1. Capital Allowances – Division 40

References


1.1 A brief introduction to Division 40

I hate “terms” and “definitions”, especially when there is a term that everyone knows and uses. In 2001, the rules regarding claiming deductions for depreciating assets were rewritten and instead of calling it “depreciation” as everyone had forever, they called it “capital allowances”.
In this session we will use the term “depreciation” and “capital allowances” interchangeably – one being the legally correct term and the other being to term that best explains what we are doing...

Division 40 contains the capital allowance provisions, which allow deductions for the decline in value of “depreciating assets”.

According to section 40-15 this Division is designed to:

- To allow a deduction for the cost of depreciating assets;
- To spread the deduction over a period that reflects the time for which the assets can be used to obtain benefits (broadly, for income producing purposes); and
- To provide a deduction for certain other capital expenditure that is not otherwise deductible.

Division 40 allows us to buy a “depreciating asset” for a “cost” that we will “hold” to be used, or installed ready for use, for a “taxable purpose”, and then claim the cost as a deduction over the “effective life”.

Each of these terms will be considered in this session.

We should also note that Division 40 has lots of other types of allowances, including:

- Subdivision 40-E - Low-value and software development pools
- Subdivision 40-F - Primary production depreciating assets
- Subdivision 40-G - Capital expenditure of primary producers and other landholders
- Subdivision 40-H - Capital expenditure that is immediately deductible
- Subdivision 40-I - Capital expenditure that is deductible over time
- Subdivision 40-J - Capital expenditure for the establishment of trees in carbon sink forests

We will only cover the general rules that are regularly used in tax depreciation schedules. But remember there are special rules for software development and primary production.

1.2 Meaning of “taxable purpose”

If we start with the easy definitions, we should start with “taxable purpose” In subsection 40-25(7) a taxable purpose is defined as:

- The purpose of producing assessable income; or
• The purpose of exploration or prospecting; or
• The purpose of mining site rehabilitation; or
• Environmental protection activities.

So if you are not out there trying to make assessable income (renting out the property, or at least trying to) you can’t claim Division 40 deductions.

What do you do if you are trying to rent it out but not finding a tenant? Trying is enough…

But the asset has to be genuinely available for rent. The Commissioner has stated that factors that may indicate a property is not genuinely available for rent include:

• It is advertised in ways that limit its exposure to potential tenants – for example, the property is only advertised at your workplace or by word of mouth or outside annual holiday periods when the likelihood of it being rented out is very low;
• The location, condition of the property, or accessibility to the property, mean that it is unlikely tenants will seek to rent it;
• You place unreasonable or stringent conditions on renting out the property that restrict the likelihood of the property being rented out, including setting the rent above the rate of comparable properties in the area or placing a combination of restrictions on renting out the property (requiring prospective tenants to provide references for short holiday stays and having conditions like "no children" and "no pets");
• You refuse to rent out the property to interested people without adequate reasons.

And remember, the deductions do not start until it is used or installed ready for use for a taxable purpose (section 40-60). You may have bought the dishwasher on day one, but until it is delivered and installed the depreciation deductions do not start.

1.3 Meaning of “depreciating asset”

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 (section 40-30).

However, it does NOT include:
• Land;

• Trading stock; or

• Intangible assets other than:
  – Mining, quarrying or prospecting rights;
  – Mining, quarrying or prospecting information;
  – Intellectual property;
  – In-house software;
  – Indefeasible rights to use;
  – Spectrum licences;
  – Datacasting transmitted licences; and
  – Telecommunications site access rights.

It is worth noting the following:

• Improvements to, or fixtures on land are treated as assets separate from the land, regardless of whether they are removable or not (subsection 40-30(3)).

• Assets can be a composite of other assets (subsection 40-30(4)). It can also be an important issue to determine whether an asset is a single depreciable asset or multiple assets. If there is more than one asset, they may have differing effective lives.

• A building can be a depreciable asset in very specific circumstances (Wangaratta Woollen Mills Ltd v FCT (1969) 119 CLR 1).

In addition, Division 40 does not apply to (section 40-45):

• Assets that are “eligible work related items” for the purposes of section 58X of the Fringe Benefits Tax Assessment Act 1986 where the relevant benefit is an expense payment benefit or a property benefit;

• Capital works for which a deduction is or would be allowed under Division 43;

• Depreciating assets where a deduction is available under certain rules dealing with Australian films; and

• Cars if certain methods for calculating deductions in relation to cars are used.

