

# ***TR 2023/D2 - Income tax: composite items - identifying the relevant depreciating asset for capital allowances***

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! There are Compendiums for this document: **TR 2024/1EC** and **TR 2017/D1EC** .



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## Draft Taxation Ruling

# Income tax: composite items – identifying the relevant depreciating asset for capital allowances

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### **ⓘ Relying on this draft Ruling**

This publication is a draft for public comment. It represents the Commissioner's preliminary view on how a relevant provision could apply.

If this draft Ruling applies to you and you rely on it reasonably and in good faith, you will not have to pay any interest or penalties in respect of the matters covered, if this draft Ruling turns out to be incorrect and you underpay your tax as a result. However, you may still have to pay the correct amount of tax.

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### What this draft Ruling is about

1. Division 40 of the *Income Tax Assessment Act 1997* provides a deduction for the decline in value of depreciating assets based on their effective life. A ‘depreciating asset’ is an asset that has a limited effective life and that can reasonably be expected to decline in value over the time it is used.<sup>1</sup>
2. All legislative references in this draft Ruling<sup>2</sup> are to the *Income Tax Assessment Act 1997*, unless otherwise indicated.
3. Where an asset consists of a number of components, it is necessary to determine whether that larger asset is itself a depreciating asset, or whether one or more of its components are separate depreciating assets. Identifying the relevant depreciating asset is important for working out its effective life and therefore the rate at which deductions can be claimed. A depreciating asset that is the composite item as a whole may have an effective life that is different to the effective life of any individual component or components. This enquiry may also be relevant when testing an asset’s eligibility for certain immediate tax write-offs and concessions.<sup>3</sup>
4. This Ruling sets out the Commissioner’s views on:
  - relevant principles to assist in determining whether a composite item is itself a depreciating asset or whether its components are separate depreciating assets for the purposes of Division 40 (about capital allowances), and
  - whether an ‘interest in an underlying asset’ for the purposes of section 40-35 requires an entity to have an interest in all parts of a composite item that is itself a depreciating asset, or whether an interest in any part of the asset is enough.
5. This Ruling does not address Division 43 which provides deductions for certain capital works expenditure.<sup>4</sup>

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<sup>1</sup> Section 40-30 of the *Income Tax Assessment Act 1997*. There are exceptions to this: see subsection 40-30(1).

<sup>2</sup> For readability, all further references to ‘this Ruling’ refer to the Ruling as it will read when finalised. Note that this Ruling will not take effect until finalised.

<sup>3</sup> For example, in determining whether the relevant asset’s cost is below the instant asset write-off threshold under section 328-180.

<sup>4</sup> Broadly, Division 40 does not apply to capital works for which a deduction is available under Division 43, or would be available under Division 43 but for the capital works being started before a particular day or used for a relevant purpose. See subsection 40-45(2).

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## Ruling

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### Composite items

6. A ‘composite item’ is an item that is made up of a number of components that are each capable of separate existence.<sup>5</sup> Subsection 40-30(4) directs an objective consideration of whether a particular composite item is itself a depreciating asset, or whether one or more of its components are separate depreciating assets – it is a question of fact and degree to be determined in the circumstances of the particular case.

### Guiding principles

7. The following paragraphs are guidelines intended to assist in identifying the relevant depreciating asset. No one principle is determinative. Every enquiry requires the exercise of judgment in the prevailing factual circumstances. A composite item may be a single depreciating asset in one taxpayer’s circumstances but not in another’s.

8. For a component (or more than one component) of a composite item to be a depreciating asset, it is necessary that the component is (or components are) capable of being separately identified and recognised as having commercial and economic value.

9. Purpose or ‘functionality’ is generally a useful guide to the identification of an item.<sup>6</sup> The main principles that are taken into account in determining whether a composite item is a single depreciating asset, or more than one depreciating asset, are:

- The depreciating asset will ordinarily be an item that performs a **separate identifiable function**, having regard to the purpose it serves in its business context.
- An item may be identified as having a discrete function, and therefore as a depreciating asset, **without necessarily being self-contained** or used on a **stand-alone basis**.
- The greater the degree of **physical or functional integration** of an item with other component parts, the more likely the depreciating asset will be the composite item.
- When the **effect of attaching** an item to another item (which itself has its own independent function) varies the function or operational performance of that other item, the attachment is more likely to be a separate depreciating asset.
- When various components are purchased (whether via one or multiple transactions) to **function together as a system** and are necessarily connected in their operation, the depreciating asset is usually the system (the composite item).

10. The relevant function considered in this context is the actual function the item is to serve in the particular taxpayer’s income-producing activity. Any theoretical function to which the item could be put in other circumstances is irrelevant. (See **Example 5** of this Ruling.)

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<sup>5</sup> *Mitsui & Co (Australia) Ltd v Commissioner of Taxation* [2012] FCAFC 109 (*Mitsui*) at [59]; per Emmett, Bennett and Gilmour JJ.

<sup>6</sup> Paragraph 1.15 of the Revised Explanatory Memorandum to the New Business Tax System (Capital Allowances) Bill 2001. See also *Commissioner of Taxation v Tully Co-operative Sugar Milling Association Ltd* [1983] FCA 163 (*Tully*); 83 ATC 4495 at [4504], per Lockhart J.

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11. To determine if a composite item is a single depreciating asset or more than one depreciating asset, the relative functions of the entire item, against its components, need to be considered in the circumstances in which they are used. (See **Examples 1, 2, 6, 11 and 13** of this Ruling.)

12. A single depreciating asset is not necessarily the smallest possible component which can be identified within a composite item. Several components or parts of a composite item which work together with other components may be parts of a larger functional item, particularly where those components are integrally linked. (See **Examples 1, 8 and 11** of this Ruling.)

