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Deduction Substantiation Requirements under the Taxation Laws

Dear Client,

Deductions are those expenses that you can claim because they were incurred while performing your work duties or while earning your assessable income.

In order to claim a deduction for expenses you may need to satisfy the ATO Substantiation Requirements.

These Substantiation Requirements discussed below are the general rules relating to most deductions. Additional information regarding vehicle expenses, conventional clothing, self-education expenses and travel expenses is provided in the document **“Work Related Expenses – some of the rules explained”** available on our website.

A deduction is *ONLY* normally allowable if an expense meets *ALL* of the following tests:-

1. the expense was actually “incurred” before the end of the income year;
2. the expense meets the deductibility/nexus tests – that is, it was incurred in deriving the taxpayer’s current income and it was not private, domestic or capital in nature; and
3. the taxpayer can satisfy the stringent substantiation rules – that is, the taxpayer has written evidence of the expense incurred (if required).

1. Expense must be incurred

A taxpayer must actually incur an expense before it is allowed as a deduction. For example, a deduction is not allowable for items provided free of charge, or for expenses reimbursed by the employer.

A salary and wage earner will normally incur an expense when they actually spend the money. An expense is also said to be “incurred” (i.e., from a salary and wage earner perspective) where the taxpayer has a clearly identifiable debt before year end.

An expense is not said to have been incurred if the liability/debit is pending, threatened or expected.

The fact that a taxpayer has received an allowance from their employer (which may or may not be taxed or shown on the payment summary) **does not** mean an automatic deduction can be claimed against the allowance.

A taxpayer must still satisfy both the incurred and nexus/ deductibility tests under S.8-1(1). Many allowances are merely provided to employees under industrial awards to compensate them for harsh conditions, etc. These include site allowances, dirty work allowances, wet work allowances, etc. However, the employees in receipt of such allowances are not entitled to an automatic tax deduction.

2. Nexus (connection) tests must be satisfied

The basic tests for deductibility of expenses are contained within S.8-1(1) of the ITAA 1997. It states:

“You can deduct from your assessable income any loss or outgoing to the extent that:

- a. *it is incurred in gaining or producing your assessable income; or*
- b. *it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.”*

However, under S.8-1(2) you cannot deduct a loss or outgoing under S.8-1 to the extent that:

- a. *“it is a loss or outgoing of capital, or of a capital nature; or*
- b. *it is a loss or outgoing of a private or domestic nature; or*
- c. *it is incurred in relation to gaining or producing your exempt income; or*
- d. *a provision of this Act prevents you from deducting it.*

Criteria for satisfying deductibility nexus tests

For an expense to satisfy the deductibility/nexus tests in S.8-1(1):

- a. it must have the essential character of an outgoing incurred in gaining assessable income or, in other words, the expense must be for the purposes of deriving income;
- b. there must be a direct nexus (i.e., relationship) between the outgoing and the assessable income, so that the outgoing is incidental and relevant to the gaining of assessable income; and
- c. there must be a connection between the particular outgoing and the operations or activities by which the taxpayer **directly gains or produces his or her assessable income** .

Private or domestic expenditure (which is therefore non-deductible) is considered to include costs of living such as food, drink and shelter etc.

The fact that an expense is voluntarily incurred by a taxpayer **does not** preclude it from being an allowable deduction as long as it satisfies the positive tests of S.8-1(1). The fact that an expense is incurred by a taxpayer at the direction of his or her employer does not mean that a deduction is automatically allowable.

3. Apportionment

If an expense is incurred for both private and deductible purposes, the expense must be apportioned between its components and no deduction claimed for the private component of the expense.

4. Substantiation rules

The substantiation provisions require taxpayers (which includes employees, self-employed taxpayers and partners in a partnership) to obtain and keep written evidence for work-related expenses which include car and/or travel records for expenses.

Generally, if documentation is not obtained before claiming the deduction in an income year and kept for the retention period of five years (which period can be extended in certain circumstances), no deduction is allowable.

