CMT301 Taxation 1

Topic 8 Capital Allowances

Objectives

To understand and apply:

B. Depreciation

C. Other Capital Allowances

D. Capital Works

A. Introduction

The capital allowance provisions provide tax deductions for capital assets (non-deductible under ITAA 1997 s8-1) such as depreciating assets, buildings and structures. Plant and equipment and other depreciating assets are generally depreciable under the depreciation provisions contained in subdivs 40-A to 40-F. Additionally, there are a number of special industry and activity allowances for certain types of capital expenditure under subdivs 40-G to 40-J.

Division 41 provided a temporary investment allowance deduction for certain depreciable assets. Buildings and other structures are usually amortised under the capital works provisions in Div 43. The ITAA 1936 contains capital allowances for research and development and Australian films. As a provision of last resort, ITAA 1997 s40-880 may provide a deduction for capital expenditure otherwise not deductible.

Some types of capital expenses do not enjoy any depreciation treatment at all (these are called black hole expenses), although the capital cost may well form part of the cost base of a CGT asset, and thus may provide some future relief against capital gains.

B. Depreciating Assets

1. Introduction

The uniform capital allowance system (UCA) provides a set of general rules that applies across a variety of depreciating assets and certain other capital expenditure. Note, the UCA maintains the pre 1 July 2001 treatment of some depreciating assets and capital expenditure such as certain primary production depreciable assets and capital expenditure.

You use the UCA rules to work out deductions for the cost of your depreciating assets, including those acquired before 1 July 2001. You can generally deduct an amount for the decline in value of a depreciating asset you held to the extent that you used it for a taxable purpose. However, an eligible small business entity may choose to work out deductions for their depreciable assets using the simplified depreciation rules - see Small business entities.
Under the UCA, there are a number of levels to work out your deduction for the decline in value of a depreciating asset:

1. Is your asset a depreciating asset covered by the UCA?
2. Do you hold the depreciating asset?
3. Has the depreciating asset started to decline in value?
4. What method will you use to work out decline in value?
5. What is the effective life of the depreciating asset?
6. What is the cost of your depreciating asset?
7. How do you calculate depreciation?
8. Do you stop holding the depreciating asset?
9. Are you a small business entity?
10. Do the Temporary investment allowance rules apply?
11. Complete the depreciation schedule

Some of these levels do not apply:
- if you choose to allocate an asset to a pool
- if you can claim an immediate deduction for the asset
- to certain primary production assets
- to some assets used in rural businesses.

**Level 1: What is a depreciating asset? s40-25(1)**

A depreciating asset is an asset that has a limited effective life and can reasonably be expected to decline in value over the time it is used. For example depreciating assets include such items as computers, electric tools, furniture and motor vehicles.

Land and items of trading stock are specifically excluded from the definition of depreciating asset: s40-25.

Most intangible assets are also excluded from the definition of depreciating asset. Only the following intangible assets, if they are not trading stock, are specifically included as depreciating assets:

- in-house software - see In-house software
- certain items of intellectual property (patents, registered designs, copyrights and licences of these)
- mining, quarrying or prospecting rights and information
- certain indefeasible rights to use a telecommunications cable system (‘IRU’)
- certain telecommunications site access rights
- spectrum licences
- data casting transmitter licences, and
- Improvements to land or fixtures on land - for example, windmills and fences - may be depreciating assets and are treated as separate from the land, regardless of whether they can be removed or not.

In most cases, it will be clear whether or not something is a depreciating asset. If you are not sure, contact your recognised tax adviser or the ATO.

*Depreciating assets excluded*
Deductions for the decline in value of some depreciable assets are not worked out under the UCA. These assets are:

- depreciable assets for which deductions are available under the specific film provisions: s40-45(5)
- depreciable assets that are capital works - for example, buildings and structural improvements for which deductions: s40-45(2)
- are available under the separate provisions for capital works: Div 43
- would be available if the expenditure had been incurred, or the capital works had been started, before a particular date
- would be available if the capital works were used in a deductible way in the income year
- cars where you use the cents per kilometre method or the 12% of original value method for calculating car expenses - these methods take the decline in value into account in their calculations: s40-55
- indefeasible rights to use an international telecommunications submarine cable system if the expenditure was incurred or the system was used for telecommunications purposes at or before 11.45am by legal time in the Australian Capital Territory (ACT) on 21 September 1999
- indefeasible rights to use a domestic telecommunications cable system or telecommunications site access rights if the expenditure was incurred before 12 May 2004 - special rules apply to deem certain of those rights to be acquired before that date, and to exclude certain expenditure incurred on or after that date that actually relates to an earlier right
- eligible work-related items, such as laptop computers, personal digital assistants, computer software, protective clothing, briefcases and tools of trade, if the item was provided to you by your employer, or some or all of the cost of the item was paid for or reimbursed by your employer, and the provision, payment or reimbursement was exempt from fringe benefits tax (there is no deduction available to you for the decline in value of such items): s40-45(1).

**Online Activity 1:** Read s 40-30; 40-40

**Level 2: Do you hold the depreciable asset?**

Only the holder of a depreciable asset can claim a deduction for its decline in value. In most cases, the legal owner of a depreciable asset will be its holder. There may be more than one holder of a depreciable asset - for example, joint legal owners of a depreciable asset are all holders of that asset. Each person's interest in the asset is treated as a depreciable asset. Each person works out their deduction for decline in value based on their interest in the asset - for example, based on the cost of the interest to them, not the cost of the asset itself - and according to their use of the asset.

In certain circumstances, the holder is not the legal owner: see s40-40 table Item 5.

**Online Activity 2:** Read s 40-25; 40-40

**Level 3: Has the depreciable asset started to decline in value?**
Division 40 contains general rules for working out the decline in value of a depreciable asset, and those rules are covered in this topic. The general rules do not apply to some depreciable assets. The UCA provides specific rules for working out deductions for the assets listed below:

- certain depreciable assets that cost $300 or less and that are used mainly to produce non-business assessable income - see Immediate deduction (for certain non-business depreciable assets costing $300 or less): s40-80(2)
- certain depreciable assets that cost or are written down to less than $1,000 - see Low-value pools: s40-425(5)
- in-house software for which expenditure has been allocated to a software development pool - see Software development pools
- depreciable assets used in exploration or prospecting - see Mining and quarrying, and minerals transport: s40-730
- water facilities and horticultural plants (including grapevines) - see Primary production depreciable assets
- certain depreciable assets of primary producers, other landholders and rural land irrigation water providers used in landcare operations - see Landcare operations: s40-630
- certain depreciable assets of primary producers and other landholders used for electricity connections or phone lines - see Electricity connections and phone lines: s40-645.

There are also specific rules for working out deductions for depreciable assets used in carrying on research and development activities.

**When does a depreciable asset start to decline in value?** s40-60

The decline in value of a depreciable asset starts when you first use it, or install it ready for use, for any purpose, including a private purpose. This is known as a depreciable asset's start time.

Although an asset is treated as declining in value from its start time, a deduction for its decline in value is only allowable to the extent it is used for a taxable purpose (see Definitions).

If you initially use a depreciable asset for a non-taxable purpose, such as for a private purpose, and in later years use it for a taxable purpose, you need to work out the asset's decline in value from its start time, including the years you used it for a private purpose. You can then work out your deductions for the decline in value of the asset for the years you used it for a taxable purpose - see Decline in value of a depreciable asset used for a non-taxable purpose.

**Online Activity 3:** Read s 40-70

**Level 4: What method will you use to work out decline in value?**
You generally have the choice of two methods to work out the decline in value of a depreciable asset: the **prime cost method** or the **diminishing value method**. You can generally choose to use either method for each depreciating asset you hold.

**Online Activity 4:** Read s 40-65 to 40-75

**Diminishing value method (DV)**

This is calculated as follows for depreciable assets acquired before 10 May 2006, per s 40-70:

\[
\text{base value} \times \frac{\text{days owned}}{\text{effective life}} \times \frac{150\%}{365}
\]

For depreciable assets acquired after 9 May 2006 the accelerated DV rate is per s 40-72:

\[
\text{base value} \times \frac{\text{days owned}}{\text{effective life}} \times \frac{200\%}{365}
\]

**Prime cost method (PC)**

This is calculated as follows per s 40-75:

\[
\text{cost} \times \frac{\text{days owned}}{\text{effective life}} \times \frac{1}{365}
\]

Under this method, the asset declines in value uniformly over its life. Cost is the asset’s cost (see below). Days are the number of days a taxpayer held the asset in the year from its start time (ignoring any days of non-use or where not installed ready to use): s 40-70(1).

