

*Worked example*

## Reduction for over-depreciated assets (step D) – administrative short cuts

**Description** This example shows how the tax cost setting amount for over-depreciated assets may be calculated (step D of cost setting process) using either one of two administrative short cuts.

**Commentary** After the joining entity's allocable cost amount (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 is 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 (as 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 inter-corporate 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 inter-corporate dividend rebate.

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## Note

### **Determining the extent to which dividends have been paid out of profits sheltered from income tax**

A last-in-first-out (LIFO) method can be used to determine the extent to which dividends were paid out of profits that were sheltered from income tax for the purpose of calculating any reduction to the tax cost setting amounts for over-depreciated assets.

Under the LIFO method, two assumptions are made. Firstly, it is assumed that dividends were paid out of profits of income years in order from the most recent to the earliest. Once the profits have been allocated between income years according to the first assumption, it is further assumed that unfranked distributions were paid out of profits of the relevant year that were not subject to income tax before they were paid out of profits that were subject to income tax. → subsection 705-50(3A), ITAA 1997; paragraphs 1.135 – 1.140 and 1.147 – 1.148 of the Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004

A worked example showing how to calculate the over-depreciation adjustment for each asset is provided separately. → 'Reduction for over-depreciated assets

(step D)', C2-4-610

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, the administrative short cut methods outlined in figure 1 may be used 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 be accepted by the Tax Office.

These administrative short cut methods have been discussed in draft form with representatives of business and the accounting profession to ensure they achieve the legislation's policy objectives and also meet the needs of the user. If these short cut methods are not suitable for your circumstances and you would like to use another administrative approach, contact the Tax Office for guidance.

The administrative short cut methods are summarised in figure 1.

## Note

### **Short cuts cannot be used for grapevines and horticultural plants**

While section 705-50 applies to all depreciating assets under the Uniform Capital Allowances regime in Division 40, these short cut methods are *not* available for grapevines and horticultural plants.

Figure 1: Summary of the over-depreciation short cut process

1	AGGREGATE METHOD	2	ANNUAL METHOD
1A	<p><b>Determine the potential over-depreciation:</b> For all depreciating assets on hand at the joining time, total the excess of the BWDV (book written down value) over the TWDV (tax written down value).</p>	2A	<p><b>Determine the potential over-depreciation:</b> For all depreciating assets on hand at the joining time, total the excess of the BWDV over the TWDV for each year back to the dates of acquisition and work out the incremental increase of the excess each year.</p>
1B	<p><b>Limit the amount of over-depreciation to the extent it could result in untaxed profits:</b> Multiply the result from 1A by 70%.</p>	2B	<p><b>Limit the amount of over-depreciation to the extent it could result in untaxed profits:</b> Multiply the results from 2A for each year by 70%.</p>
1C	<p><b>Reduce the potential over-depreciation adjustment for untaxed profits still in retained earnings at the joining time:</b> Reduce the result from 1B above by the amount of <math>1B \times [a/(a+b+c)]</math> where: a = unfrankable retained earnings at the joining time (excluding any ACA transitional step 3 amount for the joining entity) b = unfranked amount of dividends paid by the joining entity since 1.7.1987, and c = the ACA transitional step 3 amount for the joining entity.</p>	2C	<p><b>Reduce each year's potential over-depreciation adjustment for untaxed profits still in retained earnings at the joining time:</b> Reduce each year's result from 2B above by the amount of <math>2B \times [d/(d+e+f)]</math> where: d = untaxed profits of that year to the extent they are in unfrankable retained earnings at the joining time (excluding those profits that are in any ACA transitional step 3 amount for the joining entity) e = unfranked amount of dividends from untaxed profits of that year paid by the joining entity (or by a transferor under a Subdivision 126-B rollover, to the extent they relate to over-depreciation of the rollover assets), and f = untaxed profits of that year that are in the ACA transitional step 3 amount for the joining entity.</p>
1D	<p><b>Remove double counting of revenue tax losses:</b> Reduce the result from 1C above to the extent that the over-depreciation resulted in any revenue tax losses in the ACA step 5 adjustment for the joining entity.</p>	2D	<p><b>Other adjustments that may reduce the over-depreciation amount:</b> Reduce each year's result from 2C above to the extent resulting unfranked dividends paid were pre-acquisition dividends in ACA step 4.</p>
1E	<p><b>Limit adjustment to total unfranked dividends paid and transitional step 3 ACA amounts:</b> Reduce the result from 1D above to the extent that it exceeds the total of the following amounts: (a) unfranked dividends paid by joining entity since 1.7.1987, and (b) transitional step 3 unfranked profits.</p>	2E	<p>Reduce each year's result from 2D above to the extent that the over-depreciation resulted in any revenue tax losses in the ACA step 5 adjustment for the joining entity.</p>
		2F	<p>Reduce each year's result from 2E above to the extent that direct or indirect shareholders paid tax on the resulting unfranked dividends paid (excluding dividends that have resulted in a 2D reduction)</p>
1F	<p><b>Estimate the over-depreciation reduction amount per asset:</b> Allocate the result from 1E above between each asset that has been prima facie stepped up proportionately based on the amount of each asset's prima facie cost base step up (prior to the application of the over-depreciation adjustment).</p>	2G	<p>Add each year's result from 2F above.</p>
		2H	<p><b>Limit adjustment to total unfranked dividends paid and transitional step 3 ACA amounts:</b> Reduce the result from 2G above to the extent that it exceeds the total of the following amounts: (a) unfranked dividends paid by the joining entity (or by a transferor under a Subdivision 126-B rollover, to the extent they relate to over-depreciation of the rollover assets), and (b) transitional step 3 unfranked profits.</p>
		2I	<p><b>Estimate the over-depreciation reduction amount per asset:</b> Allocate the result from 2H above to each asset proportionately based on each asset's excess of BWDV over TWDV.</p>

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## Notes to figure 1, Aggregate Method

This is the simplest method for calculating the over-depreciation reduction and will minimise the cost of compliance. Broadly, this approach compares book and tax written down values at the joining time and draws some conclusions as to how the difference has given rise to prior unfranked dividends or untaxed profits that are attributable to over-depreciation.