Also, if records are not kept, a deduction may be denied even though the expense was incurred in the determination of assessable income. In general, the substantiation provisions apply to:

“work expenses” for employees only – including stationery, car parking, tools and equipment, uniform expenses and travel records in certain circumstances;

“car expenses” for employees (when claiming under certain methods), self-employed individuals and partnerships; and

“business travel expenses” for self-employed individuals and partnerships. Exceptions from the substantiation rules

A taxpayer is still entitled to claim a deduction without the existence of documentation in some circumstances. Some of the more common examples of expenses that can be claimed without documentation include:

Car expenses using the set-rate per kilometre method if your work-related claim does not exceed 5,000 kilometres.

☐ work expenses that total \$300 or less (laundry expenses count towards this limit, but not travel or meal allowance expenses or expenses covered by an award transport payment **as at 29 October 1986**);

- laundry expenses, if they total \$150 or less;
- overtime meal allowance expenses covered by an allowance payable under an Australian law, if the Commissioner considers the amount the taxpayer claims **as an employee** is reasonable (i.e., \$28.20 for the 2014/15 income year); and
- expenses covered by a travel allowance, if the Commissioner considers the amount the taxpayer claims as an employee is reasonable having regard to the location of the travel, the employee’s salary level, and the type of expense incurred:

1. *In Australia*: on accommodation, food, drink or incidental travel expenses;

2. *Overseas*: on food, drink or incidental travel expenses (but travel records and receipts must still be kept for accommodation).

The Daily Travel Allowance limits are revised annually. Please contact us if you would like information on the limits which apply to you.

Please note: although the Australian Taxation Office cannot make you produce receipts for amounts claimed against travel allowances where they are within the “Reasonable Amounts” (daily limits), they can still require you justify your claim. This is expected to be an area of growing audit activity.

The following paragraphs are direct quotes from Taxation Ruling 2004/6, which establishes the ATO’s position regarding claiming deductions under the Reasonable Amounts (daily limits) where a bona-fide travel allowance or overtime meal allowance is paid to an employee.

“If a taxpayer relies on the exception from substantiation, they may still be required to show the basis for determining the amount of their claim, that the expense was actually incurred, and that it was for work-related purposes. What counts as evidence for a claim subject to the substantiation exception will vary according to individual circumstances and the nature of the expense”.

*“The receipt of a travel allowance or an overtime meal allowance does not automatically entitle an **employee** to a deduction, nor does the amount of an allowance received determine if the claim is reasonable. Only the actual amount incurred on work-related travel expenses or overtime meal allowance expenses can be claimed as a deduction”.*

What this basically means is that, if the ATO selects your file for audit or investigation and you have claimed a deduction for work-related travel expenses, you will need to be able to confidently demonstrate how this claim was calculated.

We strongly recommend the use of a travel diary to record the nature of the work related activity undertaken and details of your expenses. We discuss the need for travel diaries further in the document **“Work Related Expenses – some of the rules explained”** available on our website.

The exceptions to the substantiation requirements above relate only to work-related expenses as an employee. They do not relate to work related expenses incurred in earning business or investment income.

Types of written evidence

Generally speaking, taxpayers must **obtain** and **retain** written evidence to support their claim for expenses, **or no deduction will be allowable** in an income year (whether the taxpayer is an employee or self-employed).

Written evidence can be obtained in one of the following ways:

1. Evidence from a supplier

Evidence from the supplier must contain the following information:

- the name or business name of the supplier; and
- the amount of the expense, expressed in the currency it was incurred; and
- the **exact** nature of the goods or services purchased (for example, if a book was purchased for the taxpayer’s professional library, the full title and description of the book to evidence its business nature); and
- the day the expense was incurred; and
- the date it was made out.

There are 2 exceptions to these requirements:

(a) if the document does not show the day the expense was incurred, you may use a bank statement or other reasonable, independent evidence that shows when it was paid;

(b) if the document the supplier gave you does not specify the nature of the goods or services, you may write in the missing details yourself before you lodge your *income tax return for the income year.

2. Evidence recorded by the taxpayer

Small expenses: If the total of small expenses is **\$200 or less in an income year**, taxpayers can make a record of these expenses in a **daily** expense diary instead of obtaining a document from the supplier. Small expenses mean that each expense **must be \$10 or less**.

3. Evidence on a PAYG Payment Summary

Taxpayers can **also** rely on a PAYG Payment Summary as written evidence of a work expense if it shows the nature and amount of the expense (e.g., union dues). Expenses of the same nature that are clearly classified need not be itemised. It is acceptable if they are totalled together on the payment summary.

