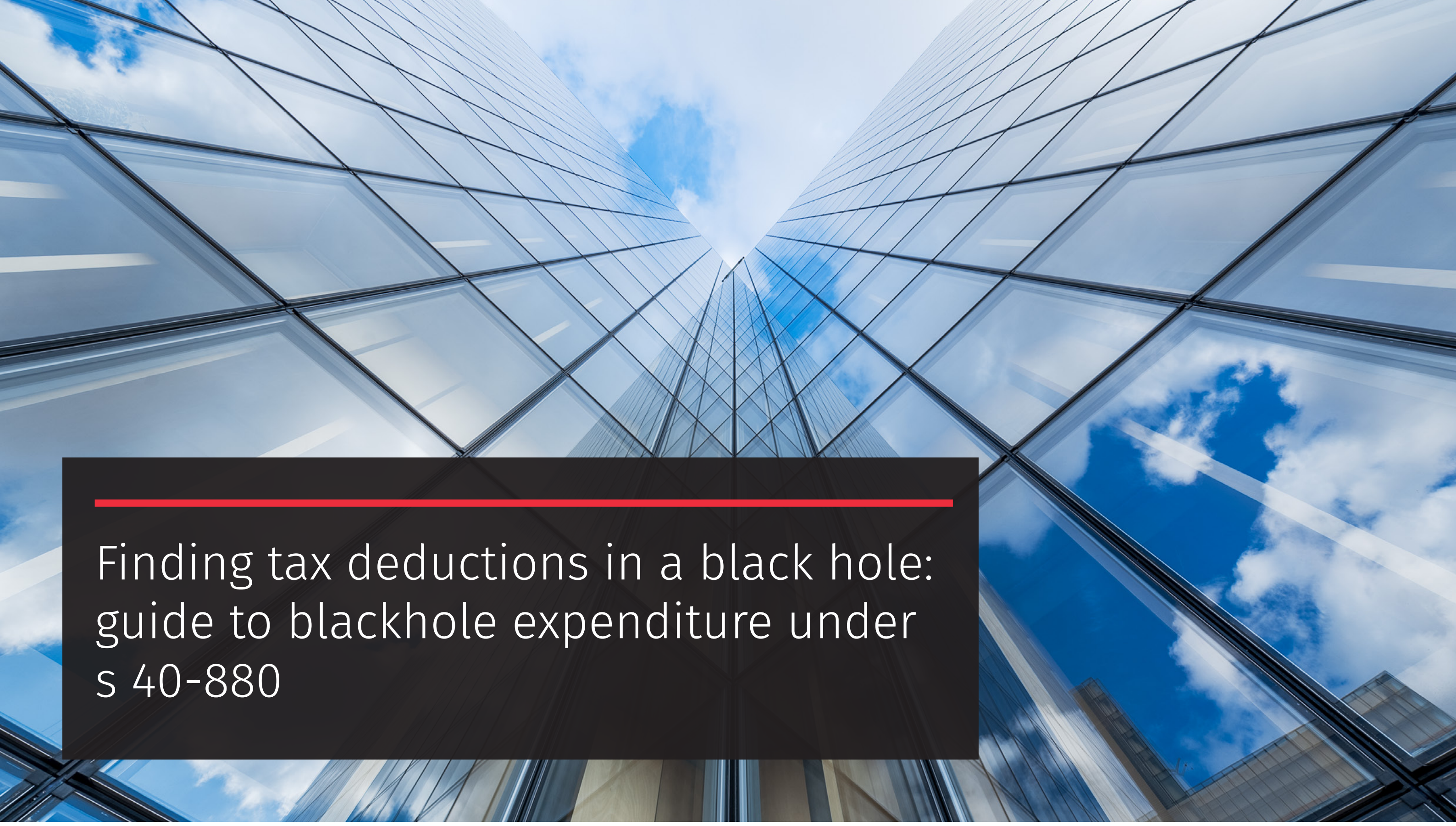

Finding tax deductions in a black hole: guide to blackhole expenditure under s 40-880

Understanding blackhole expenditure under section 40-880 is key for tax advisors.

This guide provides a foundational overview of the rules, but there is much more to consider when answering the deductibility question for your client's scenario.

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Finding tax deductions in a black hole: guide to blackhole expenditure under s 40-880

Blackhole expenditure refers to specific expenses that are neither tax deductible for a business under the general deduction rules nor otherwise recoverable as the cost of a depreciating asset or CGT asset. Such expenditure may be claimed over a 5-year period if they satisfy certain criteria. Section 40-880 of the Income Tax Assessment Act 1997 (ITAA 1997) provides the framework for these deductions.

Under section 40-880, a taxpayer carrying on a business, or proposing to carry on a business, is entitled to a deduction for specific capital expenditure over a 5-year period. This expenditure may include costs incurred in setting up, converting, or closing a business. The deduction rate is 20% per year, beginning in the year the expenditure is incurred.