While less precise than the Annual Method, the Aggregate Method is still considered to provide a reasonable estimate of the over-depreciation adjustment. Taxpayers should note that a different result will arise under the Annual Method. This could be higher or lower than the result under the Aggregate Method.

**Step 1A:** In some cases taxpayers may have assets with book written down values (BWDV) less than their tax adjustable values (TWDV); for example, where there have been write-downs of depreciating assets for accounting purposes. Where the difference is significant, inclusion of those assets in step 1A could materially impact on the result. If an asset's adjustable value (its tax written down value) is more than 1% of the joining entity's ACA and its TWDV is greater than its BWDV, that asset should be excluded from the calculation.

**Step 1C variable b:** Taxpayers should not include pre-1 July 1987 dividends in the variable 'b' amount. Ordinarily, those dividends pre-date the dividend imputation system, and taxpayers may be required to undertake a detailed analysis of those dividends to ascertain the extent to which they were paid out of untaxed profits. In the interests of minimising the costs of compliance, those dividends are not included in the Aggregate Method.

**Step 1D:** Where losses have been subtracted at step 5 in calculating the ACA they are not counted again in working out the reduction for over-depreciation. The relevant amount can be estimated by considering the ACA step 5 losses for each relevant year, and the difference between the total book and tax depreciation claim for that year. This information should be readily available in the joining entity's prior year income tax returns or working papers. Where only part of a loss for a year remains unused at the joining time, the component attributable to over-depreciation can be worked out by apportioning the remainder between over-depreciation and profits sheltered from tax for other reasons (e.g. R&D) on a pro-rata basis.

**Step 1E amount (a):** If ascertainable, exclude any such dividends paid before the acquisition date of depreciating assets held at the joining time. To maintain consistency with step 1C, only dividends paid from 1 July 1987 should be counted.

**Step 1F:** In order to keep compliance costs to a minimum, the Aggregate Method involves a proportional allocation of the overall over-depreciation adjustment amount based on the initial cost base step-up.

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## Note

Where *Law Administration Practice Statement PS LA 2004/12* is being applied in determining the tax cost setting amounts (TCSAs) for depreciating assets, this step should be applied subject to paragraph 44 of that practice statement. That is, first allocate the result from step 1E to significant individual assets and to categories of non-significant assets; then, within a category of non-significant assets, allocate the result across the individual assets within that category on the basis of their book written down values.

### Notes to figure 1, Annual Method

This approach considers over-depreciation on a yearly basis, but again by reference only to assets on hand at the joining time. Over-depreciation may have been recovered for assets sold before the joining time. In effect, this method 'reconstructs' the historical differences between book and tax depreciation. It also considers unfranked dividends and untaxed profits on a year by year basis.

This method also differs from the Aggregate Method in that it takes account of dividends paid out of pre-acquisition profits (step 2D). It also has regard to whether direct or indirect shareholders paid tax on unfranked dividends relating to over-depreciation (step 2F).

These additional steps mean that this method may more closely approximate the adjustment required by section 705-50.

**Step 2A:** In some cases taxpayers may have assets with book written down values (BWDV) less than their tax adjustable values (TWDV); for example, where there have been write-downs of depreciating assets for accounting purposes. Where the difference is significant, inclusion of those assets in step 2A could materially affect the result. If an asset's adjustable value (TWDV) is more than 1% of the joining entity's ACA and its TWDV is greater than its BWDV, that asset should be excluded from the calculation.

*Tip:* The easiest way to work out the annual amounts may be to import details of all depreciating assets, along with the book and tax WDV's, depreciation rates and methods into a spreadsheet. Then reconstruct annual book and tax depreciation for each asset for each year.

Note: Reconstruction of book and tax WDV for assets on hand at the joining time results in a reasonably accurate calculation of the total over-depreciation amount. However this requirement may give rise to a significant compliance burden. As an alternative, companies may base the step 2A amounts on the actual difference between book and tax WDV year by year. This alternative may have the effect of over-stating the over-depreciation for a year, because its use could involve counting the difference for assets held in that year but not held at the joining time. However, this would have a trade-off in reduced compliance costs.

**Step 2B:** The percentage of 70% used here reflects the current general company tax rate. Even though different tax rates may have applied in the

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years leading up to the joining time, restatement of future tax liabilities at the new rates will release (or draw) profits such that the amount available for distribution will be aligned with the tax rate at the joining time.

Taxpayers may use a percentage based on the tax rate applicable for a particular year in this step, instead of using 70%, provided adjustments are made to the potential over-depreciation figure to reflect the impact of changes in the tax rate on the deferred (or future) tax liability account and the consequential change to distributable profits in the year the tax rate changed.