Once you have chosen a method for a particular asset, you cannot change to the other method for that asset: s40-130.

**Immediate deduction** (for certain non-business depreciable assets costing $300 or less)

The decline in value of certain depreciable assets costing $300 or less is their cost. This means you get an immediate deduction for the cost of the asset to the extent that you used it for a taxable purpose during the income year in which the deduction is available.

The immediate deduction under s40-80(2) is available if all of the following tests are met in relation to the asset:

- it cost $300 or less - see Cost is $300 or less
- you used it mainly for the purpose of producing assessable income that was not income from carrying on a business - see Used mainly to produce non-business assessable income, and
- it was not part of a set of assets you started to hold in the income year that cost more than $300 - see Not part of a set, and
- it was not one of a number of identical or substantially identical assets you started to hold in the income year that together cost more than $300 - see Not one of a number of identical or substantially identical items.
If you are not eligible to claim the immediate deduction, you work out the decline in value of the asset using the general rules for working out decline in value. Alternatively, you may be able to allocate the asset to a low-value pool - see Low-value pools.

Level 5: What is the effective life of the depreciating asset?

Generally, the effective life of a depreciating asset is how long it can be used by any entity for a taxable purpose or for the purpose of producing exempt income or non-assessable non-exempt income (per s40-100(5)):

- having regard to the wear and tear you reasonably expect from your expected circumstances of use
- assuming that it will be maintained in reasonably good order and condition, and
- having regard to the period within which it is likely to be scrapped, sold for no more than scrap value or abandoned.

Effective life is expressed in years, including fractions of years. It is not rounded to the nearest whole year.

Choice of determining effective life

For most depreciable assets, you have the choice of either working out the effective life yourself or using an effective life determined by the Commissioner. See TR 2011/2 for Commissioner's effective life: extract found in text book Appendix 2.

Online Activity 5: Read s 40-95 to 40-105

You must make the choice for the income year in which the asset's start time occurs.
Generally, you must make the choice by the time you lodge your income tax return for that year: s40-130.

Level 6: What is the cost of your depreciating asset?

To work out the decline in value of a depreciating asset, you need to know its cost.
The cost of a depreciating asset has two elements.

The first element of cost is, generally, amounts you are taken to have paid to hold the asset, such as the purchase price: s40-180 and s40-185. It also includes amounts incurred after 30 June 2005 that you are taken to have paid in relation to starting to hold the asset. The amounts must be directly connected with holding the asset.

The first element of cost is worked out as at the time you begin to hold the asset.

The second element of cost is, generally, amounts you are taken to have paid after that time to bring the asset to its present condition and location, such as a cost of improving the asset: s40-190. It also includes expenses incurred after 30 June 2005 in relation to a balancing adjustment event occurring in relation to the asset (that is, costs incurred to stop holding or using the asset).
The first element of a depreciating asset's cost cannot include an amount that forms part of the second element of cost of another depreciating asset. For example, if a depreciating asset is demolished so another depreciating asset can be installed on the same site, the demolition costs will form part of the second element of cost of the asset demolished. The amount is not also included in the first element of cost of the new asset.

**Example:** First and second elements of cost – (ignoring GST). Terry wants to buy a vehicle for his business and the vehicle is not available in Australia. He locates a company in the United States from which he would be able to purchase the vehicle. He travels to the United States for the sole purpose of buying the vehicle and incurs travel costs of $5,000. Terry purchases the vehicle for $45,000.

The first element of cost is $50,000. This amount includes the purchase cost of the vehicle and the travel costs. The travel costs would be included in the first element of cost of the vehicle because they are directly connected with Terry starting to hold the vehicle. If Terry installs an alarm in the vehicle two months later at a cost of $1,500, that amount will be included in the second element of cost of the vehicle as the cost was incurred after he began to hold the vehicle.

