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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

SENATE

NEW BUSINESS TAX SYSTEM (SIMPLIFIED TAX SYSTEM) BILL 2001

REVISED EXPLANATORY MEMORANDUM

(Circulated by authority of the
Treasurer, the Hon Peter Costello, MP)

THIS MEMORANDUM TAKES ACCOUNT OF AMENDMENTS MADE BY THE HOUSE OF REPRESENTATIVES TO THE BILL AS INTRODUCED

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Glossary

The following abbreviations and acronyms are used throughout this Bill.

Abbreviation	***Definition***
A Tax System Redesigned	*Review of Business Taxation: A Tax System Redesigned*
ABARE	Australian Bureau of Agriculture Resource Economics
ABN	Australian Business Number
ABS	Australian Bureau of Statistics
ANTS	Government's Tax Reform Document: *Tax Reform: not a new tax, a new tax system*
ATO	Australian Taxation Office
Commissioner	Commissioner of Taxation
GST	goods and services tax
GST Act	*A New Tax System (Goods and Services Tax) Act 1999*
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
small business taxpayer	as defined in the *Income Tax Assessment Act 1997*
STS	Simplified Tax System
STS affiliate	an entity that is somehow related to the STS taxpayer
STS taxpayer	an entity who is eligible and who chooses to enter the STS

General outline and financial impact

Simplified tax system

This Bill amends the ITAA 1997 to introduce a simplified tax system for certain small businesses and the ITAA 1936 to introduce a new 12-month rule for prepayments of deductible expenses made by STS taxpayers and individuals incurring non-business expenditure.

Schedules 1 and 2 to this Bill amend the income tax law to introduce the STS which is an alternative method of determining taxable income for certain businesses with straightforward, uncomplicated financial affairs who choose to enter the STS. The STS modifies the current method of determining taxable income.

The STS has 3 main elements:

- new accounting arrangements for STS taxpayers which recognise most business income and deductions only when they are received and paid;
- a simplified trading stock regime where STS taxpayers do not have to account for changes in the value of trading stock or do stocktakes at the end of the income year in certain circumstances; and
- a simplified depreciation regime under which depreciating assets costing less than $1,000 are written off immediately. Most other depreciating assets will be pooled and enjoy an accelerated rate of depreciation.

Schedule 3 to this Bill amends the ITAA 1936 to replace the current 13-month prepayment rule with a new 12-month rule allowing immediate deduction for prepayments where:

- the payment is incurred in respect of a period of service not exceeding 12 months; and
- the period of service ends no later than the last day of the income year following that in which the payment was incurred.

The new 12-month rule applies to prepayments of deductible expenses made by:

- STS taxpayers; and
- individual taxpayers incurring non-business expenditure.

Date of effect: These amendments will apply to assessments for income years commencing after 30 June 2001.

Proposal announced: The proposals were announced in Treasurer's Press Release Nos. 58 and 59 of 21 September 1999. In particular, refer to Attachments I and J of Treasurer's Press Release No. 58.

Financial impact: The financial impact of the STS is set out in the following table:

2001-2002	2002-2003	2003-2004	2004-2005
– $280m	– $547m	– $236m	– $337m

The cost to revenue associated with the prepayments amendments in this Bill, in 2000-2001 and 2001-2002 (relative to the forward estimates), arises from a delay in the movement of non-business entities to apportionment as originally announced on 21 September 1999. The prepayments amendments in this Bill complete the announced changes, removing that cost from 2002-2003 onwards.

2000-2001	2001-2002	2002-2003	2003-2004	2004-2005
– $20m	– $20m	–	–	–

The other elements of the measure have a negligible positive effect on revenue.

Summary of regulation impact statement

Impact: Low.

Main points:

- The impact group of the STS are businesses which have an annual turnover of less than $1 million and choose to enter the STS.
- The STS is designed to minimise the compliance costs that certain businesses face in meeting their income tax obligations.
- The prepayments changes made by this Bill are also expected to reduce compliance costs for STS taxpayers.

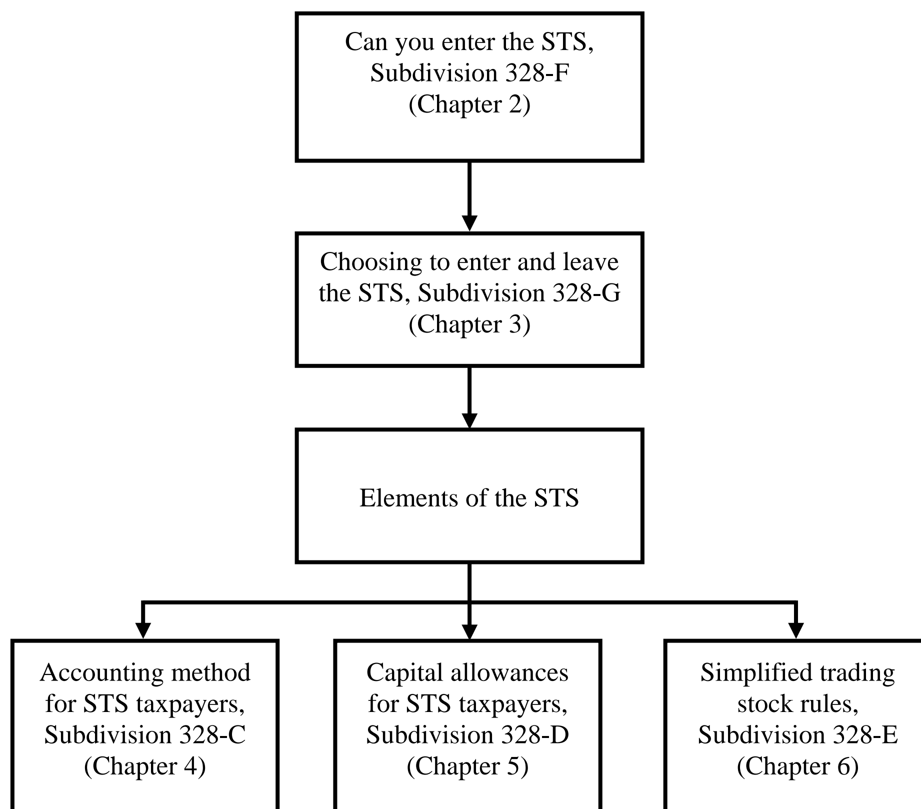
Chapter 1
An overview of the Simplified Tax System

Outline of chapter

1.1 This chapter provides a general overview of the STS. It briefly explains each component of the STS and refers readers to the relevant chapters for more detailed explanation of the rules.

1.2 Diagram 1.1 shows how the STS rules relate to each other. ***[Schedule 1, item 1, Subdivision 328-A]***

Diagram 1.1: STS for business



1.3 This chapter also provides a general overview of the new prepayments arrangements resulting from the STS changes contained in this Bill.

Context of reform

1.4 The STS modifies the method of determining taxable income for certain businesses with straightforward, uncomplicated tax affairs. Eligible businesses that choose to use the STS will have access to simpler depreciation, trading stock and accounting arrangements (although the remaining tax rules apply outside these areas).

1.5 The Review of Business Taxation's report *A Tax System Redesigned* recommended the STS and the Government supported that recommendation (Treasurer's Press Release Nos. 58 and 59 of 21 September 1999). The Review of Business Taxation estimated that around 95% of all businesses, and 99% of farming businesses, would be eligible for the STS.

1.6 Consistent with the Government's approach to business tax reform, the detailed design of the STS has benefited from extensive consultation with business representatives and professional bodies.

1.7 The object of the STS is to provide the following benefits to those businesses eligible to enter the STS:

- a reduction in effective tax burden; and
- simplified record keeping and reporting requirements.

The STS also contains integrity measures to ensure that ineligible businesses cannot structure or restructure their affairs to take advantage of these benefits. These measures reinforce that the STS is designed for small businesses with straightforward and uncomplicated affairs. ***[Schedule 1, item 1, section 328-50]***

1.8 This Bill also contains amendments that complete the Government's announced changes to the prepayments provisions in the taxation law. For more detail on the context of this reform, see Chapter 7.

Comparison of key features of new law and current law

New law	*Current law*
Cash accounting for ordinary income and general deductions – so that tax liabilities are more closely aligned with cash flow.	Businesses generally use an accrual basis of accounting. This recognises income when derived and expenses when incurred.
Assets costing less than $1,000 written off immediately. Most other assets pooled and depreciated as single asset at the rate of 30%. Assets (excluding buildings) with an effective life of 25 years or more are pooled and depreciated at the rate of 5%.	Assets costing $300 or less are written off immediately for small business taxpayers. Assets are depreciated on an individual basis at accelerated rates for small business taxpayers.

New law	***Current law***
Stocktakes only required when the difference between the value of trading stock on hand at the start of an income year and the reasonably estimated value at the end of the year is greater than $5,000.	Annual stocktakes are required – to account for the value of trading stock for income tax purposes.
A new 12-month prepayments rule applies to: • STS taxpayers, and • individual taxpayers incurring deductible non-business expenditure.	The 13-month prepayments rule applies to: • small business taxpayers, and • all taxpayers incurring deductible non-business expenditure.

Overview of new law

Main elements of the STS

1.9 There are 3 main elements of the STS. These are:

- new accounting arrangements for STS taxpayers which recognise business income and deductions only when they are received and paid ***[Schedule 1, item 1, Subdivision 328-C]***;
- a simplified depreciation regime under which depreciating assets costing less than $1,000 each are written off immediately. Most other depreciating assets are pooled and enjoy an accelerated rate of depreciation ***[Schedule 1, item 1, Subdivision 328-D]***; and
- a simplified trading stock regime where STS taxpayers do not have to account for changes in trading stock or do stocktakes at the end of the income year in certain circumstances ***[Schedule 1, item 1, Subdivision 328-E]***.

Can you enter the STS – Chapter 2

1.10 A business must meet certain criteria to be eligible for the STS.

1.11 A business is eligible to enter the STS for a year of income if:

- it carries on a business in that year;
- the STS average turnover of the business and related businesses for that year is less than $1 million; and
- the business and related businesses have depreciating assets of less than $3 million at the end of that year.

Entering and leaving the STS – Chapter 3

1.12 Eligible taxpayers may choose to enter the STS. STS taxpayers remain in the system unless:

- they choose to leave; or
- they no longer meet the eligibility rules:
  - STS taxpayers who choose to leave the STS must wait at least 5 years before they can re-enter; and
  - STS taxpayers who are required to leave the STS because they are no longer eligible may re-enter in the year they again become eligible.

Accounting method for STS taxpayers – Chapter 4

1.13 Ordinary income is recognised when *received*. Broadly, ordinary income of a business includes ongoing business or trade income.

1.14 General deductions and deductions for tax-related expenses and repairs are deductible when *paid*. Broadly, general deductions of a business include ongoing operating expenses such as wages, rent and purchase of stock.

1.15 Entry adjustment rules ensure that when a business enters the STS and uses the new accounting arrangements for STS taxpayers, business income and expenses affected by the new accounting arrangements, are not recognised twice or omitted.

1.16 Exit adjustment rules ensure that when a business leaves the STS and stops using the new accounting arrangements for STS taxpayers, business income and expenses previously affected by the new accounting arrangements, are not omitted.

1.17 These adjustments are also designed to prevent any double counting or omission of business income and deductions affected by the new accounting arrangements for STS taxpayers.

Capital allowances for STS taxpayers – Chapter 5

1.18 The capital allowances are:

- depreciating assets that cost $1,000 or less are written off immediately;
- depreciating assets with an effective life of less than 25 years are pooled – the pool is treated as a single depreciating asset with an accelerated rate of depreciation of 30% on a declining value basis;

- depreciating assets (excluding buildings, which will retain their current treatment) with an effective life of 25 years or more are pooled in a long life pool and are depreciated at the rate of 5% on a declining value basis;

- simplified treatment of private use assets; and

- simplified treatment on disposals of depreciating assets.

Simplified trading stock regime – Chapter 6

1.19 Where the difference between the value of trading stock on hand at the start of an income year and the reasonably estimated value at the end of the year is $5,000 or less, an STS taxpayer does not have to:

- value each item of trading stock on hand at the end of the income year; and

- account for any change in the value of trading stock on hand.

1.20 Where the difference between the value of trading stock on hand at the start and at the end of the year is greater than $5,000, an STS taxpayer must value each item of trading stock on hand at the end of the year and account for the change in value in accordance with the current law.

Prepayments of deductible expenses – Chapter 7

1.21 Under the new 12-month prepayments rule, an advance payment made by an STS taxpayer or an individual incurring deductible non-business expenditure will be immediately deductible where:

- it is incurred in respect of a period of service not exceeding 12 months; and

- the period of service ends no later than the last day of the income year following the date on which the payment is made.

1.22 Small business taxpayers not entering the STS and non-individual taxpayers who are incurring deductible non-business expenditure will move to the general scheme of the prepayments provisions; that is, their deductions for incurred deductible prepayments expenditure will be apportioned over the service period.

Regulation impact statement – Chapter 8

1.23 The objectives of the STS are to provide certain benefits to eligible businesses through the provisions of an alternative method of calculating taxable income. Specific details of the impacts are contained in Chapter 8.

Application and transitional provisions

1.24 The STS will apply to assessments for income years commencing after 30 June 2001. ***[Schedule 1, item 2]***

Consequential amendments

1.25 Schedule 2 to this Bill contains amendments to the ITAA 1997 resulting from the introduction of the STS.

1.26 A new item is inserted in the table in subsection 4-15(2) to show that, for STS taxpayers, taxable income is worked out in a special way. ***[Schedule 2, item 1]***

1.27 The dictionary in the ITAA 1997 is amended to insert the meaning of an 'STS taxpayer'. ***[Schedule 2, item 22]***

1.28 Consequential amendments apply to amendments for income years commencing after 30 June 2001. ***[Schedule 2, item 24]***

Chapter 2
Entities eligible to be Simplified Tax System taxpayers

Outline of chapter

2.1 This Chapter explains the circumstances in which an entity:

- is eligible to be an STS taxpayer; and
- is grouped with another entity.

[Schedule 1, item 1, Subdivision 328-F]

Context of reform

2.2 The eligibility rules ensure that only businesses that meet specific criteria can enter the STS.

2.3 The grouping rules ensure that businesses that are part of a larger group of entities do not gain access to the STS.

Comparison of key features of new law and current law

New law	*Current law*
To be eligible to enter the STS an entity must: • be carrying on a business; • have an average turnover of less than $1 million; and • have depreciating assets less than $3 million.	As the STS is a new system there are no corresponding provisions in the current law.

Detailed explanation of new law

Meaning of STS taxpayer

2.4 An entity is eligible to be an 'STS taxpayer' for an income year if:

- it carries on a business during that year;
- the STS average turnover of the business and related businesses for the year is less than $1 million net of GST credits; and
- the business and related businesses have depreciating assets with values less than $3 million at the end of that year.

[Schedule 1, item 1, subsection 328-365(1)]

2.5 However, entities that are unable to meet the general eligibility test in section 328-365 have the option of recalculating their STS average turnover by either using actual turnover for the current year, or estimating their group turnover for the current year plus the estimated group turnovers for the following 2 years. ***[Schedule 1, item 1, section 328-370]***

2.6 The value of a depreciating asset for an income year, means basically the cost of the asset less any amounts representing decline in value that have been deducted or are deductible against it under the proposed Division 40 of the ITAA 1997 or the proposed Division 328 of this Bill. The general and long life STS pools and low-value pools are each treated as a single depreciating asset and the closing pool balance of each will reflect the pool's value for the income year. In establishing whether the value of an entity's assets and its grouped entities total less than $3 million, the closing pool balance of each pool will need to be added to the adjustable value of any depreciating assets of the entity and its grouped entities which have not been subject to the pooling arrangements. ***[Schedule 1, item 1, subsection 328-365(2)]***

2.7 The limit on the total value of depreciating assets that an entity and its grouped entities can have at the end of an income year, will ensure that entities with low turnover in early years of operation but with large investments in capital assets are not eligible to enter the STS.

Example 2.1

In 2002-2003, 2 mining businesses, Ore Co and Iron Co, form a joint venture to mine copper. The income in the early years is minimal while the start-up costs are large. Ore Co supplies the large trucks to take away the raw material while Iron Co supplies the excavation equipment.

The total value of the assets both businesses have is approximately $4 million.

While both Ore Co and Iron Co are carrying on a business and their STS average turnover is less than $1 million, the fact that the value of their depreciating assets is worth more than $3 million will mean that neither entity will be eligible to be an STS taxpayer.

2.8 The limit on the total value of depreciating assets is not anticipated to affect primary production businesses with turnover under $1 million. Example 2.2 shows the type and value of assets used in a typical primary production business.

Example 2.2

A business is a mixed cropping (wheat, oats) and grazing (sheep, beef cattle) farm of 2,000 – 3,000 acres in NSW Central West.

The turnover of the business is $480,000 per annum.

Assets are replaced at the end of their effective life, with no residual value.

Values in the attached schedule are 1999 prices, verified from ABARE Farm Survey.

Item	***Quantity***	***Effective life***	***Total value $***
Offset disc plough	1	10 years	45,000
Disc plough	1	10 years	25,000
Chisel plough	1	10 years	30,000
Scarifier	1	10 years	30,000
Air seeder	1	10 years	80,000
Dams	15	40 years	75,000
Fences	100 km	33 years	170,500
Combine harvester	1	7 years	200,000
Motor cycle (1 × 2 wheel and 1 × 4 wheel)	2	3 years	10,000
Sheep dip (galvanised iron, spray dip)	1	20 years	8,000
Grain silo (iron)	12	33 years	36,000
Stock yard (1 sheepyard, 1 cattleyard)	2	20 years	18,000
Rainwater tank (galvanised iron)	4	20 years	14,000
Tractor (2 × large, 2 × small)	4	7 years	420,000
Stock trailer	1	10 years	3,000
Box trailer	2	10 years	1,400
Woolshed	1	50 years	30,000
TOTAL VALUE			**1,195,900**

This example shows that a primary production business of this type will not be excluded from entry to the STS because of the depreciating assets test[1].

Can a partnership be an STS taxpayer?

2.9 The $1 million threshold applies to partnerships in the same manner as for other entities such as companies, trusts, and individuals. This is consistent with the general treatment of partnerships under other provisions of the income tax law. Although partnerships are not liable to income tax, they are treated as entities for the purposes of calculating their net income or loss for an income year. Accordingly, a partnership is an STS taxpayer in an income year if it is carrying on a business, its STS average turnover is less than $1 million and the value of depreciating assets is less than $3 million.