**Step 2C variable e:** Variable 'e' in the formula could potentially include pre-1 July 1987 dividends, which pre-date the dividend imputation system. The Tax Office has issued Taxation Determination TD 2004/4 which confirms that dividends paid before 1 July 1987 are unfranked dividends for the purposes of section 705-50 and therefore should be counted. Given the removal of the inter-corporate dividend rebate for non-group public company shareholders from 1 July 2000, dividends after 30 June 2000 should not be counted in variable 'e' where the public company examined is not a wholly-owned subsidiary of another resident public company.

Variable 'e' should also include unfranked dividends paid by a transferor of a depreciating asset under a Subdivision 126-B rollover, to the extent the dividend was paid out of profits of the transferor that were sheltered from tax by over-depreciation of the transferred asset. If the annual method is also used to work out the over-depreciation adjustment for depreciating assets still held by the transferor when it joins the consolidated group, dividends related to rollover assets counted at variable 'e' in step 2C in the transferee's calculation should not be counted in steps 2C and 2H of the transferor's calculation. This will prevent double counting of those dividends.

**Step 2D:** To the extent that dividends paid out of profits sheltered from income tax because of over-depreciation have been subtracted at step 4 in calculating the ACA, they are not counted again in working out the reduction for over-depreciation. This amount should be subtracted at step 2D of the short cut process.

**Step 2E:** This is the same process as in step 1D.

**Step 2F:** Where unfranked dividends from profits sheltered from tax by over-depreciation have been paid as (or used to pay) unfranked dividends by a public company, it may not be possible for the consolidated group to work out the extent to which those dividends have ultimately reached the hands of recipients not entitled to the inter-corporate dividend rebate. Such a tracing exercise would also involve significant costs.

In those cases, an analysis of the public company's share register should be undertaken to estimate the breakdown between those shares for which it is clear the shareholder would not be entitled to the inter-corporate dividend rebate (e.g. an individual or non-resident), and those for which it is unclear who may be the ultimate recipient (e.g. a nominee). A methodology for



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estimating the step 2F amount, without the need for tracing, is explained in example 3.

Where a taxpayer is able to demonstrate that a higher percentage of dividends ultimately reaches beneficial shareholders who not entitled to the inter-corporate dividend rebate, that higher percentage may be used at step 2F.

**Note:**

Where a public company does not use either the Aggregate or Annual method but calculates the over-depreciation adjustment otherwise in accordance with the requirements of section 705-50, the Tax Office will accept Step 2F being used to ascertain the extent to which the unfranked dividends reached the hands of direct or indirect shareholders who were not entitled to the inter-corporate dividend rebate.

Step 2F is not available to be used in conjunction with the Aggregate Method.

**Step 2H amount (a):** If ascertainable, excluding any such dividends paid before the acquisition date of depreciating assets held at the joining time. However, dividends paid by a transferor of an asset subject to a rollover under Subdivision 126-B that relate to over-depreciation of the asset in the hands of the transferor should be included.

If the annual method is also used to work out the over-depreciation adjustment for depreciating assets still held by the transferor when it joins the consolidated group, dividends related to rollover assets counted at variable 'e' in step 2C in the transferee's calculation should not be counted in steps 2C and 2H of the transferor's calculation. This will prevent double counting of those dividends.

Given the removal of the inter-corporate dividend rebate for non-group public company shareholders from 1 July 2000, dividends after 30 June 2000 should not be counted in amount 'a' where the public company examined is not a wholly-owned subsidiary of another resident public company.

**Step 2I:** The Annual Method uses a proportional allocation of the overall over-depreciation adjustment amount based on the difference between the book written down value (BWDV) and the tax adjustable value or written down value (TWDV). This is different to the allocation under the Aggregate Method, and more closely approximates the methodology required by section 705-50.

**Note**

Where *Law Administration Practice Statement PS LA 2004/12* is being applied in determining the TCSAs for depreciating assets, this step should be applied subject to paragraph 44 of that practice statement. That is, first allocate the result from step 1E to significant individual assets and to categories of non-significant assets; then, within a category of non-significant assets, allocate the result across the individual assets within that category on the basis of their book written down values.

## Example 1 – Aggregate Method

**Facts** Sub Co was incorporated by Hold Co on 1 July 1995. Hold Co elects to form a consolidated group on 1 July 2002. Sub Co's financial position is as follows:

**Table 1: Sub Co – financial position at 30 June 2002**

Cash	13,144	Capital	50,000
Stock on hand	6,693	Retained earnings (loss)	(298)
Depreciating assets	9,520	Asset revaluation reserve	1,350
Other assets	23,850	Provision for long service	1,393
Future tax asset	418	Future tax liability	1,180
		Provision for income tax	0
	<u>53,625</u>		<u>53,625</u>

Sub Co's franking account has a credit balance on 20 June 2002 of \$56. After adjusting for hypothetical payments etc. under subsection 705-90(4), the hypothetical balance is \$56.

Sub Co's depreciation schedules for the year ending 30 June 2002 are shown in tables 2 and 3. In this case the market values (MV) of depreciating assets are equal to their book values at the joining time.