1.4 Meaning of “holding” a depreciable asset

Generally a taxpayer “holds” an asset if the taxpayer is the legal owner of the asset (section 40-40). But it is not always clear who is the holder of an asset.
Example:

Power Finance leases a luxury car to Kris who subleases it to Rachael. As lessee, Rachael is the holder of the car under Division 40, even though Power, as the legal owner, would normally hold the car.

Example 2:

Sandra sells a packing machine to Jenny under a hire purchase agreement. Jenny holds the machine under Division 40, although she is not the legal owner until she exercises her option to purchase.

This is the case as Jenny is reasonably expected to exercise that option because the final payment will be well below the expected market value of the machine at the end of the agreement.

Section 40-40 has a list of these different ways people can become the “holder” of a depreciable asset. And remember that this is important, as only the holder can claim the Division 40 deductions (and there cannot be 2 holders!!!)

Below (next page) is the table from section 40-40. Have a look at item 1 and item 6 and see why the two examples above came out the way they did.

But after saying there can only be one holder, it is worth noting an asset can be jointly held.

Example

Buford Corp owns an office block that it leases to 2 companies, Smokey Pty Ltd and Bandit Pty Ltd. Smokey and Bandit decide to install a fountain in front of the building.

They discuss it with Buford who agrees to pay half the cost (because the fountain won’t be removable at the end of the lease). Smokey and Bandit split the rest of the cost between them.

Smokey and Bandit would each hold the asset under item 3 of the table in section 40-40 and Buford would hold it under item 10. They would be joint holders, so each would write-off its interest in the fountain.

As you would expect, where a depreciating asset is held jointly by at least two people, the interest in the depreciable asset is treated as if it is a depreciable asset itself (refer to section 40-35).
## 1.5 Meaning of effective life

Generally, the effective life of a depreciable asset is how long it can be used by any entity for a taxable purpose:

<table>
<thead>
<tr>
<th>Item</th>
<th>This kind of depreciable asset:</th>
<th>Is held by this entity:</th>
</tr>
</thead>
</table>
| 1    | A "car in respect of which a lease has been granted that was a luxury car when the lessee first leased it" | The lessee (while the lessee has the "right to use the car"
|      |                                 | and not the lessor)     |
| 2    | A "depreciable asset that is fixed to land subject to a "quasi-ownership" right (including any extension or renewal of such a right) where the owner of the right has a right to remove the asset" | The owner of the quasi-ownership right (while the right to remove exists) |
| 3    | An improvement to land (whether a fixture or not) subject to a "quasi-ownership" right (including any extension or renewal of such a right) made, or itself improved, by any owner of the right for the owner's own use where the owner of the right has no right to remove the asset | The owner of the quasi-ownership right (while it exists) |
| 4    | A "depreciable asset that is subject to a lease where the asset is fixed to land and the lessor has the right to recover the asset" | The lessor (while the right to recover exists) |
| 5    | A right that an entity legally owns but which another entity (the economic owner) exercises or has a right to exercise immediately, where the economic owner has a right to become its legal owner and it is reasonable to expect that: | The economic owner and not the legal owner |
|      | (a) the economic owner will become its legal owner; or | |
|      | (b) it will be disposed of at the direction and for the benefit of the economic owner | |
| 6    | A "depreciable asset that an entity (the former holder) would, apart from this item, hold under this table (including by another application of this item) where a second entity (also the economic owner): | The economic owner and not the former holder |
|      | (a) possesses the asset, or has a right as against the former holder to possess the asset immediately; and | |
|      | (b) has a right as against the former holder the exercise of which would make the economic owner the holder under any item of this table; | |
|      | and it is reasonable to expect that the economic owner will become its holder by exercising the right, or that the asset will be disposed of at the direction and for the benefit of the economic owner | |
| 7    | A "depreciable asset that is a partnership asset | The partnership and not any particular partner |
| 8    | "Mining, quarrying or prospecting information that an entity has and that is relevant to; | The entity |
|      | (a) mining and quarrying operations carried on, or proposed to be carried on by the entity; or | |
|      | (b) a "business carried on by the entity that includes "exploration or prospecting for" minerals or quarry materials obtainable by such operations; | |
|      | whether or not it is generally available | |
| 9    | Other "mining, quarrying or prospecting information that an entity has and that is not generally available | The entity |
| 9A   | (Repealed by No 95 of 2014) | |
| 10   | Any "depreciable asset | The owner, or the legal owner if there is both a legal and equitable owner |
• 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.

For most depreciable assets you can choose to work out the effective life yourself or to use an effective life determined by the Commissioner of Taxation.