Meaning of STS average turnover

2.10 An entity's 'STS average turnover' for an income year is generally calculated using the average of the entity's 'STS group turnovers' of any 3 years out of the preceding 4. Where an entity has been in business for less than 4 years, the 'STS average turnover' is calculated by working out the average turnover for the number of years the business has been operating. ***[Schedule 1, item 1, section 328-370]***

2.11 Entities that may have had an unusually high turnover in any one of the preceding 4 years have the option to disregard the group turnover of that particular year when calculating their STS average turnover.

Example 2.3

Abacus has an accounting practice which wishes to enter the STS for the 2001-2002 income year. The practice's group turnovers for the preceding 4 years are:

- 1997-1998 – $0.85 million;
- 1998-1999 – $0.91 million;
- 1999-2000 – $1 million; and
- 2000-2001 – $1.5 million.

The 2000-2001 income year produced abnormal turnover. In calculating the sum of STS group turnover, The practice can use the turnover for the 1997-1998, 1998-1999 and 1999-2000 income years.

The practice's STS average turnover for the year 2001-2002 using the above 3 years' group turnovers is $0.92 million so the practice may be eligible to enter the STS.

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1 Department of Agriculture, Fisheries and Forestry – Australian case study with information on quantity and type of equipment used for a typical broadacre mixed cropping and grazing property provided by a Parkes NSW farmer, and 1999 prices obtained from ABARE Farm Survey, 1999.

2.12 If an entity or any of its related entities were not in business for the whole time in a year of income, the entity, when calculating its STS average turnover, is to make a reasonable estimate of what its or the related entity's turnover would have been for that income year had the business been carried on for the whole year. ***[Schedule 1, item 1, subsection 328-370(2)]***

Example 2.4

Kevin commences his locksmith business on 1 January 2002. He would like to enter the STS. He calculates his STS average turnover to be $420,000 – calculated as below.

He estimates his turnover for the period 1 January 2002 to 30 June 2002 to be $200,000.

He estimates that if he had been in business for the period 1 July 2001 to 31 December 2001 his turnover would have been $190,000.

Therefore, the total estimate for the 2002 income year is $390,000.

His estimated turnover for income year 2002-2003 is $420,000, and the 2003-2004 income year is $450,000.

The total of STS group turnover for the 3 years is $1.26 million and the number of averaging years is 3.

His STS average turnover is $420,000 and Kevin may be eligible to be an STS taxpayer.

2.13 The dictionary in the ITAA 1997 is amended to include the definition of 'STS average turnover'. ***[Schedule 2, item 20]***

Closing down a business

2.14 An entity is taken to be carrying on a business in a year if:

- the entity is closing down a business they formerly carried on ***[Schedule 1, item 1, paragraph 328-365(3)(a)]***; and
- it was an STS taxpayer when it stopped carrying on the business ***[Schedule 1, item 1, paragraph 328-365(3)(b)]***.

2.15 The above rule ensures that an entity does not need to decide whether it carried on a business in the year in which it ceased business. The provision also ensures that entities are not required to change their method of accounting for tax purposes during the closing down phase.

Recalculating average turnover

2.16 Entities whose STS average turnover exceeds $1 million using the test in section 328-365 or entities that do not have a turnover to use, are eligible to look forward and recalculate their STS average turnover. ***[Schedule 1, item 1, subsection 328-370(3)]***

2.17 When recalculating their STS average turnover for an income year entities use their STS group turnover for the present year or a reasonable estimate of the turnover for that year plus a reasonable estimate of their STS group turnovers for the following 2 years, if any. The sum of these group turnovers is then divided by those years to give an STS average turnover figure. ***[Schedule 1, item 1, subsection 328-370(3)]***

2.18 Where an entity or any of its related entities commences business during a year of income, the entity, when calculating its STS average turnover, makes a reasonable estimate of what its or its related entity's turnover would have been for that income year had the business been carried on for the full year. ***[Schedule 1, item 1, subsection 328-370(4)]***

Reasonable estimate

2.19 When making a reasonable estimate of its turnover, an entity would normally take into account considerations such as:

- any orders placed and/or forward contracts entered into;
- the amount that could have been generated in turnover for a full income year based on a pro-rating of the turnover for the part of a year provided this is typical of the turnover in a full year;
- the type of business activity undertaken, considering the nature and type of turnover of similar businesses in that industry; and
- the current size and investment in the activity.

Example 2.5

Gunter has carried on a butchery business for the last 10 years through 2 of his shops in the city. Gunter's turnover from the 2 shops has always exceeded $1 million ($750,000 for one and $520,000 for the other) so he has never been eligible to be an STS taxpayer.

In the 2003-2004 income year Gunter turns 55 and wants to ease himself into retirement so he sells one of his city shops.

Now that Gunter has only one shop he can reasonably estimate that the turnover from that butcher shop, for the 2004-2005 income year and the next 2 income years, will not exceed $1 million.

Gunter recalculates his STS average turnover on the basis of his circumstances and now may be eligible to be an STS taxpayer.

2.20 The generic penalties regime in Division 284 of Schedule 1 to the *Taxation Administration Act 1953* will apply to any estimate that proves not to have been reasonable.

Meaning of STS group turnover

2.21 An entity's 'STS group turnover' for an income year is the sum of:

- the 'value of the business supplies' made during the year by the entity; and
- the 'value of business supplies' made during the year by the grouped entities while they were grouped with the entity.

The STS group turnover is reduced by any supplies made between the entity and the grouped entities or between the grouped entities themselves. ***[Schedule 1, item 1, subsection 328-375(1)]***

2.22 The dictionary in the ITAA 1997 is amended to include the definition of 'STS group turnover'. ***[Schedule 2, item 21]***

Meaning of 'value of the business supplies'

2.23 The concept of the 'value of the business supplies' is based on the terms defined in the GST Act and is defined in section 995-1 of the ITAA 1997.

2.24 The ***value of the business supplies*** an entity makes during an income year is the sum of the values of all the 'taxable supplies' the entity made during the year in the ordinary course of carrying on a business (calculated exclusive of GST payable on supplies) and the 'prices' of the other supplies made in the ordinary course of carrying on the business. Both 'price' and 'value' are defined in section 9-75 of the GST Act.

2.25 The GST Act explains the method of working out the value of a taxable supply. A 'taxable supply' is defined in section 9-5 of the GST Act and is one on which GST is payable. The value of a taxable supply is worked out as 10/11 of the price of the supply. This calculation excludes the GST payable on the supply (the other 1/11).

2.26 If the supply is not a taxable supply, the price of all the non-taxable supplies made during the year in the ordinary course of carrying on a business is added to the value of all taxable supplies. The price of a supply is generally the amount of money an entity pays for the supply. Supplies that are not taxable include those that are GST-free and input taxed for the purposes of the GST Act.

2.27 It is anticipated that for the first few years that the STS operates, an entity may need to work out the value of their business supplies using the price of the supply. This is because for those early years an entity will be taking into account pre-GST turnover from supplies that were not a taxable supply. The main turnover test looks back on the 4 preceding years. Over the initial years of the STS, entities will use a combination of both pre and post GST years.

2.28 Value of business supplies does not include:

- supplies not made in the ordinary course of carrying on a business – for example, sale of a capital asset, goods taken for own use and renting premises (unless the rental activity constitutes a business activity);
- supplies that constitute an insurance recovery or the principal component of a loan are disregarded when calculating turnover ***[Schedule 1, item 1, subsection 328-375(3)]***; and
- things that do not constitute the making of a supply – for example, dividend receipts.

Gambling supplies

2.29 To maintain consistency between GST and the income tax laws, gambling supplies for STS purposes are accorded the same treatment as that for GST purposes. As such, the method used for calculating the value of the business supplies in respect of gambling is different to that described in paragraphs 2.23 to 2.27. Where a taxable supply that an entity makes during the income year includes gambling supplies, an amount equal to 11 times the entity's 'global GST amount' as defined in section 126-10 of the GST Act is included when working out the STS average turnover rather than using the value of the business supplies. ***[Schedule 1, item 1, subsection 328-375(2)]***

2.30 The dictionary in the ITAA 1997 is amended to include the definition of 'global GST amount'. ***[Schedule 2, item 15]***

2.31 The effect of the change for gambling supplies is to provide that the amount included in the calculation of STS group turnover is simply the difference between the total amount wagered and total monetary prizes paid out. Total amounts wagered is the sum of the consideration for all gambling supplies that are attributable to that tax period. Total monetary prizes are the sum of prizes paid or payable in money (including casino chips) in that tax period.

Regulations may alter the calculation of STS group turnover

2.32 This Bill proposes that regulations can be made to provide a different calculation of STS group turnover. It has been suggested that there may be other supplies (like gambling supplies) which generate an unusually high turnover. The ability to make regulations to adjust the calculation of STS group turnover will enable the Government to further consider such cases and make any necessary adjustments where required. The regulations, however, cannot have the affect of increasing the amount of an entity's group turnover calculation. ***[Schedule 1, item 1, subsection 328-375(4)]***

When is an entity's turnover grouped?

2.33 An entity's turnover will be grouped with that of another entity where:

- either entity controls the other;
- both entities are controlled by the same third entity; or
- the entities are STS affiliates of each other.

[Schedule 1, item 1, section 328-380]

2.34 The grouping rules are designed to ensure that businesses that are part of a larger group of entities do not gain access to the STS. However, the grouping rules also ensure that unrelated entities are not inadvertently grouped and that only entities that are related to each other are grouped.

2.35 Irrespective of whether an entity that controls another entity, or is controlled by another entity wishes to participate in the STS, the turnover of that entity will still be grouped with those entities that it controls, or that are controlled by it that wish to enter the STS. For example, there may be 5 entities in a group and only 3 wish to enter the STS. The STS group turnovers of all 5 will be taken into account when calculating the STS average turnover for those 3 wishing to enter the STS.

Who is an STS affiliate?

2.36 An entity's (the first entity's) 'STS affiliate' is an entity (the second entity) that acts or could reasonably be expected to:

- act in accordance with the directions or wishes of the first entity in relation to the affairs of the second entity's business; or
- act in concert with the first entity in relation to the affairs of the second entity's business.

[Schedule 1, item 1, subsection 328-380(8)]

2.37 Two or more partners in a partnership are not each others STS affiliates merely because one partner acts or could reasonably be expected to act in concert with the other in relation to the affairs of the partnership business. ***[Schedule 1, item 1, subsection 328-380(9)]***

2.38 The STS affiliate rule ensures that related persons such as a husband and wife will not be grouped where they each run unrelated businesses.

2.39 The dictionary in the ITAA 1997 is amended to include the definition of 'STS affiliate'. ***[Schedule 2, item 19]***

2.40 The following factors will be amongst those that will be considered in arriving at any decision about whether another entity is an affiliate of another entity. None of these factors is seen as definitive in its own right but generally an entity would not be an affiliate of another entity where each entity:

- has different employees;
- has different business premises;
- has separate bank accounts;
- never consult each other on business matters; and
- conduct their businesses independently in all regards.

The STS affiliate rules ensure that businesses that genuinely operate in isolation, that is, independently of each other are not automatically grouped.

Example 2.6

Stefan and Maria are husband and wife. They both share in the running of their household. Stefan operates a bakery with a turnover of $700,000 while Maria runs a cleaning business with a turnover of $500,000. They both have separate bank accounts for their businesses and have nothing to do with each other's business. Both businesses are run from different locations and they have their own employees. Neither Stefan nor Maria control the management of the other's business.

In this situation, even though they are married and live together, they are not each others STS affiliates because they do not act in concert with each other in respect of their businesses.

In this example, both Maria's cleaning business and Stefan's Bakery may be eligible to be an STS taxpayer.

Meaning of control

Companies, sole traders and certain trusts

2.41 An entity would be regarded as controlling another entity where that entity either alone or together with its STS affiliates can enjoy a certain level of benefit from another entity. Such a benefit can arise where the entity:

- either alone or together with its STS affiliates legally or beneficially owns; or
- has the right to acquire legal or beneficial ownership of interests in the other entity that give between them the right to receive:
  - at least 40% of any distribution of income or capital by the other entity; or
  - the right to exercise or control the exercise of at least 40% of the voting power in the other entity.

[Schedule 1, item 1, subsections 328-380(2) and (3)]

2.42 Where an entity's control percentage in another entity is at least 40% but less than 50%, the Commissioner can ignore the interest of that entity in the other entity if the first entity can satisfy the Commissioner that a third entity actually controls the other entity. ***[Schedule 1, item 1, subsection 328-380(7)]***

Example 2.7

Chandra owns a restaurant with a turnover of less than $1 million and has inherited his father's 42% interest in a software company. The other 58% of the software company is owned by a person with whom Chandra has had no dealings whatsoever. The turnover of Chandra's restaurant will not be grouped with the turnover of the software company as Chandra can demonstrate that the software company is controlled by the other person with the 58% interest.

Non-fixed trusts

2.43 The tests of control discussed in paragraph 2.40 are not appropriate for non-fixed trusts because a beneficiary may not have any entitlement to a distribution of income or capital until certain events occur. For example, a beneficiary of a discretionary trust does not have any entitlement until the trustee actually exercises a discretion to distribute to particular beneficiaries.

2.44 The first test used in the STS to identify the control of a non-fixed trust for the purposes of the grouping rules looks at the receipt, by the entity or its STS affiliates, of distributions from non-fixed trusts. This test will only group an entity with a non-fixed trust where the entity or its STS affiliates, or the entity and its STS affiliates have received a distribution from the trustee of the trust of $100,000 or more in any one of the last 4 income years. ***[Schedule 1, item 1, paragraph 328-380(4)(a)]***

Example 2.8

For the 2001-2002 income year Lucretia, who is a solicitor, has an STS average turnover of $200,000. Her great uncle Bob controls the Uncle Bob Family Trust. Lucretia is a beneficiary of the trust by virtue of her relationship.

The Uncle Bob Family Trust operates a very successful cable making business overseas and has an annual turnover in excess of $250 million.

Lucretia has not seen her great uncle for many years and has not received a distribution from the trust. In fact, Lucretia is not even aware that she is a beneficiary of the trust.

In 2004-2005, the trust distributes $80,000 to all beneficiaries with a blood relationship to Uncle Bob.

In this situation, this rule will not apply to group the turnover of the trust with Lucretia's turnover from her law practice. This is because the distribution does not exceed $100,000 and it could not be said that Lucretia has any control over Uncle Bob's Family Trust.

The following year, Lucretia has a turnover of $400,000 and also receives from the trust a distribution of $200,000.

Since Lucretia has received a distribution in excess of $100,000, her turnover of $400,000 for the 2005-2006 income year will be grouped with the whole turnover of the trust of $300 million. Therefore, her group turnover for the purpose of the STS is $300.4 million.

2.45 The other test looks at whether or not the entity or its STS affiliates are capable of directly or indirectly obtaining the beneficial enjoyment of the capital or income of the non-fixed trust. ***[Schedule 1, item 1, paragraph 328-380(4)(b)]***

Partnerships

2.46 An entity would be said to be controlling a partnership where the entity and/or its STS affiliates between them have the right to receive at least 40% of the partnership net income or have at least a 40% interest in assets used by the partnership in its business (other than assets leased to the partnership). ***[Schedule 1, item 1, subsection 328-380(5)]***

2.47 A partnership would be said to be controlling another entity (namely, another partnership, a trust or a company) where a partner or partners in the partnership have the right to receive between them at least 40% of the partnership net income or have at least 40% interest in the assets used in the partnership business and the same partner or partners:

- also have the right to receive between them at least 40% of:
  - any distribution of income or capital from a trust;
  - the net income of another partnership, or have at least a 40% interest in the assets used in that partnership business; or
  - any distribution of income or capital by a company, or have the power to exercise control of at least 40% of the voting power in the company; or
- if the other entity is a non-fixed trust it would be grouped with the trust under subsection 328-380(4) for similar reasons as explained in paragraphs 2.42 to 2.44.

[Schedule 1, item 1, subsections 328-380(5) and (6)]

Example 2.9

Lyn, David and Ross are partners in a partnership (P1) which operates an accounting practice, specialising in insolvency. The partnership has a turnover of $800,000.

The sharing of partnership profits and losses is governed by a partnership agreement. The agreement specifies that profits and losses of P1 are shared in the following way:

- Lyn with a 30% share;
- David with a 20% share; and
- Ross with a 50% share.

Lyn, David and Ross also operate another partnership (P2) which is an accounting practice specialising in taxation. The turnover of the second partnership is $600,000.

A partnership agreement specifies that the profit and losses of P2 are to be shared in the following way:

- Lyn with a 50% share;
- David with a 20% share; and
- Ross with a 30% share.

P1 and P2 operate in concert with each other and share assets and common business premises. Lyn, David and Ross have unfettered control of both partnerships.

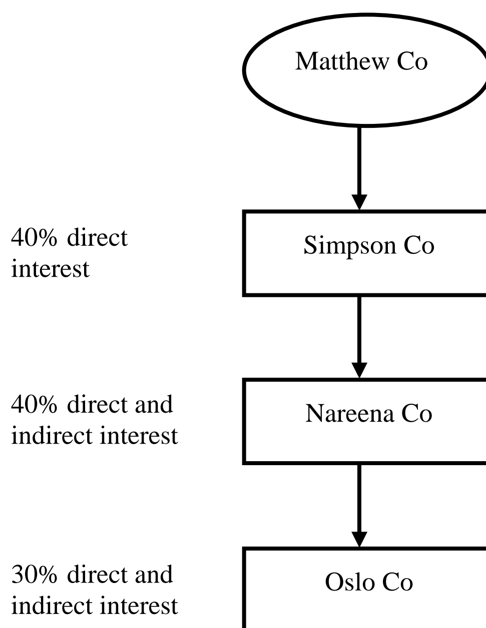
As Lyn, David and Ross together have the right to receive amongst them over 40% of the net income of P1 and P2, the grouping rules will operate to treat P1 as controlling P2. As such, P1 will add the turnover of P2 to its own when working out its STS group turnover and P2 will add P1's turnover to its when calculating its STS group turnover.

In this example, P1 and P2 will not be eligible to be STS taxpayers as the STS average turnover of both partnerships exceeds $1 million. This assumes that the turnover of past (or future) years is not significantly different.

