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50% and 10% small business and general business tax breaks on new depreciable assets

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The tax break deductions

- 1.1 On 3 February 2009 the Rudd Federal Government announced generous tax break deductions on new depreciating assets acquired by business. These measures form part of the Government's continuing fight against the global economic downturn and are a generous revision of tax breaks which the Government originally announced in December last year.
- 1.2 In its 12 May 2009 Budget the Government further sweetened this tax break for small business entities¹ by increasing the amount of the deduction for such taxpayers to **50%** of the cost of eligible assets **purchased in the period between 13 December 2008 and 31 December 2009, and installed by 31 December 2010**. This represents a significant increase from the 30% previously offered to business taxpayers.
- 1.3 The tax break deductions are significant but temporary and as such clients wishing to claim these deductions need to do so in the time periods specified.
- 1.4 Taxpayers involved in manufacturing, property developers and lessors may be particularly interested in these tax breaks in light of their significant investment in depreciating assets, but they are available to all business taxpayers and there may be joy even for taxpayers in the professional services industry.

¹ Broadly, a "small business entity" is a taxpayer that carries on a business and whose annual turnover is less than \$2 million.



- 1.5 The size of a tax break deduction differs depending on when the relevant depreciating asset was acquired and first used, and a taxpayer's profile. There are also different eligibility requirements for small business entities as compared to other business taxpayers. The tax break deduction can be claimed in respect of motor vehicles provided that the depreciation method adopted is **not** the "cents per kilometre" method.²

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Overview of the tax break deductions

2.1 Key time periods

The tax break deductions are located in Division 41 of the *Income Tax Assessment 1997* ("ITAA97") which provides that taxpayers carrying on a business may claim a one-off tax break deduction on a new depreciating asset in the following circumstances:

- (a) a **50% tax break deduction** is available to a **small business entity** who:
 - (1) acquires the depreciating asset under a contract entered into between 13 December 2008 and 31 December 2009; and
 - (2) has it installed ready for use by 31 December 2010;
- (b) a **30% tax break deduction** is available to a business taxpayer (which is not a small business entity) who:
 - (1) acquires a depreciating asset under a contract entered into between 13 December 2008 and 30 June 2009; and
 - (2) has it installed ready for use by 30 June 2010;
- (c) a **10% tax break deduction** is available to a business taxpayer (which is not a small business entity) who:
 - (1) acquires a depreciating asset under a contract entered into between 13 December 2008 and 31 December 2009;
 - (2) has it installed ready for use by 31 December 2010; and
- (d) in all of the above cases the additional requirements outlined in **paragraph 2.10** must be satisfied.

- 2.2 A **small business entity** is broadly a small business whose annual turnover is less than \$2M. It should be noted that if the same controller has more than one business then each business may be aggregated. The aggregation rules are intricate and specific advice from us should be sought if you are concerned.

- 2.3 Entry into an option agreement to acquire a depreciating asset is not sufficient to meet these time period requirements. A taxpayer must enter into a contract to hold³ the asset or otherwise start to hold the asset in some other way before they can claim the tax break deduction. Having a purchase order is not enough to meet the time period requirements.

- 2.4 The tax break deduction is available for new capital expenditure on existing depreciating assets (i.e. improvements and modifications) provided the above time period requirements and the additional requirements outlined in **paragraph 2.10** below are satisfied. Where a depreciating asset is being constructed then the time when the asset is considered to be acquired for the purposes of applying these time period requirements, is the time when the

