

Prepayments

What is a Prepayment?

Prepayments are payments that are made in one reporting period for goods or services that will not be received until a future period or are received over a longer period. This is often the case for expenses spread over several months (subscriptions or insurance premiums) and where the expense relates to separate financial periods.

Concept

The liability or the payment itself should be recognised in the first period it applies, i.e., when the invoice comes in or the payment is made.

Some businesses will expense all payments (even where it is an expense that covers the whole year) immediately, when the amount is below a predetermined threshold. This threshold amount can be different for accounting purposes – as distinct to any tax treatment – explained below.

A “Prepayment” is considered an asset to the business until such a time as the goods or services have been received. The payment (or the recognition of the purchase) will thus be allocated initially to the “Prepayments” asset account.

Some examples of common prepayments are:

- Rent
- Airfares and accommodation
- Subscriptions
- Contract payments
- Insurance
- Advertising
- Booking for conferences, major events, etc.

Prepayment Tax Rules

Small Businesses (<\$10m turnover)

You can claim items straight away if:

- Purchases less than \$1,000
- Goods or services are received in the same income year as they were paid in
- Prepayment of salary or wages (under a contract of service)
- Required to be incurred by either:
 - ▶ a law of the Commonwealth, a State or Territory (for example, statutory fees or charges payable to a government body such as vehicle registration fees)
 - ▶ an order of a court of the Commonwealth, a State or Territory

12-Month Rule (Small Business <\$10m turnover)

If:

- You incur an eligible prepaid expense for something to be obtained over a service period of 12 months or less, and
- The service period ends in the income year following the year you incur the expense.

You can claim the expense straight away.

Example for Immediate Deductible Expense

A company makes a prepayment of \$19,000 on 1st March 2020, for a service from 1st April 2020 to 31st January 2021. This satisfies the 12-month rule, as it runs for less than 12 months and finishes in the next financial year; therefore, the entire cost can be expensed immediately.

Item Not Received Until Next Tax Year

If there is no part of the goods or services received until the next tax year, be sure to advise the tax agent to consider whether it is still a deductible item for tax in this year. Typically, if the item is not received, or no part of the service is provided until the following year, it may not be deductible for tax in the year of payment.

Goods or Service Received Over More Than One Year

If the 12-month rule is not met, you must treat it as a prepayment for tax, and apportion the payment over the period of the service/goods for up to 10 years.

Example for Prepayment

A company makes a prepayment of \$200,000 on 1st June 2020, for goods to be delivered in monthly batches from 1st August 2020 to 30th July 2021. This does not satisfy the 12-month rule, as it runs for more than 12 months and covers 2 financial years. The payment will have to be apportioned out to relate to the relevant financial year.

Bookkeeping Processes

When you are accounting for prepayments, you need to create an asset account for the initial payment. This then shows on the balance sheet how much prepaid expense is still unapplied.

GST can be claimed at the time of payment regardless of whether you are on cash or accrual reporting.

Processing the Prepayment

You have prepaid \$4,400 on workers' compensation insurance. We need to code the payment to the Prepaid Asset. Note that you can claim all the GST up front.

(We have considered GST as 10% of the total amount to be paid).

Account	Details	Debit	Credit	Tax Code
Bank Account	Payment of Workers' Compensation Insurance		\$4,400.00	No Tax
Prepaid Asset Account	Allocate Prepaid Asset account	\$4,000.00		GST
GST Paid	GST Paid	\$400.00		-
Total		\$4,400.00	\$4,400.00	

Your monthly journal entry: move the pro-rata ($\$4,000 \div 12 = \333.33) amount from the prepaid asset account to the relevant P&L expense account. GST has already been accounted for, therefore no GST reporting.

Account	Details	Debit	Credit	Tax Code
Prepaid Asset Account	Allocate from Prepaid Asset account to expense account		\$333.33	No Tax
Insurance Expense	Insurance paid	\$333.33		No Tax
Total		\$333.33	\$333.33	

Resources

- [ATO – Deductions for prepaid expenses 2020](#)