Indirect control of an entity

2.48 The control tests are designed to look through business structures that include interposed entities. However, only controlled entities are taken into account in tracing interests. The indirect control rule has been adopted to avoid complex tracing requirements for an entity. If an entity directly controls a second entity, and the second entity controls (whether directly or indirectly) a third entity, the first entity is also taken to control the third entity. ***[Schedule 1, item 1, subsection 328-380(2)]***

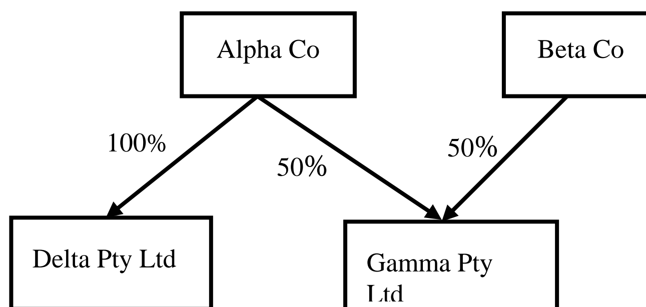
Example 2.10



Matthew Co controls Simpson Co and Nareena Co but not Oslo Co.

Example 2.11: How to work out STS group turnover

Alpha Co and Beta Co, who are unrelated to each other, own 50% each of the issued capital of Gamma Pty Ltd. As well, Alpha owns 100% of Delta Pty Ltd. The structure of Alpha and Beta's business affairs is illustrated below:



	$ Alpha	*$ Beta*	*$ Gamma*	*$ Delta*
Value of all business supplies	600,000	500,000	400,000	200,000
Value of those business supplies made to a controlled or controlling entity	80,000 to Gamma	Nil	40,000 to Alpha 60,000 to Beta	90,000 to Gamma

STS group turnovers of these entities for the income year is calculated as follows:

Alpha

Alpha controls both Gamma and Delta. The value of business supplies will be grouped as below:

Value of supplies made by :

Alpha	$600,000
Gamma	$400,000
Delta	$200,000
	$1,200,000

Less

Value of supplies made by:

Alpha to Gamma	$80,000
Gamma to Alpha	$40,000
Delta to Gamma	$90,000
	$210,000

Alpha's group turnover *$990,000*

Beta

Beta controls Gamma only.

Value of supplies made by:

	Beta	$500,000
	Gamma	$400,000
		$900,000

Less

Value of supplies made by:

	Gamma to Beta	$60,000
		$60,000

Beta's group turnover	*$840,000*

Gamma

Gamma is controlled by both Alpha and Beta and is related to Delta as Delta is also controlled by Alpha.

Value of supplies made by:

	Gamma	$400,000
	Alpha	$600,000
	Beta	$500,000
	Delta	$200,000
		$1,700,000

Less

Value of supplies made by:

	Alpha to Gamma	$80,000
	Gamma to Alpha	$40,000
	Gamma to Beta	$60,000
	Delta to Gamma	$90,000
		$270,000

Gamma's group turnover	*$1,430,000*

Delta

Delta is wholly controlled by Alpha and is related to Gamma as Gamma is also controlled by Alpha.

Value of supplies made by:

	Delta	$200,000
	Gamma	$400,000
	Alpha	$600,000

		$1,200,000
Less		
Value of business supplies:		
	Alpha to Gamma	$80,000
	Gamma to Alpha	$40,000
	Delta to Gamma	<u>$90,000</u>
		$210,000
Delta's group turnover		*$990,000*

Results

If *Alpha* wished to join the STS it would not be precluded on grounds of its group turnover for this year alone.

If *Beta* wished to join the STS it would not be precluded on grounds of its group turnover for this year alone.

If *Delta* wished to join the STS it would not be precluded on grounds of its group turnover for this year alone.

If *Gamma* wished to join the STS it may be precluded on grounds of its group turnover.

Chapter 3
Entering and leaving the Simplified Tax System

Outline of chapter

3.1 This chapter explains the circumstances in which an entity:

- enters the STS;
- leaves the STS; and
- re-enters the STS.

[Schedule 1, item 1, Subdivision 328-G]

Context of reform

3.2 Restrictions on re-entry are designed as an integrity measure to discourage entities from temporarily entering the STS regime to gain access to the benefits of the STS.

Comparison of key features of new law and current law

New law	*Current law*
This Bill provides machinery provisions which deal with the requirements when an entity: • elects to enter the STS; • elects to leave the STS; • is required to leave the STS because it ceases to be eligible to be in the STS; and • again becomes eligible and wishes to re-enter the STS.	As the STS is a new system there are no corresponding provisions in the current law.

Detailed explanation of new law

Choice to enter the STS

3.3 An entity may choose to enter the STS if they qualify as an STS taxpayer for an income year. If an entity chooses to enter the STS, they

need to notify the Commissioner in the approved form. ***[Schedule 1, item 1, section 328-435]***

3.4 Broadly, an entity is an STS taxpayer for an income year if it:

- carries on a business during the year;
- has an STS average turnover of less than $1 million; and
- has depreciating assets with values totalling less than $3 million at the end of that year.

The eligibility rules that determine who can be in the STS regime are discussed in Chapter 2.

3.5 Once in the STS, the STS taxpayer will remain in the STS until they voluntarily leave or there is a substantial change to the business that requires the entity to leave the STS. An example of such a situation would be where an entity expands its operations and thus estimates that its STS average turnover for a year would be in excess of $1 million.

Leaving the STS

3.6 There are 2 ways in which an STS taxpayer leaves the STS:

- they may voluntarily elect to leave; or
- they cease to be eligible for the STS.

3.7 If an STS taxpayer leaves the STS they will need to notify the Commissioner of their decision. ***[Schedule 1, item 1, subsections 328-440(1) and (2)]***

Restriction on re-entering the STS

3.8 Once an entity *voluntarily* leaves the STS they will be ineligible to re-enter the STS for a period of 5 years after the last income year that the entity was an STS taxpayer. This restriction is designed to stop entities from taking advantage of the benefits of the STS by entering and leaving the STS on a frequent basis ***[Schedule 1, item 1, subsection 328-440(3)]***. If the entity wishes to re-enter after 5 years they will need to notify the Commissioner of their decision ***[Schedule 1, item 1, section 328-435]***.

3.9 However, the 5 year limit does not apply if the entity is required to leave the STS because it is no longer eligible. In this situation the entity will be able to re-enter if it satisfies the eligibility criteria rules as specified in Subdivision 328-F. Again, the entity has to notify the Commissioner of its decision to re-enter. ***[Schedule 1, item 1, section 328-435]***

Example 3.1

Thomas has a restaurant in the city. In the 2004-2005 income year he purchases equipment with a 4 year effective life. He qualifies for and chooses to enter the STS in that year. Once in the STS he can use the new simplified depreciation rules. Thomas decides to leave the system the following year.

The STS rules will allow Thomas to enjoy the ongoing benefits of the pooled depreciation at the rate of 30% after leaving the STS. Subsection 328-440(3) will not allow him to enter the STS until the 2010-2011 income year. This is because Thomas had voluntarily chosen to leave the STS.

Chapter 4
Accounting method for Simplified Tax System taxpayers

Outline of chapter

4.1 This chapter explains the new accounting method (referred to as the cash accounting method) for STS taxpayers as it applies to ordinary income and general deductions. This method ensures that taxable income of an STS taxpayer broadly includes:

- 'ordinary income' when *received*; and
- 'general deductions' when *paid*.

4.2 Two specific expenses, tax-related expenses and expenses for repairs, are also deductible when *paid* (see paragraph 4.21). This is because these expenses are recurrent expenses of carrying on a business.

4.3 Under this accounting method an STS taxpayer will not be required to bring to account, at year end, income from sales for which payment has not been *received* (debtors). Similarly, business expenses owing (creditors) at year end will not be deductible until paid. This also means that the cash accounting method does not extend to statutory income and most specific deductions.

4.4 Certain adjustments to ordinary income, general deductions and deductions for tax-related expenses and repairs are required when a business starts (entry adjustment rules) or stops (exit adjustment rules) being an STS taxpayer. These adjustments are a consequence of the cash accounting method for STS taxpayers.

4.5 The entry adjustment rules ensure that the transition *to* the cash accounting method does not result in business income and expenses being recognised twice or omitted. Refer to paragraphs 4.33 to 4.41 for details.

4.6 The exit adjustment rules ensure that the transition *from* the cash accounting method does not result in omission of business income and expenses. Refer to paragraphs 4.39 to 4.45 for details.

Context of reform

4.7 The cash accounting method is designed to provide for greater alignment with the cash basis of accounting for GST.

4.8 Under the cash accounting method, ordinary income is recognised when received and general deductions and deductions for tax-related expenses and repairs are allowable when paid. A business which records all sales, purchases and payment of expenses in a cash book will be able to determine its income tax liability largely from its cash flow records, if it enters the STS. This is because the new cash accounting method allows STS taxpayers to recognise ongoing business income (ordinary income) when received and ongoing business expenses (general deductions and deductions for tax-related expenses and repairs) when paid.

4.9 The effect of the cash accounting method is that it modifies the taxing point of most business income and expenses for STS taxpayers. The adjustment rules ensure that when a business enters or leaves the STS, the change in the taxing point of business income and deductions does not give rise to double counting or omissions.

4.10 The entry and exit adjustment rules only apply to ordinary income, general deductions and deductions for tax-related expenses and repairs of an STS taxpayer.

Comparison of key features of new law and current law

New law	*Current law*
This Bill proposes the introduction of a new cash accounting method for ordinary income, general deductions and deductions for tax-related expenses and repairs which is more closely aligned to the flow of business funds.	Businesses generally use an accruals method of accounting which requires the recognition of income when derived and expenses when incurred.

Example 4.1: How an STS taxpayer will be able to relate its tax liability with cash book records

Yash runs a plumbing business and is an STS taxpayer in the 2002-2003 income year.

He has received payment of $80,000 from various jobs during the year.

He completed a job on 29 June 2003 worth $1,000 but has not been paid as yet.

He has paid business expenses of $30,000 during the year.

He owes $2,000 for materials that he ordered on 30 June 2003.

Business income (ordinary income) that is owed to Yash, but has not yet received ($1,000), will not affect his tax liability for the 2002-2003 income year. This is because the cash accounting method recognises ordinary income only when it is received.

Similarly, business expenses (general deductions) that he owes for materials ordered ($2,000), which he has not yet paid for, will also not affect Yash's tax liability for the 2002-2003 income year. This is because the cash accounting method recognises general deductions when they are paid.

Yash's cash book, for the 2002-2003 income year, shows the flow of business funds as follows:

Business receipts (ordinary income)	$80,000
Less business expenses (general deductions)	($30,000)
Flow of business funds as per cash book	$50,000

Yash's tax liability as an STS taxpayer is calculated as follows:

Ordinary income *received*	$80,000
Less general deductions *paid*	($30,000)
Taxable income	$50,000

Detailed explanation of new law

Advantages of cash accounting

4.11 The cash accounting method minimises compliance costs for STS taxpayers because, for tax purposes, they will not be required to recognise sales for which payment has not been *received*. On the deductions side, they will not be required to recognise expenses that they have not *paid*.

4.12 In many instances the cash accounting method allows STS taxpayers with ordinary income from sales and day to day business expenses to work out their taxable income using their cashbook and bank statements. This method provides for greater alignment with the cash basis of accounting used for GST.

Ordinary income is recognised when received

4.13 An STS taxpayer applies section 6-5 of the ITAA 1997 so that ordinary income is taken to be derived only when it is *received* ***[Schedule 1, item 1, paragraph 328-105(1)(a)]***. This means that an STS taxpayer is required to work out ordinary income in accordance with section 6-5 but only include amounts of ordinary income that have been *received*. The practical effect of this provision is that STS taxpayers are taxable on business income *received*, not on income owing from customers or clients. This enables them to relate their tax liability with inflow of business funds.

4.14 Broadly, ordinary income of a business includes ongoing business or trade income *received* whilst operating a business. Examples of ordinary income are income from sales of goods and/or services, professional fees and commissions. Statutory income, such as net capital gain from the sale of an asset, is not affected by the cash accounting method.

4.15 Another practical effect of paragraph 328-105(1)(a) is that where an STS taxpayer receives a payment that relates to services provided over the next few weeks, but which extend over to the next financial year, the income is taxable in the year that it is *received*. The main advantage of this rule is that (again) it allows STS taxpayers to relate their tax liability with flow of business funds.

Ordinary income applied or dealt with on behalf of an STS taxpayer is taken to have been received

4.16 Ordinary income that is applied or dealt with on behalf of an STS taxpayer is taken to have been *received*. This is the current tax treatment of ordinary income, for all taxpayers (subsection 6-5(4) of ITAA 1997).

Ordinary income not received by an STS taxpayer may still be assessable

4.17 If an amount of ordinary income has not been, and will not be, *received* by an STS taxpayer, it is not assessable under the cash accounting method ***[Schedule 1, item 1, paragraph 328-105(2)(b)]***. This is because the cash accounting method only recognises income when *received.*

4.18 In some circumstances, such as when a debt is forgiven, an STS taxpayer may be assessable on a benefit or gain that has not been *received*. In such cases, income tax laws outside the STS provisions continue to apply. In other words, income that does not meet the *received* rule as required by the cash accounting method, may be assessable according to general concepts.

Example 4.2: How income not received by a taxpayer is assessable outside the STS rules

Dominic is an STS taxpayer who operates a boat making business. He owes $25,000 to another business who supply him with boat engines for his business.

Dominic agrees to make a boat in return for the debt of $25,000 to be forgiven.

The cash accounting rules do not recognise the benefit or gain to Dominic because he has not *received* that amount.

If the $25,000 is considered to be ordinary income *applied* on behalf of Dominic it will be assessable under subsection 6-5(4) of the ITAA 1997.

If the $25,000 is *not* considered to be ordinary income applied on behalf of Dominic (i.e. if subsection 6-5(4) does not apply), it will be assessable as income according to ordinary concepts – when it is derived.

General deductions are allowed when paid

4.19 An STS taxpayer applies section 8-1 of the ITAA 1997 so that the expenses are taken to be incurred only when they are paid ***[Schedule 1, item 1, paragraph 328-105(1)(b)]***. This means that an STS taxpayer is required to work out general deductions in accordance with section 8-1 but only claim those amounts of general deductions that have been paid. The practical effect of this provision is that STS taxpayers can claim deductions for business expenses paid, not for amounts owed to suppliers. This enables them to relate their tax liability with outflow of business funds.

4.20 Another practical effect of paragraph 328-105(1)(b) is that where an STS taxpayer makes a payment for goods or services that may relate to a few weeks, but which extend over to the next financial year, the expense is deductible in the year that it is paid. The main advantage is that it (again) allows STS taxpayers to relate their tax liability with flow of business funds.

Certain specific deductions are also allowed when paid

4.21 Two specific deductions, namely tax-related expenses and expenses for repairs, are also deductible for STS taxpayers when they are paid ***[Schedule 1, item 1, paragraph 328-105(1)(b)]***. These deductions are currently allowable for business when they are incurred. This rule has been modified for STS taxpayers so that most commonly used business expenses are deductible for STS taxpayers at the time they are paid.

General and certain specific deductions paid on behalf of an STS taxpayer are taken to have been paid

4.22 General deductions and deductions for tax-related expenses and repairs that are paid on behalf of an STS taxpayer are taken to have been *paid*. This rule is consistent with the tax treatment of ordinary income applied on behalf of an STS taxpayer. Refer to paragraph 4.16 for details.

A deduction for expenses not paid by an STS taxpayer may still be available

4.23 If an amount of general deduction, a tax-related expense or an expense for repairs has not been, and will not be, paid by an STS taxpayer, it is not deductible under the cash accounting method ***[Schedule 1, item 1, paragraph 328-105(2)(c)].*** This is because the cash accounting method only recognises deductions when *paid.*

4.24 In some circumstances, such as loss from theft, an STS taxpayer may be allowed a deduction for a loss or outgoing that has not been paid. In such cases, income tax laws outside the STS provisions continue to apply. In other words, a deduction that does not meet the *paid* rule as required by the cash accounting method, may be deductible according to general concepts.

Example 4.3: How an amount not paid by an STS taxpayer is deductible outside the STS rules

Poh-Lee is an STS taxpayer who operates a delicatessen. She recognises income of the business by making a daily entry in her electronic cash book at the end of every trading day.

Poh-Lee is robbed while she is going to the bank to deposit the shop's takings from the day before.

She loses $1,000 which was recognised as business income the day before.

Poh-Lee's insurance does not cover loss of cash from theft and she does not recover the stolen amount.

The cash accounting method does not recognise the loss as it was not *paid*.

Poh-Lee can deduct the stolen amount, outside the STS rules, as a loss or outgoing under general concepts of the income tax law.

Cash accounting method does not affect statutory income and specific deductions

4.25 The cash accounting method (i.e. ordinary income is assessable when *received* and general deductions are allowable when *paid*) does *not* extend to statutory income and specific deductions (other than tax-related expenses and repairs – see paragraph 4.21).

4.26 Statutory income is an amount that is not considered to be ordinary income but is included in assessable income by a specific provision of the income tax law. An example of statutory income, relevant to business, is a capital gain resulting from the sale of an asset. Specific provisions of income tax law bring such types of income to account which would otherwise not be assessable at specific times (see Division 102 of the ITAA 1997). The cash accounting method *does not* affect the operation of statutory income provisions. Those provisions continue to operate, for STS taxpayers, exactly as they do for all other taxpayers. The taxing point for statutory income of STS taxpayers will continue to be determined by the relevant provision of the income tax law.

4.27 A specific deduction is made allowable by a particular provision (outside of the general deduction provision) of the income tax law. Such deduction provisions allow an amount to be deducted from assessable income that may not have been allowable under the general deduction provision. An example of a specific deduction, for business, is expenditure incurred by a primary producer to install mains electricity supply. Specific deduction provisions currently allow a deduction for such capital expenses which would otherwise not be deductible at specific times. The STS timing rules do not affect the operation of specific deduction provisions. Those provisions continue to operate for STS taxpayers, exactly as they do for all other taxpayers.

Cash accounting method does not override specific rules about ordinary income, general deductions and deductions for tax-related expenses and repairs

4.28 The cash accounting method does not apply to ordinary income, general deductions, and deductions for tax-related expenses and repairs if another provision of the income tax law includes an amount or allows the deduction at a different time ***[Schedule 1, item 1, paragraph 328-105(2)(a)]***. That is, if the taxing point of an amount of ordinary income, general deduction or a deduction for tax-related expenses and repairs is modified by another provision of the income tax law, that taxing point overrides the received and paid rules under the cash accounting method.

4.29 On the income side, this means that if another provision of the income tax law (other than section 6-5 of the ITAA 1997) specifically defers or brings forward the taxing point for a particular type of ordinary income, the timing rule in the specific provision overrides the received rule for STS taxpayers.

4.30 An example of an amount of ordinary income to which another timing rule applies is profit on the sale of a second wool clip within the one income year because of a natural disaster. The taxing point for such an amount is deferred by section 385-135 of the ITAA 1997. That section would override the received rule under the cash accounting method. This means that the STS taxpayer may elect to defer the taxing point even though the income has been received. Refer to Example 4.4 to see how paragraph 328-105(2)(a) applies.