13. An item may be considered a separate depreciating asset notwithstanding it performs some wider or commercially more ‘complete’ function in combination or conjunction with other items that are themselves separate depreciating assets. (See **Examples 5, 6 and 14** of this Ruling.)

14. The fact that an item cannot operate on its own and has no commercial utility unless linked or connected to another item or items, does not preclude it from being a separate depreciating asset. Where such items are designed to be used in a range of settings or in conjunction with a wide range of equipment or systems and are not acquired with other items as part of system, this may indicate they are separate depreciating assets. (See **Examples 3, 4 and 6** of this Ruling.)

15. An absence of a fixed physical connection between separate components of a composite item tends to indicate that each separate component is a depreciating asset. (See **Examples 5, 6 and 14** of this Ruling.)

16. Where an element of a system is purchased or installed at a different time to the system (irrespective of its intended operation within a system) and has a separate identifiable function, that element may be a separate depreciating asset. (See **Examples 3 and 4** of this Ruling.)

### **Modifications**

17. A modification or alteration to an existing depreciating asset can itself be a separate depreciating asset. Such modifications can be of varying degrees. (See **Examples 6, 8 and 12** of this Ruling.)

18. Where:

- an addition or attachment substantially alters a depreciating asset (the original depreciating asset)
- the original depreciating asset continues to perform its function, and
- the addition or attachment serves its own function,

the addition or attachment is likely to be a separate depreciating asset from the original depreciating asset when working out deductions for decline in value under Division 40.

19. A modification which restructures or adds new components to an existing depreciating asset will result in the asset being merged into a new depreciating asset where the new depreciating asset has a different purpose or performs a different function from the original depreciating asset.<sup>7</sup>

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<sup>7</sup> See section 40-125. You are taken to have stopped holding the existing depreciating asset and started holding the new (merged) depreciating asset.

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20. By contrast, restorations and minor alterations that do not change the overall function of the existing depreciating asset will not be considered separate depreciating assets. Where expenditure on restoring a depreciating asset to its original condition constitutes a repair, no separate depreciating asset is created and the cost is unchanged for the purposes of calculating the existing depreciating asset's decline in value deductions.<sup>8</sup> (See **Example 9** of this Ruling.)

21. Work undertaken that goes beyond what is required to restore the asset to its original state may constitute a capital improvement. Capital improvements will not necessarily create a new depreciating asset. The principles in this Ruling are applied in determining whether a new depreciating asset has been created.<sup>9</sup>

22. Modifications to certain components of an existing depreciating asset to allow it to perform additional tasks or improve its efficiency will not necessarily be considered a separate depreciating asset. (See **Examples 1** and **10** of this Ruling.)

### **The test for a composite item and depreciating assets is not the test for a facility**

23. Relief from the characterisation of assessable income amounts of a managed investment trust (MIT) as 'non-concessional MIT income' may be available in certain circumstances where there is a 'facility' to which the relevant amount relates.<sup>10</sup>

24. Although the factual inquiry in relation to a composite item and depreciating assets and a 'facility' require similar considerations, these considerations might, and are expected to, sometimes lead to different outcomes. It is necessary to consider the statutory context and purpose for the relevant inquiry.

25. A 'facility', which is considered in the context of whether a concessional withholding rate applies to payments in respect of particular investments, is identified in connection to the land on which the facility is located and the broader function it performs. Physical and functional connection are major considerations in determining which assets form part of the same facility.<sup>11</sup>

26. By contrast, the inquiry in relation to a composite item and depreciating assets is concerned with unitisation of components for depreciation purposes to ensure deductions over the effective life of the relevant asset reflect the diminution in its economic value over the period it is used. It is likely to be more focused on the function of a collection of components at a granular level.

27. In testing whether modifications or enhancements to a depreciating asset or facility in fact constitute a new depreciating asset or facility, again the Commissioner expects that different conclusions may sometimes arise given the different inquiries. For example, a collection of components that is both a facility and a composite item that is a depreciating asset may have a distinct but interconnected extension added. Depending on the circumstances, this extension might be sufficiently separate (physically and temporally) to

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<sup>8</sup> See section 40-215.

<sup>9</sup> This Ruling does not consider what constitutes a repair or capital improvement. Taxation Ruling TR 97/23 *Income tax: deductions for repairs* sets out the circumstances in which a deduction for repairs is available under section 25-10. Capital expenditure, not in relation to a section 25-10 repair, which is merely an improvement of the asset and not the creation of a new asset, is included in the second element of cost of the depreciating asset – see section 40-190.

<sup>10</sup> See subsection 12-437(5), section 12-439 and section 12-440 of Schedule 1 to the *Taxation Administration Act 1953*.

<sup>11</sup> The Commissioner's views on the meaning of 'facility' in the context of the non-concessional MIT income rules are set out in Law Companion Ruling LCR 2020/2 *Non-concessional MIT income*. See paragraphs 152 to 170 of that Ruling. Note, other factors may also be relevant with no one factor considered in isolation being determinative.

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constitute a new depreciating asset, while being considered an extension to an existing facility.

### **Jointly-held tangible assets**

28. Section 40-35 applies in circumstances where a depreciating asset (the underlying asset) that you hold is also held by one or more other entities. 'Your interest in the underlying asset' is treated as if it were the relevant depreciating asset for the purposes of Division 40.<sup>12</sup>

29. 'Your interest in the underlying asset' is not defined. It is to be read broadly to include both joint holding of the entirety of an asset and separate ownership of component parts of a composite item. Section 40-35 applies when working out the deductions for the share of the decline in value in both cases.

30. Where a composite item is the underlying depreciating asset, the amount that you can deduct for your share of the decline in value of that asset over an income year is based on the cost of:

- the component (or components) that you hold in the composite item, or
- your interest in the otherwise undivided composite item. (See **Example 7** of this Ruling.)