Understanding this concept is crucial for accountants, lawyers, and tax advisors navigating the complexities of tax deductions for their business clients.

What are some examples of blackhole expenditure?

Examples of business-related costs deductible under section 40-880 include:

- establishment costs such as fees paid to incorporate a company, register a business name, or establish a trust
- conversion costs incurred to change a business structure to a different structure
- feasibility studies and market research costs incurred to investigate the viability of a business
- pre-operational costs such as market testing, tendering, and other necessary precedents to business operations
- capital-raising expenses for a business, for example preparing a prospectus, legal fees, printing fees, and underwriting costs
- costs incurred to defend against takeovers for example legal and accounting fees, stockbrokers' fees, and other related expenses
- costs incurred in failed takeover bids
- liquidation costs related to winding up a company, and
- costs associated with ceasing business operations.

Not everything is in — conditions and limitations under blackhole provisions

To qualify for a deduction under section 40-880, the expenditure must have a sufficient and relevant connection to the business. The expenditure must relate to the business of the entity. For example, if the income of a business is from retail trading, the expenditure must be incurred in relation to that business and not for other purposes (for example, to purchase shares for investment purposes). Moreover, the business must be carried on, have been carried on, or be proposed to be carried on for a taxable purpose. A taxable purpose includes producing assessable income, exploration or prospecting, mining site rehabilitation, or environmental protection activities.

Importantly, taxpayers cannot deduct certain expenditures under section 40-880, including:

- costs that form part of a depreciating asset (which may otherwise be claimed as part of the cost of the asset under capital allowance provisions)
- expenditures otherwise deductible or accounted for in calculating assessable profit, deductible loss, or capital gains/losses (unless incurred to preserve the value of goodwill)
- costs related to land, leases, or other legal rights, for example, a profit à prendre, easement or right of access to land, or franchise rights
- private or domestic expenses, or those related to exempt or non-assessable non-exempt income which may be prohibited from deductions under other provisions
- expenses that are expressly prohibited from deductions under other provisions, for example, entertainment expenditure.

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Entrepreneurs may claim start-up costs for new business immediately

Instead of recovering costs over 5 years, small businesses and sole traders may be able to claim an immediate deduction under section 40-880 for certain expenses to establish a new business. This 100% write-off is available for certain professional expenses associated with establishing a new business, including:

- professional advice and services including expenditure on accounting and legal advice, business plan development, and due diligence
- government fees and charges such as ASIC incorporation fees and stamp duty for asset transfers.

Other business-related costs, such as restructuring expenses and liquidation costs are not immediately deductible and are only deductible over 5 years.

Broadly, this concession is only available to small business taxpayers that satisfy a $50 million or less aggregated turnover threshold, or to taxpayers that are not carrying on a business but who are also not connected with a business with a greater than $50 million aggregated turnover, for example, entrepreneurs starting their first ever business venture.

Illustration

Millicent is an amateur baker who has won several competitions for her cakes, bread and pastries. She is planning to give up her “day job” as a graphic designer in Melbourne and commence a bakery business. As part of that, she expects to rent a small industrial unit in the north of the city, acquire baking equipment and recruit a small number of staff over time. She had a feasibility study prepared for her and some initial costings were prepared by a team of consultants who charged her $3,350 for both assignments. Based on the outcome of that work, the proposal looks feasible, and she intends to proceed.

What tax deductions might Millicent be entitled to?

Step 1:

Is the expenditure on the proposed business a capital or revenue expense?

The expenditure incurred on feasibility and advice on how to set up her business would be classified as capital because it was directed at establishing a business, rather than being day-to-day outgoings in the running of a business. The expenditure would therefore not be deductible under the general provisions in ITAA 1997.

Step 2:

What is the treatment under the tax law if it is a capital expense?

Generally, a capital expense relating to a business may be deductible under various provisions depending on its purpose and nature:

- Is it the cost of a depreciating asset? No, as there is no relevant depreciating asset involved.
- Can it be included in construction expenditure? No, as there is no relevant construction expenditure.
- Do any specific deduction provisions apply? No.
- Can the expense be included in the cost base of a CGT asset? No, as there is no relevant CGT asset involved.
- Can the expense be deducted under section 40-880? Potentially yes, as the expense is a start-up expense for a small business that is not deductible or taken into account in any other way under the tax law.