4.31 On the deduction side, this means that if another provision of the income tax law (other than sections 8-1, 25-5 or 25-10 of the ITAA 1997) apportions or alters the deductibility of a particular type of general deduction, the timing rule in the specific provision overrides the paid rule for STS taxpayers.

4.32 An example of a general deduction to which another timing rule applies is prepayments made by an STS taxpayer for a magazine subscription for a period of 2 years.

Example 4.4: When an STS taxpayer recognises various types of income and deductions using the new cash accounting method

Ellita conducts a primary production business. She chooses to become an STS taxpayer in the 2002-2003 income year.

Most of the year's business transactions consist of ordinary income and general deduction amounts. The cash accounting method ensures that these transactions are only recognised when they are received and paid.

For the 2002-2003 income year only, Ellita receives $200,000 from sales.

She is owed $2,000 by a customer who pays her on a monthly basis.

She will receive $5,000 (from the sale of shares) on 1 July 2003. The shares were sold on 29 June 2003 and settlement is expected on 1 July 2003. Ellita has calculated that she is assessable on a net capital gain of $800.

Due to a drought in the area, Ellita was required to shear sheep earlier than usual. Ellita made a profit of $10,000 on that second wool clip. She elects to defer the profit to the next income year.

Ellita has business expenses of $160,000 but of that amount has paid only $150,000.

Ellita also paid $500 for tax-related expenses on 10 June 2003.

She owes $1,000 for repair of farm equipment. She has not paid this amount as yet.

Ellita also owes $20,000 for upgrading the supply of mains electricity on her farm. She is committed to paying this expense in the 2003-2004 income year.

Under the cash accounting method for STS taxpayers, Ellita includes $200,000 (ordinary income) in her assessable income because it has been received. She does not include the $2,000 owed to her because she has not received it as yet.

She includes the net capital gain of $800 (statutory income), from disposal of shares because the capital gains tax event took place in the 2002-2003 income year even though she has not received it as yet. The cash accounting method does not apply to the net capital gain as it is not ordinary income.

Ellita defers including the profit (of $10,000) on the second wool clip to the next income year (section 385-135 of the ITAA 1997). The cash accounting rules do not apply to this transaction, even though it is ordinary income. This is because another provision of the income tax law includes the amount at a different time.

Ellita claims business expenses (general deductions) of $150,000 because she paid them in the 2002-2003 income year. She does not

claim a deduction for business expenses that she has not paid as yet ($10,000).

The payment of $500 for tax-related expenses is deductible because it has been paid. Ellita does not claim a specific deduction of $1,000 for repairs (specific deduction) because she has not paid for the expense as yet.

Ellita also claims $2,000 for upgrading the mains electricity supply because the cost is allowable, over 10 years, as a specific deduction (Subdivision 387-E ITAA 1997) for primary producers. The cash accounting method does not apply to this expense as it is a specific deduction, not a general deduction.

Entry adjustment rules when entering the STS

4.33 The entry adjustment rules ensure that business income and expenses, that have, or should have, been recognised prior to the business entering the STS, are not recognised again under the cash accounting method when they are received and paid or omitted. ***[Schedule 1, item 1, section 328-110]***

Entry adjustment rules for ordinary income

4.34 The entry adjustment rules ensure that an amount of ordinary income that was:

- derived but not *received*; and
- was assessable in an income year before entering the STS,

is not included again when it is received in a later year. ***[Schedule 1, item 1, subsection 328-110(2)]***

4.35 Similarly, any income that is received, but not derived before entering the STS is included in assessable income in the year the taxpayer enters the STS. This is designed to address situations where payment has been received before entering the STS but the relevant services are not provided until a later time. ***[Schedule 1, item 1, subsection 328-110(3)]***

4.36 The practical effect of these provisions is that when an STS taxpayer receives business income that was previously assessable (because it was recognised under the accruals system of accounting) it is not taxed again under the cash accounting method when the income is received. The provisions also ensure that income is not omitted.

Entry adjustment rules for general deductions

4.37 The entry adjustment rules ensure that a general deduction and a deduction for tax-related expenses and repairs that were:

- incurred but not paid; and
- were deductible in an income year before entering the STS,

are not deductible again when they are *paid* in a later year. ***[Schedule 1, item 1, subsection 328-110(4)]***

4.38 Similarly, any expenses that you paid, but did not incur, before entering the STS are deductible in the year you enter the STS. ***[Schedule 1, item 1, subsection 328-110(5)]***

4.39 The practical effect of these provisions is that when an STS taxpayer pays business expenses that were previously deductible (because they were recognised under the accruals systems of accounting) they are not deductible again under the cash accounting method when the expenses are actually paid. The provisions also ensure that deductions are not omitted.

Entry adjustment rules for trading stock

4.40 The entry adjustment rules ensure that an outgoing for trading stock that was:

- incurred and *paid* prior to entering the STS; and
- was not deductible in that year because of section 70-15 of the ITAA 1997,

is deductible to an STS taxpayer during the year in which the item becomes part of trading stock on hand. ***[Schedule 1, item 1, subsection 328-110(6)]***

4.41 The practical effect of this provision is that an STS taxpayer can claim a deduction for trading stock when it becomes part of stock on hand even though the stock had been paid for in an earlier year. This rule addresses situations where an STS taxpayer had purchased trading stock before entering the regime but could not claim a deduction due to the operation of section 70-15 of the ITAA 1997.

Exit adjustment rules when leaving the STS

4.42 The exit adjustment rules ensure that business income and expenses (that have not been recognised under the cash accounting method because they had not been received or paid) are recognised in the first year that a business is outside the STS (changeover year). ***[Schedule 1, item 1, section 328-115]***

Exit adjustment rules for ordinary income

4.43 The exit adjustment rules ensure that an amount of ordinary income that was:

- derived in an income year while the business was an STS taxpayer; and

- was not included in assessable income because it had not been received,

is included in assessable income in the changeover year. ***[Schedule 1, item 1, subsection 328-115(2)]***

4.44 The practical effect of this provision is that when an STS taxpayer leaves the STS, business income not brought to account under the cash accounting method (because it had not been received) is included in assessable income in the first year that the STS taxpayer is outside the STS.

4.45 The exit adjustment rules only apply to the first year that the business stops being an STS taxpayer. That is, all ordinary income derived, but not received by an STS taxpayer, is brought to account in the first year that the business is outside the STS.

Exit adjustment rules for general deductions

4.46 The exit adjustment rules ensure that a general deduction and a deduction for tax-related expenses and repairs that were:

- incurred in an income year while the business was an STS taxpayer; and
- were not deductible in that income year because they had not been paid,

are deductible in the changeover year. ***[Schedule 1, item 1, subsection 328-115(3)]***

4.47 The practical effect of this provision is that when an STS taxpayer leaves the STS, any business expenses owing for which a deduction was not available under the cash accounting method (because they had not been paid) are deductible in the first year that the business is outside the STS.

4.48 Example 4.5 shows how the entry and exit adjustment rules ensure that ordinary income, general deductions and deductions for tax-related expenses and repairs are not recognised twice or omitted when a business enters and leaves the STS.

Example 4.5

Habibi enters the STS in the 2003-2004 income year.

Before entering the STS he used an accruals basis of accounting for tax purposes.

Habibi included amounts owing from customers as income derived in the 2002-2003 income year.

He also claimed deductions for business expenses outstanding at the end of the 2002-2003 income year.

The entry adjustment rule for ordinary income ensures that, when Habibi enters the STS, amounts owing from a previous year are not recognised again when *received.*

The entry adjustment rule for deductions ensures that expenses outstanding from a previous year are not recognised again when *paid.*

Habibi chooses to leave the STS in the 2005-2006 income year.

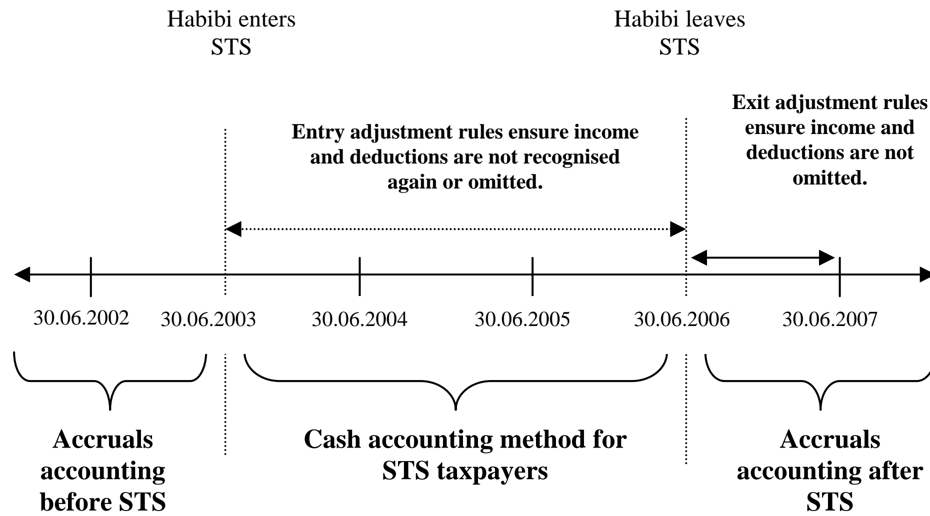
While he was an STS taxpayer he had derived ordinary income for which payment had not been *received*. Habibi did not include this amount as income as the cash accounting method does not recognise ordinary income until it is *received*.

While he was an STS taxpayer he had ordered business supplies but had not *paid* for them. Habibi did not claim a deduction for this expense as the cash accounting method does not recognise general deduction until they have been *paid*.

The exit adjustment rule for ordinary income ensures that Habibi includes in assessable income, amounts owing to him in the changeover year (2006-2007 income year).

The exit adjustment rule for deductions ensures that he can deduct expenses owed by him in the changeover year (2006-2007 income year).

Habibi's time line



Consequential amendments

4.49 Notes are inserted in sections 6-5 and 8-1 of the ITAA 1997 to refer readers to the cash accounting regime for STS taxpayers. ***[Schedule 2, items 2 to 4]***

Chapter 5
Capital allowances for Simplified Tax System taxpayers

Outline of chapter

5.1 Subdivision 328-D contains the rules for calculating deductions for the decline in value of depreciating assets and including some amounts in assessable income for businesses in the STS.

5.2 This Subdivision provides an outright deduction for depreciating assets whose cost is less than $1,000, and pooling arrangements for other depreciating assets.

5.3 It also provides simplified arrangements for accounting for the:

- private use of depreciating assets; and
- disposal of depreciating assets.

[Schedule 1, item 1, section 328-170]

5.4 The STS rules apply for income years commencing on or after 1 July 2001.

Context of reform

5.5 Division 42 of the ITAA 1997 currently contains the provisions allowing a deduction for depreciation.

5.6 Under the current provisions, items are generally treated on an individual basis. The rate of depreciation is determined by the plant's effective life. This can result in a multitude of depreciation rates. Hence, it is often a time consuming task having to calculate the depreciation deductions allowable each year.

5.7 If an item is used for both business and private purposes, apportionment calculations are required each year to determine the amount of depreciation that may be claimed. When items are disposed of, a separate calculation is also needed to determine any balancing charge. These requirements further increase the compliance burden for small business taxpayers.

5.8 The capital allowance provisions for STS taxpayers will result in compliance cost savings by removing much of the need to maintain

individual asset schedules and perform separate calculations for each asset for deduction and balancing charge purposes.

Summary of new law

5.9 The capital allowance provisions for STS taxpayers will provide an immediate write-off for depreciating assets costing less than $1,000 and pooling arrangements for other depreciating assets. There are 2 STS pools; a ***general STS pool*** for depreciating assets with an effective life of less than 25 years and a ***long life STS pool*** for depreciating assets with an effective life of 25 years or more.

5.10 Each pool will be regarded as a single depreciating asset. The private use calculation will also be simplified by attributing only the business proportion of the depreciating asset to the general or long life pool. The need to calculate balancing charges is removed because only the business proportion of the termination value of the asset is deducted from the balance of the pool.

5.11 Businesses will also effectively maintain access to accelerated depreciation since assets in the general STS pool (with an effective life of less than 25 years) will qualify for deduction on a diminishing value basis of 30% of the pool balance each year. Assets with effective lives of 25 years or more will be allocated to the long life STS pool and the pool's balance will qualify for deductions on a diminishing value basis of 5% of the pool balance per year.

5.12 Depreciating assets that an STS taxpayer first uses, or has installed ready for use, during an STS income year, qualify for deduction at half the pool's normal rate, in that first income year. This is irrespective of when, during that first year, the asset is first used or installed ready for use. Depreciating assets that were used or installed ready for use prior to entering the STS, qualify for deduction at the full pool rate.

Comparison of key features of new law and current law

New law	*Current law*
Pooling allows assets to be treated as a single depreciating asset. This will simplify the calculation for deductions.	Most assets are depreciated on an individual basis. However, the current law provides limited pooling arrangements for plant that has the same diminishing value rate of depreciation and for low-value assets: Subdivisions 42-L and 42-M respectively.

New law	***Current law***
Assets costing less than $1,000 will receive an immediate deduction.	An immediate write-off is available for small items costing less than $300 for small business taxpayers: Subdivision 42-E.
If the balance of the pool, prior to calculating the pool deduction for the year, falls below $1,000, that amount may be claimed as a deduction for the year.	There is no equivalent provision.
Each year an asset is used to produce assessable income, a percentage estimate of the business use of the depreciating asset must be made.	Subdivision 42-M allows an estimate to be made for the life of the low-cost asset.
If the estimate of the business use of a depreciating asset changes by more than 10 percentage points, an adjustment is made to the balance of the pool to reflect the changed usage.	There is no equivalent provision.
If a pooled asset is disposed of, and a business use adjustment has previously been made, an average of the business use percentage of its termination value is deducted from the pool's balance.	Depreciating assets allocated to a low-value pool have a similar provision: Subdivision 42-M.

Detailed explanation of new law

General

5.13 STS taxpayers calculate deductions under Subdivision 328-D for depreciating assets held for a taxable purpose, and which would otherwise be deductible under proposed Division 40. This Subdivision will also require amounts to be included in a taxpayer's assessable income where there is a negative pool balance or a low-cost asset is disposed of. Once the Subdivision applies to an asset, it continues to apply until that asset is disposed of. ***[Schedule 1, item 1, subsection 328-175(1)]***

5.14 Assets, including buildings, that would not be deductible under proposed Division 40 are not deductible under the STS ***[Schedule 1, item 1, subsection 328-175(2)]***. Where this Subdivision applies, proposed Division 40 will not. Proposed Division 40 will allow deductions for capital allowances.

5.15 One of the main features of the capital allowances regime for STS taxpayers in Subdivision 328-D is the pooling of assets. Generally, a pool consists of the costs, or in some cases a proportion of those costs, of the depreciating assets allocated to it. This will greatly simplify calculations because a pool is treated as a single asset and only one rate is used for all assets in that pool. ***[Schedule 1, item 1, subsection 328-185(1)]***

5.16 There are 2 kinds of pools; a ***general STS pool*** for depreciating assets with an effective life of less than 25 years and a ***long life STS pool*** for depreciating assets with an effective life of 25 years or more ***[Schedule 1, item 1, subsection 328-185(2)].*** The respective ***pool rates***, on a diminishing value basis, are 30% and 5% of the pool's opening balance ***[Schedule 1, item 1, subsection 328-190(1)].***

5.17 Depreciating assets are allocated to the respective pools according to the depreciating asset's effective life at the latter of when the taxpayer becomes an STS taxpayer, or the income year in which the STS taxpayer first uses the depreciating asset, or installs it ready for use, for a taxable purpose. ***[Schedule 1, item 1, subsections 328-185(3) and (4)]***

5.18 If a taxpayer leaves and later re-enters the STS, any unallocated business assets that the taxpayer has used, or installed ready for use, since last leaving the STS, must be allocated to a pool, unless the taxpayer can elect to claim deductions for the asset under proposed Division 40.

5.19 Once a depreciating asset has been allocated to a pool, it cannot be reallocated on the basis of effective life ***[Schedule 1, item 1, subsection 328-185(7)].*** For example, a depreciating asset in a long life STS pool cannot be allocated to the general STS pool if its effective life falls below 25 years, even if the taxpayer subsequently re-enters the STS.

5.20 This Subdivision is dependent on the uniform capital allowances regime (proposed Division 40) being enacted prior to 1 July 2001 and contains a number of terms that are defined in proposed Division 40. Very broadly, these terms are defined as follows:

- generally, a ***depreciating asset*** is an asset with a limited effective life and which can reasonably be expected to decline in value over the period it is used;
- the ***effective life*** of an asset is determined at the time the asset is first used, or installed ready for use, for any purpose. Taxpayers will have the choice of using the Commissioner's determination of effective life or working out their own effective life of the asset;
- who ***holds*** a depreciating asset may sometimes be unclear. In such cases, it is usually the taxpayer who most uses the asset according to its primary function;

- a ***taxable purpose*** is the purpose of producing assessable income;
- an asset's ***cost*** will usually be the amount(s) the taxpayer has paid to hold the asset (net of GST credits). An asset's cost consists of 2 elements – the amount(s) you initially pay to hold the asset (the first element) and the amount(s) you are taken to have paid after you start to hold the asset (the second element)[2];
- an asset's ***adjustable value*** is its cost less any amounts that the taxpayer has deducted, or could have deducted, for its decline in value since the asset was first used, or installed ready for use, for any purpose. Assets already held by the taxpayer on entering the STS are included in an STS pool at their adjustable value;
- a ***balancing adjustment event*** occurs when a taxpayer ceases to hold a depreciating asset. For example, a balancing adjustment event occurs where the asset is disposed of, lost or destroyed; and
- the ***termination value*** of a depreciating asset is broadly any proceeds received for disposing of the asset, including any insurance monies received.

Exceptions

Primary producers

5.21 A primary producer, who is an STS taxpayer for the year, is able to choose whether to claim deductions under the primary production provisions in proposed Subdivisions 40-F or 40-G, or use this Subdivision instead. For qualifying depreciating assets held prior to entering the STS the choice must be made on entry. For qualifying assets which are first used, or installed ready for use, for a taxable purpose in a later STS income year, the choice is made in that later income year. ***[Schedule 1, item 1, subsections 328-175(3) and (4)]***

5.22 A choice is available in respect of each depreciating asset. However, once the choice is made the taxpayer cannot change it. For example, if a taxpayer who enters the STS elects to claim deductions for some assets under proposed Subdivisions 40-F or 40-G they cannot choose to allocate those assets to an STS pool in a later year of income, even if they re-enter the STS.