### **Intangible depreciating assets**

31. The only intangible assets that are capable of being 'depreciating assets' are those intangible assets that are specifically listed in subsection 40-30(2) and are not trading stock.

32. While an intangible asset may consist of a number of rights, those individual rights cannot themselves be depreciating assets unless they are capable of separate existence and listed in subsection 40-30(2). The question of whether the intangible asset is a composite item requires consideration of the legal character of the item, and any underlying individual rights. This will be by reference to a relevant statute where this is how the intangible asset has been created.

33. Section 40-35, which relates to jointly-held depreciating assets, can apply to intangible depreciating assets listed in subsection 40-30(2). However, in relation to an intangible depreciating asset that is a 'mining, quarrying or prospecting right' by virtue of being an interest in an authority, licence, permit, right or lease (and not the authority, licence, permit or right itself), section 40-35 has no application.

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### **Example 1 – industrial storage racking**

34. *The Warehouse Corporation purchases storage racks for use in its warehouse. Multiple racks make up a single row. Each row of racks is physically separate from each other row and is capable of storing goods independently of any other row. The racks within each row rely on other racks within that row for their structural stability and therefore their ability to perform their storage function.*

35. *As each row is functionally complete in itself, it is a separate depreciating asset. However, each rack within a row is not functionally complete in itself; the racks merely*

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<sup>12</sup> Subsection 40-35(3) lists other provisions which treat your interest in the underlying asset as if it were the depreciating asset.

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form part of the row. Any new rows that are acquired will be separate depreciating assets.<sup>13</sup>

36. If an existing row is merely lengthened by the addition of new racks, no new depreciating asset has been created. The addition of extra racks that require structural support from the existing row is a modification to an existing asset, and that cost is included in the second element of the existing row's cost under section 40-190.

### **Example 2 – desktop computer package**

37. Alyona buys a desktop computer package which consists of a desktop computer, monitor, wireless keyboard and mouse. This package of items is a single depreciating asset. Notwithstanding that the items are easily separated, and may have been acquired from different suppliers, they were purchased to provide a single, integrated system intended to function as a whole.

38. However, if the items were acquired as replacements to an existing desktop computer package, each item would be a separate depreciating asset. For example, if Alyona upgrades the monitor in 2 years, this would constitute a separate depreciating asset. The monitor is separately identifiable and can be relatively easily used in different computer systems or with other devices.

39. The acquisition of an item that is physically incorporated into a computer (or element of a computer system) becomes part of the computer upon installation and is not a separate depreciating asset. The item's cost is included in the second element of cost of the computer system under section 40-190. Examples include processors, memory and hard drives. The additions form part of the existing physical asset (the computer) and the lack of separation outweighs the fact that the improvements:

- serve to vary the performance of the computer
- were acquired separately from the computer, and
- could potentially be incorporated in a wide range of computers and other electronic equipment.

40. If Alyona acquires a printer to be used with the computer, it will be a separate depreciating asset. A printer performs a separate function, is capable of independent existence and easily interchangeable. This would be the case regardless of whether the printer was purchased as part of the desktop computer package or separately.

### **Example 3 – mainframe computer**

41. Vitaly designs and installs a new mainframe computer system with 50 dependent terminals that are only functional when connected to the mainframe because they lack a base unit or a separate central processing unit. The terminals receive data from, and transmit data to, any compatible controlling unit to which they are connected. Twelve months later Vitaly expands the system by purchasing another 20 terminals off-the-shelf which are easily connected to any compatible mainframe computer system, including Vitaly's existing system.

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<sup>13</sup> If the storage racks support the roof or walls of the storage building, and the roof or walls do not form an integral part of the function served by the storage racks, then only the racks, not the roof or walls, will qualify as a depreciating asset.

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42. *The initial system consisting of the mainframe and 50 terminals is a single depreciating asset because:*

- *The terminals do not have a separate function. They have no independent processing ability and are reliant upon the mainframe for their functionality.*
- *The terminals were acquired at the same time as a functionally complete system to work together in that manner.*

43. *While the 20 new terminals are similarly dependent upon the mainframe for their functionality, they do have a separate existence and are not part of the system as originally acquired. The separate acquisition of the additional terminals, and their adaptability to work with a wide range of controllers, are factors sufficient to treat each new terminal as a separate depreciating asset.*

#### **Example 4 – local area network**

44. *Nazar sets up a local area network (LAN) which links a server to 10 computers. Users on each of the computers can access a shared database on the server, but these computers can also operate independently (that is, without being connected to the server). When operating independently, the computers in the LAN run on their own software and can be connected directly to a printer.*

45. *The LAN, as a whole, is not a separate depreciating asset. Each computer has a separate identifiable function and is a separate depreciating asset because each computer can operate independently. Their connection to the LAN, although increasing each computer's functionality, does not cause them to be collectively subsumed into a different larger asset.*

46. *The server has its own identifiable function to enable database sharing and is a separate depreciating asset to the computers.*

#### **Example 5 – aircraft engine and frame in service on rotation**

47. *Airlease Company leases aircraft frames and engines that it owns to multiple airlines under operating leases. Each engine that Airlease leases out is interchangeable with each frame it owns and leases. Under the lease agreements, any of Airlease's frames or engines can be combined with any frames or engines leased to the airlines by Airlease or any other leasing company.*

48. *Under a scheduled maintenance program, each engine is detached from its airframe for overhaul and replaced with another engine made available by Airlease. An inherent feature of the scheduled maintenance program is that the number of engines an airline leases is always in excess of the number of airframes they lease.*

49. *An aircraft and its engine would usually be considered to be a single depreciating asset. However, in this Example, each frame and engine is capable of having a separate identity and the particular circumstances of use provide further context in identifying each as a separate depreciating asset:*

