

Worked example

Reduction for over-depreciated assets (step D)

Description This example shows how the tax cost setting amount for over-depreciated assets may be reduced (step D of cost setting process).

Commentary After the joining entity's ACA is allocated among its reset cost base assets in proportion to their market values, and any necessary reductions are made for revenue-like assets (step C of cost setting process), a further reduction may be required for each over-depreciated asset (step D).

This further reduction will be required where all of the following tests are satisfied for the particular asset:

- the asset is over-depreciated at the joining time
- the head company's tax cost setting amount (calculated so far) is more than the joining entity's terminating value for the asset (its tax written down value) at the joining time
- the joining entity paid an unfranked or partly franked dividend during the period from when it acquired the asset to the joining time
- an amount representing the unfranked or partly franked dividend had not been further distributed as a dividend before the joining time to a recipient that was not entitled to the intercorporate dividend rebate, and
- the dividends were paid out of profits that were sheltered from income tax, at least in part, by over-depreciation of the asset.

The amount of the reduction is the least of:

- the over-depreciation amount – this is the lesser of the excess of market value of an asset over its adjustable value just before the joining time (tax written down value at the joining time), and the excess of the asset's cost over its adjustable value at that time
- the amount of income that continues to be sheltered from tax, or
- the amount by which the tax cost setting amount would, apart from this provision, exceed the joining entity's terminating value of the asset.

This reduction prevents an increase in the adjustable value of a depreciating asset where there has been a tax deferral resulting from its over-depreciation. The potential for indefinite deferral arises where a company holds an over-depreciated asset at the joining time, and the income sheltered from tax by the over-depreciation was distributed as an unfranked dividend to a recipient who was entitled to the intercorporate dividend rebate. The example below shows how to work out the reduction for each over-depreciated asset.

In many cases taxpayers will not have sufficient information available to work out the reduction for over-depreciation on an asset-by-asset basis or in strict accordance with section 705-50. In other cases, taxpayers may be able to work

out the amount of reduction accurately, but with significant costs of compliance. For these reasons, administrative short cut methods are available to work out the reduction amounts for over-depreciated assets. These short cut methods give a reasonable approximation of the reduction required by section 705-50 and will generally be accepted by the Tax Office, subject to certain constraints. → 'Reduction for over-depreciated assets (step D) – administrative short cuts', C2-4-640

Example

Facts A joining entity, SubCo, has two depreciating assets, Plant 1 and Plant 2. Their details are shown in the table below. Profits of \$20 were sheltered from income tax by the over-depreciation of Plant 1 and the whole amount was distributed unfranked to SubCo's parent company in a fully rebatable form.

Table 1: Depreciating assets

	Cost	Terminating value (TV)	Market value (MV)	Section 705-40 maximum amount	Tax cost setting amounts after reduction
Plant 1	\$500	\$200	\$220	\$220	\$220
Plant 2	\$300	\$160	\$130	\$160	\$160

The amounts allocated to Plant 1 and Plant 2 are \$220 and \$160 respectively (no reduction was required for revenue-like assets).

Calculation Now consider whether a further reduction to each payment amount is required for over-depreciated assets.

First it is necessary to determine whether the assets are over-depreciated.

Worksheet 1: For Plant 1 – is an asset over-depreciated?

Test for each depreciable asset	Test satisfied? Yes/No	Excess amount (\$)
At the joining time:		
M Does market value exceed adjustable value?	Yes	20
N Does the cost exceed adjustable value?	Yes	300
If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N.		20

The market value of \$220 exceeds the adjustable value of \$200 by \$20. The cost of \$500 exceeds the adjustable value of \$200 by \$300. Under both tests for over-depreciation, Plant 1 is over-depreciated.

The tax cost setting amount for an over-depreciated asset is reduced by the least of the over-depreciation amount (calculated above), the excess of the tax cost setting amount over its terminating value, and the tax deferral amount (worksheet 2).

Worksheet 2: For Plant 1 – over-depreciation reduction

Test for each over-depreciated asset	\$	\$ amount
<u>Over-depreciation amount</u>		
(a) Over-depreciation amount from previous table		20
<u>Tax cost setting amount exceeds terminating value</u>		
(b) Excess of the tax cost setting amount over its value		20
<u>Tax deferral amount</u>		
(c) <i>Start with</i> the amount of unfranked dividends paid by the joining entity before the joining time, that were subject to section 46 or section 46A rebate	20	
(d) The amount of the profits paid as dividends in (c) above (the <i>qualifying profits amount</i>) that were not subject to tax because of the over-depreciation of the asset, <i>but</i> count only to the extent they were not counted in ACA step 4 and to the extent the deductions for over-depreciation did not form part of a loss that reduced the ACA under step 5, were not counted in ACA step 4 (but the depreciation did not generate a tax loss to be subtracted from the entry ACA at step 5)	20	
(e) The extent to which the dividend in (c) – adjusted to amount in (d) – was <i>not</i> further distributed (directly or indirectly) to a taxpayer who was <i>not</i> entitled to such a rebate. This is the <i>tax deferral amount</i>	20	
<u>Transitional rule on formation</u>		
(f) <i>Add</i> – The tax deferral amount is increased to include any unfrankable undistributed profits accrued to head company and included in ACA step 3 (under transitional rules) to the extent that those profits were not subject to tax because of deductions for depreciation representing over-depreciation, and the deductions did not form part of a loss that reduced the ACA under step 5 (subsection 701-30(3), <i>Income Tax (Transitional Provisions) Act 1997</i> .	0	
(g) Is there a tax deferral amount? How much?	Yes	20
Reduction of tax cost setting amount is the lesser of (a), (b) and (g).		20

The tax cost setting amount for Plant 1 of \$220 must be further reduced by \$20 to \$200. (However, the \$20 reduction amount is not re-allocated among other assets.)

Worksheet 3: For Plant 2 – is an asset over-depreciated?

Test for each depreciable asset		Test satisfied? Yes/No	Excess amount (\$)
At the joining time:			
M	Does market value exceed adjustable value?	<input type="text" value="No"/>	<input type="text" value="0"/>
N	Does the cost exceed adjustable value?	<input type="text" value="Yes"/>	<input type="text" value="140"/>
If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N.			<input type="text" value="0"/>

The market value of \$130 does not exceed the adjustable value of \$160. The cost of \$300 exceeds the adjustable value of \$160 by \$140. Plant 2 is not over-depreciated, so no further reduction in the payment amount of \$160 is required.

References

Income Tax Assessment Act 1997, section 705-50; as amended by:

- *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1
- *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 2

Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 5.44–52

Income Tax Transitional Provisions Act 1997, subsection 701-30(3); as amended by *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (No. 90 of 2002), Schedule 7