(b) captures capital expenditure incurred to cease carrying on a business and expenses incurred as a consequence of the business ceasing.

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[3] *Spriggs v. FC of T; Riddell v. FC of T* [2009] HCA 22.

Example 9

104. *AusCo carries on businesses in Australia and overseas. The directors are considering whether the overseas business should continue to be carried on by AusCo. A number of proposals are considered one of which is that AusCo will continue to carry on the domestic business and a separate entity will carry on the overseas business.*

105. *AusCo obtains legal and accounting advice to give effect to the restructure but is not invoiced for these services until after the restructure occurs and does not incur the relevant expenditure until after the restructure.*

106. *The expenditure incurred relates to two businesses one of which is the overseas business that AusCo used to carry on for the purposes of paragraph 40-880(2)(b).*

Proposed business

107. Paragraph 40-880(2)(c) gives the taxpayer an entitlement to a deduction for capital expenditure incurred in relation to a business proposed to be carried on. The use of the words 'a business' means that a business that another entity proposes to carry on is included. In other words, the taxpayer does not have to propose to carry on the business themselves.

108. Whether a business is proposed to be carried on is determined on the facts. This means that the taxpayer's subjective intentions are not sufficient to evidence whether there is a proposed business. At the time they incur the expenditure they need to be able to identify the business they propose to carry on and demonstrate a real commitment to commence that business. In other words, the taxpayer needs to be able to demonstrate more than just a vague or imprecise idea to start a business.

109. Activities which demonstrate the relevant commitment include, but are not limited to:

- preparation of a business plan;
- establishment of a business premises;
- research into the likely markets or profitability of the business; and
- acquiring assets for use in the business.

110. The formation of an entity through which the business is proposed to be carried on and the registration of a trading name are also indicators that the business has been identified and the necessary commitment exists.

111. The commitment to carry on the business must be evident at the time expenditure is incurred.

Example 10

112. *Matthew travels overseas on a working holiday and spends $10,000 on airfares and accommodation. While there he becomes aware of a business operation which is likely to succeed in Australia. On his return to Australia he prepares a business plan and establishes business premises for his new venture.*

113. *The $10,000 does not satisfy paragraph 40-880(2)(c) to any extent because when the expenditure was incurred there was no commitment to commence the business.*

114. It is not always necessary that the business related capital expenditure be incurred after there is already a commitment to carry on the business. In some circumstances, the incurrence of the expenditure may evidence the commitment so that the business can be regarded as one proposed to be carried on.

Example 11

115. *James spends $5,000 on a feasibility study and the preparation of a business plan for the operation of 10 accommodation cabins which he intends to build and manage on his hinterland property.*

116. *The $5,000 expenditure evidences a commitment to commence the business.*

117. The kind of capital expenditure which relates to a proposed business is expenditure incurred for the purpose of assessing, advancing or leading to the commencement of a business. Examples include expenditure:

- to investigate the viability of a business such as the fees paid for feasibility studies or market research;
- to establish the business structure; and
- on market testing or submitting a tender.

Example 12

118. *Michael intends to start up his own small business. He has no previous experience in running his own business so has decided to purchase a franchise because of the training, experience and on-going support that comes with being a franchisee.*

119. *Michael is not yet sure which industry or market segment the franchise will be in, the entity through which the business will operate or where the business will be located. He incurs capital expenditure on legal fees to visit a lawyer to get some general commercial advice on how franchises operate.*

120. *While Michael knows he intends to operate a franchise business, he is unsure which industry the business will be in, the activities of the business, the entity structure and where the business will be located. This indicates that sufficient identity about the business does not exist at the time the expenditure on legal fees was incurred. Michael merely has a vague idea about wanting to start a small business. Therefore, the expenditure incurred is not in relation to a proposed business.*

121. The fact that the proposed business does not actually commence does not preclude the expenditure from being 'in relation to a proposed business'. A deduction may be available before the business is carried on where the conditions for the deduction are met.

Example 13

122. *Jack is employed as a landscaper. He wants to acquire a landscaping business. He incurs travel expenses to assess a number of businesses which may satisfy his requirements.*

123. *Prior to incurring the travel expenditure Jack:*

- *identified a specific business model and concept for carrying on the business and made decisions about the activities to be carried on by the business;*
- *decided on business structure through which the business would be carried on; and*
- *narrowed the number of possible acquisition targets.*

124. *However, for various reasons a business was not acquired.*

125. *These facts demonstrate a commitment of some substance to commence an identifiable business at the time when the expenditure was incurred. The fact that the business was not acquired does not mean that it was not a proposed business.*

126. In addition to showing that the expenditure relates to a proposed business, the taxpayer is required under subsection 40-880(7) to demonstrate that it is reasonable to conclude that the business is proposed to be carried on within a reasonable time.

127. There is no hard and fast rule as to what is a reasonable time within which a proposed business needs to commence. What is reasonable will depend on the facts of each case, such as the nature of the business and lead times for the particular industry.

Example 14

128. *Cameron incurs legal expenses relating to a feedlot and abattoir business that he proposes to carry on. He plans to commence business as soon as the necessary government agency approvals are obtained. Generally, the approvals take two years.*

129. *It is reasonable to conclude that the business was proposed to be carried on within a reasonable time because the lead time to commence business in that particular industry is generally two years and Cameron plans to commence the business as soon as the approvals are obtained.*

Capital expenditure incurred to liquidate or deregister a company or wind up a partnership or trust

130. Paragraph 40-880(2)(d) specifically deals with capital expenditure incurred by:

- a member of a company to liquidate or deregister the company;
- a partner in a partnership to wind up the partnership; and
- a beneficiary in a trust to wind up the trust.

131. Unlike paragraphs 40-880(2)(a) to 40-880(2)(c) which use the expression 'in relation to' to link the expenditure to the business, paragraph 40-880(2)(d) uses the preposition 'to' as the connector. To come within the scope of this paragraph, the expenditure must be meant directly to initiate or advance the process of bringing to an end, the structure through which the business is or was carried on.

132. The types of expenditure covered by this paragraph are the costs directly referable to the liquidation of a company or the winding up of a partnership or trust; for example, the legal and administration costs of the winding up application and any government fees or charges for deregistration.

133. Expenditure incurred by a shareholder, partner or beneficiary prior to making the decision to liquidate or wind up an entity does not have the relevant connection under paragraph 40-880(2)(d) because it is not incurred directly in the process of bringing the entity to an end. This type of expenditure may nevertheless be considered under paragraph 40-880(2)(b).

134. If expenditure to wind up the company, partnership or trust is incurred by the company, partnership or trust, it will need to be considered under paragraph 40-880(2)(b) because paragraph 40-880(2)(d) only applies to expenditure incurred by shareholders, partners and beneficiaries themselves, not the company, partnership or trustee which carries on the business in which they hold an interest.

Capital expenditure that serves more than one purpose or object

135. Determining the amount allowable as a deduction under section 40-880 is a multi-step process. The first step is to determine initial entitlement under subsection 40-880(2). Once entitlement is established, the limitations in subsections 40-880(3) and 40-880(4) and the exceptions in subsection 40-880(5) must be considered.

136. The use of the expression 'to the extent that' in subsections 40-880(3), 40-880(4) and 40-880(5) indicates that an apportionment may be required when applying those subsections. In contrast, subsection 40-880(2) does not contain the expression 'to the extent that'.

137. Nevertheless, the Commissioner considers that the absence of the expression 'to the extent that' in subsection 40-880(2) does not prevent an apportionment if the taxpayer incurs an amount of expenditure in relation to both a matter covered by any of paragraphs 40-880(2)(a) to 40-880(2)(d) and another matter.

138. In general, section 40-880 is structurally similar to the general deduction provision in section 8-1 and its predecessor subsection 51(1) of the ITAA 1936. The leading case governing the apportionment of losses and outgoings under those provisions is well-known: *Ronpibon Tin NL v. FCT* (1949) 78 CLR 47 (*Ronpibon Tin*). It is unlikely that Parliament would have adopted a general legislative structure similar to those provisions unless it intended the established case law on those provisions to apply. There is no stated indication that the provision is meant to operate differently from section 8-1 in this respect; for example, the subsection does not stipulate that the taxpayer must incur capital expenditure *principally* or *wholly and exclusively* in relation to the matters specified. Nor does it state that it is sufficient if the expenditure is incurred in relation to one of the matters specified regardless of what else it may relate to. Rather, the provision is simply silent about the possibility that some expenditure might be incurred in relation to more than one matter.