- *Neither the engine nor the aircraft frame is physically separate or capable of performing a function identifiable from the other. However, no particular airframe is reliant on any particular engine for the performance of its function. Each engine is generally available for use in whichever airframe requires an engine on any particular occasion.*

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- *Airlease, and the industry broadly, deal separately with engines and airframes. The lease terms and the scheduled maintenance program demonstrate this.*
- *Airlines can, and do, combine any airframe with any engine regardless of who owns each. Airlease's engines are not a permanent part of any particular airframe.*

### **Example 6 – car global positioning system**

50. *Orson has a parcel delivery business, including a delivery vehicle. He is contemplating what type of global positioning system (GPS) to buy for it.*

51. *A car comprises many components but it is usually the whole car that is the depreciating asset. The relevant function or purpose of the car is transportation. Where a car has a GPS integrated in it, either from original manufacture or post-manufacture modification, the GPS forms part of the car. While the GPS has its own function, it is subsumed into the existing depreciating asset, being the vehicle.*

52. *In the case of a modification after manufacture, the expenditure on materials and labour for the installation is an amount paid to bring the asset to its present condition and included in the second element of cost of the car under section 40-190.*

53. *If Orson purchased a portable GPS, that GPS retains its separate function to that of the car. This is irrespective of whether he plugs the GPS into the car's power outlet or not. The GPS is a separate depreciating asset to the car. The GPS's function is as a navigation system. It was purchased separately from the car, it is removable from the car, and it may be operated in other vehicles or independently of vehicles.*

### **Example 7 – jointly-held fibre optic cable communications system**

54. *An undersea communications cable system was constructed to transmit data between 3 countries. The system was constructed with 2 major segments, the segment that transmits data from country A to country B (Segment 1) and the segment that transmits data from country B to country C (Segment 2).*

55. *Each segment of the system consists of fibre optic cables and transmission and receiving equipment.*

56. *Fibropca Co owns the fibre optic cables in Segment 1 and Segment 2 while transmission and receiving equipment are owned by another entity.*

57. *Fibropca Co and the other entity have contractual relationships which bring the complete cable system together to enable the carrying of data on the system from:*

- *country A to country B*
- *country B to country C, and*
- *country A to country C (via country B).*

58. *In this case, each of the 2 segments of the system perform the function of carrying data between 2 countries. While the 2 segments of the system are physically connected and commenced their function of transmitting data at the same time, the segments operate independently of each other in the transmission of data to and from the 2 countries linked by each cable. It does not matter that the transmission of data from country A to country C is only achievable with the operation of both segments. Each segment of the system,*

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rather than the overall system or the components of each segment, is a depreciating asset in these circumstances.<sup>14</sup>

59. While each segment is a depreciating asset, the components of each segment are owned by different entities. For the purposes of section 40-35, Fibropca Co is a holder of 2 depreciating assets, being its interest in Segment 1 and its interest in Segment 2. Fibropca Co calculates its decline in value deduction for each segment based on the cost of the fibre optic cables, plus its share of the contractual costs incurred in readying the segment for use. Decline in value will be calculated over the effective life of the particular segment, rather than the effective life of any particular components within the segment.

### **Example 8 – a new electricity distribution line**

60. An electricity distribution network owner builds a new distribution line connected to existing distribution lines to supply customers who were not previously supplied by the network.

61. The above-ground electricity distribution line incorporates conductors, cross arms, insulators and fittings, poles made from concrete, wood, steel or a combination thereof, and (where relevant) a pole or ground pad-mounted transformer or transformers.

62. While each item has a function or purpose at an individual item level, the relevant function in the context of the business being conducted is the distribution of electricity to end users who are connected to the network. This function is only able to be performed when the system is complete. A new depreciating asset in the form of a distribution line comes into being when all its components have been assembled.<sup>15</sup>

63. The new distribution line is, on balance, a separate asset from the existing distribution network:

- The new distribution line is capable of being separately identified or regarded as having a separate function from any existing distribution infrastructure. It performs an identifiable function of distributing electricity to a new group of customers.
- The new distribution line is planned, designed, built and developed to operate as one system.
- Each item of the distribution line is physically connected and commences its function of distribution of electricity at a different time to the original distribution lines or other elements of the distribution network.
- While it is reliant on its supply of electricity from the original distribution line or other elements of the network, its function as a medium of distribution for the electricity is otherwise independent of those things.

64. The fact that the new distribution line may be incapable of independent operation without connection to an existing distribution line or other element of the network does not outweigh the factors, leading to characterisation of the new distribution line as a separate asset.

65. Therefore, the new electricity distribution line is the depreciating asset at the time it is first used or installed ready for use (its 'start time'<sup>16</sup>), not the individual parts. The

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<sup>14</sup> Cf *Overseas Telecommunications Commission (Aust) v The Commissioner of Taxation* [1989] FCA 665 (OTC) at [55–61], per Lockhart J.

<sup>15</sup> See the example of the erection of a farm fence in *Tully* 83 ATC 4495 at [4504], per Lockhart J.

<sup>16</sup> Section 40-60.