For both first and second elements of cost of a depreciating asset, amounts you are taken to have paid include:

- an amount you pay
- the market value of a non-cash benefit you provide
- if you incur or increase a liability to pay an amount - the amount of the liability or increase
- if you incur or increase a liability to provide a non-cash benefit - the market value of the non-cash benefit or the increase
- if all or part of another's liability to pay you an amount is terminated - the amount of the liability or part terminated
- if all or part of another's liability to provide a non-cash benefit (except the depreciating asset) to you is terminated - the market value of the non-cash benefit or part terminated.

The cost of a depreciating asset does not include:

- amounts of input tax credits to which you are or become entitled - see GST input tax credits
- expenditure not of a capital nature: s40-220, or
- any amount that you can deduct or that is taken into account in working out a deductible amount under provisions outside the UCA: s40-215.

**Online Activity 6:** Read s 40-180 to 40-190
Level 7: How do you calculate depreciation?

Calculating depreciation can be broken up into five steps:

◆ Determine the period
◆ Choose between diminishing value method or the prime cost method
◆ Working out effective life and depreciation rate
◆ Determine cost
◆ Calculate depreciation.

_Determine the period_

Section 40-60 states that a depreciating asset starts to decline in value when a taxpayer first uses it or has it installed ready for use for any purpose. This is known as the start time. The period for the depreciation calculation is based on the number of days from the start time to 30 June of the income tax year (ignoring periods of any non-use or not being installed ready for use): s40-70(1).

**Online Activity 7:** Read s 40-60, 40-70

**Choose between diminishing value method or the prime cost method**

See above.

**Working out effective life and depreciation rate**

See above level 5 for effective life. The depreciation rate is calculated as follows:

Diminishing value method (DV)

This is calculated as follows for depreciating assets acquired before 10 May 2006, per s 40-70:

\[
\text{base value} \times \frac{\text{days owned}}{365} \times 150\% 
\]

For depreciating assets acquired after 9 May 2006 the accelerated DV rate is per s 40-72:

\[
\text{base value} \times \frac{\text{days owned}}{365} \times 200\% 
\]

Prime cost method (PC)

This is calculated as follows per s 40-75:

\[
\frac{\text{cost}}{\text{effective life}} \times \frac{\text{days owned}}{365}
\]

Under this method, the asset declines in value uniformly over its life. Cost is the asset’s cost (see below). Days are the number of days a taxpayer held the asset in the year from its start time (ignoring any days of non-use or where not installed ready to use): s40-70(1).
Once you have chosen a method for a particular asset, you cannot change to the other method for that asset.

**Determine cost**

See above

**Calculate depreciation.**

**Example:** Sarath acquires a desk for $500 on 1 July and use the desk for 100 per cent work purposes during the year. He uses the diminishing value method. The first element of cost is $500, the period is 365 days and the effective life is 20 years. Using the DV method the depreciation deduction is:

\[
\text{Depreciation} = \frac{500 \times 10\% \times 365}{365/365} = 50.365
\]

The adjustable value at 30 June for the desk will be $450 and the opening adjustable value for 1 July of the next tax year will be $450.

**Apportionment**

Apportionment of deductions is required where:

1. a depreciating asset is held for part of the year: ss 40-70, 40-75
2. a depreciating asset is only part-used for a taxable purpose: s 40-25(2), (7).

**Example:** Lulu has a laptop acquired on 1 June which she used 40 per cent for work purposes. The depreciation decline is $500. Her depreciation claim needs to be apportioned as follows: $500 × 30/365 × 40% = $16

**Level 8: Do you stop holding the depreciating asset?**

If you cease to hold or use a depreciating asset, a balancing adjustment event may occur. If there is a balancing adjustment event, you need to calculate a balancing adjustment amount to include in your assessable income or to claim as a deduction.

A balancing adjustment event occurs for a depreciating asset when:

- you stop holding it - for example, if the asset is sold, lost or destroyed
- you stop using it and expect never to use it again
- you stop having it installed ready for use and you expect never to install it ready for use
- you have not used it and decide never to use it, or
- a change occurs in the holding or interests in an asset which was or is to become a partnership asset.

A balancing adjustment event does not occur just because a depreciating asset is split or merged - see Split or merged depreciating assets.