139. There is no obvious policy reason for prohibiting apportionment in the situations concerned. The 2006 Explanatory Memorandum does not clearly resolve the ambiguity. In these circumstances, on balance recourse to the established principles on apportionment under section 8-1 seems most likely to be what was intended.

140. Accordingly, expenditure incurred on a thing or service as an undivided amount where distinct and severable parts of the thing or service relate to different businesses or objects needs to be apportioned against the relevant paragraphs of subsection 40-880(2) on some fair and reasonable basis: see *Ronpibon Tin* at page 59.

141. Likewise, apportionment must be made on a fair and reasonable basis on the facts of the case where:

(a) a single amount is incurred for a thing or service that indifferently serves business and non-business objects or that indifferently serves two or more businesses, at least one of which is not of the type specified in subsection 40-880(2). An example is where a single outlay is for a service that indifferently serves two current businesses only one of which is the taxpayer's; or

(b) a single amount is incurred for a thing or service that indifferently serves several businesses that are each of the type specified in subsection 40-880(2).

Example 15

142. *ResCo, an Australian resident company, wants to incorporate a non-resident holding company that will hold 100% of the issued shares in ResCo. The holding company will be listed on an overseas stock exchange.*

143. *ResCo will not derive any assessable income from the business of the non-resident holding company. However, ResCo's board of directors expects that the new structure will better position the company globally for future growth by allowing direct equity raising in the overseas marketplace and by allowing debt raising in that marketplace to reflect the overseas listing.*

144. *ResCo incurs capital expenditure on legal, accounting and consulting fees to give effect to the incorporation and overseas listing. The professional services provided result in the incorporation and listing of the overseas entity. That is the immediate or direct economic advantage that the expenditure is directed to achieving.*

145. *The professional services also relate to the business which will continue to be conducted by ResCo therefore the expenditure on the services must be apportioned on a fair and reasonable basis.*

146. Identifying the extent to which a single amount of expenditure relates to different businesses covered by subsection 40-880(2) is a question of fact and degree. It follows that in each case the method which produces a fair and reasonable apportionment will depend on the facts and circumstances unique to that case.

147. There is no single formula or universal approach that necessarily gives a true reflex of the extent of the relationship between such expenditure and each particular business. Just as the courts have rejected a prescriptive approach to apportionment in the context of section 8-1 of the ITAA 1997 and subsection 51(1) of the ITAA 1936, so too apportionment of expenditure for the purposes of applying subsection 40-880(2) involves an exercise of judgement rather than the application of a rigid approach.

148. If the method used is properly considered and supported by the available evidence then it is apt to reflect an apportionment of the expenditure that is fair and reasonable in those particular circumstances.

149. In some cases, the available evidence may support an apportionment based on a comparison of projected revenue flows from the different businesses. For example, in *Adelaide Racing Club Inc. v. Federal Commissioner of Taxation* (1964) 114 CLR 517, the High Court considered the apportionment of expenditure relative to the assessable and non-assessable income of the club in the context of subsection 51(1) of the ITAA 1936 and endorsed an approach that allowed a deduction corresponding to the formula of assessable income to total assessable income and exempt income. Owen J at page 525 observed that the process of ascertaining the figure allowable as a deduction in such cases is difficult. In that case, the taxpayer had proposed alternative methods which produced varying results and although the Commissioner's method was criticised by the taxpayer, his Honour remarked that the Commissioner had 'made what he regarded as a just apportionment of the Club's expenditure….that seemed right and I am not satisfied that the course he followed was wrong…'.

150. In other cases, where a comparison of anticipated revenue does not seem in the circumstances to correctly reflect the importance of the expenditure relative to each of the businesses, the extent to which the expenditure meets a purpose of each business may be a more suitable way to allocate the expenditure. Again, the question is one of judgement.

Limitations on the amount of expenditure allowable as a deduction

151. Once the relevant business is determined for the purposes of subsection 40-880(2), subsections 40-880(3) and 40-880(4) apply to limit deductibility of the capital expenditure to the extent that it relates to that business being carried on for a taxable purpose.

152. If the capital expenditure is incurred in relation to more than one business identified in subsection 40-880(2) and is apportioned accordingly, the limitation in subsections 40-880(3) and 40-880(4) is applied to each apportioned amount on the basis of the extent of the taxable purpose of the business to which that amount relates.

The deduction is limited by the extent to which the taxpayer's current business is, a former business was or a proposed business is to be carried on for a taxable purpose

153. Subsection 40-880(3) and paragraph 40-880(4)(a) both limit the deduction for the expenditure to the extent that it relates to the business being carried on for a taxable purpose (the 'taxable purpose test').

154. 'Taxable purpose' is defined in subsection 40-25(7) to mean:

- the *purpose of producing assessable income; or
- the purpose of *exploration or prospecting; or
- the purpose of *mining site rehabilitation; or
- *environmental protection activities.

155. Section 40-880 is concerned with 'the purpose of producing assessable income'. The deduction of capital expenditure on the other listed taxable purposes is expressly provided for in sections 40-730, 40-735 and 40-755 respectively. 'The purpose of producing assessable income' is defined in subsection 995-1(1) as being something done:

- for the purpose of gaining or producing assessable income; or
- in carrying on a *business for the purpose of gaining or producing assessable income.

156. The taxable purpose test is applied to the capital expenditure to the extent to which it relates to carrying on the business for a taxable purpose. This is achieved by providing that *the* expenditure identified in subsection 40-880(2) is deductible only to the extent that it relates to so much of the business that is, was or will be, carried on for a taxable purpose. If the expenditure relates to the whole of a business only some of which is, was or will be, carried on for a taxable purpose, deduction for the expenditure under subsection 40-880(2) will be limited accordingly by the application of subsection 40-880(3) or paragraph 40-880(4)(a).

157. The taxable purpose of the business is tested as at the time the expenditure is incurred. Where expenditure is incurred for an existing or proposed business, the test takes into account all known and predictable facts about the taxable purpose of the business in future years – not just in the year the expenditure is incurred or the years for which a deduction under section 40-880 is sought.

158. This means that the taxpayer must consider current and proposed business plans (for example, restructure or expansion) and how those plans affect the taxable purpose of the business in the year in which the expenditure is incurred in light of what is foreseeable and intended.

159. If, at the time the taxpayer incurs the expenditure, the business in relation to which the expenditure is incurred is carried on wholly for a taxable purpose and there are no proposals or plans for activities from which exempt income or non-assessable non-exempt income could be derived, then no apportionment will be required under subsection 40-880(3) or paragraph 40-880(4)(a).

160. In contrast to the taxable purpose test for current and proposed businesses, the taxable purpose test for a former business is applied to the period which reasonably reflects the taxable purpose of the former business. Generally, the Commissioner will accept that a period of five years before the taxpayer permanently ceased operating the business will give a reasonable reflection.

161. The legislation does not prescribe a particular methodology to determine the extent of the taxable purpose of the business. The 2006 Explanatory Memorandum is also silent as to how an apportionment under subsection 40-880(3) and paragraph 40-880(4)(a) is made. In the absence of a prescribed method of apportionment the Commissioner will accept an apportionment made on a fair and reasonable basis.

162. As a general rule, the extent to which a business is, was or is proposed to be carried on for a taxable purpose is determined by comparing the amount of any exempt income and non-assessable non-exempt income the business has derived or will derive with total income (that is, assessable income plus exempt income plus non-assessable non-exempt income). This percentage is then applied to the amount of expenditure to reduce the deduction.