Sub Co incurs a tax loss of \$640 in the year ending 30 June 2002. Tax deductions related to over-depreciation and R&D for that year are \$378 and \$26 respectively. As the total loss exceeds these tax deductions, \$378 of the loss is treated as being attributable to deductions related to over-depreciation. But for the loss incurred in the year ending 30 June 2002, Sub Co would have had \$99 in undistributed profits accrued to the head company able to be counted in ACA step 3.

Before the consolidated group was formed, Sub Co paid a total of \$1,135 in unfranked dividends. These were partly attributable to profits sheltered from tax by over-depreciation and partly attributable to profits sheltered from tax by concessional deductions for research and development expenditure.



**Table 2: Accounting depreciation schedule for year ending 30 June 2002**

Asset	Cost	Opening WDV	Method	Life (years)	Rate %	Depreciation	Closing WDV
Asset 1	1,100	732	PC	15	6.7	74	658
Asset 2	1,200	480	PC	10	10	120	360
Asset 3	1,300	1,040	PC	20	5	65	975
Asset 4	1,400	980	PC	10	10	140	840
Asset 5	1,500	1,283	DV	20	7.5	96	1,187
Asset 6	1,600	1,493	PC	15	6.7	107	1,386
Asset 7	1,700	1,700	DV	5	30	510	1,190
Asset 8	1,800	781	DV	12	13	101	679
Asset 9	1,900	1,487	DV	40	4	59	1,428
Asset 10	2,000	929	DV	8	12	111	817
<b>Total</b>		<b>10,904</b>				<b>1,385</b>	<b>9,520</b>

**Table 3: Income tax depreciation schedule for year ending 30 June 2002**

Asset	Cost	Opening WDV	Method	Life (years)	Rate %	Depreciation	Closing WDV
Asset 1	1,100	385	PC	15	13	143	242
Asset 2	1,200	0	PC	10	17	0	0
Asset 3	1,300	624	PC	20	13	169	455
Asset 4	1,400	686	PC	10	17	238	448
Asset 5	1,500	1,110	PC	20	13	195	915
Asset 6	1,600	1,280	DV	15	20	256	1,024
Asset 7	1,700	1,700	DV	5	30	510	1,190
Asset 8	1,800	320	DV	12	25	80	240
Asset 9	1,900	1,010	DV	40	10	101	909
Asset 10	2,000	235	DV	8	30	71	164
<b>Total</b>		<b>7,350</b>				<b>1,763</b>	<b>5,587</b>

## Calculation Worksheet 1: ACA calculation

<b>Step 1</b>			
Cost base (CB) of membership interests (indexed)		52,450	
Reduced cost base (RCB) of membership interests		50,000	
Market value (MV) of membership interests		56,552	
MV exceeds CB, so use CB			52,450
<b>Step 2</b>			
Add: Liabilities			
Provision for long service leave (note 1)		975	
Provision for income tax		0	
<b>Future tax liability (note 2)</b>		716	1,691
<b>Result after step 2</b>			54,141
<b>Step 3</b>			
Add: Frankable undistributed owned profits	0		
<i>Transitional rule</i> for transitional entity			
Add: Unfrankable undistributed owned profits	0	0	
<b>Result after step 3</b>			54,141
<b>Step 3A</b>			
Adjust for Subdivision 126-B rollovers by non-resident	NA		0
<b>Result after step 3A</b>			54,141
<b>Extra step on formation only</b>			
Adjust for Subdivision 126-B rollovers by head company	NA		0
<b>Result after formation rollover adjustment</b>			54,141
<b>Step 4</b>			
Subtract: distributions of acquired profits		0	
Distributions of owned profits recouping owned loss		0	0
<b>Result after step 4</b>			54,141
<b>Step 5</b>			
Subtract: owned unused losses		640	
Exclude to extent step 3 amount reduced		99	541
<b>Result after step 5</b>			53,600
<b>Step 6</b>			
Subtract: tax benefit from acquired transferred losses		0	
(acquired transferred losses x general company tax rate)	x 30%	0	0
<b>Result after step 6</b>			53,600
<b>Step 7</b>			
Subtract certain inherited deductions	NA		0
<b>Result after step 7 is the ACA</b>			53,600

**Note 1.** Accounting value of the long service leave provision requires adjustment under section 705-75 and section 705-80. It is assumed the amount after such adjustments is as shown.

**Note 2.** The future tax liability to be carried by the head company in respect of depreciating assets is counted at step 2, under subsection 705-70(1A). It is assumed the amount is as shown.

**Note 3.** Step 5 excludes losses accrued to the group to the extent that they have reduced the accounting profits available for distribution: subsection 705-100(2). The balance of retained earnings prior to the year commencing 1 July 2001 was \$99. This amount would have been counted at step 3 as it would have been payable as a fully franked dividend, but for the loss made in the 2001-02 year. The step 5 amount is reduced accordingly.

## Retained cost base assets

Cash (\$13,144) and trading stock (\$6,693) retain their existing tax values. In this example Sub Co is a continuing majority owned entity, so items of trading stock are treated as retained cost base assets.

The remainder of the ACA after setting the tax cost of retained cost base assets is \$33,763. This is allocated among the reset cost base assets (table 4). The tax cost setting amount (TCSA) for revenue-like assets, such as depreciating assets, is limited to the greater of their market value or terminating value (i.e. tax adjustable value at the joining time). Assets 11 to 19 are not revenue-like assets.