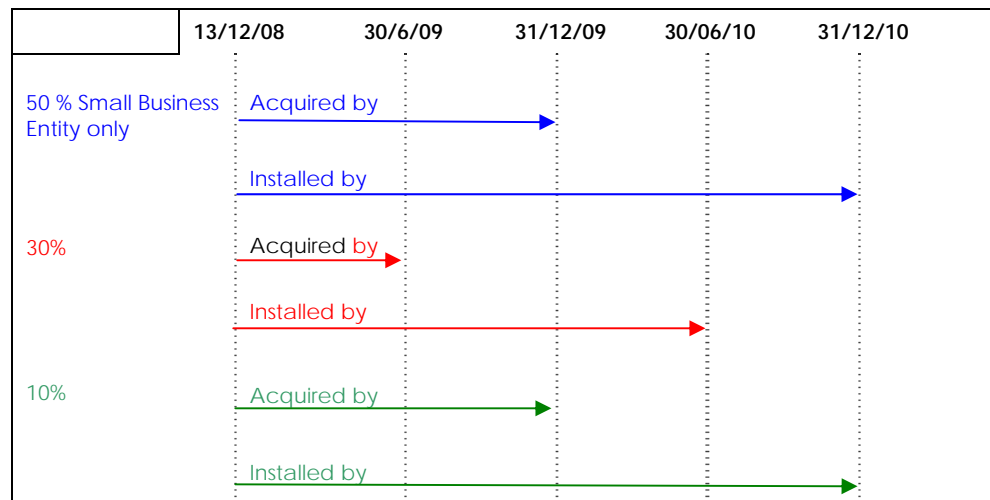
² The luxury car limit will apply to cap the size of the tax break deduction for luxury cars.

³ The concept of "hold" is a tax technical term. See paragraph 2.6 below for a discussion.



taxpayer first incurs expenditure in respect of the construction of the asset or modifications to an existing asset.

- 2.5 No tax break deductions can be claimed where the depreciating asset is acquired under a contract entered into after 31 December 2009 or where installation is not completed by 31 December 2010. There are integrity rules which will deny the tax break deduction to taxpayers who entered into a contract to acquire a depreciating asset before 13 December 2008 and then seek to cancel the contract and enter into a new contract so as to be able to claim the tax break deduction.
- 2.6 The following diagram summarises these important time period requirements.



- 2.7 The tax break deductions are based on the cost of the eligible depreciating asset and would generally be claimed in the income year in which the asset is installed ready for use – that is, the same income year when normal depreciation can be claimed on the asset.
- 2.8 The taxpayer who is entitled to claim the tax break deductions is the entity who is considered the “holder” of the depreciating asset for depreciation purposes.⁴ Generally the “holder” is the legal owner of the asset. However, this may not always be the case where a lease or hire purchase arrangement is involved. For instance, in the case of a leased non-luxury car where the lessee does not have a right to purchase the car, the finance company would be considered the “holder” of the car (and hence the one who would benefit from the tax break) rather than the lessee.⁵ Conversely if a luxury car is leased then the lessee would be considered the “holder” of the car. **If you are uncertain as to whether you will be a “holder” of the depreciating asset contact MBP Legal for advice.**
- 2.9 The tax break deductions are claimed on top of the usual depreciation deductions which may be claimed in respect of the depreciating asset under the existing law. The tax break deduction will not affect the tax written down value of the asset and so it is possible for a taxpayer to deduct more than 100% of the cost of the asset over its effective life. This also means that when the asset is later sold, the fact that a tax break deduction has been claimed will not affect any tax balancing adjustment that the taxpayer has in respect of the asset’s disposal.
- 2.10 **Additional Requirements**
The additional requirements which need to be met before a taxpayer can claim a tax break deduction are as follows:

⁴ ITAA97 s40-40 provides a table that describes who the “holder” is for depreciation purposes.

⁵ It would be up to the lessee to negotiate a reduction in lease payments with the finance company to take into account the finance company’s receipt of the tax break deduction.