Example 16

163. *Company A carries on a business of being a holding company for Australian and foreign subsidiaries. It receives its assessable income and also its non-assessable non-exempt income from its subsidiaries.*

164. *Company A incurred capital expenditure to raise equity for the business. The proportion of non-assessable non-exempt income to total income in the income year in which the capital expenditure was incurred was 20%.*

165. *Taking into account all known and predictable facts in foreseeable years as at the time the expenditure was incurred, the company did not expect this figure to change. Therefore, the extent to which the company's business is carried on for a taxable purpose is 80%.*

Example 17

166. *Using the facts of the previous example, Company A's expenditure was incurred in the 2010 income year. At the time the company incurred the expenditure, the company could predict that the proportion of non-assessable non-exempt income to total income in the 2011, 2012 and 2013 income years would be 10%.*

167. *A restructure of the company group was planned to take place in the 2014 income year. The proportion of non-assessable non-exempt income to total income after the restructure was not known or predictable.*

168. *Therefore, using an average over the income years for which the proportion of non-assessable non-exempt income to total income can be predicted, the extent to which the company's business is carried on for a taxable purpose is 87.5% (80% + 90% + 90% + 90%/4 years).*

169. However, a comparison of non-assessable non-exempt and exempt income with total income may not always be the most relevant method of apportionment – particularly, if an integral part of the business activities is not for the purpose of gaining or producing any income, assessable or otherwise.

Example 18

170. *Company X carries on the business of investing in, funding and managing its subsidiaries as a holding company. The holding of shares in subsidiaries is a significant and strategic part of the company's overall business activities. The company receives some interest and fee income from its subsidiaries which is assessable income. Company X incurred capital expenditure to raise equity for the business.*

171. *Taking into account all known and predictable facts in future years as at the time the expenditure was incurred, the company did not expect a declaration of dividend in its favour from any of the subsidiaries.*

172. *The part of the company's business activities that relate to the holding of shares in subsidiaries is not carried on for the purpose of gaining or producing assessable income. Therefore, it is not carried on for a taxable purpose.*

173. *Based on the amount of time and resources required to undertake each of the particular business activities, the activities related to the holding of shares in subsidiaries account for 75% of the overall business activities of the company. Therefore, the extent to which the company's business is carried on for a taxable purpose is 25%.*

174. The purpose for which a business is carried on may be determined by considering the activities that are currently carried on and reasonably expected to be carried on by the business. It is all the activities that are a part of carrying on the business both now and into the future that must be considered, and whether those activities are for the purpose of gaining or producing assessable income. It is the scope of the business activities and the extent to which they have, or are likely, to produce assessable income, that is important and not simply the actual receipt of assessable or other income.

175. Objective evidence such as public documents and independent reports may be useful for the purposes of evidencing what were known and predictable facts at the time the expenditure was incurred.

Example 19

176. *Using the facts of the previous example, at the time Company X incurred the expenditure, there was no evidence of a policy for the payment of dividends to Company X from its subsidiaries.*

177. *An independent report prepared at that time on the underlying value of the company's business operations did not make any reference to the receipt of dividends from subsidiaries and included no value to Company X on account of expected dividends.*

178. *The report was prepared on the basis of known circumstances affecting the company's business at that time. It provides objective evidence as to the known and predictable facts and expectations of the company as at the time the capital expenditure was incurred.*

Example 20

179. *Company S incurred capital expenditure in respect of implementing a merger with another company. Company S did not derive any non-assessable non-exempt or exempt income for the income year in which the expenditure was incurred.*

180. *Statements issued to the company's members regarding the merger were prepared on the basis of existing circumstances affecting the company's business at the time. They did not make any reference to activities that would result in the company (before and after the merger) deriving non-assessable non-exempt or exempt income. They provide objective evidence as to the known and predictable facts and expectations of the company in respect of its business as at the time the expenditure was incurred.*

If the relevant business is a former or proposed business of another entity, the expenditure must be in connection with the business and the taxpayer deriving assessable income from the business

181. Subsection 40-880(4) applies where the business is a former or proposed business of another entity.

182. In contrast to subsection 40-880(3) subsection 40-880(4) contains an additional test which requires a connection between the expenditure and the former or proposed business and the derivation by the taxpayer of assessable income from the business.

183. Under paragraph 40-880(4)(b) the deduction allowable under section 40-880 is given only to the extent that the expenditure is in connection with:

- the taxpayer deriving assessable income from the business (subparagraph 40-880(4)(b)(i)); and
- the business that was carried on or is proposed to be carried on (subparagraph 40-880(4)(b)(ii)).

184. 'In connection with' in the context of paragraph 40-880(4)(b) has the same, wide meaning as the words 'in relation to' in subsection 40-880(2).

185. The 2006 Explanatory Memorandum explains at paragraph 2.55 that the requirement that the expenditure be in connection with the taxpayer deriving assessable income from the business refers to the entitlement to a share in the profits from the business. The way in which this entitlement arises is by way of a distribution from the entity carrying on the business for example dividends or a trust distribution.

186. Assessable income from the business includes not only direct distributions but also assessable income derived indirectly from the business. For example, if a dividend paid by another company ultimately represents dividends paid to it by the business then the assessable income is from that business because it can be traced to it.

187. However, it should be noted that whether the expenditure is deductible depends on the other requirements of section 40-880 being satisfied. For example, a deduction will be denied by paragraph 40-880(5)(f) if the purpose or expected effect of the expenditure is to increase or preserve the value of a CGT asset so that the expenditure is included in the fourth element of the asset's cost base (paragraph 110-25(5)(a)).

188. The derivation of assessable income solely by way of remuneration as an employee does not have the requisite connection: it is not a derivation of assessable income from the business, but rather a derivation of assessable income from employment.

Example 21

189. *Company A incurred capital expenditure to establish a holding company, which holds 100% of the shares in the taxpayer. The shares in the holding company are held by Company A's former shareholders. The holding company carries on the business of being a holding company.*

190. *Company A is not a shareholder in the holding company therefore it is not in a position to derive assessable income, being an entitlement to a share in the profits (derived either directly or indirectly) from the holding company's business. It is Company A's former shareholders who are in such a position. Therefore, subparagraph 40-880(4)(b)(i) is not satisfied.*

191. A beneficiary of a discretionary trust has no entitlement to derive assessable income from the business of the trust and therefore cannot satisfy subparagraph 40-880(4)(b)(i).

192. The words 'your deriving' in subparagraph 40-880(4)(b)(i) are not to be read as a verb of the present tense, but rather as a circumstance that has relevance for the past, the present and the future.

193. This interpretation is supported by the 2006 Explanatory Memorandum which explains that the requirement that the expenditure be in connection with the taxpayer deriving their assessable income from the business provides a 'proxy for the relationship between the taxpayer and 'their' (that is, the taxpayer) business where the taxpayer that incurs the expenditure is not the same taxpayer that carries on the business'.

194. The 2006 Explanatory Memorandum also explains that the taxpayer does not need to be actually deriving assessable income from the business at the time the expenditure was incurred for there to be a connection to deriving assessable income from the business.

195. Paragraph 40-880(4)(b) also requires that the expenditure is in connection with the business that was carried on or proposed to be carried on.

196. For the purposes of subparagraph 40-880(4)(b)(ii), the character of the expenditure must be of a kind that is connected with the business itself (for example, pertaining to the business structure or to its operations).

Exceptions to allowing a deduction

197. Once entitlement is initially established under subsection 40-880(2) and the limitations in subsection 40-880(3) or 40-880(4) are considered, further restrictions may be placed on the amount of expenditure which is deductible. There are a further 12 possible restrictions which are contained in subsections 40-880(5), 40-880(8) and 40-880(9).

1. Expenditure which forms part of the cost of a depreciating asset

198. Paragraph 40-880(5)(a) provides that the taxpayer cannot deduct anything under section 40-880 for an amount of expenditure they incur to the extent that it forms part of the cost of a depreciating asset that they hold, used to hold or will hold.

199. 'Cost of a depreciating asset' is a defined term and has the meaning given by Subdivision 40-C. There are two elements of the cost of a depreciating asset and Subdivision 40-C shows how those elements are worked out.

200. The word 'hold' in relation to a depreciating asset as defined in subsection 995-1(1) has the meaning given by section 40-40.

