the Spry Roughley report

explanatory memorandum

May 2011

CURRENCY:

This issue of Client Alert takes into account all developments up to and including 13 April 2011.

Tax Planning

Put simply, tax planning is the arrangement of a taxpayer's affairs so as to comply with the tax law at the lowest possible cost. A common mistake is to believe that tax planning is optimised when every opportunity to reduce tax is taken. This is because some opportunities to reduce tax rely on strained interpretations of the law. Therefore, tax planning involves much more than taking the option that at first appears to result in lower tax costs. It involves objectively assessing and actively managing tax risk.

Common tax planning techniques are deferring the derivation of assessable income and bringing forward deductions. It is equally important that consideration be given to any pending changes to the tax legislation, especially when a proposed amendment will be backdated.

Deferring Assessable Income

The timing of when income is included in the assessable income of a taxpayer will depend on whether it is statutory income or ordinary income. Statutory income is included in assessable income at the time specified in the relevant provisions dealing with that income. Ordinary income is included in assessable income when it is derived unless a specific provision includes the amount in assessable income at some other time.

Consideration must be given to the nature of an income – is it revenue or capital? – because the difference in their tax treatment will ultimately have an impact on a taxpayer's tax position.

Business income

When ordinary income of a business is derived and to be included in assessable income will depend on whether the business returns income on a cash basis or on an accruals basis.

If a business uses the cash basis, ordinary income is, generally, derived in the year in which it receives the income. Conversely, if the business is reporting income on an accrual basis, ordinary income is derived when a recoverable debt is created such that the taxpayer is not obliged to take any further steps before becoming entitled to payment.

Payment received in advance

Income received in advance of services being provided, generally, is not assessable until the services are provided (the *Arthur Murray* principle). This principle applies regardless of whether a taxpayer is reporting its income on an accrual basis or on a cash basis.

Work in progress

In relation to manufacturers, partly manufactured goods that are not 'finished' goods are treated as trading stock and it is necessary to determine the difference between the opening and closing value of the trading stock for the income year. (*See* **Trading Stock** on page 9.)

TIP: Taxpayers who provide professional services may consider, in consultation with their clients, rendering accounts after 30 June to defer the income.

Small business entities

If a small business entity elects to apply the trading stock concession under Div 328, it is permitted to ignore the difference between the opening and closing value of trading stock if the difference between the opening value of stock on hand and a reasonable estimate of stock on hand at the end of that year does not exceed $5,000. The effect of electing this concession is that the value of the entity's stock on hand at the beginning of the income year is the same as the value taken into account at the end of the previous income year.

However, a taxpayer could choose to account for changes in the value of trading stock even if the reasonably estimated difference between opening and closing values was less than $5,000.

TIP: Accounting for the difference between the opening and closing stock is a good tax planning method to avoid a large adjustment in the calculation of taxable income in a future year when the benefit of Div 328 is not available or to claim a deduction in the current year for a reduction in the value of trading stock.

Other business taxpayers

It is a requirement to value each item of trading stock at the end of an income year at its cost, market value or replacement value. There is no requirement to permanently adopt any one of the three methods of valuation. Further, there is no compulsion for a taxpayer to use the same method across all items of trading stock.

Obsolete stock

A deduction may be available for obsolete stock. Therefore, a taxpayer should review its closing stock to identify whether any obsolete stock exists. In Taxation Ruling TR 93/23, the Tax Office states that obsolete stock is either:

- going out of use, going out of date, becoming unfashionable or becoming outmoded (ie becoming obsolete); or
- out of use, out of date, unfashionable or outmoded (obsolete stock).

When valuing obsolete stock, a taxpayer does not need to use any of the prescribed methods (ie cost, market value or replacement value). Rather, provided adequate documentation is maintained, the Tax Office will accept any fair and reasonable value which is calculated taking into account the appropriate factors: see s 70-50 of ITAA 1997.

Repairs and maintenance

A deduction is available for repairs to premises, part of premises or a depreciating asset (including plant) held or used by a taxpayer solely for the purpose of producing assessable income: see s 25-10(1) of ITAA 1997. If the relevant premises or assets are held or used only partly for income-producing purposes, expenditure on repairs is only deductible to the extent that it is reasonable in the circumstances: see s 25-10(2).

A common issue that arises is the distinction between restoration of an item to its former condition (deductible) and improvement of the item (capital and thus not deductible). It is important to realise the mere fact that different materials from those replaced are used will not of itself cause the work to be classified as an improvement, particularly in circumstances where the previous materials are no longer in current use. If the change is merely incidental to the operation of the repair, the deduction, generally, will be allowed.

Initial repairs, the replacement of the entire item, and improvements are not deductible, but may qualify for a periodic write-off under the capital allowance provisions. In addition, the expenditure may form part of the cost base of an asset for capital gains tax purposes.

TIP: The Tax Office has stated that if a taxpayer replaces something identifiable as a separate item of capital equipment, the taxpayer has not carried out a repair. Therefore, the taxpayer is required to depreciate the item over its effective life.

TIP: Taxpayers should seek an itemised invoice to separate the costs of work if the work includes both repairs and improvements.