

### **TIGHTENING THE 13 MONTH RULE FOR ADVANCE EXPENDITURE**

The provision allowing immediate deductibility for advance expenditure ('prepayments') incurred in respect of services to be completed within 13 months is being tightened to improve the tax treatment of such payments in the hands of the payer and payee and reduce tax minimisation opportunities.

#### **Key features**

Expenditure incurred in respect of things to be done within 13 months of the expenditure being incurred will be deductible over the period during which the services are provided, rather than being immediately deductible.

This measure will not apply to:

- small business taxpayers (i.e. those with 3 year average turnovers of less than \$1 million) until the commencement on 1 July 2001 of the Simplified Tax System for small business taxpayers — see Attachment I for more details; and
- individuals not carrying on a business.

A transitional arrangement will be implemented to phase-in the initial impact of this measure over a period of five years.

Further details are provided in the appendix to this attachment.

#### **Commencement**

This measure will apply to all expenditure incurred after 11.45am AEST, 21 September 1999 but exclude those prepayments to which the taxpayer is irrevocably committed under a contractual obligation entered into prior to the time of announcement.

#### **Current arrangements**

Under existing law a taxpayer can claim an immediate deduction for expenditure incurred in respect of the provision of services to be completed within 13 months of the day on which the expenditure is incurred.

This 13 month rule is an exception to the more general treatment of advance expenditure, which requires the deduction to be spread over the lesser of the period during which the services are provided and 10 years.

#### **Why change is needed**

The 13 month rule for prepayments allows an inappropriate bringing forward of annual deductions and is inconsistent with the accounting practice of treating such payments as assets at year-end.

Tightening the 13 month rule will correct the existing asymmetric tax treatment of such receipts and expenditures and will reduce tax minimisation opportunities.

- In contrast to prepaid expenditure, advance payments received by a taxpayer are, as a general rule, not included in the income of the taxpayer until such time as the services to which the payment relates have been provided.

## **Tightening the 13 Month Rule for Advance Expenditure — Further Details**

The prepayment rule in subsection 82KZM(1) of the *Income Tax Assessment Act 1936* is being modified for taxpayers carrying on a business who are *not* small business taxpayers. Other taxpayers (i.e. small business taxpayers and individuals not carrying on a business) will be unaffected by the change.

The change will affect expenditure (other than excluded expenditure — as defined in subsection 82KZL(1)) incurred:

- in carrying on the business; and
- in return for the doing of a thing under the agreement that is to be wholly done within 13 months after the day on which it is incurred.

For affected taxpayers, the deductions for this expenditure will now be apportioned over the eligible service period (defined in subsection 82KZL(1)) using the method set out in subsection 82KZM(1).

### ***Small business taxpayer for the purposes of this change***

In broad terms, a small business taxpayer for the purposes of this change will be a taxpayer carrying on a business with a 3 year average turnover of less than \$1 million.

Appendix I sets out the detail for determining who is a small business taxpayer.

### ***Timing***

The change to subsection 82KZM(1) set out above will apply to expenditure incurred after 11.45am AEST, 21 September 1999.

However, if the expenditure is incurred after that time under a contractual obligation entered into before that time, it will not be subject to the change. This will only be the case if the taxpayer is irrevocably committed to incur the expenditure in advance of the provision of the thing under the prepayment agreement.

### ***Transitional rule***

The transitional rule will phase-in, over a period of five years, the initial effect of the change to the prepayment rules.

The transitional rule will apply to modify the deductibility of a part of the expenditure that is no longer immediately deductible because of the reform of the prepayment rules. This modification will apply to such expenditure incurred in the first four income years of the change (called ***transitional income years*** in this Attachment).

The part of the expenditure that will get modified deductibility is the amount (called the ***later year amount*** in this Attachment) incurred in a ***transitional income year*** that would otherwise be deductible in a later income year.

However, if a *later year amount* incurred in the 2000-2001, 2001-2002 or 2002-2003 income year is greater than the *later year amount* incurred in the 1999-2000 income year, a special rule will cap the amount getting the transitional treatment at the level of the 1999-2000 *later year amount*.

Under the transitional rule, only, a proportion of the *later year amount* getting transitional treatment will be deductible in the transitional income year in which it is incurred. The rest of that amount will be deductible in the following income year.

The proportions of the *later year amount* getting transitional treatment that are deductible in each of the two relevant income years are set out in this table.

<b><i>A later year amount getting transitional treatment incurred in this income year...</i></b>	<b><i>Is deductible in this way...</i></b>
1999-2000	In 1999-2000: 80% of the amount In 2000-2001: 20% of the amount
2000-2001	In 2000-2001: 60% of the amount In 2001-2002: 40% of the amount
2001-2002	In 2001-2002: 40% of the amount In 2002-2003: 60% of the amount
2002-2003	In 2002-2003: 20% of the amount In 2003-2004: 80% of the amount

## Example of how the transitional rule works

A non-small business taxpayer has prepayments, to which the amendments apply, in each of the transitional income years. This table sets out details of the prepayments and the amounts deductible in each income year.

		<i>Current income year</i>				
		<i>1999-2000</i>	<i>2000-2001</i>	<i>2001-2002</i>	<i>2002-2003</i>	<i>2003-2004</i>
Details of Prepayments to which change in s.82KZM(1) applies						
a	Amount of prepayment incurred in current income year	\$100,000	\$130,000	\$100,000	\$110,000	Nil
b	Amount relating to eligible service period in income year (the <i>current year amount</i> )	\$20,000	\$30,000	\$10,000	\$20,000	
c	Amount relating to eligible service period in later income year (the <i>later year amount</i> )	\$80,000	\$100,000	\$90,000	\$90,000	
d	<i>Later year amount</i> getting the transitional treatment (i.e. after capping)	\$80,000	\$80,000	\$80,000	\$80,000	
e	- part deductible in current income year under transitional rule	\$64,000	\$48,000	\$32,000	\$16,000	
f	- part deductible in later income year under transitional rule	\$16,000	\$32,000	\$48,000	\$64,000	
Calculation of deductible amount under amended s.82KZM(1)						
g	<i>Current year amount</i> deductible in current income year [b]	\$20,000	\$30,000	\$10,000	\$20,000	
h	<i>Later year amount</i> deductible in current income year under transitional treatment [e]	\$64,000	\$48,000	\$32,000	\$16,000	
i	<i>Later year amount</i> incurred in previous income year not deducted in previous income year [c-e in previous income year]		\$16,000	\$52,000	\$58,000	\$74,000
k	Total amount deductible in current income year [g + h + i]	\$84,000	\$94,000	\$94,000	\$94,000	\$74,000