[2] Note: Proposed Division 40 will modify the 'cost' of luxury cars to include only the amount of the vehicle's cost up to the specified luxury car limit. The exception is where a non-luxury car is modified to enable it to be used by a taxpayer with a disability. In such cases, the full cost of the vehicle may be claimed by the taxpayer.

Horticultural plants

5.23 Horticultural plants, including grapevines, are specifically excluded from receiving a deduction under this Subdivision. STS taxpayers who incur expenditure on horticultural plants must use Subdivision 40-F to claim a deduction for these assets. ***[Schedule 1, item 1, subsection 328-175(5)]***

Leases

5.24 Concessional STS treatment could be transferred to non-STS taxpayers if STS taxpayers received pool deductions for depreciating assets they lease to others. Therefore, depreciating assets let, or that will be let, predominantly on a depreciating asset lease are also specifically excluded from deduction under Subdivision 328-D. A depreciating asset is let, or will be let, predominantly on a depreciating asset lease if it is let, or is intended to be let, more than 50% of the time on a depreciating asset lease. ***[Schedule 1, item 1, subsection 328-175(5)]***

5.25 Subsection 995-1(1) of the ITAA 1997 will define a depreciating asset lease as an agreement, or renewal of an agreement, under which a right to use a depreciating asset is granted. It does not include a short-term hire agreement or a hire purchase agreement (also defined in subsection 995-1(1)).

5.26 Subsection 995-1(1) will define a short-term hire agreement as an agreement for the intermittent hire of an asset on an hourly, daily, weekly or monthly basis. Short-term hirings of the same asset to the same entity, or associates of that entity, will not be regarded as a short-term hire agreement if they are reasonably continuous and total a period longer than a few months.

Low-value pools and software development pools

5.27 Depreciating assets a taxpayer has previously allocated to either a pool created under the former Subdivision 42-L, their low-value pool or a software development pool, are excluded from deduction under Subdivision 328-D ***[Schedule 1, item 1, subsection 328-175(7)]***. Taxpayers must use the rules in Division 40 for assets allocated to a Subdivision 42-L or low-value pool prior to entering the STS. However, low-cost assets acquired after entering the STS will be subject to the STS low-cost asset rules in section 328-180.

5.28 Where a taxpayer has a software development pool on entry to the STS, the software development expenditure allocated to that pool remains subject to the rules in proposed Division 40. Further, where a taxpayer incurs software development expenditure after entering the STS, the software development expenditure must continue to be allocated to the software development pool according to the rules in proposed Division 40. Any depreciating assets that are created out of the expenditure allocated to a software development pool cannot be allocated to an STS

pool or receive an outright deduction under the STS. ***[Schedule 1, item 1, subsection 328-175(8)]***

5.29 Taxpayers who do not have a software development pool on entry to the STS, and who incur software development expenditure whilst an STS taxpayer, may create software development pools under proposed Division 40 and allocate all future software development expenditure to such pools (see paragraph 5.28). Alternatively, taxpayers may choose not to create a software development pool, in which case they will allocate the depreciating asset, the software, to an STS pool in the income year it is first used, or installed ready for use, for a taxable purpose, provided they are still an STS taxpayer.

5.30 Off the shelf software and the like which is acquired by an STS taxpayer for use in their business is deductible under the STS in accordance with this Subdivision. For example, software costing less than $1,000 will qualify for an outright deduction.

Low-cost depreciating asset

5.31 An outright deduction is available for low-cost depreciating assets. These are defined as depreciating assets whose total cost is less than $1,000 at the end of the income year in which the taxpayer starts to use it for a taxable purpose. The deduction is limited to the taxable purpose proportion of the asset's adjustable value and is available in the year the depreciating asset is first used, for a taxable purpose, provided the person is an STS taxpayer for that year and the year the asset was first held. Such a depreciating asset is never allocated to a pool. ***[Schedule 1, item 1, section 328-180]***

5.32 Where the depreciating asset is not used for private purposes, the deduction will usually be the asset's cost. Where the cost is less than $1,000 and the depreciating asset is used partly for private purposes, the deduction is limited to the proportion of the asset's adjustable value which is used for producing assessable income.

Example 5.1: Deduction for the taxable purpose proportion of low-cost assets

For the 2001-2002 income year, Lindsay is an STS taxpayer. Lindsay bought a tool set for $800. As its cost was less than $1,000 it qualifies for a deduction as a low-cost asset. Lindsay estimates that it will be used for business purposes 70% of the time. Multiplying the cost of the asset by this percentage, results in the amount of $560 being allowed as an immediate deduction under the STS.

If the cost had been $1,300, Lindsay would not have been able to claim an immediate deduction even though the 70% business use estimate would have brought the amount ($910) below $1,000.

5.33 Further, where a depreciating asset is acquired after the taxpayer enters the STS and is first used solely for private purposes, the business use proportion of the asset's adjustable value (at that time) becomes deductible in the first year the asset is used, or installed ready for use, for a taxable purpose, providing the taxpayer is still an STS taxpayer.

5.34 Low-cost depreciating assets that were held, or used for a taxable purpose, prior to the taxpayer entering the STS, do not qualify for the immediate deduction for low-cost assets, even if the asset's cost was less than $1,000. This is because the immediate deduction is only available for business assets acquired by taxpayers after joining the STS. However, such assets may be allocated to an STS pool, provided they have not previously been allocated to a Division 40 low-value pool by the taxpayer.

Opening pool balance

5.35 A taxpayer in the STS must first calculate the opening balance of each pool in order to determine the amount on which annual deductions will be calculated. For the first year that the taxpayer enters the STS, the ***opening pool balance*** of a pool is the sum of the taxable purpose proportions of the adjustable value of each depreciating asset that is allocated to that pool. ***[Schedule 1, item 1, subsection 328-195(1)]***

5.36 For a later income year, the ***opening pool balance*** will be the pool's closing pool balance from the previous year, unless an adjustment is made to reflect the changed business use of a pooled asset (section 328-225). ***[Schedule 1, item 1, subsection 328-195(2)]***

5.37 Where a taxpayer leaves and later re-enters the STS, the ***opening pool balance*** of an STS pool will be the closing pool balance of that pool for the previous year plus the taxable purpose proportion of the adjustable value of any depreciating assets not yet allocated to a pool (excluding assets to which an exception applies – section 328-175). This means that on re-entry, an STS taxpayer will need to allocate, to the appropriate pool, assets they have begun to use, or have installed ready for use, for a taxable purpose since last leaving the STS. ***[Schedule 1, item 1, subsection 328-195(3)]***

Taxable purpose proportion

5.38 STS taxpayers must estimate how much they will use a depreciating asset for a taxable purpose. For example, if a taxpayer estimates that the asset is to be used solely for a taxable purpose, the estimate of taxable use is 100% for that income year. This will be the case, even if the asset is used for minor incidental private purposes. ***[Schedule 1, item 1, subsections 328-205(1) and (2)]***

5.39 For business assets the taxpayer initially brings into the STS, the estimate will be made at the end of the income year in which the taxpayer first enters the STS. For business assets acquired during an STS income year, the estimate will usually be made at the end of that income year. Where a taxpayer leaves and later re-enters the STS, the estimate will need to be made at the end of the year of re-entry for business assets not yet allocated to a pool which the taxpayer has acquired while outside the STS.

5.40 The original estimate is multiplied by the asset's adjustable value to determine the ***taxable purpose proportion*** of the asset's adjustable value ***[Schedule 1, item 1, paragraph 328-205(3)(a)]***. After the year for which the original business use estimate is made, for each later income year that the taxpayer holds the asset, they must estimate the amount they will use the asset for a taxable purpose ***[Schedule 1, item 1, subsection 328-225(1)]***.

5.41 However, subsequent estimates will not require an adjustment to the pool balance unless the estimate varies from the original estimate by more than 10 percentage points. In that case, an adjustment is required under section 328-225 to reflect the significant change in the business use of the asset. Likewise, if a present year's estimate of business use for an asset varies by more than 10 percentage points from the last estimate that resulted in an adjustment under section 328-225, a further adjustment to the business use estimate will be required under section 328-225. ***[Schedule 1, item 1, subsection 328-225(1A)]***

5.42 If a STS taxpayer incurs further expenditure in relation to an asset, the taxable purpose proportion of the amount included in the second element of cost will be based on the original estimate, except where an adjustment has been made to the business use estimate. In that case, the taxable purpose proportion of an amount included in the second element of cost will be based on the most recent business use estimate that resulted in an adjustment under section 328-225. ***[Schedule 1, item 1, paragraph 328-205(3)(b)]***

5.43 However, the need to make an adjustment to the pool balance and the need to estimate the business use of an asset in income years after the year in which the asset is allocated to an STS pool, is limited to the 3 years after the asset is allocated to a general STS pool, and to 20 years after the asset is allocated to a long life STS pool. ***[Schedule 1, item 1, paragraph 328-225(5)(a)]***

5.44 The ***taxable purpose proportion*** of an asset's termination value is based on the original business use estimate of the asset unless this estimate has been adjusted under section 328-225. Where an asset's business use estimate has been adjusted under section 328-225, the taxpayer must use the average of the asset's current and previous business use estimates to work out the ***taxable purpose proportion*** of the asset's termination value. ***[Schedule 1, item 1, subsection 328-205(4)]***

Example 5.2: Determining the taxable purpose proportion of the adjustable value of STS assets

Eugene is an STS taxpayer for the 2001-2002 income year. He owns 2 assets which are used in his print shop business.

He has a van. It has an effective life of 8 years and the adjustable value is $25,000. Eugene's estimate of how much he will use the van for the purpose of producing assessable income in the year it is allocated to the pool is 70%. This means the taxable purpose proportion of the van's adjustable value is $17,500 (70% of $25,000).

The other asset is a printing press. It has an effective life of 2 years and the adjustable value is $5,000. The press is used solely for the purpose of producing assessable income. This means the taxable purpose proportion of the press' adjustable value is $5,000 (100% of $5,000).

As the effective life of each asset is less than 25 years, they are both allocated to the general STS pool. The STS general pools opening balance for the 2001-2002 income year is:

$17,500 (the taxable purpose proportion of the van)
\+ $ 5,000 (the taxable purpose proportion of the press)
= $22,500

Pool deductions

5.45 A taxpayer in the STS will calculate the annual deduction for pooled depreciating assets by multiplying the opening balance of the pool by the pool's deduction rate ***[Schedule 1, item 1, subsection 328-190(1)].*** (Note that if the pool has a low-value for an income year, an amount can be claimed under section 328-210 instead of calculating the annual pool deduction.)

Example 5.3: Calculating the annual pool deduction for an STS pool

Eugene calculates the deduction for the general STS pool by multiplying its opening pool balance by the general STS pool rate of 30%:

$22,500 × 30% = $6,750

This results in a deduction of $6,750 for the pool for the year.

5.46 Depreciating assets that are first used, or installed ready for use, for a taxable purpose during an STS income year, qualify for a deduction at half the normal pool rate for that income year. Such assets are allocated to a pool at the end of the year in which they are first used, or installed ready for use, for a taxable purpose ***[Schedule 1, item 1, subsection 328-185(4)].*** For assets with an effective life of less than 25 years, the rate to be applied is 15%. For assets with an effective life of 25 years or more, the rate is 2.5% ***[Schedule 1, item 1, subsection 328-190(2)].***

5.47 This rate applies to depreciating assets irrespective of when, during the income year, the asset is first used, or installed ready for use, for a taxable purpose. For example, it does not matter whether the asset is first used, or installed ready for use, for a taxable purpose at the beginning or the end of an income year. Such a rule avoids the need to apportion the asset's business use over its first income producing year. The rate is multiplied by the taxable purpose proportion of the asset's adjustable value (determined at the time the asset is first used, or installed ready for use, for a taxable purpose).

Example 5.4: Treatment of assets that are first used, or installed ready for use, during an STS income year

In the 2001-2002 income year, Eugene acquires and begins to use a new millennium press in place of the old press. The millennium press costs $20,000. The press has an effective life of less than 25 years.

Eugene estimates it will be used only for business purposes, so the taxable purpose proportion of the adjustable value of the millennium press is $20,000 (100% of $20,000).

In the first year the millennium press is used to produce assessable income, the deduction is 15% of the taxable purpose proportion of the asset's adjustable value:

$\$20{,}000 \times 0.15 = \$3{,}000$

Eugene claims $3,000 in respect of the millennium press in the 2001-2002 income year. (The press is then allocated to the general STS pool in the 2001-2002 closing pool balance calculation.)

5.48 If a depreciating asset has an effective life of more than 25 years and was first used, or installed ready for use, for a taxable purpose before 1 July 2001, an STS taxpayer may choose not to allocate that asset to the long life STS pool. In that case, the taxpayer would claim deductions for the asset under proposed Division 40. The choice is irrevocable and is made for the first income year a person is an STS taxpayer. ***[Schedule 1, item 1, subsections 328-185(5) and (6)]***

Second element of cost

5.49 If an STS taxpayer incurs, in respect of a depreciating asset pooled in an STS pool in a previous income year, an amount that is included within the second element of cost (as worked out under proposed section 40-190) this amount (the *cost addition amount*) is allocated to the STS pool to which the asset is allocated. ***[Schedule 1, item 1, subsection 328-190(3)]***

5.50 For assets with effective lives of less than 25 years, and which have been allocated to a general STS pool in an earlier income year, the deduction is 15% of the taxable purpose proportion of the cost addition amount in the year the amount is incurred. For assets with an effective life of 25 years or more, and which have been allocated to a long life STS pool in an earlier income year, the deduction is 2.5% of the taxable purpose proportion of the cost addition amount in the year the expenditure is incurred. ***[Schedule 1, item 1, subsection 328-190(4)]***

Disposal of depreciating assets

5.51 When a balancing adjustment event occurs for a depreciating asset that has been, or will be, allocated to a pool, the depreciating asset's termination value is subtracted from the pool. If the asset has not been used exclusively for a taxable purpose, the asset's termination value is reduced because only the taxable purpose proportion of the asset's termination value is deducted from the pool ***[Schedule 1, item 1, section 328-200]***. This taxable purpose proportion is determined by the taxpayer's business use estimate of the asset.

Example 5.5: Calculating the taxable purpose proportion of assets disposed of during the year

> During the 2001-2002 income year Eugene sells his old press for $2,000.
>
> The taxable purpose proportion of the asset's termination value is $2,000 (because Eugene's business use estimate is 100%).

5.52 Where a pooled depreciating asset's business use estimate has previously been adjusted under section 328-225, the taxable purpose proportion of the asset's termination value must reflect the average of the business use estimates made for that asset. In other words, the taxable purpose proportion of an asset's termination value is only averaged if the taxpayer's original business use estimate for a depreciating asset has changed by more than 10 percentage points. ***[Schedule 1, item 1, subsection 328-205(4)]***

5.53 For assets in the general STS pool this average is calculated having regard to each of the 3 years the taxpayer holds the asset after the year in which the asset was allocated to that pool. For assets in the long life STS pool, this average is calculated having regard to each of the 20 years the taxpayer holds the asset after the year in which the asset was allocated to that pool ***[Schedule 1, item 1, paragraphs 328-205(4)(b) and (c)]***. For example, if a taxpayer had previously estimated that the business use estimate of an asset in the general STS pool was 80% in year 1 (original estimate), 60% in year 2, 40% in year 3 and 100% in year 4 (the last 3 adjustments having been made under section 328-225), the average business use estimate would be 70%.

Closing pool balance

5.54 The closing pool balance calculation incorporates all the additions and subtractions to the pool for the income year. For each year after the first year as an STS taxpayer, the ***opening pool balance*** is the closing pool balance of the immediately preceding income year ***[Schedule 1, item 1, subsection 328-195(1)].*** However, the opening pool balance, on which the deductions for the year are calculated, may need to be adjusted to reflect changes in a taxpayer's estimate of a depreciating asset's use for business purposes (section 328-225) ***[Schedule 1, item 1, subsection 328-195(2)].*** Such an adjustment is made prior to calculating the closing pool balance for an income year ***[Schedule 1, item 1, subsection 328-225(2)].***

5.55 The ***closing pool balance*** for a year of income is calculated in the following way. The taxpayer adds to the opening balance of the pool for the income year:

- the taxable purpose proportion of the adjustable value of each depreciating asset that was first used, or installed ready for use, for a taxable purpose during the income year; and

- the taxable purpose proportion of the cost addition amount which has been incurred in that income year and which relates to assets allocated to that pool in a previous income year.

5.56 The taxpayer then subtracts from the resulting amount:

- the taxable purpose proportion of the termination values of each depreciating asset disposed of during the income year which has been allocated to the pool (subsection 328-205(4)). Taxpayers will also need to subtract the taxable purpose proportion of a depreciating asset's termination value if the asset was held for less than 12 months (e.g. where the asset began to be used and was disposed of within the same income year);

- the deduction allowable for the pool calculated under subsection 328-190(1);

- the deduction allowable for depreciating assets first held by the taxpayer during the income year as calculated under subsection 328-190(2); and

- the deduction allowable for the cost addition amount incurred in the income year as calculated under subsection 328-190(3).

5.57 The result is the closing balance of the pool for the income year. ***[Schedule 1, item 1, section 328-200]***

Example 5.6: Calculating the closing pool balance

Eugene calculates the general STS pool's 2001-2002 closing pool balance in the following order:

1. Eugene must add the taxable purpose proportion of the adjustable value of the millennium press (acquired during 2001-2002) to the pool's 2001-2002 opening balance:

   $22,500

   + $20,000 (100% business purpose estimate for the millennium press)

   = $42,500

   (Eugene has incurred no cost addition amounts.)

2. Eugene then subtracts from $42,500 the following amounts:

   $2,000 (termination value of old press – see Example 5.5)

   $6,750 (pool deduction – see Example 5.3)

   $3,000 (15% deduction for the millennium press Eugene began to hold in 2001-2002 – see Example 5.4)

   = $30,750

3. Therefore, the final closing pool balance for Eugene's general STS pool in 2001-2002 is $30,750.

The opening pool balance for Eugene's 2002-2003 general STS pool will be $30,750.