Table 4: First cut apportionment to reset cost base assets

Asset	Cost (\$)	Terminating value (\$)	Market value (\$)	Apportionment	Tax cost setting amount before reduction (\$)	Section 705-40 max. amount (\$)	Excess for revenue-like assets (\$)	Tax cost setting amount after reduction (\$)
<b>Depreciating assets</b>								
1	1,100	242	658	33,763 x 658/38,870	571	658	0	571
2	1,200	0	360	33,763 x 360/38,870	313	360	0	313
3	1,300	455	975	33,763 x 975/38,870	847	975	0	847
4	1,400	448	840	33,763 x 840/38,870	730	840	0	730
5	1,500	915	1,187	33,763 x 1,187/38,870	1,031	1,187	0	1,031
6	1,600	1,024	1,386	33,763 x 1,386/38,870	1,204	1,386	0	1,204
7	1,700	1,190	1,190	33,763 x 1,190/38,870	1,034	1,190	0	1,034
8	1,800	240	679	33,763 x 679/38,870	590	679	0	590
9	1,900	909	1,428	33,763 x 1,428/38,870	1,240	1,428	0	1,240
<b>Non-depreciating assets</b>								
10	2,000	164	817	33,763 x 817/38,870	710	817	0	710
11	2,100	2,204	2,210	33,763 x 2,210/38,870	1,920	–	–	1,920
12	2,200	2,309	2,320	33,763 x 2,320/38,870	2,015	–	–	2,015
13	2,300	2,413	2,430	33,763 x 2,430/38,870	2,111	–	–	2,111
14	2,400	2,518	2,540	33,763 x 2,540/38,870	2,206	–	–	2,206
15	2,500	2,623	2,550	33,763 x 2,550/38,870	2,215	–	–	2,215
16	2,600	2,728	2,600	33,763 x 2,600/38,870	2,258	–	–	2,258
17	2,700	2,833	2,500	33,763 x 2,500/38,870	2,172	–	–	2,172
18	2,800	2,938	2,450	33,763 x 2,450/38,870	2,128	–	–	2,128
19	2,900	3,043	2,750	33,763 x 2,750/38,870	2,389	–	–	2,389
Good-will	0	0	7,000	33,763 x 7,000/38,870	6,080	–	–	6,080
<b>Total</b>			<b>38,870</b>		<b>33,763</b>			<b>33,763</b>

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**Table 5: Adjustment for over-depreciation using the Aggregate Method**

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<b>Step 1A. Potential for over-depreciation</b>		
Total book written down value (BWDV)	9,520	
Less: total tax written down values (TWDV)	5,588	
Result of step 1A		3,932
<b>Step 1B. Limit 1A to extent it could result in untaxed profits</b>		
Result of step 1B (Result of 1A x 70%, i.e. 3,932 x 70%)		2,752
<b>Step 1C. Reduce potential for untaxed profits still in retained earnings</b>		
Subtract $1B \times a / (a + b + c)$ from result of step 1B, where:		
a = unfrankable retained earnings (excluding transitional step 3)	0	
b = unfranked amount of prior dividends paid since 1987	1,135	
c = transitional additional step 3 ACA amount	0	
$[2,752 \times (0/0 + 1,135 + 0) = 0]$		0
Result of step 1C		2,752
<b>Step 1D. Remove double counting for unused losses</b>		
Unused loss of \$640 for the 2001–02 year		
\$378 relates to over-depreciation		378
Result of step 1D		2,374
<b>Step 1E. Limit to unfranked dividends plus transitional step 3 ACA</b>		
Total unfranked dividends since 1987	1,135	
Add: transitional step 3 ACA amount	0	
Result of step 1E		1,135

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**Step 1F:** The amount at step 1E is allocated in table 6 to each of the depreciating assets on a pro-rata basis according to the potential step-up of tax value.

**Table 6: Allocation of over-depreciation aggregate adjustment**

Asset	TWDV (AV)	TCSA (Table 4)	Potential step up	Pro-rata according to potential step up	Over-depreciation adjustment	New TCSA
1	242	571	329	$1,135 \times 329/2,839$	132	439
2	0	313	313	$1,135 \times 313/2,839$	125	188
3	455	847	392	$1,135 \times 392/2,839$	157	690
4	448	730	282	$1,135 \times 282/2,839$	113	617
5	915	1,031	116	$1,135 \times 116/2,839$	46	985
6	1,024	1,204	180	$1,135 \times 180/2,839$	72	1,132
7	1,190	1,034	0	$1,135 \times 0/2,839$	0	1,034
8	240	590	350	$1,135 \times 350/2,839$	140	450
9	909	1,240	331	$1,135 \times 331/2,839$	133	1,107
10	164	710	546	$1,135 \times 546/2,839$	217	493
<b>Total</b>	<b>5,587</b>		<b>2,839</b>		<b>1,135</b>	

Note that the over-depreciation adjustment must not reduce the TCSA below the depreciating asset's tax written down value (i.e. its adjustable value) at the joining time.

## Example 2 – Annual Method

**Facts** The facts are the same as for example 1. The taxpayer wishes to use the Annual Method outlined in figure 1 to estimate the total amount of reduction for over-depreciation.