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*components that make up the new distribution line at its start time identify the limit of that distribution line.*

### **Example 9 – replacing electricity pole**

66. *An electricity distribution network owner replaces a pole in a distribution line after it was destroyed in a storm. The new pole is made from the same material and has the same specifications as the previous one.*

67. *The replacement of the pole does not create a new depreciating asset separate from the distribution line. There has been no substantial alteration to the function of the distribution line of which the relevant pole is a part.<sup>17</sup> Further, the replacement pole is physically integrated in the electricity distribution network and unable to be used for any other purpose once installed.*

### **Example 10 – upgrade of transformer**

68. *An electricity distribution network owner upgrades a pole-mounted distribution transformer which forms part of an existing distribution line. The upgrade will enable the distribution line to deal with higher electricity load demands.*

69. *The electricity distribution transformer transforms high voltage electrical current to a usable voltage for consumers. In the context of a functional electricity distribution line, each element of the system is physically connected to each other part of the system and each part is reliant upon the other elements of the system (wires, poles, distribution transformers etcetera) for their functionality – to form a single integrated distribution system which is intended to function as a whole. Each of the functions of the individual parts is subsumed into the larger system when it is constructed. The overall function of the distribution line is to transmit electricity to consumers.*

70. *In establishing the function of the system as an electricity distribution line, an improvement of an element of that system will constitute an improvement to the distribution line itself, rather than an acquisition and installation of a separate depreciating asset. The replacement of the existing transformer with a higher load capacity transformer is an improvement to the distribution line itself. It does not substantially change the function of the electricity distribution line (that is, to transmit electricity to consumers) of which it is a part for a separate depreciating asset to be created. The costs of purchasing, installing and connecting the transformer ready for use are included in the second element of cost of the distribution line.*

### **Example 11 – rail transport infrastructure**

71. *A rail transport infrastructure developer incurs capital expenditure on constructing rail transport infrastructure, including rail transport track work, on which it operates a passenger rail service. The track work is a composite item that consists of several components including rails, sleepers, ballast, the earthworks or embankments on which the ballast, sleepers and rails are laid, integral bridges, girders, culverts and tunnels.*

72. *The rail transport track work is formed by combining or linking constituent components in a particular integrated or interdependent way. While each component contributes to the track work, the relevant function or purpose of the composite item is that of enabling travel of rolling stock. The function can only be performed by the integration of*

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<sup>17</sup> See Tully, Case S51 85 ATC 380 and Case T33 87 ATC 293 (Case T33).

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*all the components in a particular way. While the track work components can be physically separated, and would otherwise be considered to perform their own functions, their individual function is subsumed by the larger depreciating asset's function. They are integrally linked to create a single larger item having its own discrete function in respect of the taxpayer's operations, and in such a way that they have to be integrated to perform the function of providing track work for rail transport. This includes the earthworks and embankments referred to as the 'permanent way' and the track foundation. Based on this functionality, the entire track work, rather than each of its components, is the depreciating asset.*

### **Example 12 – new railway branch line**

73. *A railway consisting of a main line has been in operation for many years. A new branch line is planned, designed and built to provide rail transport accessibility to additional customers.*

74. *The new branch line is capable of being separately identified or regarded as having a separate function from any existing track work infrastructure. It performs an identifiable function of supplying rail transport infrastructure for a new group of customers. While the branch line is physically connected to the main line and provides access for rolling stock originating from the main line, its function of providing rail infrastructure is otherwise independent. It does not matter that the new branch line may be incapable of independent operation without connection to a main line. The cost of the branch line infrastructure is claimed over that line's effective life rather than over the effective life of the existing main line.*

### **Example 13 – solar power system**

75. *SM Co decides to invest in a solar power system. SM Co engages a contractor to provide and install a solar power system tailored to its needs. The system consists of solar panels, mounting frames, wiring and inverters. Each of these items has a particular function but all of the components are connected, integrated and interdependent in the context of a solar power system, because they function together as a whole system to convert solar energy to consumable electricity.*

76. *The system was purchased and installed with the purpose or function of supplying electricity. While each component has a function of its own, that function is subsumed and contributes to the function or purpose of the overall system. The function can only be derived from the integration of all the components in a particular way. Based on this functionality, the system, rather than each of its components, is the depreciating asset in these circumstances.*

77. *Twelve months later, SM Co expands the system by purchasing 2 additional solar panels which have been designed to work with the original system. They are connected to the system that was already in operation. The addition of the 2 panels will increase the supply of electricity from the solar power system but not substantially alter its operational function. The additional panels are a modification to an existing depreciating asset and their cost is included in that asset's second element of cost under section 40-190.*

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**Example 14 – photographic lighting equipment**

78. *Georgia is a keen photographer who purchased the following lighting equipment and accessories to use in her photography business:*

- *Flash generator and flash head – these were purchased as a special package. The generator distributes and regulates power and contains 3 power outlets. The flash head comes with its own cord so it can be plugged into any compatible generator to produce the lighting.*
- *Light shaping tools – including zoom reflectors and a grid and filter hold kit. They are lighting attachments purchased separately. Their functions are to change the pool of light spill from the standard operating flash heads so as to produce narrower or wider beams, or softer and harder qualities of light. They clip onto, and work with, a range of flash heads.*
- *Modelling glass protector – a glass mould (like a cup) that fits over a modelling light and flash tube to protect the light from being damaged, especially while in transit.*

79. *Each of the items listed may be purchased individually and are separately identifiable.*

80. *All of the items are physically detachable and compatible with other generators or flash heads. The fact that each has no commercial utility unless linked or connected to other items does not preclude them from being separate depreciating assets. None of the listed items are integrated with the flash head or the generator but each have their own independent function, which is to vary the performance of the unit they are attached to. Accordingly, each of these listed items is a separate depreciating asset.*

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**Date of effect**

81. When the final Ruling is issued, it will apply to years of income commencing both before and after its date of issue. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

82. This Ruling replaces draft Taxation Ruling TR 2017/D1 which issued on 17 January 2017 and which is withdrawn with effect from 4 October 2023.

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**Commissioner of Taxation**

4 October 2023

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Status: **draft only – for comment**

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## Appendix 1 – Explanation

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**ⓘ** *This Explanation is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.*

83. The question of whether a composite item is itself a depreciating asset or if its components are separate depreciating assets is a question of fact and degree to be determined in the circumstances of the particular case.<sup>18</sup> An item may be considered a depreciating asset in one factual circumstance but not in another.