Example 22

201. *In February 2010, Company A incurs expenditure to inspect a depreciating asset it intends to purchase for its business. The company subsequently acquires the asset. The expenditure forms part of the cost of the asset.*

202. *Paragraph 40-880(5)(a) excludes the expenditure from deductibility under section 40-880 as it forms part of the cost of a depreciating asset that the company holds.*

Example 23

203. *In February 2010, Company B incurs expenditure to inspect a depreciating asset it intends to purchase for its business. Upon inspection, it is determined that the asset does not suit the company's needs and the purchase of the asset does not proceed.*

204. *As the company does not hold the asset and will never hold it, the expenditure does not form part of the cost of a depreciating asset that the company holds or will hold.*

205. *Paragraph 40-880(5)(a) does not exclude the expenditure from deductibility under section 40-880.*

2. Expenditure deductible under another provision

206. Paragraph 40-880(5)(b) provides that the taxpayer cannot deduct anything under section 40-880 for an amount of expenditure they incur to the extent they can deduct an amount for it under a provision of the income tax law other than section 40-880.

207. Provisions which allow deductions for capital expenditure include, but are not limited to, section 40-25 (capital allowances), section 43-10 (capital works), 40-830 (project pools) and section 25-110 (capital expenditure to terminate a lease etc).

208. The expression 'can deduct' is not defined in the legislation. However, paragraph 2.66 of the 2006 Explanatory Memorandum explains in relation to paragraph 40-880(5)(b) that:

> Expenditure that qualified or qualifies for deduction elsewhere under the income tax law is not deductible. This applies even if the expenditure has not yet been or can no longer be deducted.

Example 24

209. *In February 2010, Company A undertakes a feasibility study directly connected with a project that it proposes to start operating during the 2011 income year. The expenditure qualifies as a project amount under the project pools provisions in Subdivision 40-I.*

210. *No part of the expenditure is deductible until the income year in which the project either starts to operate or is abandoned. For the purpose of paragraph 40-880(5)(b) the taxpayer 'can deduct' an amount for the expenditure even though the expenditure will be deducted in future income years.*

Example 25

211. *Arthur is unaware that he can claim a capital works deduction for the building in which he carries on his business. He therefore does not claim a capital works deduction in the income years ended 30 June 2006 to 30 June 2010.*

212. *When he realises that he was entitled to a $25,000 deduction for capital works the amendment period for his 2006 assessment has expired.*

213. *Arthur is not entitled to claim this amount under section 40-880.*

3. Expenditure that forms part of the cost of land

214. Paragraph 40-880(5)(c) provides that the taxpayer cannot deduct expenditure they incur to the extent that it forms part of the cost of land.

215. The expression 'forms part of the cost of land' is not defined in the legislation. Paragraph 2.67 of the 2006 Explanatory Memorandum states that:

> Expenditure that forms part of the cost of land, whether or not the land is held by the taxpayer, is not deductible. This exclusion is transferred from the repealed section 40-880.

216. The word 'cost' is defined in subsection 995-1(1) but only by reference to depreciating assets and trading stock. This definition does not assist in providing a meaning of the word as it applies to land that is not trading stock. Reference must therefore be made to the ordinary meaning of the word shaped by the context in which it is found.

217. The Macquarie Dictionary, 2005, 4th edition, The Macquarie Library Pty Ltd, NSW, relevantly defines the word 'cost' as:

> 1. the price paid to acquire, produce, accomplish, or maintain anything.

218. Having regard to that definition of 'cost', the expression 'the cost of land' could be read as extending to a cost of holding, or maintaining land already acquired. However, on balance the Commissioner considers that the more natural reading of the full expression in the context in which it appears is that it covers only the cost of acquiring land. The cost of acquiring land, in this context, includes stamp duty and conveyance costs.

219. Where expenditure is incurred by the taxpayer to acquire their own land it will form part of the cost base or reduced cost base of land. This type of expenditure is specifically excluded by paragraph 40-880(5)(f) which is discussed at paragraphs 253 to 263 of this Ruling.

220. As a matter of statutory construction there is a presumption that paragraph 40-880(5)(c) must have some practical operation and so should be interpreted as excluding some expenditure not already captured by another exception in subsection 40-880(5). Therefore, in the context of section 40-880 paragraph 40-880(5)(c) operates to exclude expenditure incurred to acquire land where the amount does not form part of the cost base or reduced cost base of the land. This can occur if the expenditure is incurred by someone other than the owner of the land, consistently with the statement in the 2006 Explanatory Memorandum.

Example 26

221. *Y Coy is in the process of incorporating a subsidiary which will carry on one of its business activities. Y Coy places a deposit on a property which is to be owned by the subsidiary and from which the subsidiary will carry on business. The companies are not part of a consolidated group.*

222. *This expenditure is captured by paragraph 40-880(5)(c) and is therefore not deductible under section 40-880.*

4. Expenditure in relation to a lease or other legal or equitable right

223. Paragraph 40-880(5)(d) provides that the taxpayer cannot deduct anything under section 40-880 for an amount of expenditure they incur to the extent that it is in relation to a lease or other legal or equitable right.

224. The expression 'in relation to a lease or other legal or equitable right' or any part of the expression is not defined in the legislation.

225. Paragraph 40-880(5)(d) replicates the former paragraph 40-880(3)(d). The Explanatory Memorandum to Taxation Laws Amendment Bill (No. 5) 2002 ('2002 Explanatory Memorandum') which introduced the former section 40-880 provides the following explanation at paragraph 3.67 about the meaning of the expression 'in relation to a lease or other legal or equitable right':

> The Government is reviewing the treatment of expenditure incurred in relation to leases or other legal or equitable rights as part of the consideration of the recommendations of the Review of Business Taxation. The appropriate income tax treatment of capital expenditure incurred in relation to these leases and rights will be determined as part of that review. Consequently, capital expenditure on leases or other legal or equitable rights will be excluded from deduction under section 40-880. For example, expenditure representing lease surrender payments incurred in closing down your business will not be deductible under section 40-880.

226. The Review of Business Taxation was concerned with the lack of a consistent framework for taxing income from and recognising expenditure associated with leases over non-wasting assets and other rights. The main focus of its review of leases and rights was on anomalies in the tax treatment of payments for the acquisition of a right and receipts from the use of those rights, and in the tax treatment of payments from the grant of a right and losses from the grant of the right.

227. The rights with which the discussion paper[4] deals are rights in respect of tangible and intangible assets which were divided between the following three broad categories:

(i) rights granted over the use of physical and intangible business assets;

(ii) rights under financial transactions; and

(iii) rights that are trading stock, such as software produced or developed for sale.

228. The 2006 Explanatory Memorandum provides the following limited guidance on the scope of paragraph 40-880(5)(d) at paragraph 2.68:

> This exclusion replicates that found in the repealed section 40-880, having been added in 2002 in the context of the Government's review of the treatment of expenditure incurred on leases or other legal or equitable rights. The 2005-6 Budget announced that the Government would take a case-by-case approach in relation to the taxation of rights.

229. To date, the leases and rights review has produced section 25-110 which allows a deduction over five years for capital expenditure to terminate a lease. However, coincidentally with the enactment of section 25-110, subsection 110-25(5) was amended to relax the test for inclusion of capital expenditure in the fourth element of cost base of a CGT asset, including a lease. Consequently, certain capital expenditure incurred by a lessee, such as expenditure under a 'make good' clause, may now be eligible for inclusion in the cost base of a lease. In those circumstances where a taxpayer incurs this type of expenditure and it is not deductible under another provision or otherwise taken into account the expenditure is not deductible under section 40-880 because it relates to a lease.

230. In explaining paragraph 40-880(5)(d) the 2006 Explanatory Memorandum gives this example at example 2.12:

> In January 2006, AORT Pty Ltd was seeking to obtain a prospecting right over a particular tract of land. It undertakes an investigation to determine if there are any other rights held over that land. The investigation finds that a farmer holds a right of access over the land, and AORT Pty Ltd agrees to pay the farmer compensation to access the land. As the taxpayer's expenditure is in relation to a right (being compensation for the right to access the land) it is not deductible under the business-related costs provision.

[4] Paragraph 8.2 *A Platform for Consultation Discussion Paper Volume 1.*

However, the expenses would be included in the expanded first element of cost of a depreciating asset the taxpayer starts to hold as being in relation to starting to hold that asset, being the exploration right.