**Table 7: Known data**

Asset	Cost \$	Tax method	Tax depreciation rate (%)	Tax depreciation y/e 30.6.02	TWDV 30.6.02	Book method	Book depreciation rate (%)	Book depreciation y/e 30.6.02	BWDV 30.6.02
1	1,100	PC	13	143	242	PC	6.7	74	658
2	1,200	PC	17	0	0	PC	10	120	360
3	1,300	PC	13	169	455	PC	5	65	975
4	1,400	PC	17	238	448	PC	10	140	840
5	1,500	PC	13	195	915	DVM	7.5	96	1,187
6	1,600	DV	20	256	1,024	PC	6.7	107	1,386
7	1,700	DV	30	510	1,190	DVM	30	510	1,190
8	1,800	DV	25	80	240	DVM	13	101	679
9	1,900	DV	10	101	909	DVM	4	59	1,428
10	2,000	DV	30	71	165	DVM	12	111	817

**Table 8: Calculating TWDV extrapolating backwards to acquisition time**

Asset	Cost	TWDV	TWDVs calculated for these dates						
		30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96	1.7.95
1	1,100	242	385	528	671	814	957	1,100	
2	1,200	0	0	0	0	0	0	0	0
3	1,300	455	624	793	962	1,131	1,300		
4	1,400	448	686	924	1,162	1,400			
5	1,500	915	1,110	1,305	1,500				
6	1,600	1,024	1,280	1,600					
7	1,700	1,190	1,700						
8	1,800	240	320	427	569	759	1,013	1,350	1,800
9	1,900	909	1,010	1,122	1,247	1,385	1,539	1,710	1,900
10	2,000	165	235	336	480	686	980	1,400	2,000
<b>Total</b>		<b>5,588</b>	<b>7,350</b>	<b>7,035</b>	<b>6,591</b>	<b>6,175</b>	<b>5,789</b>	<b>5,560</b>	<b>5,700</b>

Assets 1 to 5 were depreciated for tax purposes using the prime cost (PC) method. The TWDVs as at 30.6.01 were calculated by simply adding back the annual depreciation amount to the TWDV at 30.6.02. This method was used for each asset until its cost was reached. Note that no amount has been

calculated for asset 2, as this asset had been written off for tax purposes before the joining time. Further work is necessary to work out the TWDVs for asset 2.

Assets 6 to 10 were depreciated using the diminishing value (DV) method. Asset 6's TWDV as at 30.6.01 was worked out by multiplying the TWDV at 30.6.02 by 100/80. The figure of 80 is 100 minus the depreciation rate of 20% – i.e.  $\$1,024 \times 100/80 = \$1,280$ . For the next year back, the TWDV was worked out at  $\$1,280 \times 100/80$ . This method was used for each asset until its cost was reached.

**Table 9: Calculating BWDV extrapolating backwards to acquisition time**

Asset	BWDV		BWDVs calculated for these dates					
	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96	1.7.95
1	658	732	805	879	953	1,026	1,100	
2	360	480	600	720	840	960	1,080	1,200
3	975	1,040	1,105	1,170	1,235	1,300		
4	840	980	1,120	1,260	1,400			
5	1,187	1,283	1,388	1,500				
6	1,386	1,493	1,600					
7	1,190	1,700						
8	679	781	897	1,031	1,185	1,362	1,566	1,800
9	1,428	1,487	1,549	1,614	1,681	1,751	1,824	1,900
10	817	929	1,055	1,199	1,363	1,549	1,760	2,000
<b>Total</b>	<b>9,520</b>	<b>10,904</b>	<b>10,120</b>	<b>9,373</b>	<b>8,657</b>	<b>7,949</b>	<b>7,330</b>	

Table 9 uses the same methods used in table 8 to calculate the BWDVs.

Table 9 shows asset 2 was acquired on 1.7.95. We can now go back and work out the TWDVs for that asset, working forward from the acquisition time calculated in table 9.

**Table 10: Calculating TWDV for asset 2 and adding to totals for table 8**

Asset	Cost	TWDV		TWDVs calculated for these dates					
		30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96	1.7.95
2	1,200	0	0	180	384	588	792	996	1,200
Sub-total from table 8		5,588	7,350	7,035	6,591	6,175	5,789	5,560	
<b>Total</b>		<b>5,588</b>	<b>7,350</b>	<b>7,215</b>	<b>6,975</b>	<b>6,763</b>	<b>6,581</b>	<b>6,556</b>	



**Table 11: Step 2A – Incremental increase in excess of book and tax written down values**

	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96	Total
BWDVs from table 9	9,520	10,904	10,120	9,373	8,657	7,949	7,330	
TWDVs from table 10	5,588	7,350	7,215	6,975	6,763	6,581	6,556	
Excess	3,932	3,554	2,905	2,398	1,893	1,368	774	
Incremental increase	378	649	507	505	525	594	774	3,932

**Table 12: Step 2B – Limit to extent it could result in untaxed profits**

	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96
Result after step 2A	378	649	507	505	525	594	774
70% = result after step 2B	265	454	355	353	368	416	542

**Table 13: Step 2C – Reduction for certain retained earnings**

	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96
Result after step 2B table 12	265	454	355	353	368	416	542
D	0	0	0	0	0	0	0
E	0	0	218	264	137	355	161
F	0	0	0	0	0	0	0
2B x [d/(d+e+f)]	0	0	0	0	0	0	0
Result after step 2C	265	454	355	353	368	416	542

There were no undistributed profits at the joining time, so no amounts for 'd' and 'f' in the formula in table 13. Accordingly there is no adjustment for step 2C. The amounts for 'e' are based on an analysis of the unfranked dividends paid and summarised in table 14.