### Guiding principles

84. The Revised Explanatory Memorandum<sup>19</sup> (EM) that accompanied the Bill to insert subsection 40-30(4) states at paragraph 1.15:

Taxpayers will be required to exercise judgment in identifying the depreciating asset where the asset itself is made up of different parts and components. In doing this, the functionality test that is used as a basis of identifying a unit of plant in the existing plant depreciation rules can be used. (Specific reference to a unit or an item is not necessary to attract the test, as the definition of a depreciating asset is based on a life in effective use, and the depreciating asset must be identified as having its own life in such use.) **[Schedule 1, item 1, subsection 40-30(4)]**

85. The ‘functionality test’ referred to in the EM has its origin in judicial decisions which considered the meaning of the phrase a ‘unit of property’ for the purposes of general investment allowance deductions under former section 82AT of the *Income Tax Assessment Act 1936*.

86. The case law concerns the phrase ‘unit of property’. However, the principles for determining whether a composite item is one unit of property, or more than one unit, also apply in determining whether a composite item is one depreciating asset or more than one depreciating asset.

87. In the Full Federal Court case of *Tully*, Lockhart J contemplated the difficulties of defining the meaning of ‘unit’ in the context of the functionality test. His Honour said<sup>20</sup>:

The difficulty of identifying a “unit of property” for the purposes of the Assessment Act is that sometimes an item may be correctly described as a “unit” when it is one of a number of parts which upon assembly perform a subsidiary function. Sometimes each part may be correctly described as a unit before assembly and other times after assembly. On other occasions there may not be a unit until a number of parts have been integrated into a complete system. Then the whole may answer the description of a unit. The possibilities and combinations are numerous. But purpose or function must generally be a useful guide to the identification of an item as answering the description of a unit of property in particular cases.

### Case law on the ‘functionality test’

88. Ascertaining purpose or function to identify a depreciating asset can be difficult.

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<sup>18</sup> Subsection 40-30(4).

<sup>19</sup> Revised Explanatory Memorandum to the New Business Tax System (Capital Allowances) Bill 2001.

<sup>20</sup> 83 ATC 4495 at [4504–4505].

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89. Cases such as *Ready Mixed Concrete*<sup>21</sup>, *Tully* and *Monier Colourtile*<sup>22</sup> explain that a separate 'unit of property' is one which has an identifiable, separate function. For example, in *Monier Colourtile*, in determining that pallets that conveyed concrete through a tile-making machine were separate units of property, Lee J found that:

... The additional pallets did nothing to alter operation of the system which produced the tiles. The system remained exactly as it was before except that the alteration in the speed of the machine altered the output of the machine. The system ran for the same time and in the same way as before, but at a faster rate and produced more tiles, ...

The 5,150 pallets remained 5,150 individual pallets, each one performing its individual function ... The total number of pallets, i.e. 5,150 never took on or performed a function additional to and distinguishable from that of the individual pallets making up that total ...

90. In that same case, each of several mobile radio stations, and a base station, were also held to be functionally complete in themselves and therefore separate units of property. Each had a separate independent existence. Lee J found that, even though the base station was useless without one or more mobile stations and vice versa, this of itself was no basis for a conclusion that the entirety was to be regarded as one unit. The base station and each of the mobile radios had a function which was separate from each other, in the same way that a television has a separate function, even though it cannot effectively operate unless a television signal is being broadcast. Therefore, it can be seen that it is not necessary for an item to be capable of independent operation in a practical or commercial sense to qualify as a separate depreciating asset.

91. A telephone system consisting of a central processing unit and 7 interactive handsets was considered to be a single unit of property in *Commissioner of Taxation v Veterinary Medical and Surgical Supplies Ltd.*<sup>23</sup> The Court considered that the handsets were an integral part of the telephone system, with no separate function of their own. Pincus J observed<sup>24</sup>:

... where a system consisting of diverse elements is bought as a system intended to function as a whole and each element interacts with at least one other, one should find unity in the function of the whole system, at least where the elements are physically connected.

92. Pincus J gave weight to the fact that the composite item was purchased as one functioning system and the elements of the system were physically connected. This may explain the divergence from the decision in *Monier Colourtile* where the components of the radio system were not physically connected and some components were purchased separately to the original radio system.

93. It must also be noted, however, that even though the handsets were dependent on the central processing unit for their operation, this factor alone did not lead to the conclusion that the entire system was a single unit of property. The fact that an item cannot operate without the assistance of another item does not necessarily mean that the 2 items are a single depreciating asset.

94. In *Tully's* case Fitzgerald J said<sup>25</sup>:

... there is ... a unit of property if it is capable of independent existence, not necessarily self contained, e.g. it may require power from an external source, not necessarily separately used, e.g. it may be incorporated into an operating system such as a machine or complex of

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<sup>21</sup> *Ready Mixed Concrete (Vic) Pty Ltd v Commissioner of Taxation (Cth)* [1969] HCA 12.

<sup>22</sup> *Monier Colourtile Pty Ltd v Federal Commissioner of Taxation* (1983) 68 FLR 111.

<sup>23</sup> [1988] FCA 500.

<sup>24</sup> [1988] FCA 500; 88 ATC 4642 at [4648].

<sup>25</sup> 83 ATC 4495 at [4506].

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machinery in a manufacturing process, but capable either of separate function, or of function in conjunction with different parts, or in a different context, from its current user.

95. In *Tully's* case, the crushing mills, juice heaters, effert vessels and other items in a cane processing system were held to be separate units of property. The fact that the system could not effectively process the cane unless they all operated together did not prevent the individual items from being separate units for tax purposes. Fox J said<sup>26</sup>:

When one looks to see whether there is a unit, one normally looks to see whether there is a whole something. Whether there is a whole will normally be judged by the intended function or purpose of that which is being looked at.