The sort of information you could use to make an estimate of effective life of an asset is found in TR 201612 titled “Effective life of depreciable assets” and include:

• Physical life;
• Manufacturing specifications;
• Use of the asset in a particular industry;
• Use of the asset in different industries;
• Industry standards;
• Repairs and maintenance;
• Retention period;
• Obsolescence;
• Scrapping or abandonment practices;
• Lease periods;
• Financial analysis; and
• Market value

In this Ruling, the Commissioner estimates the effective life of thousands of depreciable assets.

COMMON MISTAKE: In making his determination, the Commissioner assumes the depreciable asset is new and has regard to general industry circumstances of use.

To quote from every yearly ruling and every yearly “Rental Property Guide” that the Commissioner has ever published… “In making his determination, the Commissioner assumes the depreciable asset is new and has regard to general industry circumstances of use.”

If this is not the case the effective life will almost certainly be different to the Commissioner’s estimate.
In the 2015 ruling he states that the effective life for new internal window blinds is 10 years. He does not say the effective life for second hand internal window blinds is 10 years. If you buy a 5-year-old building that has 5-year-old internal window blinds you are not required to depreciate the blinds using a 10-year effective life. If you are attempting to get the best outcome for your clients I would hope you would consider that the effective life will be less that 10 years.

Each year the Commissioner makes a Ruling regarding how to determine the effective life of depreciating assets. The previous year rulings are:

- TR 2015/2 is applicable from 1 July 2015
- TR 2014/4 is applicable from 1 July 2014
- TR 2013/4 is applicable from 1 July 2013
- TR 2012/2 is applicable from 1 July 2012
- TR 2011/2 is applicable from 1 July 2011
- TR 2010/2 is applicable from 1 July 2010
- TR 2009/4 is applicable from 1 July 2009
- TR 2008/4 is applicable from 1 July 2008
- TR 2007/3 is applicable from 1 July 2007
- TR 2006/15 is applicable from 1 January 2007
- TR 2006/5 is applicable from 1 July 2006
- TR 2000/18 is applicable from 1 July 2001.

As a general rule, use the ruling or schedule that is in force at the time you:

- Entered into a contract to acquire the depreciating asset or otherwise acquired it, or
- Started to construct it.

The Commissioner also produces a “Guide to rental properties” each year and in it he summaries the assets from the larger ruling that might be in a rental property.

See below for an example of the 9 pages of table… What is the Commissioner's estimate of an electric clock?
You do not need to use the Commissioner’s estimates of effective life. However, if you do not, you will need some form of evidence as why you chose a certain effective life.

It is worth noting that certain assets for their effective lives set in Division 40.

For example

- Standard patent - 20 years
- Innovation patent - 8 years
- Petty patent - 6 years
- Registered design - 15 years
- Copyright (except copyright in a film) - The shorter of: (a) 25 years from when you acquire the copyright; or (b) The period until the copyright ends.
- A licence - The term of the licence
- A licence relating to a copyright (except copyright in a film) - The shorter of: (a) 25 years from when you become the licensee; or (b) The period until the licence ends.
- In-house software - 4 years
- Spectrum licence - The term of the licence
- Datacasting transmitter licence - 15 years
- Telecommunications site access right - The term of the right

The Government recently introduced a draft bill to allow a taxpayer to use an effective life rather than these statutory rates. However, it is unlikely this will be introduced before the 2016 election is called.
1.6 What does cost mean?

**COMMON MISTAKE**

Notice that we have not discussed “cost” yet. The law very clearly states you identify the depreciable assets first, then you work out their “cost”.

Every now and then I come across what is commonly called a “top down” depreciation schedule. In these all the costs are identified first and then this amount is pushed down onto the depreciable (and other) assets. The spreadsheet doing this top down schedule states that:

\[ \text{Purchase price} - \text{undeducted construction expenditure (Div 43 deductions)} = \text{cost of depreciable assets} \]

This is wrong. For example, if you pay $2 million for a building with just a dishwasher in it but the undeducted construction expenditure is $1 million don’t tell me the arms length value paid for the dishwasher is $1 million.

You find the assets first then you either work out what the actual cost was to buy the asset, or you estimate the actual cost.

The last term we need to understand is “cost”. This consists of two elements

1.6.1 First element of cost

The first element is worked out when the taxpayer begins to hold the deprecating asset. The first element is either the amount specified in the table in subsection 40-180(2) or if none of the items in the table apply, the amount the taxpayer is taken to have paid under section 40-185.