231. The example demonstrates that paragraph 40-880(5)(d) captures capital expenditure which may be captured by other exceptions in subsection 40-880(5). However, as a matter of statutory construction, it should not be assumed that this paragraph was inserted as a mere duplication of existing exemptions. In other words, there is a presumption that the paragraph excludes some expenditure not already captured by the other exceptions.

232. The object of section 40-880 and its legislative context indicate that paragraph 40-880(5)(d) does not exclude all expenditures incurred when a contract is entered into. If a contrary interpretation was adopted then only voluntary expenditure would be deductible under section 40-880 and this clearly was not intended by Parliament.

Example 27

233. *Company X attempts to takeover Company Y. Company Y enters into an agreement with a legal firm for the provision of legal services in relation to the takeover. Ultimately the takeover is unsuccessful.*

234. *Company Y has a right under the contract to the provision of legal services. The legal firm has a corresponding right to payment for those services when it invoices Company Y. For the purposes of paragraph 40-880(5)(d) the expenditure incurred by Company Y when it is invoiced is not in relation to a legal or equitable right.*

235. In the absence of a definition or guidance in the 2006 Explanatory Memorandum the expression 'in relation to a lease or other legal or equitable right' takes on its ordinary meaning shaped by the context of the provision. That context shows that paragraph 40-880(5)(d) relates to rights granted over the use of physical and intangible business assets and that at a practical level the paragraph does not have a wide operation because the other, more specific exceptions in subsection 40-880(5) capture the majority of expenditure relating to leases or other legal or equitable rights.

236. The rights to which paragraph 40-880(5)(d) is directed are those similar to leases in that they give the taxpayer a right to exploit the asset with which the right is associated. In other words, the right is carved out of an asset but falls short of full ownership of the asset. Examples of such rights include profits à prendre, easements and other rights of access to land. The rights however are not limited to rights associated with land.

Example 28

237. *Ed Dee Co proposes to start a new business to be carried on by a subsidiary it intends to incorporate. Ed Dee Co is in the process of negotiating the purchase of property which the subsidiary will own and from which it will carry on its business. Ed Dee Co incurs capital expenditure on negotiating an easement over the land which adjoins the property. The property is purchased by the subsidiary which is ultimately incorporated. The companies are not part of a consolidated group.*

238. *The expenditure incurred by Ed Dee Co falls within paragraph 40-880(5)(d).*

239. The legislative context of section 40-880 indicates that expenditure 'in relation to a lease or other legal or equitable right' must be relevantly related to a lease or right. To be relevantly related there must be an objective connection between the expenditure and the acquisition, creation, alteration or termination of the lease or right. The context also indicates that the expenditure that relates to a lease or right is expenditure in addition to expenditure which falls within the other exceptions in subsection 40-880(5) such as paragraph 40-880(5)(a) or 40-880(5)(f). In other words, expenditure incurred by the taxpayer which has the requisite connection with a lease or right and which is not captured by another subsection 40-880(5) exception will fall within paragraph 40-880(5)(d).

240. Likewise, expenditure incurred by the taxpayer on a lease or right held by someone else such as an associate has the requisite connection with a lease or right.

Example 29

241. *X Coy proposes to start a new business to be carried on by a soon-to-be incorporated subsidiary. X Coy incurs legal expenditure on lease negotiations which result in a lease ultimately being granted to the now incorporated subsidiary. The companies are not part of a consolidated group.*

242. *The expenditure incurred by X Coy falls within paragraph 40-880(5)(d).*

243. In contrast, if a lease or right is sought but not obtained, capital expenditure incurred in trying to obtain the lease or right is not expenditure incurred in relation to a lease or right for the purposes of paragraph 40-880(5)(d).

244. Subsection 40-880(6) states that the exception in paragraph 40-880(5)(d) does not apply to expenditure incurred by the taxpayer to preserve (but not enhance) the value of goodwill if the expenditure is in relation to a legal or equitable right and the value to the taxpayer of the right is solely attributable to the effect that the right has on goodwill. Subsection 40-880(6) is explained in more detail at paragraphs 315 to 317 of this Ruling.

5. The expenditure would otherwise be taken into account in working out a profit included in the taxpayer's assessable income or a loss that they can deduct

245. Paragraph 40-880(5)(e) provides that to the extent expenditure incurred by the taxpayer is taken into account in working out a profit included in their assessable income or a deductible loss, they cannot deduct it under section 40-880. The paragraph lists sections 6-5 and 15-15 as examples of provisions that take account of expenditure in working out an assessable profit. Correspondingly, sections 8-1 and 25-40 are listed as examples of provisions that take account of expenditure in working out a deductible loss.

246. This paragraph replicates the exclusion contained in former paragraph 40-880(3)(e). The 2002 Explanatory Memorandum, which introduced the original exclusion, notes that it gives effect to the policy intention that section 40-880 is a provision of last resort. Accordingly, if expenditure is already dealt with by the income tax law because it is reflected in either a profit or a loss calculation then it is outside the scope of section 40-880.

247. Case law affirms that under subsection 25(1) of the ITAA 1936 gross income can include a net amount such as a profit from a transaction that is income according to ordinary concepts (*FC of T v. Whitfords Beach Pty Ltd* 82 ATC 4031 per Gibbs CJ and Mason J). Profit will have the character of ordinary income because it arises in the course of carrying on a business or in carrying out a business operation or commercial transaction. A net loss may be a deduction in the same way and according to the same principles.

248. This interpretation applies equally to section 6-5.

249. Section 15-15 (the successor provision to section 25A of the ITAA 1936) includes profit arising from the carrying on or carrying out of a profit-making undertaking or plan that is not ordinary income under section 6-5. Broadly, profit arising from a transaction will be assessable under section 15-15 where the transaction is more than the mere advantageous realisation of a capital asset and has the character of a business dealing.

250. 'Profit' is not a defined term and ordinarily refers to an amount remaining after deducting all costs from gross receipts.

251. The purpose of paragraph 40-880(5)(e) is to exclude the costs forming part of a profit calculation from the scope of section 40-880 because they are properly accounted for under section 6-5 or section 15-15.

252. In the same way, the paragraph excludes expenditure that is taken into account in working out a loss the taxpayer can deduct, for example under section 8-1 or section 25-40. This is because in contributing to a deductible loss the expenditure receives the appropriate and intended tax recognition. Consistent with the status of section 40-880 as a provision of last resort, if expenditure forms part of a deductible loss calculation then it is outside the reach of the provision.

6. The expenditure could be taken into account in working out the amount of a capital gain or capital loss from a CGT event

253. Paragraph 40-880(5)(f) provides that the taxpayer cannot deduct anything under section 40-880 for an amount of expenditure they incur to the extent that it could be taken into account in working out the amount of a capital gain or capital loss from a CGT event.

Example 30

254. *Zoltan is a director shareholder of a private company. He guaranteed the payment of a bank loan obtained by the company. The company failed to meet its obligations under the loan and the bank sought to enforce the guarantee. Zoltan paid out the full amount of the loan.*

255. *This expenditure is not allowable under section 40-880 because it forms part of the cost base of the right of subrogation which the guarantor is taken to acquire under the contract of guarantee.*[5]

Example 31

256. *Assume the same facts as above. Zoltan incurred legal fees in applying to the Supreme Court as a creditor for the company to be wound up on the basis that it was insolvent.*

257. *Zoltan's right to be indemnified by the company in respect of the payment made by him to the bank is a CGT asset. The payment of the amount by Zoltan gives rise to a debt owed by the company to Zoltan. CGT event C2 in section 104-25 will happen when the company is deregistered. The legal fees are included in the second element of the debt's cost base and reduced cost base.*

258. In most cases, capital proceeds and cost base (or reduced cost base) are taken into account in working out the amount of a capital gain or capital loss from a CGT event. Therefore, capital expenditure which reduces capital proceeds from a CGT event or forms part of the cost base (or reduced cost base) of a CGT asset could be taken into account in working out the amount of a capital gain or capital loss from a CGT event for the purposes of paragraph 40-880(5)(f).