4. Other evidence

Over recent times the Australian Taxation Office has provided guidelines of some other forms of evidence they are prepared to accept, in view of the increasing use of e-commerce for transactions. Alternative evidence the ATO is prepared to consider include;

- bank statements
- credit card statements
- internet-generated bank or credit card statements
- BPAY reference numbers, combined with bank statements
- BPAY reference numbers, combined with tax invoices
- internet generated receipts
- email receipts
- paper copies of receipts
- electronic receipts
- electronic copies of receipts
- Retaining written evidence

There is no time limit within which taxpayers must obtain written evidence of an expense (i.e. unless the taxpayer records the expense). But until taxpayers have obtained or created written evidence of it, a deduction cannot be claimed for the expense.

If, when lodging an income tax return for the income year, a taxpayer has a good reason to expect to get written evidence of the expense within a reasonable time, the expense can be claimed **without actually having the evidence on hand**. But, if the evidence is not obtained within a reasonable time, an assessment should be amended to disallow the deduction.

Taxpayers are recommended **not** to claim for expenses until all written evidence documents are received. In essence, this could sometimes mean a taxpayer will be required to lodge a tax return without making certain claims to avoid lodging the return late. When the written evidence documents are received, the return should then be amended.

Retention period – work-related records

Records should generally be retained for five years from the date of lodgment of the taxpayer's tax return. For depreciation expenses, records must be kept for the entire period over which the item is depreciated, **plus five years**. Therefore, if the depreciable property was depreciated for eight years, written evidence must be kept for those eight years, **plus another five-year period**.

Retention period – log books and odometer records, diaries

Log books need to be generally kept for a period of five years after the latest income year for which they are relevant (i.e., a total of up to ten years). Odometer records must be kept for the same period as the log book (if a log book has been kept) or for five years if no log book has been kept.

Also, taxpayers must keep simultaneous new log books if one or more additional cars are acquired for which claims will be made under the log book method. Diaries should be kept for a minimum period of 5 years.

Records – loss or destruction

If the documents have been lost or destroyed and the taxpayer has a complete copy, it is treated as an original from the date of loss or destruction. If the taxpayer does not have such a copy, but the Commissioner is satisfied that all reasonable precautions have been taken to prevent their loss or destruction, the following rules apply:

☐ if the document was a travel diary, log book or evidence other than the written evidence required by Subdiv 900-E, the taxpayer does not have to replace it and the deduction remains available.

☐ If the document was written evidence, the taxpayer must try to obtain a substitute that meets all the criteria of the original. Provided a reasonable attempt to obtain the substitute is made, the deduction is not affected, whether or not a substitute is actually obtained. However, where it is reasonably possible to obtain a substitute and none is obtained, the deduction may not be available.

Note that relief will not be granted where documents are lost or destroyed due to the taxpayer's carelessness or recklessness.

Benchmarking & Data Matching

The Australian Taxation Office is committing significant resources to combat underpaid taxes by targeting "cash economy" businesses. The ATO, in conjunction with some industry bodies, has developed industry benchmarks for a number of businesses in the construction, personal services, accommodation, hospitality and retail trade sectors, and the list continues to grow rapidly. These benchmarks are being used as audit tools, and you may be required to explain why your business results vary from industry averages.

The ATO has also developed a "personal living expenses guide" and will be seeking explanation from individuals whose family income is considered insufficient to support their living expenses.

The use of data matching is also being expanded, with data being sourced from the various land titles offices, vehicle registration transfers, and material suppliers.

Data marching and benchmarks are set to become significant ATO audit tools.

Audit

The Australian Taxation Office may conduct an audit if they think that the taxpayer is not complying with their tax obligations, or if they believe a review will not investigate the issues sufficiently. The types of written evidence required in the event of an audit and the exceptions from obtaining written evidence are discussed above.

If the audit results in the taxpayer understating their tax liability or overstating their entitlements then they are liable to repay the tax owing, and the Australian Taxation Office may also impose general interest charge and penalties.

If you receive notification of a Tax Audit you should:

- review your tax return to ensure all income for the year was declared and you comply with the nexus, apportionment and substantiation rules for all expenses claimed;
- contact me should you wish me to be present at the audit, or if you wish to make a voluntary disclosure (if you have found an error or inconsistency in your return voluntary disclosure will normally lead to a lower penalty being imposed).