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 (i.e. the tax deferral amount). The example below shows how to work out the reduction for each over-depreciated asset.

Note

Transitional rule on formation

The tax deferral amount is increased to include any unfrankable undistributed profits accrued to the 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.

(subsection701-30(3), *Income Tax (Transitional Provisions) Act 1997*.

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

Note

Proposed changes to consolidation rules

Proposed changes to the treatment of allowable capital expenditure (ACE), transport capital expenditure (TCE) and exploration and prospecting assets will allow over-depreciation adjustments to be made to the tax costs of exploration and prospecting assets and to assets created by ACE and TCE – see Tax Laws Amendment (2004 Measures No. 4) Bill 2004, Schedule 1, Part 4, 'Expenditure relating to mining or quarrying'.

Proposed changes to the consolidation rules will ensure that, where dividends have been paid before the joining time, it is acceptable to treat them as being paid on a LIFO basis in sourcing dividends to the profits of individual years – see Treasury Position Paper No. 24, *Treatment of distributions in the cost allocation process – Last-In-First-Out (LIFO)* on the Consolidation CD or at **www.treasury.gov.au**

Proposed changes to the consolidation rules will clarify the interaction between the cost setting rules and the entry history rule in respect of certain capital allowances claimed under Division 40 of the ITAA 1997 and its predecessor provisions – Tax Laws Amendment (2004 Measures No. 4) Bill 2004, Schedule 1, Part 5, 'Low-value and software development pools'.

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 At the joining time:	Test satisfied? Yes/No	Excess amount ($)
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
	Over-depreciation amount		
(a)	Over-depreciation amount from previous table		20
	Tax cost setting amount exceeds terminating value		
(b)	Excess of the tax cost setting amount over its value		20
	Tax deferral amount		
(c)	*Start with* 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 *qualifying profits amount*) that were not subject to tax because of the over-depreciation of the asset, *but* 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 *not* further distributed (directly or indirectly) to a taxpayer who was *not* entitled to such a rebate. This is the *tax deferral amount*	20	
	Transitional rule on formation		
(f)	*Add* – 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 (subsection701-30(3), *Income Tax (Transitional Provisions) Act 1997*.	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 At the joining time:	Test satisfied? Yes/No	Excess amount ($)
M	Does market value exceed adjustable value?	No	0
N	Does the cost exceed adjustable value?	Yes	140
	If the answer is YES to both questions, the asset is over-depreciated by the lesser of M and N.		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

Revision history

Section C2-4-610 first published (excluding drafts) 2 December 2002 and updated 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
14.7.04	Note on proposed changes to consolidation rules, p. 2.	Proposed legislative amendments.
27.1.05	Insertion of note on transitional rule on formation, p. 2.	For clarification.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).