- (a) the asset must be a **tangible** depreciating asset – no tax break deductions can be claimed for intangible depreciating assets such as software, information, patents, copyright, registered designs and mining rights;
 - (b) the asset must be “**new**” – the tax break is **not** available for second hand assets, although assets are still considered new if they have only been used for the purposes of reasonable testing and trialling (e.g. demonstrator use⁶);
 - (c) at the first use time of the asset it must be reasonable to conclude that the taxpayer will use the asset principally in Australia for the principal purpose of carrying on a business – subsequent non-business use of the asset after this first use time does not result in a clawback of the tax break deduction;⁷
 - (d) the following minimum cost thresholds must be satisfied:
 - (1) in the case of a small business entity – the cost of the depreciating asset must equal or exceed **\$1,000**;⁸ and
 - (2) in the case of other business taxpayers - the cost of the depreciating asset must equal or exceed **\$10,000**; and
 - (e) subject to certain exceptions, the taxpayer must be able to claim depreciation deductions in respect of the asset under the general deduction provision in section 40-25 of the ITAA97 – this means that a tax break deduction cannot be claimed in respect of assets which already receive concessionary capital allowance deduction treatment⁹ such as primary production assets and capital expenditure for establishing trees in carbon sink forests. Exceptions to this rule (i.e. assets upon which tax break deductions may be claimed even though they do not qualify for depreciation deductions under section 40-25 of the ITAA97) include:
 - (1) motor vehicles where the taxpayer uses the “12% of original value” method;
 - (2) assets which small business entities can claim capital allowance deductions under Subdivision 328-D of the ITAA97; and
 - (3) tangible depreciating assets that qualify for research and development deductions.
- 2.11 Significantly, a tax break deduction is not available for trading stock, land or capital works upon which building depreciation is claimed. This is because such assets do not constitute “depreciating assets”. Where a depreciating asset is a fixture there is an issue as to whether it is considered part of the building (in which case no tax break deduction may be claimed) or whether it is still considered a depreciating asset. The Commissioner of Taxation provides guidance on this issue in Taxation Ruling TR 2004/16, however, in some cases the issue may not always be clear cut.
- 2.12 **Minimum cost thresholds of \$1,000 and \$10,000**
In trying to satisfy the minimum cost threshold, taxpayers are provided with a number of concessionary rules which mean that it is not necessary for a business taxpayer to spend the whole of the threshold amount in one income year on one particular depreciating asset.
- 2.13 The concessionary rules provide that:
- (a) expenditure on a “set” of assets can be grouped for the purposes of meeting the threshold – items will be regarded as a “set” if they are dependant on each other,

⁶ Some demonstrator assets may not be considered 'new' if the dealer has otherwise used the asset for private purposes. Care needs to be had in buying demonstrator assets to ensure that the seller provides a warranty that the demonstrator asset has not otherwise been used for private purposes.

⁷ There may, however, be an increasing adjustment for GST purposes in respect of this change of creditable purpose.

⁸ The cost thresholds outlined in this Brief are all GST-exclusive.

⁹ Under Subdivisions 40-F, 40-G and 40-J of Part 2-10 of the ITAA97.



- marketed as a set, or are designed and intended to be used together e.g. an office telephone system would include all the individual hand sets;
- (b) expenditure on batches of assets which are identical or substantially identical can be grouped for the purposes of meeting the threshold;
 - (c) multiple expenditure over income years in relation to the **same** individual depreciating asset can be aggregated to determine whether the threshold is met – for instance, if a taxpayer (who is not a small business entity), acquires a depreciating asset for \$9,500 in June 2009 and then spends a further \$500 on improving the asset in July 2009, then their expenditure would be grouped to get to the \$10,000 threshold and the tax break deduction may be claimed in the income year ending 30 June 2010. A similar aggregation can occur where a taxpayer purchases a batch of identical assets in June 2009 and then in September 2009 purchases another batch of the identical assets. This aggregation cannot occur in respect of different types of depreciating assets;
 - (d) once a taxpayer satisfies the minimum cost threshold in one income year in respect of a depreciating asset, then any further capital expenditure in respect of that depreciating asset will satisfy the minimum cost threshold and may be eligible for a tax break deduction if the rest of the tax break requirements are met. For instance, say a business taxpayer acquired equipment for \$10,000 and claimed the 30% tax break on it in the 2008/2009 income year. Later in the 2009/2010 income year the taxpayer expends \$2,000 modifying the equipment. The \$2,000 expenditure will be considered to satisfy the minimum cost threshold in the 2009/2010 income year since it is aggregated with the \$10,000 expended on the plant in the 2008/2009 income year. Provided the taxpayer satisfies all the other tax break requirements, this allows the taxpayer to claim a 10% tax break in the 2009/2010 income year in respect of the \$2,000 expenditure.