5.58 If an asset is removed from the pool due to a balancing adjustment event, the closing pool balance may be a negative amount. Where this occurs, the amount below zero is included in assessable income ***[Schedule 1, item 1, paragraph 328-215(2)(a)].*** The closing pool balance then becomes zero, rather than the negative amount ***[Schedule 1, item 1, subsection 328-215(3)].***

Low-pool value

5.59 Instead of claiming an annual deduction for an STS pool under section 238-190, an STS taxpayer may be able to claim a low pool value deduction. An STS taxpayer may only claim this deduction if the value of the pool would be a positive amount less than $1,000. To work out this amount, the taxpayer adds to the opening balance of the pool for the income year:

- the taxable purpose proportion of the adjustable value of assets that are first used, or installed ready for use, for a taxable purpose during the year; and

- the taxable purpose proportion of the cost addition amounts incurred in the income year in respect of assets allocated to the pool in an earlier income year.

5.60 The taxpayer then subtracts from the resulting amount the taxable purpose proportion of the termination value of assets disposed of during the year. Where a low pool value deduction is available, the pool's closing pool balance for that income year is zero. ***[Schedule 1, item 1, section 328-210]***

5.61 If, as a result of a balancing adjustment event the low pool value calculation (subsection 328-210(2)) results in a negative amount, the amount below zero is included in assessable income ***[Schedule 1, item 1, paragraph 328-215(2)(b)]***. In such cases, the pool's closing balance then becomes zero, rather than the negative amount ***[Schedule 1, item 1, subsection 328-215(3)]***.

5.62 If a balancing adjustment event occurs in respect of a depreciating asset which was immediately deductible (because the asset cost less than $1,000), the taxable purpose proportion of the asset's termination value is included in the taxpayer's assessable income. ***[Schedule 1, item 1, subsection 328-215(4)]***

Change in the asset's taxable purpose proportion

5.63 Under the current Division 42 of the ITAA 1997, where a taxpayer apportioned a depreciating asset's use between business and private purposes, a calculation was required each year to reduce the depreciation allowed by the private use proportion. The taxpayer could change the business/private use apportionment from year to year. However, the asset's written down value would be reduced by an amount equivalent to the asset having been used solely for business purposes.

5.64 The following calculation works in exactly the same way, except it has been simplified so that the adjustment is made to the pool balance, which reflects only business use, instead of the annual depreciation deduction. Where a taxpayer's estimate of an asset's use for a taxable purpose for the present income year increases or decreases by more than 10 percentage points from the original estimate, or the estimate that last resulted in an adjustment under this section, an adjustment to the opening balance of the pool must be made to reflect the changed business use of one of the asset's allocated to it ***[Schedule 1, item 1, subsection 328-225(1A)]***. No adjustment can be made for an asset whose business use estimate changes by 10 percentage points or less ***[Schedule 1, item 1, paragraph 328-225(5)(b)]***.

5.65 The adjustment must be made in the income year for which the change occurs and it must be made to the pool's opening balance prior to calculating the deduction for the pool for that income year. The adjustment will ensure that the deduction for the pool for the income year is based on the depreciating asset's correct business use estimate for the present, and future, income years ***[Schedule 1, item 1, subsections 328-225(1A) and (2)]***. The adjustment is:

$$\text{reduction factor} \times \text{asset value} \times (\text{present year estimate} - \text{last estimate})$$

5.66 The reduction factor provides the depreciating asset with its value in the pool for that income year. Basically, it will determine the taxable purpose proportion of the pooled asset's adjustable value at the start of the income year.

5.67 The ***reduction factor*** for depreciating assets first used, or installed ready for use, for a taxable purpose while the taxpayer was an STS taxpayer is:

$$[1 - (\text{rate} \div 2)] \times (1 - \text{rate})^{n-1}$$

5.68 The formula requires half the rate of the appropriate pool, (i.e. 0.15 for the general STS pool and 0.025 for the long life STS pool) to be deducted from 1. The result is then multiplied by the following: 1 minus the full pool rate (i.e. 0.3 for the general STS pool or 0.05 for the long life STS pool) raised to the power of 'n – 1'. ***[Schedule 1, item 1, paragraph 328-225(4)(a)]***

5.69 In the equation, ***n*** represents the number of years, including part years, for which the taxpayer has, or could have, deducted an amount for the depreciating asset under Subdivision 328-D, excluding the present year. ***[Schedule 1, item 1, subsection 328-225(4)]***

5.70 For assets that were first used, or installed for use, for a taxable purpose while the taxpayer was an STS taxpayer, the reduction factor for assets in the general STS pool is:

- 0.85 in the second year deductions are calculated under this Subdivision;
- 0.595 in the third year deductions are calculated under this Subdivision; and
- 0.417 in the fourth year deductions are calculated under this Subdivision.

5.71 The ***reduction factor*** for depreciating assets first used, or installed ready for use, for a taxable purpose while the taxpayer was not an STS taxpayer is:

$$(1 - \text{rate})^{n}$$

5.72 Taxpayers must deduct from 1 either 0.3 (for assets in the general STS pool) or 0.05 (for assets in the long life STS pool). The result is raised to the power 'n'. ***[Schedule 1, item 1, paragraph 328-225(4)(b)]***

5.73 For assets that were first used, or installed ready for use, for a taxable purpose while the taxpayer was not an STS taxpayer, the reduction factor for assets in the general STS pool is:

- 0.70 in the second year deductions are calculated under this Subdivision;
- 0.49 in the third year deductions are calculated under this Subdivision; and
- 0.343 in the fourth year deductions are calculated under this Subdivision.

5.74 The ***asset value*** for a depreciating asset that was first used, or installed ready for use, for a taxable purpose while the taxpayer was an STS taxpayer, will be the asset's adjustable value at the time the asset was first used, or installed ready for use, for a taxable purpose. For a depreciating asset that was first used, or installed ready for use, for a taxable purpose while the taxpayer was not an STS taxpayer, the ***asset value*** is its adjustable value at the start of the income year in which the asset was allocated to a pool. In each case, an asset's adjustable value is increased by any amounts of expenditure (amounts included in the second element of cost) the taxpayer has incurred in respect of the asset in an income year after the year the asset was allocated to the pool. ***[Schedule 1, item 1, subsection 328-225(3)]***

5.75 The difference between the ***present year estimate*** and the ***last estimate*** reflects the change in a taxpayer's estimate of how much an asset will be used to produce assessable income. ***[Schedule 1, item 1, subsection 328-175(3)]***

5.76 The completed adjustment will reflect the change in the taxable purpose proportion of the pooled asset's adjustable value and will ensure that the pool's deduction for the year is based on the asset's revised estimate of business use. If the adjustment is a negative amount it will reduce the pool's opening pool balance. If it is a positive amount it will increase the pool's opening pool balance.

Example 5.7: Change in an asset's taxable purpose proportion

In September 2002 Eugene estimates that the taxable purpose proportion of his van increases from 70% to 85%. Before Eugene can calculate the 2002-2003 deduction for the general STS pool, Eugene must adjust the 2002-2003 opening pool balance to reflect the van's new business use estimate.

The closing pool balance for 2001-2002 is $30,750. This is the opening pool balance for 2002-2003. The adjustment that is required to be made is:

reduction factor × asset value × (present year estimate – last estimate)

Eugene was depreciating the van prior to entering the STS. The 'reduction factor' is therefore:

$(1 - \text{rate})^n$

Excluding this year (2002-2003), a deduction was allowed for the van under this Subdivision in the 2001-2002 income year. Therefore n = 1 and the reduction factor is:

$(1 - 0.3)^1 = 0.70$

The 'asset value' of the van is $25,000 (its adjustable value when Eugene's print shop joined the STS).

The present year estimate less the last estimate is:

0.15 (0.85 – 0.70)

As a result the calculation is:

$0.70 \times \$25{,}000 \times 0.15 = \$2{,}625$

The 2002-2003 opening pool balance of Eugene's general STS pool needs to be increased by this amount. Thus, the adjusted opening pool balance is:

$30,750 (2002-2003 opening pool balance)

\+ $ 2,625 (positive adjustment to the 2002-2003 opening pool balance)

= $33,375

Once Eugene's 2002-2003 general STS opening pool balance has been adjusted, the 2002-2003 pool deduction can be calculated.

The deduction is:

$30\% \times \$33{,}375 = \$10{,}013$

As Eugene has not acquired or disposed of any assets during 2002-2003, the closing balance calculation is as follows:

$33,375 (2002-2003 adjusted opening pool balance)

– $10,013 (general STS pool deduction: 30% × $33,375)

= $23,362

The opening pool balance for Eugene's 2003-2004 general STS pool will also be $23,362.

5.77 No business use estimate or adjustment need be made more than 3 income years after an asset is allocated to the STS general pool. Similarly, no estimate or adjustment need be made more than 20 income years after the asset is allocated to the STS long life pool. ***[Schedule 1, item 1, paragraph 328-225(5)(a)]***

Deduction prohibited by another provision

5.78 If a deduction would be calculated under this Subdivision but another provision of the ITAA 1936 or ITAA 1997, outside this Division,

denies that deduction, this Subdivision will deem an STS taxpayer as having made a business use estimate of zero for that depreciating asset for the income year. ***[Schedule 1, item 1, section 328-230]***

5.79 This treatment will generally trigger an adjustment under section 328-225. Where this deeming provision applies in a year and a deduction is not denied by another provision of the Act in a later income year, a further business use adjustment may be made in the time permitted under section 328-225. The further adjustment would add back to the pool the taxable purpose proportion of the asset's adjustable value, based on the taxpayer's business use estimate of the asset for that later income year.

Example 5.8: Deduction prohibited by another provision

> Eugene allocates a vehicle to his general STS pool in 2001-2002 and uses the logbook method to claim deductions for his car expenses. In 2003-2004 he begins to use the cents per kilometre method instead. As this method denies a claim for depreciation of the vehicle for the income year, an adjustment under section 328-225 is required.

5.80 Taxpayers subject to sections 85-10 and 86-60 of the ITAA 1997 can deduct amounts for depreciating assets under the STS provided they meet all the STS requirements. However, in accordance with sections 86-60 and 86-70, these taxpayers cannot allocate more than one vehicle with a private use component to an STS pool. ***[Schedule 1, item 1, section 328-235]***

Ceasing to be an STS taxpayer

5.81 If a taxpayer elects to leave the STS or is ineligible to remain, the taxpayer continues to claim deductions under this Subdivision for the general and long life STS pools. However, depreciating assets that are first used, or installed ready for use, for a taxable purpose while the taxpayer is not an STS taxpayer cannot be added to either pool until the taxpayer re-enters the STS ***[Schedule 1, item 1, section 328-220]***. Immediate deductions for low-cost depreciating assets a taxpayer begins to use to produce assessable income (section 328-180) are no longer available.

5.82 Further, where a taxpayer sells a business and there is a remaining pool balance after the assets have been disposed of, that balance continues to be written-off according to this Subdivision notwithstanding that the taxpayer is no longer in business. This provides similar treatment to situations where, for example, an STS taxpayer disposes of a single asset that has been allocated to a general STS pool and an amount of the asset's value remains in the pool. In both situations it is the existence of a pool balance that attracts a deduction, rather than whether the taxpayer still holds individual assets.

Example 5.9: Treatment when ceasing to be an STS taxpayer

In 2003-2004, Eugene elects to leave the STS. Eugene's general STS pool is frozen when the opening pool balance is $23,362. Eugene continues to apply the STS rules as far as they apply to assets already in the pool. In 2003-2004 Eugene does not dispose of any of these assets. Although Eugene acquires 3 new items of plant in the 2004-2005 income year, these are not added to the general STS pool.

Eugene claims the following deduction:

Income Year	*Opening pool balance*	*Capital allowances (30%)*	*Closing pool balance*
2003-2004	$23,362	$7,009	$16,353
2004-2005	$16,353	$4,906	$11,447
2005-2006	$11,447	$3,434	$ 8,013 and so on

The pool balance continues to be written down in this fashion. Assuming that Eugene does not re-enter the STS, in 2012-2013 the pool's opening pool balance is $943. As this is less than $1,000, Eugene can write off $943 in that income year which will bring the general STS pool balance to zero.

Application and transitional provisions

5.83 These amendments apply for the income year commencing 1 July 2001 and all later years.

Consequential amendments

5.84 A consequential amendment is made to Subdivision 20-B of the ITAA 1997 to avoid the profits on the sale of a previously leased vehicle, that is allocated to an STS pool, being taxed under both Subdivision 328-D and Subdivision 20-B. In these situations Subdivision 20-B is amended so as not to apply. ***[Schedule 2, item 5]***

5.85 Consequential amendments are made to subsection 995-1(1) of the ITAA 1997 to reflect a number of new definitions used in the STS capital allowances provisions.

Term	***Description***
Depreciating asset lease	An agreement whereby the holder of a depreciating asset grants a right to use the asset to another. It excludes hire purchase agreements and short-term hire agreements (which are both defined in subsection 995-1(1)).
General STS pool	Refer section 328-185.
Long life STS pool	Refer section 328-185.
Opening pool balance	Refer section 328-195.
Short-term hire agreement	An agreement for the intermittent hire of an asset, provided that the periods of hire do not give rise to substantial continuity of hiring for longer than a short-term basis.
Taxable purpose proportion	This amount of a depreciating asset’s adjustable value, second element of cost or termination value has the meaning given by section 328-205.

[Schedule 2, items 12 to 14, 16 to 18 and 23]

Chapter 6
Trading stock for taxpayers in the Simplified Tax System

Outline of chapter

6.1 This chapter sets out the method of accounting for trading stock while a taxpayer is in the STS. STS taxpayers will be subject to a modification of the existing trading stock rules contained in Division 70 of the ITAA 1997. In certain circumstances STS taxpayers will not have to account for changes in trading stock or do stocktakes at the end of the year.

Context of reform

6.2 Recommendation 17.4 of *A Tax System Redesigned* proposed that a simplified treatment of trading stock be implemented for certain small businesses. The existing law requires all business taxpayers with trading stock to conduct a stocktake at the end of each income year and to determine the value of each item of trading stock on hand for tax purposes. This value is compared with the value of trading stock on hand at the start of the year and the difference is included as either assessable income or a deduction. The proposed treatment for STS taxpayers is designed to reduce these compliance costs by requiring that changes in trading stock only be brought to account in certain limited circumstances.

Current law

6.3 'Trading stock' is defined in section 70-10 of the ITAA 1997 to include:

- anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of a business; and
- live stock.

6.4 Division 70 of the ITAA 1997 contains the rules for the taxation treatment of trading stock. These provisions are designed to produce an overall result that reflects the activities of a taxpayer with trading stock during an income year. This is achieved by matching the cost of goods sold with sales revenue in the following way:

- a deduction is allowed for expenditure incurred in acquiring trading stock under section 8-1 of the ITAA 1997 (Subdivision 70-B);
- sales revenue is assessable under section 6-5 (Subdivision 70-D); and
- an adjustment is made to either assessable income or deductions to take into account the change in value of trading stock on hand over the income year (Subdivision 70-C) if:
  - the value of trading stock on hand at the start of the income year is greater than the value at the end of the income year, a deduction is allowed for the excess; or
  - the value of trading stock on hand at the end of the income year is greater than the value at the start of the income year, an amount is included in assessable income equal to the excess.

6.5 This effectively gives a net deduction for trading stock equal to the cost of goods sold (i.e. opening stock plus purchases less closing stock) in each income year. This treatment is illustrated in Example 6.1.

Example 6.1: Treatment of trading stock under Division 70

At the start of the 1999-2000 year, Kramer has 13,000 units of trading stock on hand valued at a cost of $1 per unit ($13,000). During this year, he purchases another 19,500 units at $1 per unit and he sells 17,000 units at $3 per unit. From his stocktake at the end of the year, he determines that he has 15,500 units of trading stock on hand which he values at cost ($15,500).

Because the value of trading stock on hand at the end of the year ($15,500) is greater than the value at the start of the year ($13,000), the difference of $2,500 is included in assessable income.

At the start of the 2000-2001 year, Kramer has trading stock on hand valued at $15,500. During this year, he purchases another 15,000 units at $1 per unit and he sells 19,000 units at $3 per unit. From his stocktake, he determines that he has 11,500 units of trading stock on hand at the end of the year. Kramer again decides to value these units at cost ($11,500).

Because the value of trading stock on hand at the end of the year ($11,500) is less than the value at the start of the year ($15,500), the difference is allowed as a deduction of $4,000.

The following calculations illustrate the operation of Kramer's trading stock account and the calculation of his taxable income over the 2 income years.