[5] Taxation Ruling TR 96/23 *Income tax: capital gains: implications of a guarantee to pay a debt.*

259. Where the expenditure is not reflected in the net capital gain included in the taxpayer's assessable income for the income year in which the CGT event happened because, for example, the amendment period under section 170 of the ITAA 1936 has expired without the expenditure actually having been taken into account this does not mean that the expenditure could not be taken into account. The words of paragraph 40-880(5)(f) do not require that the capital expenditure be actually taken into account in working out a capital gain or capital loss, or that the capital gain or capital loss worked out be actually taken into account in working out the net capital gain included in the taxpayer's assessable income – that is a separate process. If the words were interpreted otherwise expenditure which should receive CGT treatment could inappropriately become a revenue deduction.

260. Therefore, whether capital expenditure could be taken into account in working out the amount of a capital gain or capital loss from a CGT event for the purposes of paragraph 40-880(5)(f) does not depend on the ability of the taxpayer to amend the net capital gain for the income year in which the CGT event happened.

261. This is consistent with the application of paragraph 40-880(5)(f) if a capital gain or capital loss that is worked out is disregarded (for example, because an asset is a pre-CGT asset) or reduced. Paragraph 2.73 of the 2006 Explanatory Memorandum makes it clear that where a capital gain or capital loss worked out is to be disregarded or reduced an amount is still 'taken into account in working out the amount of a capital gain or capital loss'.

262. Tax Determinations TD 2010/1, TD 2011/8, TD 2011/9 and TD 2011/10 deal with incidental costs incurred when a subsidiary member joins or leaves a consolidated group.

263. Subsection 40-880(6) states that the exception in paragraph 40-880(5)(f) does not apply to expenditure incurred by the taxpayer to preserve (but not enhance) the value of goodwill if the expenditure is in relation to a legal or equitable right and the value to the taxpayer of the right is solely attributable to the effect that the right has on goodwill. Subsection 40-880(6) is explained in more detail at paragraphs 315 to 317 of this Ruling.

7. Another provision would make the expenditure non–deductible if it was not of a capital nature

264. Paragraph 40-880(5)(g) provides that the taxpayer cannot deduct anything under section 40-880 for an amount of expenditure they incur to the extent that a provision of the income tax law other than section 40-880 would expressly make the expenditure non-deductible if it were not of a capital nature.

265. The deduction available under section 40-880 is not intended to alter the existing income tax treatment of expenditure that was already specifically recognised in the law even if that recognition was by way of making the expenditure non-deductible.

266. This exclusion ensures that expenditure specifically denied a deduction under a provision of the income tax law is also denied a deduction under section 40-880. In other words, paragraph 40-880(5)(g) applies if the expenditure would be expressly made non-deductible if it had been of a revenue nature rather than capital expenditure.

Example 32

267. *Company B incurs capital expenditure on entertainment for the purpose of producing assessable income. As the expenditure is capital expenditure it cannot be considered for a deduction under section 8-1.*

268. *However, if the expenditure had been of a revenue nature, section 32-5*[6] *would expressly prevent a deduction under section 8-1 for it. Therefore, paragraph 40-880(5)(g) excludes the expenditure from deductibility under section 40-880.*

269. For the exclusion in paragraph 40-880(5)(g) to apply, the expenditure must be expressly prevented from being deductible. Therefore, expenditure that merely fails to be deductible under a general provision (such as section 8-1) is not excluded under the paragraph.

270. As paragraph 40-880(5)(g) applies to the extent that expenditure is expressly prevented from being deductible, it also applies to exclude any deduction under section 40-880 where a deduction for expenditure is given but is capped or limited.

8. Another provision expressly prevents the expenditure being taken into account as described in paragraphs 40-880(5)(a) to 40-880(5)(f) for a reason other than the expenditure being of a capital nature

271. Paragraph 40-880(5)(h) provides that the taxpayer cannot deduct anything under section 40-880 for an amount of expenditure they incur to the extent that a provision of the income tax law other than this section expressly prevents the expenditure being taken into account as described in paragraphs 40-880(5)(a) to 40-880(5)(f) for a reason other than the expenditure being of a capital nature.

272. The deduction available under section 40-880 is not intended to alter the existing income tax treatment of expenditure that was already specifically recognised in the law even if that recognition was by way of preventing it from being taken into account.

[6] Section 32-5 prevents a deduction under section 8-1 for losses or outgoings incurred in respect of providing entertainment, subject to certain exceptions.

273. This exclusion ensures that if a particular type of expenditure is expressly prevented from being taken into account, then the expenditure is denied deduction under section 40-880.

274. Expenditure is taken into account as described in paragraphs 40-880(5)(a) to 40-880(5)(f) if:

- it forms part of the cost of a depreciating asset the taxpayer holds, used to hold or will hold (paragraph 40-880(5)(a)); or
- the taxpayer can deduct an amount for it under a provision of the income tax law other than section 40-880 (paragraph 40-880(5)(b)); or
- it forms part of the cost of land (paragraph 40-880(5)(c)); or
- it is in relation to a lease or other legal or equitable right (paragraph 40-880(5)(d));
- it would, apart from section 40-880, be taken into account in working out a profit that is included in the taxpayer's assessable income or a loss that they can deduct (paragraph 40-880(5)(e)); or
- it could, apart from section 40-880, be taken into account in working out the amount of a capital gain or capital loss from a CGT event (paragraph 40-880(5)(f)).

275. Therefore, if a provision of the income tax law expressly prevents expenditure being taken into account as above (for a reason other than the expenditure is capital expenditure), then paragraph 40-880(5)(h) will exclude the expenditure from deductibility under section 40-880.

Example 33

276. *Company C incurs capital expenditure on entertainment to market the sale of a CGT asset of the company. The expenditure is an incidental cost under section 110-35 and would, apart from the operation of subsection 110-38(3), be included in the cost base of the asset under subsection 110-25(3).*

277. *However, subsection 110-38(3) expressly prevents expenditure in respect of providing entertainment from forming part of the cost base of a CGT asset. Therefore, the expenditure is expressly prevented from being taken into account in working out the amount of the capital gain or capital loss from the CGT event. Paragraph 40-880(5)(h) excludes the expenditure from deductibility under section 40-880.*

278. For the exclusion in paragraph 40-880(5)(h) to apply, the expenditure must be expressly prevented from being taken into account. Therefore, expenditure that merely fails to be taken into account under a general provision (such as section 8-1) is not excluded under the paragraph.

279. As paragraph 40-880(5)(h) applies to the extent that expenditure is expressly prevented from being taken into account, it also applies to exclude any deduction under section 40-880 where only part of expenditure is prevented from being taken into account (for example, because a deduction is capped or limited).

Example 34

280. *Company T made a payment to an employee in the form of a retiring allowance which meets the conditions for a deduction under section 25-50. However, the payment resulted in the company making a loss for income tax purposes. Paragraph 26-55(1)(a) limits the deduction otherwise available under section 25-50 if the deduction creates or increases a loss for income tax purposes.*

281. *As a result, the part of the payment to the employee that created the loss is not deductible under section 25-50. As paragraph 26-55(1)(a) expressly prevents part of the payment being deductible under section 25-50, paragraph 40-880(5)(h) excludes that part of the payment from deductibility under section 40-880.*

[Note: the part of the payment that is deductible under section 25-50 is excluded from deductibility under section 40-880 by paragraph 40-880(5)(b).]

9. The expenditure is of a private or domestic nature

282. Paragraph 40-880(5)(i) provides that the taxpayer cannot deduct anything under *section* 40-880 for an amount of expenditure they incur to the extent that it is expenditure of a private or domestic nature.

283. Expenditure may have a sufficient connection with the business being carried on for it to be in relation to the business for the purposes of paragraph 40-880(2)(b). However, if the essential character of the expenditure is of a private or domestic nature, then to that extent it will be denied a deduction under paragraph 40-880(5)(i).