96. The pumping station in *Tully's* case, which comprised an electric motor, starter and other parts, was held to be a single unit of property. These parts of the station may have, under different circumstances, been regarded as separate units. But the evidence, in this particular case, showed that these components had become an integral part of a (larger) whole, and therefore the pumping station was a single unit of property.

97. In *Ready Mixed Concrete*, it was held that a transit mixer did not form part of a total vehicle which might be thought of as a mobile cement mixer comprising the mixer and the truck. In describing the mixer and the truck as separate units of property, Kitto J said<sup>27</sup>:

Notwithstanding the mode and degree of annexation, the truck and the mixer are functionally separate and independent units of property. The function of delivery belongs to the truck. The use of the mixer is for mixing, as a step in the production of concrete in the condition required for pouring ...

98. It is not necessary that a depreciating asset be functionally operative provided that the asset is capable of fulfilling an independent function.

99. This is evident where various units each perform a discrete function. For example, in *Tully's* case Lockhart J gave an example of an assembly line where he said that<sup>28</sup>:

... if five parts are installed in an assembly line and all that is needed to render the line operative is a sixth part, but until that part is installed no part may function or operate, the functional incompleteness does not necessarily deprive each of the five units of its character as a "unit of eligible property" ...

100. However, in *Tully's* case Lockhart J also said<sup>29</sup>:

Yet, at other times a "unit" may not come into being until all the components have been assembled. For example, a farm fence is made up of a number of posts and rails or wires. It is difficult to conceive of any "unit" coming into being until the fence is erected.

101. In such a case, each and every post, rail and wire serves an identical single purpose, which is to act as a fence. No part of the fence serves a discrete function from any other part nor achieves any outcome distinguishable from the outcome of the fence as an entirety.

102. In *BP Oil Refinery (Bulwer Island) Ltd v Commissioner of Taxation*<sup>30</sup> one question was whether water coils which were added to a furnace were a separate unit of property. Jenkinson J found that the coils had a separate function within the overall plant (being the carriage of water – albeit through the furnace to allow the water to be heated) and as such were a 'unit of property'. The function of the coils could be distinguished from the function of the furnace, which was to generate heat.

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<sup>26</sup> 83 ATC 4495 at [4500].

<sup>27</sup> 69 ATC 4038 at [4042].

<sup>28</sup> 83 ATC 4495 at [4504].

<sup>29</sup> 83 ATC 4495 at [4504].

<sup>30</sup> [1992] FCA 14.

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103. The issues of physical separability, mechanical independence and the separateness of purchases are also relevant when considering whether an item has an independent function sufficient for it to be treated as a depreciating asset. In *Case M98*<sup>31</sup> a tractor, carry-all and ripper were each held to be separate units of property. In reaching its decision, the Board of Review referred to the 2 attachments as separate physical objects not mechanically designed and constructed as part of the tractor. The detachability of the attachments was also relevant to the decision<sup>32</sup>:

... the taxpayer might find it desirable to keep the tractor and the ripper, and to sell the carry-all, ... and he might sell the tractor and buy a different make of tractor which he thereupon uses with the same ripper and the same carry-all.

### Case law on modifications

104. The question as to whether a modification to an existing unit can itself be a unit of property was considered in *Wangaratta Woollen Mills Ltd v Commissioner of Taxation (Cth)*.<sup>33</sup> An electrical device which enabled the temperature of liquid to be raised was modified so as to enable it to regulate cooling as well as heating. The modification consisted of the addition of a few small pieces of electrical equipment to the device. Most of the expense related to the workmanship involved in fitting the small electrical parts to the device. The modification was not considered to involve the creation, installation or attachment of a separate unit of property. McTiernan J, in reaching his decision, said<sup>34</sup>:

The expenditure was on a modification to an existing unit of property ... not an addition. The fact that a proportion of the expenditure is for workmanship and not even additional articles compels me to find that this item of expenditure cannot be the subject of a deduction ...

105. The installation of a new power source which consisted of an engine, fuel tanks etcetera in a trawler was held to be a separate unit of property in *Case S51*<sup>35</sup>. The installation of a more highly-rated power source enabled the trawler to engage in deep sea fishing. Therefore, the function of the trawler was substantially altered. The power source was, in those circumstances, considered as essentially separate from the trawler. This case illustrates the difference between the varying degrees of modifications, that is, one which consists of a minor alteration (not a separate depreciating asset) and another where the expenditure relates to an addition to an existing depreciating asset which substantially alters the performance or function of that depreciating asset (and is a separate depreciating asset).

### Jointly-held tangible assets

106. The issue of composite items also arises in relation to jointly-held assets. Section 40-35 applies in circumstances where a depreciating asset (the underlying asset) that you hold is also held by one or more other entities. Each holder of the asset applies Division 40 as if their 'interest in the underlying asset' is the depreciating asset.

107. The issue that arises is whether the phrase 'interest in the underlying asset' in subsection 40-35(1) is limited to circumstances where an entity jointly owns the entirety of a depreciating asset with other entities, or whether it extends to circumstances where an entity owns part or all of a discrete component of the underlying asset.

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<sup>31</sup> 80 ATC 689.

<sup>32</sup> 80 ATC 689 at [690].

<sup>33</sup> [1969] HCA 39.

<sup>34</sup> 69 ATC 4095 at [4103].

<sup>35</sup> 85 ATC 380.

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108. The word ‘interest’ in this context is not defined and is to be construed broadly. It is not limited to interests in the entirety of an asset. The phrase extends to the holding of a separate part of a depreciating asset.