Purchases	**1999-2000**	**2000-2001**
Units purchased on credit	6,000	5,000
Units purchased for cash	13,500	10,000
Units purchased	19,500	15,000
Cost of purchases	$19,500	$15,000
Sales		
Units sold on credit	0	0
Units sold for cash	17,000	19,000
Units sold	17,000	19,000
Sales revenue at $3 per unit	$51,000	$57,000

Trading stock valued at cost	**1999-2000**	**2000-2001**
Value of trading stock on hand at start of year	$13,000	$15,500
Value of trading stock on hand at end of year	$15,500	$11,500

Calculation of taxable income	**1999-2000**	**2000-2001**
Assessable income		
Sales	$51,000	$57,000
Excess of closing stock over opening stock	$2,500	0
Deductions		
Purchases	$19,500	$15,000
Excess of opening stock over closing stock	0	$4,000
Taxable income	$34,000	$38,000

Summary of new law

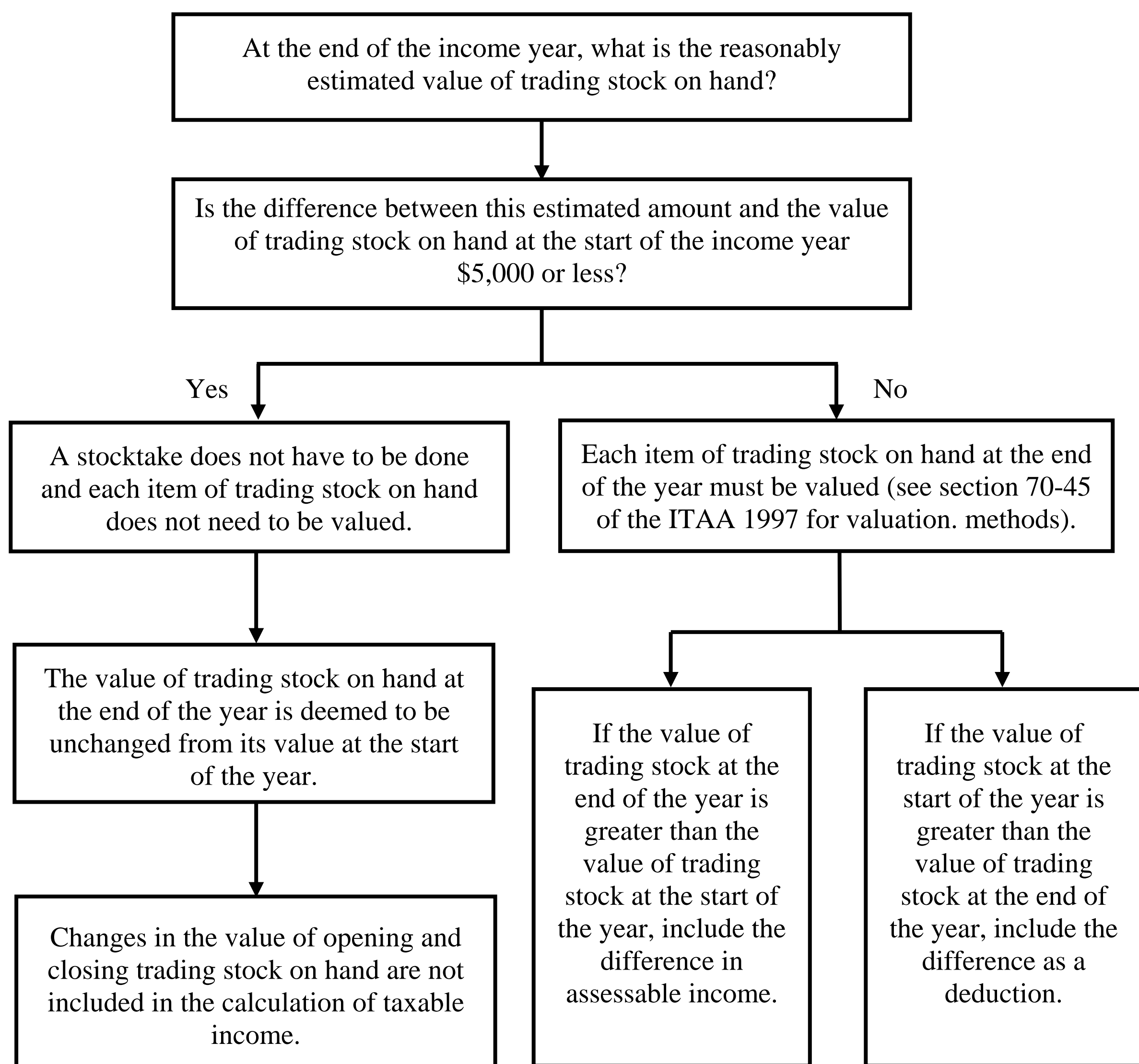
6.6 Subdivision 328-E modifies the trading stock rules in Division 70 of the ITAA 1997 for STS taxpayers. The STS provides that:

- where the difference between the value of trading stock on hand at the start of an income year and the reasonably estimated value at the end of the year is $5,000 or less, an STS taxpayer does *not* have to:
  - value each item of trading stock on hand at the end of the income year; or
  - account for any change in the value of trading stock on hand for income tax purposes; and

- where the difference between the value of trading stock on hand at the start of the year and the reasonably estimated value at the end of the year is greater than $5,000, an STS taxpayer must:
  - value each item of trading stock on hand at the end of the year; and
  - account for the change in value of trading stock.

6.7 Diagram 6.1 provides an overview of how the trading stock rules will apply for STS taxpayers.

Diagram 6.1: STS trading stock overview



Comparison of key features of new law and current law

New law	*Current law*
Purchases of stock A deduction is allowed for the cost of acquiring trading stock in the year in which the *payment* is actually made. See Chapter 4 for an explanation of the accounting method for STS taxpayers.	***Purchases of stock*** A deduction is allowed, on an accruals basis, for expenditure incurred in acquiring trading stock. The deduction is allowed in the year in which the expense is *incurred*.
Sales Sales revenue is included in assessable income in the year in which it is *received*. See Chapter 4 for an explanation of the accounting method for STS taxpayers.	***Sales*** Sales revenue is included in assessable income on an accruals basis, that is, in the year in which it is *derived*.
Stocktakes The value of each item of trading stock on hand at the end of the income year does not need to be determined when the difference between the value of trading stock on hand at the start of the income year and the estimated value of trading stock on hand at the end of the year is $5,000 or less.	***Stocktakes*** Each item of trading stock on hand at the end of the income year must be valued at either cost, replacement price or market selling value.
Accounting for changes in stock Variations in the value of trading stock must be taken into account in working out assessable income and deductions only when the difference between the value of trading stock on hand at the start of the income year and the estimated value of trading stock on hand at the end of the year is greater than $5,000.	***Accounting for changes in stock*** The difference between the value of trading stock on hand at the start and at the end of the income year must be brought to account under section 70-35 of the ITAA 1997.

Detailed explanation of new law

Trading stock and the accounting method for STS taxpayers

6.8 Under the STS, taxpayers are required to use a certain method of accounting. As a result, deductions for purchases of trading stock will be allowed in the year in which payment is made and sales revenue will be included in assessable income in the year in which it is received. For a detailed explanation of the accounting method for STS taxpayers see Chapter 4.

STS treatment of trading stock

6.9 Subdivision 328-E modifies the trading stock rules in Division 70 of the ITAA 1997 for STS taxpayers so that they do not have to value each item of trading stock on hand at the end of the income year or account for changes in the value of trading stock in certain circumstances. ***[Schedule 1, item 1, section 328-280]***

6.10 Whether an STS taxpayer is required to account for trading stock depends on the amount of the estimated change in the value of trading stock in a year, that is:

- where the change in value is $5,000 or less, trading stock does not have to be accounted for; and
- where the change in value is greater than $5,000, trading stock must be accounted for in accordance with section 70-35 of the ITAA 1997.

STS taxpayers who do not have to account for changes in trading stock

6.11 An STS taxpayer does not have to value each item of trading stock on hand at the end of an income year or account for changes in the value of trading stock on hand over the year where the difference between:

- the value of trading stock on hand at the start of the income year; and
- the reasonably estimated value of trading stock on hand at the end of the income year,

does not exceed $5,000. ***[Schedule 1, item 1, subsection 328-285(1)]***

6.12 A taxpayer, however, may choose to account for changes in the value of trading stock in any income year ***[Schedule 1, item 1, subsection 328-285(2)]***. One reason a taxpayer may choose to account for changes in the value of trading stock is that they prefer to adjust their assessable income in annual increments rather than in one larger amount when the change in value of trading stock exceeds $5,000. Paragraphs 6.19 to 6.25 explain the method of accounting for changes in trading stock in the STS.

Reasonable estimate

6.13 Under Division 70 of the ITAA 1997, a taxpayer must determine the value of each item of trading stock on hand at the end of an income year. It is expected that this requirement will be removed for most STS taxpayers. Instead, these taxpayers must make a reasonable estimate of the value of trading stock on hand at the end of the year. ***[Schedule 1, item 1, subsection 328-285(1)]***

6.14 A reasonable estimate will be an approximation of the value by the taxpayer that is reasonable in all of the circumstances. For example, some taxpayers may maintain a constant level of stock each year and will know the value of stock on hand, while others with fluctuating stock levels may keep comprehensive stock records from which the estimate can be derived. Therefore, a reasonable estimate will depend on the circumstances of the taxpayer.

6.15 When making a reasonable estimate, a taxpayer may refer to the valuation methods and the special valuation rules in Subdivision 70-C of the ITAA 1997; for example, the cost of natural increase of live stock. The estimated value will exclude an amount equal to any input tax credits that the taxpayer would have been entitled to if the taxpayer had acquired the trading stock at that time solely for a creditable purpose.

6.16 To assist STS taxpayers to make reasonable estimates, the Commissioner has advised that guide material will be provided on how to estimate values of trading stock on hand.

Value of trading stock on hand

6.17 The value of trading stock on hand at the start of an income year is the same as the amount that was taken into account under the ITAA 1997 at the end of the previous year. It does not matter whether the amount that was taken into account at the end of the previous year was determined under Subdivision 328-E or Division 70 ***[Schedule 2, items 9 and 10, subsections 70-40(1) and (2)]***. Therefore, the value of trading stock at the end of the previous year is carried forward as the trading stock value for the start of the current year. However, where a taxpayer does not have an end of year value of trading stock on hand to carry forward, the value at the start of the year is zero ***[Schedule 1, item 1, subsection 328-295(1)]***.

6.18 Given that these STS taxpayers are not required to account for changes in the value of trading stock, the value of trading stock on hand at the end of the year is deemed to be the same as the value of trading stock on hand at the start of the year. ***[Schedule 1, item 1, subsection 328-295(2)]***

Example 6.2: Treatment for STS taxpayers who do not have to account for trading stock changes

For the 2001-2002 income year, Shayla is an STS taxpayer. Shayla had 15,500 units of trading stock on hand at the end of the 2000-2001 income year which she valued at a cost of $1 per unit ($15,500). This value becomes the value of trading stock on hand at the start of the 2001-2002 income year.

Shayla purchases 5,000 units of trading stock on account (the account is not paid until the following income year) and 10,000 units for cash at a cost of $1 per unit. 19,000 units are sold for cash at $3 per unit.

Shayla estimates that her trading stock has declined in value by $4,000 to $11,500. This estimate is based on the difference between units purchased (15,000) and units sold (19,000) in the year. This estimate is reasonable because Shayla maintains accurate records of her trading stock.

Because Shayla has estimated that the change in value of trading stock does not exceed $5,000, she does not have to account for the change. Shayla is not required to value each item of trading stock on hand at the end of the year for income tax purposes.

The value of trading stock on hand at the end of the 2001-2002 year is deemed to equal the value of trading stock on hand at the start of the year, that is, $15,500.

In calculating taxable income for 2001-2002, Shayla includes $57,000 in assessable income for sales (i.e. 19,000 × $3) and deducts $10,000 for purchases (i.e. purchases of trading stock for cash).

The following calculations illustrate the operation of Shayla's trading stock account and the calculation of her taxable income over the years 2000-2001 (when she was not an STS taxpayer), 2001-2004 (as an STS taxpayer) and 2004-2005 (when she is no longer an STS taxpayer).

Purchases	**Non-STS 2000-2001**	**STS Yr 1 2001-2002**	**STS Yr 2 2002-2003**	**STS Yr 3 2003-2004**	**Non-STS 2004-2005**
Units purchased on credit	6,000	5,000	0	7,000	9,500
Units purchased for cash	13,500	10,000	27,000	42,500	53,000
Units purchased	19,500	15,000	27,000	49,500	62,500
Cost (∗cash basis)	$19,500	∗$10,000	∗$27,000	∗$42,500	$69,500
Sales					
Units sold on credit	0	0	0	6,000	8,000
Units sold for cash	17,000	19,000	23,000	40,000	37,000
Units sold	17,000	19,000	23,000	46,000	45,000
Sales revenue at $3 per unit (∗cash basis)	$51,000	∗$57,000	∗$69,000	∗$120,000	$153,000

Trading stock valued at cost	**2000-2001**	**2001-2002**	**2002-2003**	**2003-2004**	**2004-2005**
Value of trading stock at start of year	$13,000	$15,500	$15,500	$15,500	$15,500
Value (°estimated value) of trading stock at end of year	$15,500	°$11,500	°$19,500	°$19,000	$33,000
Change in value of trading stock	$2,500	$4,000	$4,000	$3,500	$17,500
Deemed value of trading stock at end of year	n/a	$15,500	$15,500	$15,500	n/a

Calculation of Taxable Income	**2000-2001**	**2001-2002**	**2002-2003**	**2003-2004**	**2004-2005**
Assessable income					
Sales	$51,000	$57,000	$69,000	$120,000	$153,000
Excess closing over opening stock	$2,500	0	0	0	$17,500
Deductions					
Purchases	$19,500	$10,000	$32,000	$42,500	$69,500
Taxable income	$34,000	$47,000	$37,000	$77,500	$101,000

STS taxpayers who have to, or choose to, account for changes in trading stock

6.19 It is expected that most STS taxpayers will not have to make adjustments to account for changes in the value of their trading stock.

6.20 If an STS taxpayer has a change in value of trading stock that is greater than $5,000 or chooses to account for trading stock under subsection 328-285(2), the taxpayer must:

- value each item of trading stock on hand at the end of the year in accordance with section 70-45 ***[Schedule 1, item 1, paragraph 328-290(a)]***; and
- make an adjustment to assessable income or deductions for any change in value of trading stock in accordance with section 70-35 of the ITAA 1997 ***[Schedule 1, item 1, paragraph 328-290(b)].***

Value of trading stock on hand

6.21 The value of trading stock on hand at the start of an income year is the same amount that was taken into account under the ITAA 1997 at the end of the previous year ***[Schedule 2, items 9 and 10, subsections 70-40(1) and (2)].*** Where a taxpayer does not have an end of year value of trading stock on hand to carry forward, the value at the start of the year is zero ***[Schedule 1, item 1, subsection 328-295(1)].***

6.22 The value of trading stock on hand at the end of the year is determined by Division 70. Under section 70-45, the taxpayer may choose to value each item of trading stock at either its cost, market selling value or replacement price. These valuation methods may be modified or different methods used in some cases; for example, stock obsolescence and horse breeding stock.

Adjustments to assessable income and deductions

6.23 STS taxpayers who have to, or choose to, account for changes in trading stock will do so under the existing rules in Division 70 of the ITAA 1997. Under Division 70 the values of trading stock on hand at the start and end of an income year are compared when working out assessable income and deductions (section 70-35).

6.24 If the value of trading stock on hand at the end of the income year is greater than the value of trading stock on hand at the start of the year, the excess is included in assessable income under subsection 70-35(2).

6.25 If the value of trading stock on hand at the end of the year is less than the value of trading stock on hand at the start of the year, the difference is a deduction under subsection 70-35(3).

Example 6.3: Treatment for STS taxpayers who have to account for trading stock changes

For the 2001-2002 income year, Buffy is an STS taxpayer. Buffy had 15,500 units of trading stock on hand at the end of the 2000-2001 income year which she valued at a cost of $1 per unit ($15,500). This value becomes the value of trading stock on hand at the start of the 2001-2002 income year.

Buffy purchases 5,000 units of trading stock on account, which is not paid until the next income year, and 21,000 units for cash at a cost of $1 per unit. 19,000 units are sold for cash at $3 per unit. From this information, Buffy estimates the change in value of trading stock to exceed $5,000.

Buffy values each item of trading stock on hand at the end of the 2001-2002 income year at cost ($1 per unit). She values all her trading stock on hand at the end of the year at $22,500.

The value of trading stock on hand at the end of the year ($22,500) exceeds the value of trading stock on hand at the start of the year ($15,500) by $7,000. This amount is included in Buffy’s assessable income for 2001-2002.

The following calculations illustrate the operation of Buffy’s trading stock account and the calculation of her taxable income over the years 2000-2001 (when she was not an STS taxpayer), 2001-2004 (as an STS taxpayer) and 2004-2005 (when she is no longer an STS taxpayer).

Purchases	**Non-STS 2000-2001**	**STS Yr 1 2001-2002**	**STS Yr 2 2002-2003**	**STS Yr 3 2003-2004**	**Non-STS 2004-2005**
Units purchased on credit	6,000	5,000	0	7,000	9,500
Units purchased for cash	13,500	21,000	27,000	42,500	53,000
Units purchased	19,500	26,000	27,000	49,500	62,500
Cost (*cash basis)	$19,500	*$21,000	*$32,000	*$42,500	$69,500
Sales					
Units sold on credit	0	0	0	6,000	8,000
Units sold for cash	17,000	19,000	23,000	34,000	37,000
Units sold	17,000	19,000	23,000	40,000	45,000
Sales revenue at $3 per unit (*cash basis)	$51,000	*$57,000	*$69,000	*$102,000	$153,000

Trading stock valued at cost	**2000-2001**	**2001-2002**	**2002-2003**	**2003-2004**	**2004-2005**
Value of trading stock at start of year	$13,000	$15,500	$22,500	$22,500	$36,000
Value (°estimated value) of trading stock at end of year	$15,500	$22,500	°$26,500	$36,000	$53,500
Change in value of trading stock	$2,500	$7,000	$4,000	$13,500	$17,500
Deemed value of trading stock at end of year	n/a	n/a	$22,500	n/a	n/a

Calculation of taxable income	**2000-2001**	**2001-2002**	**2002-2003**	**2003-2004**	**2004-2005**
Assessable income					
Sales	$51,000	$57,000	$69,000	$102,000	$153,000
Excess closing over opening stock	$2,500	$7,000	0	$13,500	$17,500
Deductions					
Purchases	$19,500	$21,000	$32,000	$42,500	$69,500
Taxable income	$34,000	$43,000	$37,000	$73,000	$101,000

Application and transitional provisions

6.26 These amendments apply for the first income year commencing after 30 June 2001 and all later income years. ***[Schedule 1, item 2]***

Consequential amendments

6.27 Consequential amendments are made to Division 70 of the ITAA 1997 to reflect the effects of the STS.

6.28 A note is inserted in subsection 70-5(3) to alert taxpayers that the change in value of trading stock on hand over an income year may not have to be brought to account by STS taxpayers. ***[Schedule 2, item 5]***

6.29 A note is inserted in subsection 70-15(3) to indicate that the timing of deductions relating to outgoings for trading stock may change if the taxpayer is an STS taxpayer. ***[Schedule 2, items 6 and 7]***

6.30 A note is inserted in subsection 70-35(1) stating that STS taxpayers may not be required to do a stocktake. ***[Schedule 2, item 8]***

6.31 An amendment is made to the table in subsection 70-45(2) to refer to Subdivision 328-E for valuation rules for STS taxpayers. ***[Schedule 2, item 11]***

6.32 These amendments apply to assessments for the first income year commencing after 30 June 2001 and all later income years. ***[Schedule 2, item 24]***

Chapter 7
Prepayments of deductible expenses

Outline of chapter

7.1 This chapter explains the new 12-month rule for deducting prepayments of expenses made by:

- STS taxpayers; and
- individual taxpayers incurring deductible non-business expenditure.

This rule replaces the current 13-month rule used by small business taxpayers and taxpayers who are not carrying on a business.

7.2 This chapter also explains the transitional arrangements for those:

- small business taxpayers who do not become STS taxpayers; and
- non-individual taxpayers incurring deductible non-business expenditure,

who previously accessed the 13-month rule but will not be able to access the new 12-month rule.

Context of reform

What is the current treatment of prepayments?

7.3 Section 82KZM of the ITAA 1936 disallows an immediate deduction for prepayments that are deductible under the general deductions provision, section 8-1 of the ITAA 1997, unless the prepayment was incurred for something that is to be done wholly within 13 months of the payment being incurred (13-month rule). If the service period is 13 months or more, section 82KZM provides for the prepayment deduction to be spread over the service period (or 10 years, if that is less).