Example 35

284. *Bruce is a solicitor and runs his own law firm specialising in conveyancing. His brother, Louie has recently started business as real estate agent and is struggling to pay his start up costs. Bruce feels sorry for Louie and decides to help by giving him $10,000. Bruce expects that Louie will refer clients to him in the future and is hopeful that his business will expand as a result.*

285. *Although there is a connection between the expenditure and Bruce's business, the circumstances of the payment and the family relationship between Bruce and Louie indicate that the essential character of the payment is of a private or domestic nature. Accordingly, Bruce is not able to deduct the expenditure under section 40-880 because it is excluded by the operation of paragraph 40-880(5)(i).*

10. The expenditure is incurred in relation to gaining or producing exempt income or non-assessable non-exempt income

286. Paragraph 40-880(5)(j) provides that the taxpayer cannot deduct anything under section 40-880 for an amount of expenditure they incur to the extent that it is incurred in relation to gaining or producing exempt income or non-assessable non-exempt income.

287. The terms exempt income and non-assessable non-exempt income are defined in sections 6-20 and 6-23 respectively.

288. Section 6-20 defines exempt income as:

> (1) An amount of *ordinary income or *statutory income is ***exempt income*** if it is made exempt from income tax by a provision of this Act or another *Commonwealth law;
>
> (2) *Ordinary income is also ***exempt income*** to the extent that this Act excludes it (expressly or by implication) from being assessable income;
>
> (3) By contrast, an amount of *statutory income is ***exempt income*** only if it is made exempt from income tax by a provision of this Act outside this Division or another *Commonwealth law; and
>
> (4) If an amount of *ordinary income or *statutory income is *non-assessable non-exempt income, it is not ***exempt income***.

289. Section 6-23 defines non-assessable non-exempt income as:

> An amount of *ordinary income or *statutory income is ***non-assessable non-exempt income*** if a provision of this Act or of another *Commonwealth law states that it is not assessable income and is not *exempt income.

290. Exempt income and non-assessable non-exempt income do not form part of assessable income and are therefore tax free. Since this income is not subject to tax it follows that capital expenditure incurred in relation to gaining the income is also not recognised by the tax system. This result is confirmed by paragraph 40-880(5)(j). It is consistent with and replicates the operation of paragraph 8-1(2)(c).

Example 36

291. *Company Y carries on the business of investing in, funding and managing its subsidiaries as a holding company. It derives assessable income in the form of management fees and dividends from its subsidiaries. Company Y acquires all the shares in an offshore company. It incurs capital expenditure in relation to its business as a holding company on a rights issue and share placement to raise funds for the acquisition.*

292. *Company Y will derive dividend income from the acquired company which is non-assessable non-exempt income under section 23AJ of the ITAA 1936. Company Y also expects to derive management fees for the services it provides the acquired company which will be assessable income.*

293. *To the extent that the expenditure is incurred in relation to the earning of dividend income from the acquired company paragraph 40-880(5)(j) will deny a deduction under section 40-880.*

294. Where expenditure is incurred in relation to gaining or producing exempt income or non-assessable non-exempt income and an apportionment is required under subsection 40-880(3) or 40-880(4) (because the relevant business or aspect of the business was not carried on wholly for a taxable purpose) this does not mean that the section 40-880 deduction is reduced twice.

295. The interaction of subsection 40-880(3) or 40-880(4) and paragraph 40-880(5)(j) results in only one reduction under these respective provisions to the amount that a taxpayer can deduct under section 40-880.

11. The expenditure is excluded from the cost of a depreciating asset or the cost base or the reduced cost base of a CGT asset because of a market value substitution rule

296. Subsection 40-880(8) provides that the taxpayer cannot deduct anything under this section for an amount of expenditure that, because of a market value substitution rule, was excluded from the cost of a depreciating asset or the cost base or reduced cost base of a CGT asset.

297. The note to the subsection provides some examples of market value substitution rules: subsection 40-180(2) (table item 8); subsection 40-190(3) (table item 1); section 40-765; and section 112-20.

298. A market value substitution rule replaces what would otherwise be the cost of a depreciating asset or the cost base or reduced cost base of a CGT asset with the market value of the asset. A market value substitution rule will apply, for example, if the taxpayer acquires an asset for more than the asset's market value and the taxpayer did not deal with another party to the transaction at arm's length.

299. If the taxpayer incurs capital expenditure which forms part of the cost of a depreciating asset or the cost base or reduced cost base of a CGT asset, the expenditure is excluded from deductibility under section 40-880 by paragraph 40-880(5)(a) or 40-880(5)(f), respectively. However, if a market value substitution rule applies, the market value of the asset becomes its cost, cost base or reduced cost base. In that case, any excess of the capital expenditure incurred over the market value of the asset is excluded from the cost, cost base or reduced base of the asset. Therefore, paragraphs 40-880(5)(a) and 40-880(5)(f) would arguably not apply to deny a deduction under section 40-880 for the excess.

300. Subsection 40-880(8) ensures that any excess of capital expenditure over the market value of an asset, which has been excluded from the cost, cost base or reduced cost base of the asset by a market substitution rule, is not deductible under section 40-880.

Example 37

301. *Terry purchases a ute for his plumbing business from his cousin. His cousin has fallen on hard times and Terry wants to help. He pays $24,000 for the ute but the market value is only $20,000.*

302. *Terry did not deal with his cousin at arm's length and the amount he paid for the ute exceeds its market value. Therefore, under item 8 of the table in subsection 40-180(2), the cost of the ute is $20,000 – the market value at the time Terry started to hold the ute.*

303. *The excess of $4,000 that Terry paid over the market value does not form part of the cost of the ute so that amount is not excluded from deductibility under section 40-880 by paragraph 40-880(5)(a).*

304. *However, subsection 40-880(8) ensures that the amount excluded from the cost of the ute is not deductible under section 40-880.*

12. The expenditure is a return on or of debt or equity

305. Subsection 40-880(9) provides that the taxpayer cannot deduct anything under section 40-880 for an amount of expenditure they incur:

(a) by way of returning an amount they have received (except to the extent that the amount was included in their assessable income or taken into account in working out an amount so included); or

(b) to the extent that, for another entity, the amount is a return on or of:

(i) an equity interest; or

(ii) a debt interest that is an obligation of theirs.

306. Subsection 40-880(9) ensures that amounts that comprise the transfer or distribution of or on funds, that comprise repayments or that comprise amounts that do not otherwise give rise to any income tax consequences are not deductible under section 40-880. Such amounts do not represent an economic loss to the taxpayer.

307. Paragraph 40-880(9)(a) excludes from deductibility under section 40-880 expenditure incurred by the taxpayer which returns an amount the taxpayer has received and that has not been included in the taxpayer's assessable income or in working out an amount included in that assessable income, for example, the repayment of loan principal or a payment made as a result of certain margin calls.

308. For the purpose of paragraph 40-880(9)(b), 'equity interest' takes its meaning from Subdivision 974-C for a company and section 820-930 in the case of a trust or partnership. 'Debt interest' takes its meaning from Subdivision 974-B. Broadly, the test to distinguish an interest in an entity as debt or equity focuses on the effectively non-contingent obligation of an issuer to return to the investor an amount at least equal to the amount invested. This is based on the economic substance of the rights and obligations arising under the particular arrangement rather than merely the legal form. A share in a company could be classified as an equity interest or a debt interest in the company depending on the pricing, terms and conditions of the share.

309. To the extent that the taxpayer's capital expenditure is a return on or of an equity interest of another entity it is excluded from deductibility under section 40-880 by subparagraph 40-880(9)(b)(i).

Example 38

310. *Company D holds shares in Company E. Company D has an equity interest in Company E for the purposes of Subdivision 974-C. Company E pays a dividend to Company D. The dividend is a return on Company D's equity interest in Company E. Therefore, subparagraph 40-880(9)(b)(i) applies and the expenditure is not deductible to Company E under section 40-880.*

311. *If Company E subsequently institutes a share buy back scheme and acquires any of the shares of Company D, the amount paid for the shares is also a return of an amount Company D invested in the equity interest in Company E and is not deductible under section 40-880.*

312. Similarly, to the extent that the taxpayer's capital expenditure is a return on or of a debt interest for another entity and the return on or of that interest is an obligation of the taxpayer's, it is excluded from deductibility under section 40-880 by subparagraph 40-880(9)(b)(ii).