**Table 14: Summary of dividends paid before the joining time**

Date	Dividend paid		Out of this year's profits		
	Franked \$	Unfranked \$	Year ended	Taxed \$	Untaxed \$
1.12.96	2,039	161	30.6.96	2,039	161
1.12.97	2,145	355	30.6.97	2,145	355
1.12.98	2,663	137	30.6.98	2,663	137
1.12.99	2,136	264	30.6.99	2,136	264
1.12.00	2,282	218	30.6.00	2,282	218
1.12.01	1,600	0	30.6.01	1,600	0

**Table 15: Step 2D – Reduction for step 4 ACA amount attributable to over-depreciation**

	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96
Result after step 2C	265	454	355	353	368	416	542
Step 4 ACA distributions attributable to over-depreciation	0	0	0	0	0	0	0
Result after step 2D	265	454	355	353	368	416	542

There were no distributions of profits subtracted at ACA step 4.

**Table 16: Step 2E – Reduction for step 5 ACA amount attributable to over-depreciation**

	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96
Result after step 2D	265	454	355	353	368	416	542
Step 5 ACA losses attributable to over-depreciation	265	0	0	0	0	0	0
Result after step 2E	0	454	355	353	368	416	542

**Table 17: Step 2F – Reduction for distributions to individuals etc. not entitled to inter-corporate dividend rebate**

	30.6.02	30.6.01	30.6.00	30.6.99	30.6.98	30.6.97	30.6.96
Result after step 2E	0	455	354	353	368	416	542
Distributions traced to individuals etc.	0	0	0	0	0	0	0
Result after step 2F	0	455	354	353	368	416	542

All of the unfranked rebatable dividends were retained by the head company in this example.

**Step 2G** totals the year-by-year results after step 2F, i.e. \$2,488.

**Table 18: Step 2H – Limit to unfranked dividends plus transitional step 3 ACA**

Total unfranked dividends paid	1,135
Add: transitional step 3 ACA amount	0
Result of step 2H	1,135

The maximum adjustment for over-depreciation is limited to the step 2H amount of \$1,135. This amount is allocated to the depreciating assets in table 19.

**Table 19: Step 2I – Allocation of over-depreciation total adjustment under Annual Method**

Asset	TWDV (AV)	BWDV	Excess of BWDV over TWDV	Pro-rata according to excess of BWDV over TWDV	Over-depreciation adjustment	TCSA (Table 4)	New TCSA
1	242	658	416	$1,135 \times 416/3,932$	120	571	451
2	0	360	360	$1,135 \times 360/3,932$	104	313	209
3	455	975	520	$1,135 \times 520/3,932$	150	847	697
4	448	840	392	$1,135 \times 392/3,932$	113	730	616
5	915	1,187	272	$1,135 \times 272/3,932$	79	1,031	953
6	1,024	1,386	362	$1,135 \times 362/3,932$	104	1,204	1,099
7	1,190	1,190	0	$1,135 \times 0/3,932$	0	1,034	1,034
8	240	679	439	$1,135 \times 439/3,932$	127	590	463
9	909	1,428	519	$1,135 \times 519/3,932$	150	1,240	1,090
10	165	817	652	$1,135 \times 652/3,932$	188	710	522
<b>Total</b>	<b>5,588</b>	<b>9,520</b>	<b>3,932</b>		<b>1,135</b>		

Note that the over-depreciation adjustment must not reduce the TCSA below the depreciating asset's tax written down value (i.e. its adjustable value) at the joining time.

The method of apportionment in table 19 is different to that used in table 6, as the Annual Method provides more detailed information, allowing a better estimate of the reduction amount than is afforded by the Aggregate Method.

### Example 3 **Estimating the proportion of unfranked dividends paid by listed public companies that reach entities not entitled to the inter-corporate dividend rebate**

For the purpose of working out the amount to be excluded at step 2F of the short cut method for calculating the over-depreciation reduction amount, the Tax Office will accept an estimate worked out as follows:

1. Examine the largest 20 shareholders named in the public company's annual report, determine the category (in table 20) that each falls into and apply the proportions set out in the table to the share percentage held by each of these top 20 shareholders to arrive at a ratio for the total shareholding of the top 20.
2. Apply the ratio worked out in step 1 for the top 20 shareholders to the remaining shareholders to arrive at an estimated breakdown between entitled and not entitled for those remaining shareholders.
3. Add step 1 and step 2 amounts.

**Table 20: Ratios for different shareholder categories for use in determining proportions of unfranked dividends to be treated as reaching entities that *are* and *are not* entitled to the inter-corporate dividend rebate**

Shareholder entity category	Proportion of dividends paid to this category of entity treated as ultimately reaching recipients that <i>are</i> entitled to the inter-corporate dividend rebate	Proportion of dividends paid to this category of entity treated as ultimately reaching recipients that <i>are not</i> entitled to the inter-corporate dividend rebate
Public company	55%	45%
Life insurance company	25%	75%
Corporate unit trust	15%	85%
Public trading trust	15%	85%
Other trusts	15%	85%
Superannuation fund	0%	100%
Private company	0%	100%
Nominee	25%	75%
Individual	0%	100%
Non-resident	0%	100%
Exempt body	0%	100%

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The final percentage for all shareholders in the 'not entitled' category after step 3 is treated as being the proportion of unfranked dividends that ultimately reached beneficial owners not entitled to the inter-corporate dividend rebate. The balance is treated as the proportion not reaching such beneficial owners.