Subsection 40-185(1) provides that the amount that a taxpayer is taken to have paid (in relation to holding the asset initially or bringing it to its present condition or location) is the greater of the following amounts:

- The amounts included in assessable income, being the sum of the amounts included in assessable income because a taxpayer started to hold the deprecating asset or gave something to start holding it and any amount that would have been included in assessable income if the amount of any consideration given by the taxpayer were ignored (refer to paragraph 40-185(1)(a)); and

- The consideration given by the taxpayer, being:
  - The sum of money paid or non-cash benefits provided;
  - A liability to pay money or provide non-cash benefits; and
A reduction in a right to receive money or non-cash benefits (refer to paragraph 40-185(1)(b)). These kinds of consideration and the relevant amounts are listed in the table at the end of subsection 40-185(1).

Note that Subdivision 27-B generally provides that the cost of a depreciating asset will be calculated on a GST-exclusive basis where the taxpayer is entitled to an input tax credit.

Example

Gold Medals Ltd manufactures some medals for a local sporting association's annual meeting in return for a die cut stamping machine. The medals have a market value of $20,000. The machine has an arm's length value of $100,000 but Gold Medals has to contribute $75,000 towards acquiring it from the association. Gold Medals will have to include:

\[(100,000 - 75,000) = 25,000\]

in its assessable income because of section 21A of the Income Tax Assessment Act 1936.

The first element of the machine's cost will be the greater of:

- The amount it paid ($75,000) plus the market value of the non-cash benefits it provided ($20,000), which comes to $95,000; and
- The amount that was assessable income from receiving the machine ($25,000) plus the amount by which that assessable income was reduced because of the payment Gold Medals made ($75,000), which comes to $100,000.

So, in this case, the first element of the machine's cost to Gold Medals is $100,000.

Example

Laura travels overseas to purchase a purpose-built vehicle for use in her trade. The purchase of the vehicle is the sole reason for the trip. Laura incurs expenses for airfares and accommodation. These expenses are included in the cost of the vehicle because they are "in relation to starting to hold" the vehicle.

1.6.2 The second element of cost

The second element is worked out after the taxpayer starts to hold the depreciating asset.

The second element generally consists of the amount the taxpayer is taken to have paid for each economic benefit that has contributed to bringing the asset
to its present condition and location from time to time since the taxpayer started to hold the asset.

**Example**

Andrew adds a new tray and canopy to his ute. The materials and labour that go into the addition are economic benefits that Andrew received and that contribute to the ute’s present condition. The payments he makes for those economic benefits are included in the second element of the ute’s cost.

**Example**

Leonie needed to replace one of her old depreciating assets that was fixed to her land with a new, more efficient one. Leonie paid a contractor a fee to demolish and remove the old asset. This resulted in a balancing adjustment event occurring for the old asset, and the fee forms part of the second element of the cost of the old asset that was demolished.

1.6.3 **There are a few modifications to the cost**

**Apportionment of cost** - If you pay an amount for 2 or more things that include at least one depreciating asset, or that include a contribution to bringing a depreciating asset to its present condition and location, you take into account as part of its cost only that part of what you paid that is reasonably attributable to the asset.

**Example:**

Ian buys 3 assets (one depreciating asset and 2 other assets) under the one transaction. He pays $30,000 for the 3 assets. $25,000 of that amount is reasonably attributable to the depreciating asset. The first element of the depreciating asset's cost is $25,000.

**Cost of a split depreciating asset** - If you split a depreciating asset into separate assets, the first element of the cost of each of the separate assets is a reasonable proportion of the sum of these amounts: (a) the adjustable value of the original asset just before it was split; and (b) the amount you are taken to have paid under section 40-185 for any economic benefit involved in splitting the original asset.

**Example:**

Barry owns a spectrum licence that covers 3 areas: Area A, area B and area C. The licence has an adjustable value of $160,000. He sells area A to Chris, and his costs of splitting are $10,000. Barry is taken to have split the licence into 2 assets. On the basis of their relative market
values, Barry apportions $170,000 to area A (that he disposed of) and to the licence he still holds for areas B and C.

**Cost of merged depreciating assets** - If a depreciating asset or assets that you hold is or are merged into another depreciating asset, the first element of the cost of the merged asset is a reasonable proportion of the sum of: (a) the adjustable value or adjustable values of the original asset or assets just before the merger; and (b) the amount you are taken to have paid under section 40-185 for any economic benefit involved in merging the original asset or assets.

**Cars** - The first element of the cost of a car designed mainly for carrying passengers is reduced to the car limit for the financial year in which you started to hold it if its cost exceeds that limit.