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“Danger, danger Will Robinson?” – traps and limitations

- 3.1 Whilst the tax break deductions appear generous, a number of practical issues arise when seeking to claim the deductions. Common business equipment purchases may not always be eligible because of the specific eligibility requirements. These difficulties raise the question as to whether the legislation as drafted accurately reflects the Government’s policy in encouraging businesses to invest in these uncertain economic times.
- 3.2 Subject to the concessionary aggregation rules discussed in **paragraph 2.121** above the minimum cost threshold which a taxpayer must satisfy to claim a tax break apply on an asset by asset basis. Accordingly, even though a business (which is not a small business entity) may have bought in aggregate over \$10,000 worth of plant and equipment it may not always be able to claim the tax break if the value of each depreciating asset is less than \$10,000. For instance if a business acquires a printing machine for \$8,000 and an air conditioner for \$6,000, these two items cannot be grouped to reach the \$10,000 threshold.
- 3.3 If a collection of plant and equipment can be considered one composite depreciating asset then the \$10,000 threshold may be met. Whether a set of depreciating assets forms one composite depreciating asset is a question of fact and degree determined in the light of all circumstances of the particular case. This question can often be difficult to answer. A functionality test is generally used to determine this issue. That is, a depreciating asset is considered a separate asset where it is functionally complete by itself. If the depreciating asset requires other depreciating assets to perform its function, then collectively those assets would form one composite depreciating asset. For instance, a railway track is one composite depreciating asset that is made up of sleepers, rails, earthworks and tunnels.



The following example illustrates some of the issues that a business must navigate in order to meet the minimum cost threshold.

EXAMPLE 1

Lucky Co is a professional insolvency firm with an annual turnover of \$14M who wishes to replace its old computer system and IT platform with a new computer system and IT platform in order to claim the new tax break deductions. Lucky Co spends \$423,500 on its new computer system and IT platform comprising

*70 CPU's @ \$2,000 each totalling \$140,000,
1 monitors for each CPU at \$750 per monitor totalling \$52,500,
4 servers @\$7,000 each totalling \$28,000;
6 new black and white printers @\$4,000 each and 2 colour printers @ \$6,000 each totalling \$36,000
new system and user software in the sum of \$120,000;
'ancillaries' at a unit cost of less than \$2,000 per ancillary totalling \$47,000.*

Without the concessionary aggregation rules, Lucky Co would be most unfortunate since it would not be able to meet the \$10,000 minimum cost threshold. This is because Lucky Co's computer system uses a server that links up individual personal computers to one network. In this situation the Commissioner of Taxation would consider that each computer is a separate depreciating asset.¹⁰ The cost of each computer (even if one included the cost of a monitor) is less than \$10,000. Lucky Co is saved, however, by the aggregation rule which allows batches of identical assets to be grouped in determining whether the threshold is met. As a result Lucky Co can aggregate its individual purchases of identical assets to get to the \$10,000 threshold.

Suppose that within the purchase, Lucky Co's managing director wants special modifications to his new computer so that it can run more applications than the standard computers that will be issued to general employees of the company. The director also insists that a special sound card be inserted into the computer so that he can listen to Handel properly at work. The modifications cause the cost of the director's computer to amount to \$5,000. Lucky Co will have difficulty claiming the tax break deduction in respect of the director's computer. The only reason why the tax break deduction can be claimed on the other computers was they were aggregated as a batch of identical assets. It is noted that the aggregation rule stretches to assets which are "substantially identical" but query whether a super computer can be said to be substantially identical to a bog standard computer.