Step 3:

Calculate the deductible amount

Millicent qualifies as an eligible taxpayer for the small business start-up concession under section 40-880. She would be entitled to an immediate deduction for the $3,350 expenditure related to the baking business as:

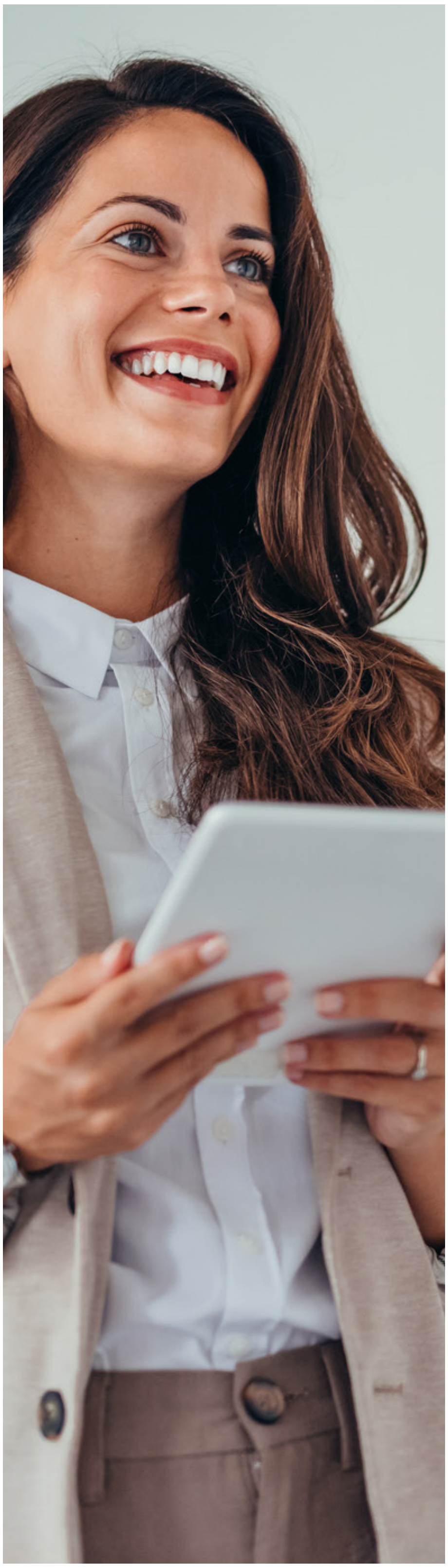
1. the expenditure relates to a proposed business
2. the expenditure is incurred in obtaining advice or services relating to the proposed operation of a business
3. she does not currently carry on a business and does not control, and is not controlled by, a small business entity.

Apportionment and arm's length value

If an expenditure serves multiple purposes, it must be apportioned on a fair and reasonable basis before it is claimed as blackhole expenditure, and taxpayers must be able to demonstrate the basis of apportionment used. Additionally, if expenses are incurred under non-arm's length arrangements and exceed market value, the deductible amount is limited to the market value.

The ATO is always peering into the black hole

The blackhole provisions have been the subject of dispute with the ATO in decisions such as Clough ([2021] FCAFC 197) and Satterley Property Group Pty Ltd ([2024] FCA 421). These judgments provide further insights on how section 40-880 is to be applied appropriately. They highlight the importance of the purpose and nature of the expenditure, and the need for careful application of the various exceptions to the primary deduction rule in section 40-880. As it is a provision of last resort, a varied range of expenditures seeking a 40-880 deduction have been disputed by the ATO. The ATO's views and guidance on the provision also need to be taken into consideration.



Tips and traps: searching in the dark for a deduction

01
Do not start at section 40-880, although you may very well end up there.

When considering tax deductibility of any expense, start with the basic deduction principles. Consider whether an outgoing is a revenue expense under the general deduction provisions, qualifies under a specific deduction provision or if it is a cost that may be recovered as a capital allowance or CGT asset's cost base. If no deduction appears available, then consider section 40-880.

02
Look out for the various exclusions in section 40-880.

If an expense is specifically prohibited from deduction by the tax law, or if an expense is not related to a business (eg related to employment or a passive investment), section 40-880 cannot help.

03
Consider the impact of other anti-avoidance tax rules.

The non-commercial loss rules (Division 35 of ITAA 1997) or the personal services income rules (Division 85 of ITAA 1997) can affect or deny the operation of section 40-880. For example, for expenses incurred in connection with a proposed business, the first or immediate deduction may be deferred until the business activity commences.

04
The cost may not be fully recoverable.

No deduction is available once a taxpayer ceases to exist, even though the expense was not fully claimed over a 5-year period. This may occur where the taxpayer entity (such as a company) is wound up.

Stay in the know with CCH iKnowConnect

Understanding blackhole expenditure and the provisions of section 40-880 is essential for professionals advising businesses on their tax positions. The perennial capital v revenue argument when it comes to claiming deductions may invariably lead to consideration of the blackhole expenditure rules. This summary provides a foundational overview of the rules, but there is much more to consider when answering the deductibility question for your client's scenario.

CCH iKnowConnect offers detailed analysis and explanation of the rules, including more worked examples, procedures and checklists to step you through from question to answer to arrive at a correct outcome under section 40-880, taking into consideration its interaction with numerous other tax law provisions.

CCH iKnowConnect's flagship Income Tax module brings it altogether for you, including the CCH Master Tax Guide. Easily access all relevant legislation, court decisions and regulatory guidance, including the ATO's edited private advice, to give you the full picture and gain more insights for your client's situation.

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