And most importantly... **Double deduction** – If you deduct it elsewhere, it cannot be a part of the cost (see repairs below)

### 1.7 How do you work out the deduction?

You work out your deduction for the decline in value of a depreciating asset using either the prime cost or diminishing value method. However, for a depreciating asset that you acquire from an associate of yours where the associate has deducted or can deduct an amount for the asset under this Division, you must use the same method that the associate was using (section 40-65).

The diminishing value method assumes that the decline in value each year is a constant proportion of the remaining value and produces a progressively smaller decline over time.

For depreciating assets you started to hold on or after 10 May 2006, you generally use the following formula for working out decline in value using the diminishing value method:

\[
\text{base value}^* \times \frac{\text{days held}}{365^{**}} \times \frac{200\%}{\text{asset's effective life}}
\]

* For the income year in which an asset is first used or installed ready for use for any purpose, the base value is the asset's cost. For a later income year, the base value is the asset's opening adjustable value plus any amounts included in the asset's second element of cost for that year.

** Can be 366 in a leap year.

This formula does not apply in some cases, such as if you dispose of and reacquire an asset just so the decline in value of the asset can be worked out using this formula.
For depreciating assets you started to hold prior to 10 May 2006, the formula for working out decline in value using the diminishing value method is:

\[
\text{base value} \times \frac{\text{days held}}{365^{**}} \times \frac{150\%}{\text{asset's effective life}}
\]

* For the income year in which an asset is first used or installed ready for use for any purpose, the base value is the asset's cost. For a later income year, the base value is the asset's opening adjustable value plus any amounts included in the asset's second element of cost for that year.

** Can be 366 in a leap year.

The prime cost method assumes that the value of a depreciating asset decreases uniformly over its effective life. The formula for working out decline in value using the prime cost method is:

\[
\text{asset's cost} \times \frac{\text{days held}}{365^{*}} \times \frac{100\%}{\text{asset's effective life}}
\]

* Can be 366 in a leap year.

Under either the diminishing value method or the prime cost method, the decline in value of an asset cannot amount to more than its base value.

**So which one do you use?** Diminishing value gives greater up front deductions but tails off at the end (forever??). So when does the taxpayer really need the deductions?

And remember - If you use a depreciating asset for other than a taxable purpose (for example, you use the same lawn mower at both your rental property and your private residence) you are allowed only a partial deduction for the asset’s decline in value, based on the percentage of the asset’s total use that was for a taxable purpose.

1.8 **Balancing adjustments**

If you cease to hold a depreciating asset (as you have sold it) or to use a depreciating asset (don’t need it anymore), a “balancing adjustment” will occur.

This balancing adjustment will see the taxpayer either including an amount in their assessable income or claiming a deduction.

**Example**
Michael buys a widget machine for $1,000 and a gidget machine for $2,000. After 2 years the adjusted value of the widget machine is $0 (fully depreciated) and a gidget machine is $1,000. He then sells both machines, each for $500 under an arms length transaction.

The balancing adjustment for the widget machine is an assessable $500. He depreciated the widget machine to zero but sold it for $500.

The balancing adjustment for the gidget machine is a deductible $500. He had only depreciated the gidget machine to $1,000 but sold it for $500.

You work out the balancing adjustment amount by comparing the asset’s termination value (such as the proceeds from the sale of the asset) and its adjustable value at the time of the balancing adjustment event.

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.

If a balancing adjustment event happens to a depreciating asset that you used at some time other than for income-producing purposes (for example, privately) then a capital gain or capital loss might arise to the extent that you so used the asset.

1.9 Immediate deductions

There are two main types of depreciable assets that can be deducted immediately.

The first is small business entities, with turnover of less than $2 million, can immediately write of assets less than $1,000.

However, in the 2016 Federal Budget the Government announced it will significantly expand accelerated depreciation for small businesses by allowing small businesses with aggregate annual turnover of less than $2 million to immediately deduct assets they start to use or install ready for use, provided the asset costs less than $20,000.

This will apply for assets acquired and installed ready for use between 7.30pm (AEST) 12 May 2015 and 30 June 2017. Assets valued at $20,000 or more (which cannot be immediately deducted) can continue to be placed in the small business simplified depreciation pool (the pool) and depreciated at 15 per cent in the first income year and 30 per cent each income year thereafter. The pool can also be immediately deducted if the balance is less than $20,000 over this period (including existing pools).
Remember this only applies to “businesses”, but what is a business. The Commissioner’s position is summarised in Taxation Ruling TR 97/11. But the mere ownership of rental property is not a business.

The Commissioner has already indicated that small businesses exhibit behaviours that indicate a high level of risk, they can expect a higher level of interaction with the ATO. The ATO has a risk-based program to identify taxpayers that are not meeting their obligations and will take measured approaches to influence taxpayer behaviour.