On the basis that the new system and user software are purchased separately from the computer hardware then no tax break deductions can be claimed on the software since they are intangible assets. It is noted that where software is bundled with the purchase of computer hardware (e.g. preloaded operating system software) generally it would be included in the cost of the hardware (and hence be eligible for the tax break deduction), rather than constituting separate software. If the cost of the software is separately itemised on the invoice then the Commissioner's position appears to be that the software would be regarded as a separate asset upon which no tax break may be claimed.¹¹

- 3.4 The tax breaks are more readily available to small business taxpayers because of the lower \$1,000 cost threshold. Even so, such taxpayers still have to wade through minimum cost threshold issues.

EXAMPLE 2

Abacus is a small accounting practice with a turnover that is less than \$2 million. It decides to upgrade its boardroom table and chairs to attract more custom. The total spend is \$4,000 for the new board room table and each of the 10 chairs costs \$400 per chair

¹⁰ See Taxation Ruling TR 94/11.

¹¹ Drawing from the now withdrawn ATO ID 2006/236 which was concerned with exempt fringe benefits and lap top computers.
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Abacus may claim a tax break deduction on the new board room table since its cost exceeds \$1,000. There is an issue as to whether the tax break can be claimed on the chairs which are functionally separate and cost less than \$1,000 each. The concessionary aggregation rules should allow Abacus to claim the tax break on the chairs either because:

(a) the chairs form a set with the table – this would be a question of fact. For instance, if both the table and the chairs were a bespoke set then the issue would be settled. If, however, the chairs were generic and separate in style from the table then they would not be considered a set; or

(b) the chairs form a batch of identical assets which when aggregated have a value which exceeds \$1,000.

As noted above the concessionary aggregation rules only allow aggregation of expenditure in relation to the same depreciating asset and in respect of identical assets. Aggregation of different types of depreciating assets is not permitted. For instance, if Abacus had a turnover of \$10 million and besides the boardroom table and chairs it acquired a new computer at a cost of \$2,000, it would not be able to aggregate the computer with the table and chairs to get to the required \$10,000 minimum cost threshold.

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Opportunities and strategies

- 4.1 Critical to claiming the tax break deductions will be determining eligibility to claim the deductions and timing contracts to acquire depreciating assets to ensure that they are entered into and that the depreciating assets are installed ready for use by the set cut off dates. MPB Legal can provide tax advice in relation to the applicability of these deductions to client purchases and assist in drafting the relevant commercial documentation to facilitate this.
- 4.2 If no written contract is entered into with respect to the acquisition or installation of an asset then care will need to be taken to ensure that a taxpayer has other source documents to substantiate that they have met the required time frames e.g. invoices and purchase orders.
- 4.3 These generous tax break deductions mean that legitimate tax preferred income streams can be created for the benefit of commercially focused clients.
- 4.4 Clients should take care in choosing what business vehicle to acquire the depreciating asset since the benefit of the tax break may not be able to be passed onto the ultimate business owners and instead may be clawed back. For instance, if a company acquired the depreciating asset and claimed the tax break, then the surplus cash resulting from the tax break deduction would be trapped in the company. If the company paid out the cash to its shareholders, then the recipient shareholder would be taxed on the dividend as an unfranked dividend at their marginal tax rate which can be up to 46.5%.
- 4.5 Claw back of the tax break also occurs if a fixed unit trust is used to acquire the depreciating asset since the pay out of cash sheltered from tax by the tax break will write down a unit holder's cost base in their units and to the extent the amount paid out exceeds the cost base will result in a taxable gain for the unit holder. Both these tax results contrast with the situation where a discretionary trust or partnership acquires the depreciating asset. If a discretionary trust acquired the depreciating asset and claimed the tax break, the trust could pay out the surplus cash as a capital distribution without triggering further tax in the hands of the recipient beneficiary. In the case of a partnership the benefit of the tax break deduction would flow directly to the individual partners.