7.4 Amendments made by the *New Business Tax System (Integrity and Other Measures) Act 1999* removed the 13-month rule for business expenditure other than by small business taxpayers. A limited amount of prepayments expenditure, based on the expenditure incurred in the year of income including 21 September 1999, was eligible for a 5-year transitional arrangement up to and including the year of income including 21 September 2002. These amendments are referred to as 'stage 1' amendments.

7.5 Amendments made by the *New Business Tax System (Integrity Measures) Act 2000* removed the 13-month rule for all taxpayers if the prepayment was incurred under a tax shelter arrangement. These amendments are referred to as 'stage 2' amendments.

7.6 After the stage 1 and 2 amendments, section 82KZM only provides the 13-month rule to small business taxpayers and to *all* taxpayers incurring non-business expenditure providing the expenditure was not under a tax shelter arrangement.

Summary of new law

7.7 The 13-month rule will be replaced by a new 12-month rule for taxpayers who are either in the STS or are *individuals* incurring deductible non-business expenditure. The new 12-month rule allows immediate deduction for prepayments where:

- the payment is incurred for a period of service not exceeding 12-months; and
- the period of service ends in the next income year.

7.8 Small business taxpayers incurring business expenditure, and non-individual taxpayers incurring deductible non-business expenditure, will have their expenditure apportioned over the eligible service period unless they enter the STS. They will receive the balance of the stage 1 transitional arrangements that phase out the access to the existing 13-month rule.

7.9 This is the third stage in a series of amendments to implement the Government's announcements which strengthen the rules for prepayments, as recommended in *A Tax System Redesigned*.

Comparison of key features of new law and current law

<table>
<tr><th>New law</th><th>Current law</th></tr>
<tr><td>A 12-month rule provides an immediate deduction for prepayments where:
the eligible service period for the expenditure incurred is no longer than 12 months; and
the eligible service period ends in the income year after that in which the payment was incurred.</td><td>The 13-month rule provides immediate deductibility for prepayments for something that will be wholly done within 13 months of the prepayment being incurred.</td></tr>
<tr><td>The 12-month rule applies to:
STS taxpayers; and
individual taxpayers incurring deductible non-business expenditure.</td><td>The 13-month rule applies to:
small business taxpayers; and
all taxpayers incurring deductible non-business expenditure.</td></tr>
<tr><td>The following taxpayers will enter the existing transitional arrangements that apply for the year of income including 21 September 2001 (assuming a taxpayer with a standard financial year):
small business taxpayers, who do not enter into STS, incurring business expenditure; and
non-individual taxpayers, not in STS, incurring deductible non-business expenditure.
For these taxpayers, the transitional provisions will not be capped.</td><td>A 5-year transitional arrangement applies to non-small business taxpayers incurring business expenditure. The transitional provisions cap the amount of prepayments eligible for the transitional arrangements in any year, in relation to prepayments incurred in the year of income including 21 September 1999.</td></tr>
</table>

Detailed explanation of new law

7.10 Currently, immediate deductibility for prepayments is available to small business taxpayers incurring business expenditure, and to all taxpayers incurring deductible non-business expenditure, where the service period is completed within 13 months.

7.11 These amendments will provide immediate deductibility for prepayments in respect of a service period of no longer than 12 months. In addition, the eligible service period must end by the last day of the year of income following the one in which the expenditure was incurred. The new 12-month rule will now apply only to STS taxpayers and individual taxpayers who are incurring deductible non-business expenditure. ***[Schedule 3, item 4, paragraphs 82KZM(1)(b) and (ba), items 2 and 3, subparagraphs 82KZM(1)(aa)(i) and (ii)]***

7.12 Those taxpayers who, as result of these amendments, can no longer immediately deduct their prepayments must now apportion their expenditure over the eligible service period. These taxpayers are:

- those small business taxpayers, who are not in STS, incurring business expenditure; and
- non-individual taxpayers, who are not in STS, incurring deductible non-business expenditure.

[Schedule 3, items 6 to 8, paragraphs 82KZMA(2)(a) and (b) and subsection 82KZMA(3)]

Transitional arrangements

7.13 The taxpayers, discussed in paragraph 7.12, will have their prepayments apportioned over the eligible service period. These taxpayers will receive the balance of the stage 1 transitional arrangements, contained in section 82KZMB of the ITAA 1936, that phase out the access to the existing 13-month rule. That is, they will enter the existing transitional arrangements that apply for the year of income including 21 September 2001 (assuming a taxpayer with a standard financial year). ***[Schedule 3, items 6 and 7, paragraphs 82KZMA(2)(a) and (b)]***

7.14 The existing limitations which currently apply to non-small business taxpayers, that is:

- the taxpayer being required to be eligible for the transitional treatment in the commencement year to be eligible in later years – subsection 82KZMB(7); and
- the prepayments amount eligible for the transitional treatment in later years being capped with reference to the commencement year – subsection 82KZMC(1),

will not apply to the taxpayers discussed in paragraph 7.12. ***[Schedule 3, item 9A, subsection 82KZMB(8) and item 10, subsection 82KZMC(1A)]***

Consequential amendments

7.15 The previously enacted stage 2 amendments which removed the 13-month rule for all taxpayers if the prepayment was incurred under a tax shelter arrangement, may not apply to a taxpayer under the second condition of the 12-month rule. Should the period of service end later than 13 months, but no later than the last day of the income year following that in which the expenditure was incurred, section 82KZME of the ITAA 1936 would not apply. Removing the timing constraint in paragraph 82KZME(1)(b) will ensure that apportionment applies to all taxpayers using tax shelter arrangements, as originally enacted. ***[Schedule 3, items 11 to 13, paragraph 82KZME(1)(b), subsection 82KZME(1), notes 1 and 2]***

7.16 The heading to section 82KZMD is being amended to reflect the changes made by this Bill. ***[Schedule 3, item 14 and sub-item 15(2)]***

Application and transitional provisions

7.17 These changes apply to assessments for the first year of income starting after 30 June 2001 and later years of income. ***[Schedule 3, sub-item 15(1)]***

7.18 The stage 1 amendments automatically repeal the transitional arrangements, provided by sections 82KZMB and 82KZMC, once they expire. Notes 1 and 2 after subsection 82KZMA(1), which refer to those sections, also become redundant from that date and will therefore be repealed also from the same date. ***[Schedule 3, item 5, subsection 82KZMA(1) (notes 1 and 2), and sub-item 15(2)]***

Chapter 8
Regulation impact statement

Policy objective

The objectives of the New *Business* Tax System

8.1 The measures in this Bill are part of the Government's broad ranging reforms which will give Australia a New *Business* Tax System. The reforms are based on the recommendations of the Review of Business Taxation, instituted by the Government to consider reform of Australia's business tax system.

8.2 The Government instituted the Review of Business Taxation to consult on its plan to comprehensively reform the business income tax system (as outlined in ANTS). The Review of Business Taxation made 280 recommendations to the Government designed to achieve a more simple, stable and durable business tax system.

8.3 The New *Business* Tax System is designed to provide Australia with an internationally competitive business tax system that will create the environment for achieving higher economic growth, more jobs and improved savings, as well as providing a sustainable revenue base so that the Government can continue to deliver services to the community.

8.4 The New *Business* Tax System also seeks to provide a basis for more robust investment decisions. This is achieved by:

- improving simplicity and transparency;
- reducing the cost of compliance; and
- providing fairer, more equitable outcomes.

8.5 This Bill is part of the legislative program implementing the New *Business* Tax System. Other Bills have been introduced and passed already, and are summarised in Table 8.1.

Table 8.1: Earlier business tax legislation

Legislation	*Status*
New Business Tax System (Integrity and Other Measures) Act 1999	Received Royal Assent on 10 December 1999
New Business Tax System (Capital Allowances) Act 1999	Received Royal Assent on 10 December 1999
New Business Tax System (Income Tax Rates) Act (No. 1) 1999	Received Royal Assent on 10 December 1999
New Business Tax System (Former Subsidiary Tax Imposition) Act 1999	Received Royal Assent on 10 December 1999
New Business Tax System (Capital Gains Tax) Act 1999	Received Royal Assent on 10 December 1999
New Business Tax System (Income Tax Rates) Act (No. 2) 1999	Received Royal Assent on 10 December 1999
New Business Tax System (Miscellaneous) Act (No. 1) 2000	Received Royal Assent on 30 June 2000
New Business Tax System (Miscellaneous) Act (No. 2) 2000	Received Royal Assent on 30 June 2000
New Business Tax System (Venture Capital Deficit Tax) Act 2000	Received Royal Assent on 22 June 2000
New Business Tax System (Alienation of Personal Services Income) Act 2000	Received Royal Assent on 30 June 2000
New Business Tax System (Alienated Personal Services Income) (Tax Imposition) Act (No. 1) 2000	Received Royal Assent on 30 June 2000
New Business Tax System (Alienated Personal Services Income) (Tax Imposition) Act (No. 2) 2000	Received Royal Assent on 30 June 2000
New Business Tax System (Integrity Measures) Act 2000	Received Royal Assent on 30 June 2000

The objectives of measures in this Bill

8.6 Broadly, the New *Business* Tax System will enhance Australia's competitiveness through lower company and capital gains tax rates, and reduced compliance costs.

8.7 More specifically, the objective of the measures contained in this Bill is to provide an alternative method of calculating taxable income that offers reduced compliance costs for eligible businesses.

Implementation options

8.8 The Government has adopted the recommendations of the Review of Business Taxation to implement the STS, which consists of:

- a new accounting method for STS taxpayers which recognises most business income and expenses when they are received and paid;

- a simplified depreciation regime for depreciating assets which provides an immediate write-off for assets costing less than $1,000 and introduces pooling arrangements for other depreciating assets (a general asset pool and a long-life asset pool); and

- a simplified trading stock regime where changes in the value of stock on hand need not be accounted for if the difference between the opening value of trading stock on hand and the expected closing value of trading stock on hand is not greater than $5,000. This will avoid the need for many small businesses to undertake an annual stocktake for taxation purposes.

8.9 Those recommendations were the subject of extensive consultation. The implementation options to minimise compliance cost for small business taxpayers who elect to become STS taxpayers can be found in *A Tax System Redesigned* at Recommendations 17.1 to 17.4 on pages 575 to 586.

8.10 The Government is also completing the implementation of the recommendations of the Review of Business Taxation relating to the new 12-month rule for prepayments of deductible expenses made by STS taxpayers and individuals incurring non-business expenditure. Those recommendations can be found in *A Tax System Redesigned* at Recommendations 4.6(c) and 17.2(iv) on pages 172 and 578 respectively. This measure includes a new 12-month prepayment rule under which a deductible advance payment will be immediately deductible where:

- the payment is incurred in respect of a period of service not exceeding 12 months; and

- the period of service ends no later than the last day of the income year following that in which the payment was incurred.

8.11 The Government has announced that the STS and prepayments measures will begin from 1 July 2001.

Assessment of impacts

8.12 The potential compliance, administrative and economic impacts of the measures in this Bill have been carefully considered, by both the Review of Business Taxation and by the business community. The Review of Business Taxation focussed on the economy as a whole in assessing the impacts of its recommendations and concluded that there would be net gains to business, government and the community from business tax reform.

Impact group identification

8.13 The impact group for the STS is businesses which have an annual turnover of less than $1 million and choose to enter the STS. This represents potentially over one million businesses (i.e. 95% of all businesses)[3]. Many of these businesses consist of family businesses and many have few or no employees. Around 65% of these businesses operate as individuals or partnerships.

8.14 The changes to prepayments affect all taxpayers having deductible prepayments expenditure with the exception of businesses (other than small businesses) who are already subject to the general scheme of the prepayments provisions; that is, apportionment of deductions over the eligible service period.

Analysis of costs / benefits

Compliance costs

8.15 A major concern for businesses is the cost incurred in complying with their obligations under the various taxation and other laws. The measures contained in this Bill are designed to reduce compliance costs incurred by businesses who choose to enter the STS.

8.16 As is standard with new measures, groups affected by them are expected to incur a small up-front cost in either familiarising themselves with the new law or having advisors familiarise themselves with the new law and, if necessary, communicating that information to affected taxpayers.

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[3] Based on data obtained from ABS publication *Small Business in Australia (1999),* adjusted for turnover level from ATO data.

8.17 Eligible small businesses may choose to enter the STS. In deciding to enter the STS, businesses and their advisors are likely to consider any tax savings they may make. In addition, they are likely to consider any compliance cost savings. Small businesses will therefore incur some costs in deciding if they should enter the STS (e.g. time reviewing business records or accounting fees for professional advice). Similarly, before deciding to leave the STS, businesses will go through the same comparison of tax liabilities to help them with their decision making process.

8.18 As previously cited, over 95% of businesses and around 99% of farming businesses are expected to be eligible for the STS.

8.19 The implementation of these 3 measures is intended to reduce the level of documentation that small business taxpayers are required to prepare for taxation purposes as well as reduce labour and other on-going costs required to meet their tax obligations.

Accounting method for STS taxpayers

8.20 It is expected that the accounting method for STS taxpayers will reduce compliance costs. For tax purposes, these taxpayers will largely be able to rely on their day-to-day records (cash book and bank statements) rather than prepare separate accounts for tax purposes.

8.21 From ABN registrations to date, for registrants who have indicated their annual turnover is up to $1 million, 85% have indicated that they will account for GST on a cash basis. Taxpayers who are eligible and choose to enter the STS will also be required to account for income tax on a cash basis. They will not be required to have different methods of accounting for GST and income tax.

Simplified depreciation system

8.22 The level of compliance savings from this measure will depend on the quantity of depreciating assets held by the small business taxpayer. Simplification is achieved by pooling qualifying depreciating assets and treating the pool as a single depreciating asset for calculation purposes. The number of calculations required to determine total deductions for depreciation for the year is therefore reduced to the single calculation for the pool.

8.23 The simplified depreciation regime may result in savings in compliance costs because of the reduced complexity in dealing with the disposal of depreciating assets. The proceeds from the sale of a depreciating asset are deducted from the pool balance. This effectively removes the need for balancing charges. No further calculations are required in respect of the depreciating assets for the taxpayer.

8.24 In addition, the immediate deduction for depreciating assets which cost less than $1,000 will reduce record keeping requirements by removing the need to keep asset schedules for small value assets.

Simplified trading stock system

8.25 The STS trading stock provisions remove the need to account for changes in trading stock if an STS taxpayer reasonably estimates the difference between the value of trading stock on hand at the end of the year and the value of trading stock on hand at the start of the year is not more than $5,000. This means that STS taxpayers who have low or constant levels of trading stock will not have to do stocktakes or value their actual trading stock on hand at the end of the income year. The removal of these obligations is expected to reduce compliance costs for these taxpayers. The amount of reduction in compliance costs will depend on the stocktaking practices of each business.

12-month prepayment rule

8.26 The current 13-month prepayment rule used by small business taxpayers and *all* taxpayers incurring deductible non-business expenditure will be replaced by a new 12-month prepayment rule. The new rule will apply to all STS taxpayers, and *individuals* incurring non-business expenditure. Previously, prepayments for these taxpayers have been:

- immediately deductible if they were under an agreement for the doing of a thing within 13 months of the prepayment date; or
- deducted on an apportioned basis over the period of service if the period was 13 months or more.

8.27 Under the 12-month prepayment rule, an advance payment will be immediately deductible where it is incurred in respect of a period of service not exceeding 12 months and the period of service ends no later than the last day of the income year following the date on which the payment is made.

8.28 For the majority of taxpayers with expenses that are immediately deductible, there will be no change in practice.

8.29 Small business taxpayers not entering the STS and non-individual taxpayers who are incurring deductible non-business expenditure will move to the general scheme of the prepayments provisions; that is, their deductions for incurred deductible prepayments expenditure will be apportioned over the service period. These taxpayers will receive the balance of the transitional arrangements put in place at the time that businesses (other than small businesses) moved from the 13-month rule to apportionment.

8.30 The existing limitations which currently apply to non-small business taxpayers, that is:

- the taxpayer being required to be eligible for the transitional treatment in the commencement year to be eligible in later years – section 82KZMB(7); and
- the prepayments amount eligible for the transitional treatment in later years being capped with reference to the commencement year – section 82KZMC(1),

will not apply to those taxpayers under the new rule as described in paragraph 8.26. This will reduce the one-off compliance costs associated with the transition to apportionment.

Administrative costs

8.31 In the first year of STS it is expected the ATO will incur additional administration costs in updating systems and tax returns and in providing advice to taxpayers on the new system. The ATO will also incur on-going costs in monitoring the system including assessing the eligibility of small business taxpayers entering the system. These costs in administering the system will be funded from existing resources. In the longer term, administration costs should decrease as the need for advice on the STS decreases.

8.32 The ATO will allocate approximately $2 million in funds for direct costs in the education of taxpayers, preparation of information brochures, worksheets, electronic record keeping packages and other packages which will provide information to taxpayers on the STS to assist them in meeting their obligations under the new system.

Government revenue

8.33 The financial cost to revenue as a result of the STS is expected to be as follows:

2001-2002	2002-2003	2003-2004	2004-2005
– $280m	– $547m	– $236m	– $337m

8.34 The cost to revenue associated with the prepayments amendments in this Bill, in 2000-2001 and 2001-2002 (relative to the forward estimates), arises from a delay in the movement of non-business entities to apportionment as originally announced on 21 September 1999. The prepayments amendments in this Bill complete the announced changes, removing that cost from 2002-2003 onwards.

2000-2001	2001-2002	2002-2003	2003-2004	2004-2005
– $20m	– $20m	–	–	–

Economic benefits

8.35 The New *Business* Tax System will provide Australia with an internationally competitive business tax system that will create the environment for achieving higher economic growth, more jobs and improved savings.

Other issues – consultation

8.36 The consultation process on these measures commenced with the release of documents on business tax reform. The STS is discussed in *A Tax System Redesigned* in which the Review of Business Taxation canvassed options and issues and sought public comment.

8.37 The ATO and Treasury held numerous public seminars and focus group meetings with stakeholders in the taxation system. The views of representatives of the professional bodies and businesses which will be affected by this measure were sought, 376 submissions from the public on reform options were received and analysed. Further details are contained in paragraphs 12 to 16 of the Overview of *A Tax System Redesigned.*

8.38 In analysing options, the published documents frequently referred to, and often were guided by, views expressed during the consultation process.

8.39 Further consultation was undertaken by the ATO and Treasury in the development of the STS legislative package. This included considering submissions and having discussions following the public release of STS Exposure Draft legislation for comment in October 2000.

Conclusion

8.40 The STS will free up time for small businesses to focus on their day-to-day operations. Accordingly, the measures contained in this Bill should support a more efficient, innovative and internationally competitive Australian business sector.

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