All assets (including new and second hand) will be eligible, except for a small number of exclusions, which receive different depreciation treatment. Excluded assets include:

- Horticultural plants - subject to their own ‘uniform capital allowance’ rules (UCA);
- Capital works - subject to their own ‘capital works’ depreciation rules;
- Assets allocated to a low-value or software depreciation pool - subject to the depreciation rules under those pools;
- Primary production assets - you can choose to use the specific UCA rules or accelerated depreciation rules; and
- Assets leased out to another party on a depreciating asset lease.

Businesses need to ensure that they only claim a deduction to the extent to which the asset is used in an income earning activity.

And remember old or second hand assets are eligible.

**NOTE:** It should be noted that the Commissioner allows all businesses to write off immediately any expenses less than $100 GST inclusive.

The second relates to those not in business (i.e. rental property owners).

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 use it for a taxable purpose during the income year in which the deduction is available.

The immediate deduction is available if all of the following tests are met in relation to the asset:

- It cost $300 or less
Division 40 and Division 43 Basics

- You used it mainly for the purpose of producing assessable income that was not income from carrying on a business

- It was not part of a set of assets costing more than $300 that you started to hold in the income year, and

- It was not one of a number of identical, or substantially identical, assets that you started to hold in the income year that together cost more than $300.

Example

In November 2013, Terry purchased a toaster for his rental property at a cost of $70. He can claim an immediate deduction as he uses the toaster to produce assessable income, provided he is not carrying on a business from the rental activity.

Example

Paula is buying a set of four identical dining room chairs costing $90 each for her rental property. She cannot claim an immediate deduction for any of these because they are identical, or substantially identical, and the total cost is more than $300.

1.10 Low value pools

You can allocate low-cost assets and low-value assets relating to your rental activity to a low-value pool.

A low-cost asset is a depreciable asset whose cost is less than $1,000 (after GST credits or adjustments) as at the end of the income year in which you start to use it, or have it installed ready for use, for a taxable purpose.

A low-value asset is a depreciable asset that is not a low-cost asset and:

- That has an opening adjustable value for the current year of less than $1,000, and

- For which you have worked out any available deductions for decline in value under the diminishing value method.

You work out the decline in value of an asset you hold jointly with others based on the cost of your interest in the asset. This means if you hold an asset jointly and the cost of your interest in the asset or the opening adjustable value of your interest is less than $1,000, you can allocate your interest in the asset to your low-value pool.

Once you choose to create a low-value pool and allocate a low-cost asset to it, you must pool all other low-cost assets you start to hold in that income year.
and in later income years. However, this rule does not apply to low-value assets. You can decide whether to allocate low-value assets to the pool on an asset-by-asset basis.

Once you have allocated an asset to the pool, it remains in the pool. Once an asset is allocated to a low-value pool it is not necessary to work out its adjustable value or decline in value separately. Only one annual calculation for the decline in value for all of the depreciating assets in the pool is required. You work out the deduction for the decline in value of depreciating assets in a low-value pool using a diminishing value rate of 37.5%.

For the income year you allocate a low-cost asset to the pool, you work out its decline in value at a rate of 18.75%, or half the pool rate. Halving the rate recognises that assets may be allocated to the pool throughout the income year and eliminates the need to make separate calculations for each asset based on the date it was allocated to the pool.

When you allocate an asset to the pool, you must make a reasonable estimate of the percentage of your use of the asset that will be for a taxable purpose over its effective life (for a low-cost asset) or the effective life remaining at the start of the income year for which it was allocated to the pool (for a low-value asset). This percentage is known as the asset’s taxable use percentage.

Note that the proposed changes to immediate deductions above will mean you may be able to write off a less than $20,000 pool balance on either 30 June 2015, 2016 and 2017.

1.11 Second hand depreciable assets

Second hand goods often cause confusion, especially where a series of second hand goods are purchased as a part of a larger purchase (like a non-new rental property). If you purchase a second-hand asset you can claim a deduction based on the cost of the asset to you.

COMMON MISTAKE:

There is a myth that there are different rules for second hand depreciable assets depending on what the previous owners did with the asset. This myth arises as people try to look at how much the previous owner had depreciated the asset before they purchased it to ensure the right amount has been claimed as depreciation. This is 100% wrong.

There is nothing in Division 40 that mentions second hand assets so we treat them just like new assets. And, as we have already discussed, if you buy a depreciable asset you need to know what you paid for it and what its effective life is. Once you know this, to the extent you use it for a taxable purpose, you can claim depreciation deductions.
It does not matter if the previous owner fully depreciated it or not. If they had fully depreciated the asset and then sell it to you for $100, that previous owner will have a $100 balancing adjustment.