However, a balancing adjustment event does occur if you stop holding part of a depreciating asset.
Expenses of a balancing adjustment event (such as advertising or commission expenses) may be included in the second element of the cost of the depreciating asset - see The cost of a depreciating asset.

You work out the balancing adjustment amount by comparing the asset's termination value (such as the proceeds from the sale of an asset) and its adjustable value at the time of the balancing adjustment event. See Termination value in the next column for information about how to work out an asset's termination value.

If the termination value is greater than the adjustable value, you include the excess in your assessable income.

If the termination value is less than the adjustable value, you can deduct the difference.

**Online Activity 8: Read s 40-285, 40-290, 40-305**

**Level 9: Are you a small business entity?**

You are eligible to be a small business entity for an income year if:

- you carry on a business in that year, and
- you have an aggregated turnover of less than $2 million.
- Similarly to the previous grouping rules that existed under the former simplified tax system, the new aggregation rules use the concepts of 'connected with' (which is based on control) and 'affiliates' to determine whether the turnover of any related businesses need to be included in the aggregated turnover of your business.

It is not necessary to specifically elect to be an eligible small business each year in order to access the concessions. However, you must assess your eligibility for the concessions each year.

**Simplified depreciation rules**

If you are an eligible small business you may choose to calculate deductions for your depreciating assets using these rules.

In general, the taxable purpose proportions of the adjustable values and second element of cost amounts of most:

- depreciating assets costing less than $1,000 each can be written off immediately
- other depreciating assets with an effective life of less than 25 years are pooled in a general small business pool and deducted at the rate of 30%
- depreciating assets with an effective life of 25 years or more are pooled in a long-life small business pool and deducted at the rate of 5%
- newly acquired assets are deducted at either 15% or 2.5% (half the relevant pool rate) in the first year, regardless of when they were acquired during the year.

The taxable purpose proportion is your reasonable estimate of the proportion you will use, or have installed ready for use, a particular depreciating asset for a taxable purpose.
Simplified depreciation

If a small business entity chooses to stop using the simplified depreciation concession, it cannot again choose to use that concession until at least five years after the income year in which it chose to stop using that concession.

If you are eligible, and choose to continue to use the depreciation rules, you will continue to include any new depreciable assets in the relevant pool. If you choose not to use the simplified depreciation rules you cannot add any new assets to those pools. You can alternatively account for those assets under the rules.

**Level 10: Do the Temporary investment allowance rules apply (Div 41)?**

A temporary investment allowance (also known as the Tax Break) is limited to new tangible, depreciable assets for which a deduction is available under subdiv 40-B of the ITAA 1997 and new investment in existing assets. A deduction may be available in relation to a depreciable asset for the 2008-09, 2009-10, 2010-11 or 2011-12 income years. The amount of a taxpayer's investment in an asset needs to exceed a certain threshold and the asset must be used principally in Australia for the principal purpose of carrying on a business. The new investment threshold is $1000 for small business entities and $10,000 for all other taxpayers. The investment allowance can be claimed in the income year that the asset is first used or installed ready for use.

**Level 11: Complete the depreciation schedule**

Apply all of the above levels in a depreciation schedule.

**Example:** Shane runs a sports cricket shop in Melbourne and his opening adjustable values are set out in the depreciation schedule below as at 1 July of the current tax year ended 30 June. All assets were acquired after 9 May 2006 and have a 100 per cent business use (except his car which is 90% business use). He uses the diminishing value method. Additionally, he paid $5,000 for a new cash register plus $100 for electricians to install it. The register was not ready for use in the business until 1 June. The old register was sold for $200 on 1 May. Calculate the deductions available under Div 40 and the closing adjustable values. Round to the nearest dollar.

<table>
<thead>
<tr>
<th>DEPRECIATING ASSET</th>
<th>OPENING VALUE</th>
<th>DEP’N RATE</th>
<th>ADDITIONS VALUE</th>
<th>TERMINATION VALUE</th>
<th>DEPRECIATION</th>
<th>CLOSING VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Car</td>
<td>40,562</td>
<td>25</td>
<td></td>
<td>10,140</td>
<td>30,421</td>
<td></td>
</tr>
<tr>
<td>Cash register, old</td>
<td>589</td>
<td>20</td>
<td>200</td>
<td>389</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Shop fittings</td>
<td>12,784</td>
<td>10</td>
<td>5,100</td>
<td>1,278</td>
<td>11,506</td>
<td></td>
</tr>
<tr>
<td>Cash register, new</td>
<td>20</td>
<td>5,100</td>
<td></td>
<td>84</td>
<td>5,016</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>53,935</td>
<td></td>
<td>200</td>
<td>11,891</td>
<td>46,943</td>
<td></td>
</tr>
<tr>
<td>Less private use</td>
<td></td>
<td></td>
<td></td>
<td>1,014</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deduction</td>
<td></td>
<td></td>
<td></td>
<td>10,877</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Calculations:

Car $\quad 40,562 \times 25\% \times 365/365 = 10,140$

Cash register, old $\quad 589 \times 20\% \times 305/365 = 98$

Balancing adjustment $\quad TV - AV = 200 - 491 = 291$ deduction

Shop fittings $\quad 12,784 \times 10\% \times 365/365 = 1278$

Cash register, new $\quad 5100 \times 20\% \times 30/365 = 84$

C. Other capital allowances

Capital expenditure of primary producers and other landholders: subdiv 40-G

Subdivision 40-G provides capital allowances for the following capital expenditure of primary producers and other landholders:

◆ landcare operations
◆ electricity or telephone lines.

Capital expenditure that is immediately deductible: subdiv 40-H

Subdivision 40-H provides 100 per cent deductions for the following capital expenditure:

◆ exploration or prospecting
◆ rehabilitation of mining or quarrying sites
◆ paying petroleum resource rent tax
◆ environmental protection activities.

Capital expenditure that is deductible over time: subdiv 40-I

Subdivision 40-I firstly provides capital allowances for certain capital expenditure associated with projects over the life of the project. These projects include:

◆ certain mining capital expenditure
◆ certain transport capital expenditure
◆ community infrastructure
◆ site preparation for depreciating assets
◆ feasibility studies
◆ environmental assessments
◆ obtaining project information
◆ expenses incurred in seeking a right to intellectual property
◆ amounts for ornamental trees and shrubs.
Capital expenditure for the establishment of trees in carbon sink forests: subdiv 40-J

Subdiv 40-J provides deductions for capital expenditure incurred for establishing trees that meet the requirements for constituting a carbon sink forest.

Five-year write-off for certain business-related costs: s40-880

Section 40-880 is a provision of last resort as it may provide a deduction to the extent that the expenditure is not taken into account in some way elsewhere in the income tax law. Section 40-880 makes certain capital expenditure of business deductible over five years.

Online Activity 9: Read s40-880

D. Capital works: Div 43

You can deduct a portion of your construction expenditure for the following capital works set out in s43-20: buildings, structural improvements and environmental protection earthworks; as well as extensions, alterations and improvements to these.

The deductions are at a 2.5 per cent rate (previously 4 per cent): s43-25. The types of structures are (see table of intended use s43-90):

◆ hotel buildings and apartment buildings used for short-term traveller accommodation
◆ industrial buildings
◆ research and development facilities
◆ income-producing structural improvements
◆ environmental protection buildings and earthworks

Capital allowances: ITAA 1936

◆ research and development: ss73A, 73B to 73G
**Online Activity 10:** Dave owns a rental property and installed insulation batts in the roof. Are the batts deductible under Division 40 ITAA 1997?

**Online Activity 11:** Carol uses a caravan for accommodation and as an office when she travels to various country towns for her work as a salesperson. The caravan is not used for private purposes. Is she entitled to a deduction in respect of the caravan?

**Online Activity 12:** Grab It Co moved depreciating assets from one location to another. The depreciating assets are used wholly for taxable purposes. Do costs incurred for relocating a depreciating asset form part of its cost under Div 40?

**Online Activity 13:** A motor cycle, used on a pig farm and had 10% private use, was acquired on 31 May of the current tax year for $7,000. Calculate the tax depreciation.

**Online Activity 14:** Disposal of office equipment used 100% for business use, what is the balancing adjustment? It cost $10,000, its adjustable value at time of sale was $7,000 and sale proceeds were $6,000.

**Online Activity 15:** Australian Tax 2013 text Chapter 12, Practice Problems 1-13. Optional, if you need more practice also attempt problems 14-22.