TOPIC 7: CAPITAL WRITE OFFS AND ALLOWANCES

Introduction

- **Depreciating assets** capital in nature – no deduction allowed per **<u>s8-1</u>** (first neg limb)
- Capital expenditure is only **deductible** if it falls into a **specific deduction provision**
- **We study two regimes that provide deductions for capital expenditure:**
    - **1) Capital allowance regime** (Div 40 ITAA97): deduct cost of **depreciating assets**
    - **2) Capital works regime** (Div 43 ITAA97): deductions for **construction expenditure**

7.1 Capital allowance regime (Div 40 ITAA97)

- **<u>s40-25(1):</u>** provides deductions for the ‘***decline in value’*** for an income year of ‘***depreciating assets’*** that it ‘***held’*** during the year
    - **<u>s40-25(2):</u>** deduction **reduced by the decline in value** attributable to the entity’s use of the asset (or installation ready for use) for a **purpose other than a *‘taxable purpose’***

Deduction	=	'Decline in value' of a 'depreciating asset' 'held' during the income year	−	Part of the asset’s decline in value that is <u>*not*</u> attributable to a 'taxable purpose'

- **Five steps to consider:**
    - Must have a ***depreciating asset*** (s40-30)
    - Must have a ***holder*** of the depreciating asset (s40-40)
    - Must have a ***taxable purpose*** (s40-25(7))
    - Calculate the ***decline in value*** for the income year (s40-70; s40-72; s40-75)
    - Calculate the tax consequences of any ***balancing adjustment*** events

<u>i) Must have a ‘Depreciating asset’ (s40-30):</u>

- **<u>s40-30(1)</u>**: An asset that has a *limited ‘effective life’* and can **reasonably be expected to decline in value** over the time it is used
- **<u>(1)</u> Excludes**:
  <u>(a)</u> Land;
  <u>(b)</u> trading stock (already covered by s8-1);
  <u>(c)</u> Intangible assets that are not mentioned in **<u>s40-30(2)</u>** (eg. goodwill)
    - **‘goodwill’**: the price paid to acquire a business over the value of tangible assets less liabilities
- **Eg.** Fridges in a supermarket; display cabinets in cake shop; computers in an office; tools for construction workers
- **<u>S40-30(2):</u>** these intangible assets are depreciating assets if they are not trading stock: mining, quarrying or prospecting rights; items of intellectual property
- **<u>s40-30(3)</u>**: Improvements/fixtures on the land (removable or not) are treated as **separate assets** from the land
    - However, it is generally not possible to deduct amounts under Div 40 in relation to expenditure on items such as buildings – the Div does not apply to ‘capital works’ deductible under Div 43 (**<u>s40-45(2)</u>**)

- **S40-30(4):** Whether a ***composite item*** is itself a *depreciating asset* or is a number of separate depreciating assets is a **question of fact and degree** (eg. car has many separate components, but is a depreciating asset for all combined)

ii) Must have a 'Holder' (s40-40): (p257 leg book)

- 'Holder' determined in accordance with table in **s40-40**
  - Generally, the holder is the 'legal owner' of the asset
  - Sometimes it is the 'economic owner' of the asset if has right to use (and expected to become legal owner
  - The 'holder' is the lessor and hiree of lease/hire license

iii) Must have a 'Taxable purpose' is (s40-25(7)):

(a) for the **purpose of producing AI,**

(b) purpose of exploration or prospecting, **(c)** purpose of mining site rehab; or **(d)** environmental protection activities

iv) Calculate the Decline in value:

- **Start date: s40-60(1)** Decline in value commences from the 'start time':
  - **(2)** When the entity **first uses the asset**, **or** it is **installed** or ready to use for any purpose
- **Two methods to calculate a decline in value:**
  - **a. 'Prime cost method' (s40-75); or**
  - **b. 'Diminishing value method' (DVM)**
    - Pre 9 May 2006: **s40-70**
    - Post 9 Mat 2006: **s40-72**
    - DATE IS CRUCIAL
- **s40-65:** entities can choose which method to use
- **s40-130**: Once a method to calculate the decline in value *of an asset* it **cannot be changed**
- **Alternatively, special '*pooling rules'*** (s40-E) can apply to low cost/value assets: (**s40-425**)
  - Low cost assets (cost <$1000)
  - Low value assets (opening adjustable value <$1000)

a. Prime cost method:

$$Asset\ Cost \times \frac{Days\ Held}{365} \times \frac{100\%}{Asset's\ Effective\ Life}$$

- **Days held:** the number of days in the income year that the entity held the asset (ignoring any days it did not use it or have it installed ready for use)
- **Asset's cost**:
  - **Two elements (s40-175; s40-185)**:
    - **1)** the amount paid to hold the asset (eg. cash paid to acquire the asset)
    - **2)** the amount paid for each economic benefit that contributed to bringing the asset to its current condition/location (eg. cash paid to transport or modify an asset)
  - Certain amounts are excluded:
    - The cost of depreciating asset is reduced by the amount of any **input tax credits** available to the entity (**s27-80**)