Assuming you did not buy it from an associate, it does not matter if they used the prime cost or diminishing value method. You choose what you want to use irrespective of what they used.

Put simply, you don’t need to know anything about the previous owners use for a depreciable asset as it does not change what you paid for it or what its effective life is.

Where you purchase a rental property from an unrelated party, one objective means of establishing your cost of depreciating assets acquired with the property is to have their value, as agreed between the contracting parties, specified in the sale agreement.

If separate values for depreciating assets are not included in the sale agreement for your rental property when you purchase it, you may be required to demonstrate the basis of your valuation.

Generally, independent valuations that establish reasonable values for depreciating assets satisfy ATO requirements. In the absence of an independent valuation, you may need to demonstrate that your estimate provided a reasonable value. Considerations would include the market value of the asset compared to the total purchase price of the property.

1.12 What is Capital Works, what is a depreciable asset, what is a repair and what do I get no deduction for at all?

The final and hardest thing about Division 40 deductions is establishing whether:

- There is an immediate deduction available as the costs are a repair;
- There is deduction over an effective life (much less than 40 years) under the depreciation deductions in Division 40;
- There is a Capital Works deduction under Division 43: or
- The costs just go into the cost base of the asset and therefore reduce any Capital Gains tax that will be paid in the future when the asset is sold.

1.12.1 Immediate deductions and no deductions
This paper is about tax depreciation but before we consider what is depreciable under Division 40 or under Division 43 we need to understand that not every cost falls into these two sections. This is best shown through a series of examples:

- The fence is damaged on a rental property and the owner spends money on repairing it. You see the cost the owner has spent, include it in the tax depreciation schedule and depreciate it over 40 years at 2.5%. But it is a repair and should have been claimed 100% in the year in which it was incurred.

- Legal costs and stamp duty was paid to buy the rental property. You apportion this cost across the building and the depreciable assets so the cost is reflected in the tax depreciation schedule. But these costs where not the cost of the depreciable assets and definitely were not the cost of construction is relation to a rental property that was built 20 years ago, so the cost cannot be included in a tax depreciation schedule. These costs are included in the capital gains tax calculations when the rental property is sold.

- My favourite example of this is where the taxpayer claims a deduction for their strata title levies, and then is told in a tax depreciation schedule to claim the same amount again over a series of years to reflect the common assets. Double dipping at its best… and very wrong.

The reason these costs are often incorrectly claimed in a tax depreciation schedule is that the top down approach is used (find all the costs and push them down to the depreciable assets). As discussed earlier, this is legally wrong.

**1.12.2 Repairs**

The Commissioner has summarised his position on what is a repair in Taxation Ruling TR 97/23. Generally, expenditure for repairs made to an income producing property are immediately deductible. However, the repairs must relate directly to wear and tear or other damage that occurred as a result of your renting out the property.

Repairs generally involve a replacement or renewal of a worn out or broken part, for example, replacing some guttering damaged in a storm or part of a fence that was damaged by a falling tree branch.

However, the following expenses are capital, or of a capital nature, and are not deductible:

- Replacement of an entire structure or unit of property (such as a complete fence or building, a stove, kitchen cupboards or refrigerator)
• Improvements, renovations, extensions and alterations, and
• Initial repairs, for example, in remedying defects, damage or deterioration that existed at the date you acquired the property.

Examples of repairs for which you can claim deductions are:

• Replacing broken windows
• Maintaining plumbing
• Repairing electrical appliances.

Examples of improvements for which you cannot claim deductions are:

• Landscaping
• Insulating the house
• Adding on another room.

1.12.3 Capital Works

The Commissioner has summarised his position on what is deductible under Division 43 and what is deductible under Division 40 (in relation to residential rental properties) in Taxation Ruling TR 2004/16.

According to this ruling the factors to consider are:

• Whether the item appears visually to retain a separate identity;
• The degree of permanence with which it has been attached;
• The incompleteness of the structure without it; and
• The extent to which it was intended to be permanent or whether it was likely to be replaced within a relatively short period.

For example (x4):

**Example 1**

Kitchen cupboards form part of the premises and therefore are part of the setting of the landlord's rental income earning activities and so not within the ordinary meaning of plant. Kitchen cupboards form part of the premises as they are fixed to the premises, intended to remain in place indefinitely and are necessary to complete the premises. Any
separate visual identity is outweighed by the other factors. Since kitchen cupboards form part of the premises they are not depreciable under Division 40 but under Division 43.