The results under this method for a sample financial year may be used for other years, provided there has been no significant change in the shareholder mix. Where there has been a significant change, sampling will be necessary either side of the period of abnormal trading to ensure the samples are more representative of the mix of shareholder categories for those years.

The proportion of life companies, other public companies, trusts, and nominees treated as being entitled to the inter-corporate dividend rebate has been based on statistical analysis of shareholder types, retention of profits rates, and varying entitlements to the rebate depending on the type of entity involved.

Where a taxpayer is able to demonstrate that a higher percentage of dividends ultimately reaches beneficial shareholders who are not entitled to the inter-corporate dividend rebate, that higher percentage may be used at step 2F.

Note: This method for estimating the step 2F amount is only available for dividends paid by listed public companies.

**Facts** Company X is a listed public company. It elects to consolidate, with S Co as one of its wholly owned subsidiaries. It received unfranked rebatable dividends from S Co before consolidation, attributable to profits made by S Co that were sheltered from tax by over-depreciation. Company X used these funds to pay unfranked dividends. Company X is unable to work out precisely the extent to which these dividends reached beneficial owners not entitled to the inter-corporate dividend rebate. This is due primarily to large shareholdings by nominees. Company X's largest 20 shareholders are listed in table 21. Shareholder 5 is a life insurance company.

**Calculation** The shareholders are first categorised according to entitlement to the inter-corporate dividend rebate (table 21).

**Table 21: Estimating the amount to be subtracted under step 2F**

Shareholder	% held	Ratio of entitled to not entitled	Entitlement to inter-corporate dividend rebate	
			Entitled	Not entitled
<b>Top 20</b>				
1. Nominee A	9.1	25:75	2.28	6.82
2. Nominee B	6.4	25:75	1.60	4.80
3. Nominee C	5.1	25:75	1.28	3.82
4. Individual X	2.2	0:100		2.20
5. Public company A (life insurance coy)	1.7	25:75	0.42	1.28
6. Public company B	1.5	55:45	0.80	0.70
7. Nominee E	1.2	25:75	0.30	0.90
8. Superannuation fund	1.0	0:100		1.00
9. Corporate unit trust	0.8	1:6	0.10	0.70
10. Nominee F	0.8	25:75	0.20	0.60
11. Non-resident 1	0.5	0:100		0.50
12. Public company D	0.4	55:45	0.22	0.18
13. Pooled development fund	0.2	0:100		0.20
14. Non-resident 2	0.1	0:100		0.10
15. Private company A	0.1	0:100		0.10
16. Trustee 1	0.1	1:6	0.01	0.09
17. Trustee 2	0.1	1:6	0.01	0.09
18. Non-resident 3	0.1	0:100		0.10
19. Public trading trust	0.1	1:6	0.01	0.09
20. Tax exempt body	0.1	0:100		0.10
<b>Totals for top 20</b>	<b>31.6</b>		<b>7.23</b>	<b>24.37</b>
Extrapolated to remaining shareholders	68.4		15.65	52.75
<b>Totals for all shareholders</b>	<b>100</b>		<b>22.88</b>	<b>77.12</b>

Shareholdings have been split between the entitled and not entitled categories in the proportions stated above. After this adjustment, the top 20 (31.6%) consists of 7.23% entitled to the inter-corporate dividend rebate under section 46 or section 46A of the ITAA 1936, and 24.37% not entitled to the rebate. The same proportions are applied to the remaining shareholders to get proportions of entitled (22.88%), and not entitled (77.12%). Unfranked dividends in this latter category are not counted in the tax deferral amount for over-depreciation under step 2F.

## References

*Income Tax Assessment Act 1936*, Divisions 46 and 46A

*Income Tax Assessment Act 1997*, section 40-85

*Income Tax Assessment Act 1997*, sections 705-50, 705-70, 705-75, 705-100; 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

*Income Tax Assessment Act 1997*, section 705-80; as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002), Schedule 1

*Income Tax Assessment Act 1997*, Subdivision 126-B

*Income Tax Assessment Act 1997*, subsection 705-90(10); as inserted by *Tax Laws Amendment (2004 Measures No. 6) Act 2005* (No. 23 of 2005), Schedule 1, Part 7

Explanatory Memorandum to Tax Laws Amendment (2004 Measures No. 6) Bill 2004, paragraphs 1.135 – 1.148

Taxation Determination TD 2004/4 – Income tax: Is a dividend paid before 1 July 1987 an unfranked dividend for the purposes of section 705-50 of the *Income Tax Assessment Act 1997*?

### Revision history

Section C2-4-640 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
10.12.04	Constraints on use of short cuts narrowed down so that the only depreciating assets excluded are grapevines and horticultural plants, p. 2.  Reference to new TD 2004/4, p. 6.  Note on use of step 2F by a public company not using either Aggregate or Annual method, p. 7.  Notes on use of steps 1F and 2I where <i>Law Administration Practice Statement PS LA 2004/12</i> is being applied in determining TCSAs for depreciating assets, pp. 4 and 7.	Provided under Commissioner's administrative powers.  Clarification.  Clarification.  Clarification.
26.10.05	New information on determining the extent to which dividends have been paid out of profits sheltered from income tax, p. 2, and change to worksheet 1, step 3, p. 10.	Legislative amendments.



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### 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](http://www.treasury.gov.au) (Treasury papers on refinements to the consolidation regime).