109. Section 15AA of the *Acts Interpretation Act 1901* provides:

In the interpretation of a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether that purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object.

110. Similar logic was employed in the Federal Court decision of *OTC*. The Overseas Telecommunications Commission had an interest in certain segments (but not others) of a submarine cable. Different parts of segments were found to be owned by different taxpayers, and the parts that were offshore and not in territorial waters were jointly owned by tenants in common.<sup>36</sup> Although Lockhart J found that each segment between countries was a single unit of property, His Honour found that the provisions did not preclude acquisition or construction of a unit of eligible property by the taxpayer in conjunction with other persons.

111. Although the decision in *OTC* related to the availability of deductions under the former investment allowance provisions, the Commissioner considers that a similar conclusion would be reached in the identification of depreciating assets and the joint holding of those assets for the purposes of Division 40.

112. Further support for the application of the finding in *OTC* to section 40-35 is provided in paragraph 1.58 of the Explanatory Memorandum to the New Business Tax System (Capital Allowances) Bill 2001, which provides as follows (emphasis added in italics):

Where there is more than one holder of a depreciating asset, it is the decline in value of an entity’s cost of that asset which is taken into account [**Schedule 1, item 1, subsection 40 35(1)**]. The interest in the underlying asset is dealt with as if it were the depreciating asset itself. This rule looks to whether, under the table in section 40-40, there is more than one entity which holds the same depreciating asset; *it is not necessarily concerned with whether there is joint tenancy or co-ownership at general law.*

113. Subsection 40-35(1) therefore extends to cases where the underlying asset is a composite item and one or more of the components are held by different entities.

114. Each entity is able to take into account the decline in value of the cost of their interest in the single depreciating asset over the effective life of the single depreciating asset identified pursuant to subsection 40-30(4).

### **Intangible depreciating assets**

115. Division 40 only applies to intangible assets that are listed in subsection 40-30(2) and are not trading stock. The question of whether an intangible asset is a composite item requires consideration of the legal character of the item, and any underlying individual rights. This will be by reference to the relevant statute where this is how the intangible asset has been created.

116. Where a statute creates a bundle of rights that exist as a whole, then subsection 40-30(4) does not permit it to be divided to the level of those individual rights. An example of the application of this principle is the Full Federal Court case of *Mitsui* where a production licence was granted under the *Petroleum (Submerged Lands) Act 1967*. The Full Federal Court clarified that, in accordance with paragraph 40-30(2)(a), only the ‘mining, quarrying or prospecting right’ (MQPR) as defined in subsection 995-1(1)

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<sup>36</sup> [1989] FCA 665 at [16], per Lockhart J.

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qualified for treatment as a depreciating asset under Division 40. In the context of a production licence granted under the relevant Act, the MQPR was the whole licence itself and not individual rights which were incidents of being a licence holder.

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## **Appendix 2 – Your comments**

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117. This draft Ruling has content that reflects changes made in response to feedback to the previous version of this draft Ruling, TR 2017/D1, which issued on 17 January 2017. A compendium of comments for TR 2017/D1 is available.

118. You are invited to comment on the changes contained in this draft Ruling, including the clarification of existing examples and new content. We also invite comments on the proposed date of effect. Please forward your comments to the contact officer by the due date.

119. A compendium of comments is prepared when finalising this Ruling, and an edited version (names and identifying information removed) is published to the Legal database on ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

**Due date: 3 November 2023**

**Contact officer details have been removed following publication of the final ruling.**

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Status: **draft only – for comment**

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## References

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*Previous draft:*

TR 2017/D1

*Related Rulings/Determinations:*

LCR 2020/2; TR 97/23; TR 2006/10

*Legislative references:*

- ITAA 1936 82AT
- ITAA 1997 25-10
- ITAA 1997 Div 40
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- ITAA 1997 40-190
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- ITAA 1997 Div 43
- ITAA 1997 328-180
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- TAA 1953 12-437(5)
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- AIA 1901 15AA
- Petroleum (Submerged Lands) Act 1967

*Cases relied on:*

- BP Oil Refinery (Bulwer Island) Ltd v Federal Commissioner of Taxation [1992] FCA 14; (1992) 33 FCR 594; 23 ATR 65; 92 ATC 4031
- Case M98 80 ATC 689
- Case S51 85 ATC 380
- Commissioner of Taxation v Tully Co-operative Sugar Milling Association Ltd [1983] FCA 163;

- (1983) 68 FLR 39; (1983) 51 ALR 751; 14 ATR 495; 83 ATC 4495
- Commissioner of Taxation v Veterinary Medical and Surgical Supplies Ltd [1988] FCA 500; 19 ATR 1593; 88 ATC 4642; 15 ALD 732
- Mitsui & Co (Australia) Ltd v Commissioner of Taxation [2012] FCAFC 109; 90 ATR 171; 2012 ATC 20-341
- Monier Colourtile Pty Ltd v Federal Commissioner of Taxation (1983) 68 FLR 111; 14 ATR 379; 83 ATC 4399
- Overseas Telecommunications Commission (Aust) v The Commissioner of Taxation [1989] FCA 665; 89 ATC 5200; 20 ATR 1482
- Ready Mixed Concrete (Vic) Pty Ltd v Commissioner of Taxation [1969] HCA 12; 118 CLR 177; 1 ATR 123; 69 ATC 4038; 15 ATD 215
- Wangaratta Woollen Mills Ltd v Commissioner of Taxation [1969] HCA 39; 119 CLR 1; 43 ALJR 324; 1 ATR 329; 69 ATC 4095

*Other references:*

- Explanatory Memorandum to New Business Tax System (Capital Allowances) Bill 2001
- Revised Explanatory Memorandum to the New Business Tax System (Capital Allowances) Bill 2001

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ATO references

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