Example 39

313. *Company F issues a redeemable security to Company G. Under the terms of the issue, Company F must redeem it for 100% of its issue price in five years' time and must pay returns of 5% per annum. Company G has a debt interest in Company F for the purposes of Subdivision 974-B.*

314. *Assuming the payment of the return of 5% per annum meets all the conditions for a deduction under section 8-1, it is deductible to Company F under that section. Therefore, it is not also deductible under section 40-880. However, the payment made by Company F to redeem the security is capital expenditure and it is a return of the amount Company G invested in the debt interest in Company F. Therefore, subparagraph 40-880(9)(b)(ii) applies and the expenditure is not deductible under section 40-880.*

Expenditure which preserves (but does not enhance) the value of goodwill

315. As discussed at paragraphs 244 and 263 of this Ruling the exceptions in paragraphs 40-880(5)(d) and 40-880(5)(f) are not absolute.

316. Subsection 40-880(6) provides that the exceptions in paragraphs 40-880(5)(d) and 40-880(5)(f) do not apply to expenditure the taxpayer incurs to preserve (but not enhance) the value of goodwill if the expenditure incurred is in relation to a legal or equitable right and the value to the taxpayer of the right is solely attributable to the effect that the right has on goodwill.

317. The subsection ensures that expenditure in relation to a right which has no value of itself and does not increase the value of goodwill from what it was before the expenditure took effect is not excluded from deduction under section 40-880.

Example 40

318. *Felicity and Rick carry on a business in partnership. Rick decides to leave the partnership to run his own business. To preserve the value of the goodwill of her business, Felicity incurs capital expenditure to secure Rick's agreement not to operate a similar business in the same town. Subsection 40-880(6) applies to prevent the application of paragraph 40-880(5)(f) which would otherwise deny a deduction for the expenditure.*

Example 40A

318A. *The Koala Hotel and Tavern (KHT) carries on a hospitality business that includes offering authorised gaming activities on gaming machines. Under state gaming regulations, KHT must hold a gaming machine entitlement for each gaming machine operated at its premises. There are statutory caps on the number of entitlements issued state-wide, and to each holder and in each region. Each entitlement, identified by its unique serial number, authorises its holder to operate a gaming machine for a 10-year term, after which a reapplication and reallocation process will occur. Each entitlement is tradable on a state-regulated entitlement trading market.*

318B. *KHT applied for, and was granted by the state, an allocation of gaming machine entitlements upon payment of an agreed price per entitlement. The capital expenditure incurred to acquire a gaming machine entitlement constitutes the first element of the cost base of the entitlement and will be taken into account in determining the capital gain or capital loss arising from either the sale or expiry of the entitlement. The expenditure therefore is excluded by the exception in paragraph 40-880(5)(f).*

318C. Subsection 40-880(6) does not prevent paragraph 40-880(5)(f) from applying. The value to KHT of the entitlements is

not solely attributable to the effect that the entitlements have on the goodwill in KHT's business. Each entitlement has a distinct value to KHT because it permits KHT to conduct authorised gaming activity using a gaming machine at its business premises and thereby earn profits, which it otherwise could not earn, from such conduct for a 10-year period. An entitlement may also be traded on a secondary market. This value arises regardless of whether the expenditure can also be said to be 'to preserve' goodwill to any extent.

318D. *As the expenditure is recognised under the capital gains tax provisions, a deduction under section 40-880 is not allowable.*

How the deduction is claimed

319. The expenditure is allowed as a straight-line write-off over five years and the expenditure is not apportioned if it is incurred part way through the year.

320. A deduction of more than 20% of the expenditure cannot be claimed in any particular income year.

Example 41

321. *On 1 September 2007 A Pty Ltd incurred expenditure of $10,000 which satisfied the requirements of section 40-880. A Pty Ltd was wound up in the 2010 income year. A Pty Ltd is entitled to claim a deduction under section 40-880 as follows:*

2008	*$2,000*
2009	*$2,000*
2010	*$2,000*

Other provisions that may affect the taxpayer's section 40-880 deduction

Non-commercial losses

322. If the taxpayer is an individual taxpayer (operating either alone or in partnership) the non-commercial loss provisions in Division 35 may apply to defer deductions for expenditure they incur in relation to a business they carry on or propose to carry on.

323. Where the taxpayer has incurred business capital expenditure in relation to a former business and the activity does not satisfy the commerciality tests or the Commissioner does not exercise his discretion not to apply the rule in subsection 35-10(2), the section 40-880 deduction will be denied rather than deferred.

Personal services income

324. A taxpayer who incurs capital expenditure in relation to employment income is not able to claim a deduction under

section 40-880 as the expenditure is not incurred by them in relation to a business.

325. Under the personal services income rules an individual carrying on a business which generates personal services income but does not meet the 'personal services business tests' and does not have a 'personal services business determination' from the Commissioner, will not be regarded as conducting a personal services business. Therefore, under section 85-10 they will be prevented from deducting any amount under the Act, including section 40-880, that an employee could not deduct in relation to their personal services income.

326. However, a taxpayer that is a 'personal services entity' (company, partnership or trust) which carries on business and is in receipt of personal services income may be entitled to a deduction under section 40-880, even though it does not meet any of the 'personal services business tests' and has not received a 'personal services business determination'.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the binding public ruling.

Capital expenditure that serves more than one purpose or object

Alternative View 1

327. The framework of the provision adopts a staged approach to establishing an entitlement to a deduction for capital expenditure. Subsection 40-880(2) operates to establish the basic entitlement. It requires that the expenditure is in relation to one or more of the things listed in paragraphs 40-880(2)(a) to 40-880(2)(c) or satisfies paragraph 40-880(2)(d). Expenditure that does not meet these requirements is out of scope. There is no requirement to apportion or allocate the expenditure across the four paragraphs at this stage.

328. Once the basic eligibility is established under subsection 40-880(2), subsections 40-880(3) and 40-880(4) then apply further tests to determine how much of that expenditure can be deducted. Subsection 40-880(3) identifies three classes of expenditure – expenditure **for** a business you carry on, expenditure **for** a business you used to carry on and expenditure **for** a business you propose to carry on. Each separate category of expenditure is then tested to determine the extent to which the particular business satisfies the taxable purpose test. Identifying the three potential categories of expenditure requires a matching or an allocation of the total expenditure that qualifies under subsection 40-880(2) to each of the relevant businesses. This matching process can be approached to produce the same result as if a 'to the extent that' test existed in the law. The same reasoning would apply in relation to the construction of subsection 40-880(4).

329. In the Commissioner's opinion, this approach does not take proper account of the language of subsections 40-880(3) and 40-880(4) which provides that the taxable purpose test applies to 'the expenditure' as it has already been identified under subsection 40-880(2) by reference to the extent to whichever of the businesses listed there it relates.

Alternative View 2

330. Apportionment is allowable only in the circumstances described at subparagraph 141(a) of this Ruling. The apportionment is implied and is required to carve out expenditure that was not intended to be allowable under section 40-880. Take the example of a single outlay for a service that indifferently serves two current businesses only one of which is the taxpayer's. Section 40-880 was never intended to allow a deduction for expenditure relating to a current business that is not the taxpayer's. Here the apportionment must be made on a fair and reasonable basis on the facts of the case.

331. But in the subparagraph 141(b) of this Ruling situation, the question of apportionment does not arise under subsection 40-880(2) because the whole of the expenditure satisfies that subsection one way or the other.

332. In the Commissioner's view, this approach cannot be sustained because the extent to which the expenditure relates to each relevant business nonetheless can matter for the purposes of subsections 40-880(3) and 40-880(4) and possibly 40-880(5). In that circumstance, the same logic which allows apportionment in the subparagraph 141(a) of this Ruling situation would apply in the subparagraph 141(b) situation.

Alternative View 3

333. The apportionment in question is not possible because the language of the section does not permit it. For each item of expenditure, a single assessment must be made as to which business or other matter it most closely relates to.

334. In the Commissioner's view, this approach is not the better view for the reasons given in the Explanation section at paragraphs 137 to 141 of this Ruling and because it would result in some seemingly arbitrary outcomes. For example, a business may have legitimate business related capital expenditure but if the thing or service on which the expenditure is incurred also relates to another business the decision must be made about which is the most relevant business. If the thing or service is marginally more relevant to another business, for example, one which is not carried on for a taxable purpose then no deduction would be allowable under section 40-880 on this view.

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