**Example 2**

Insulation batts form part of the premises and therefore are part of the setting of the landlord's rental income earning activities and so not within the ordinary meaning of plant. Insulation batts form part of the premises, although they are generally not fixed to the premises, as they are intended to remain in place indefinitely, lose their separate visual identity and add to the completeness of the premises. Since insulation batts form part of the premises they are they are not depreciable under Division 40 but under Division 43.

**Example 3**

59. A 'built-in' wardrobe, whether it be the type built-in to an alcove shaped wall or the type labelled 'built-in' by the manufacturer because its side panels create the appearance of a wardrobe which is created out of the walls of the property, 44 forms part of the premises and therefore is part of the setting of the landlord's rental income earning activities and so not within the ordinary meaning of plant. Built-in wardrobes form part of the premises as they are fixed to the premises, intended to remain in place indefinitely, do not retain a separate visual identity and add to the completeness of the premises. Since built-in wardrobes form part of the premises they are they not depreciable under Division 40 but under Division 43.

**Example 4**

In a ducted (built-in) vacuum system inlet valves are installed in various locations throughout the home. Those valves are connected via tubing installed in the walls to a power unit (essentially a motor) located in an out-of-the way location such as a garage. A hose attached to the brush unit (the vacuum head and rod) is plugged into one of the inlets to begin vacuuming.

The power unit is machinery and is therefore plant. The hose and brush unit are articles and therefore plant. The tubing installed in the walls is not machinery as it is merely a conduit, although it is connected to the power unit which is machinery.

6We do not accept an alternative view that the hose, brush unit, tubing and power unit are together a single unit of machinery because they operate together to perform the function of vacuuming.

The tubing forms part of the premises and therefore is part of the setting of the landlord's rental income earning activities and so not
within the ordinary meaning of plant. The tubing forms part of the premises as it is fixed to the premises, intended to remain in place indefinitely and loses any separate visual identity. Those factors outweigh the fact that the premises are probably not incomplete without the tubing. Since the tubing forms part of the premises it is also not an article.

Since the power unit, hose and brush unit in this example are plant, deductions for their decline in value may be available under Division 40.

Since the kitchen cupboards, insulation batts, built-in wardrobes and tubing in the examples are not plant, deductions for their decline in value are not available under Division 40, but deductions may be available under Division 43.

Further, in the tables at the back of the Commissioner’s “Rental Property Guide” he has listed 9 pages of assets in these residential rental properties and identified what is subject to Division 43 and what is subject to Division 40. This is an amazing product for establishing what items in a residential rental property are able to be claimed under Division 43.

An example of these tables is:

### TABLE 3

<table>
<thead>
<tr>
<th>ASSET</th>
<th>DECLINE IN VALUE DEDUCTION</th>
<th>CAPITAL WORKS DEDUCTION</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Effective life (years)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Assets acquired before 1 July 2004</td>
<td>Assets acquired from 1 July 2004</td>
</tr>
<tr>
<td>Assets, general:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>air conditioning assets</td>
<td>see table 5 on page 36</td>
<td>see table 5 on page 36</td>
</tr>
<tr>
<td>cable trays</td>
<td></td>
<td>✔</td>
</tr>
<tr>
<td>ceiling fans</td>
<td>own estimate</td>
<td>5</td>
</tr>
<tr>
<td>clocks, electric</td>
<td>13 ½</td>
<td>10</td>
</tr>
<tr>
<td>cupboards, other than freestanding</td>
<td></td>
<td></td>
</tr>
<tr>
<td>DVD players</td>
<td>own estimate</td>
<td>5</td>
</tr>
<tr>
<td>door closers</td>
<td>own estimate</td>
<td>10</td>
</tr>
<tr>
<td>door locks and latches (excluding electronic code pads)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>door stops, fixed</td>
<td></td>
<td></td>
</tr>
<tr>
<td>door stops, freestanding</td>
<td>own estimate</td>
<td>10</td>
</tr>
<tr>
<td>electrical assets (including conduits, distribution boards, power points, safety switches, switchboards, switches and wiring)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>escalators (machinery and moving parts)</td>
<td>see table 4 on page 35</td>
<td>see table 4 on page 35</td>
</tr>
<tr>
<td>evaporative coolers</td>
<td>see table 6 on page 37</td>
<td>see table 6 on page 37</td>
</tr>
<tr>
<td>facade, fixed</td>
<td></td>
<td></td>
</tr>
<tr>
<td>floor coverings, fixed (including cork, linoleum, parquetry, tiles and vinyl)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>