




## ATO Interpretative Decision

ATO ID 2006/259

### Income Tax

### Capital Allowances: depreciating asset - section 73BA depreciating asset - full-scale test model

FOI status: may be released

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## Issue

Is the full-scale test model of an item of equipment, which is the subject matter of the taxpayer's research and development (R&D) activities, a 'section 73BA depreciating asset' within the meaning of that term in section 73BB of the *Income Tax Assessment Act 1936* (ITAA 1936) for which the taxpayer has a 'notional Division 40 deduction' within the meaning of section 73BC of the ITAA 1936?

## Decision

Yes. The full-scale test model is a 'section 73BA depreciating asset' because the test model is a tangible depreciating asset that is used by the taxpayer, an 'eligible company', for the purpose of carrying on their R&D activities and the taxpayer has a 'notional Division 40 deduction' for the asset.

## Facts

The taxpayer is an 'eligible company', as defined in subsection 73B(1) of the ITAA 1936, that carries on 'research and development activities' as defined in subsection 73B(1). The taxpayer has registered its R&D activities in the manner contemplated by subsection 73BD(1) of the ITAA 1936. The subject matter of the taxpayer's R&D activities is an item of equipment capable of performing a specific manufacturing process. The taxpayer's R&D activities encompass not only designing and developing the item of equipment but also testing the performance of the asset against the requisite specifications.

As an integral part of the R&D activities, the taxpayer built a full-scale model of the item of equipment for the purpose of testing the asset's capacity to perform the specific manufacturing process at a commercially viable level. The test model is not an item of trading stock of the taxpayer and the expenditure on the test model does not represent 'feedstock expenditure' within the meaning of that term in subsection 73B(1) of the ITAA 1936. The test model was constructed after 29 January 2001 and no deduction under subsection 73B(15AA) of the ITAA

1936 is allowable in relation to it (see subsection 73B(15AAAA) of the ITAA 1936). Testing revealed that the model did not operate at the requisite level and required some refinement of its functionality.

The process of refining the test model's functionality involved continuous and various modification, adaptation and retesting over a further period of about 18 months. While this process resulted in the removal of some components from the test model and their replacement with other components, neither the functionality nor the physicality of the test model was altered to any material extent.

Following this period of refinement, the taxpayer was satisfied that the test model was capable of performing the required functionality for the specific manufacturing process at a commercially viable level. The taxpayer then proceeded to replicate and market the item of equipment.

## Reasons for Decision

As far as is relevant here, the combined effect of sections 73BB and 73BC of the ITAA 1936 is to define a 'section 73BA depreciating asset' as one for which the taxpayer has a 'notional Division 40 deduction': that is, where it is a tangible depreciating asset for which an 'eligible company' could deduct an amount under section 40-25 of the *Income Tax Assessment Act 1997* (ITAA 1997) if certain assumptions were made about the requirements for deductibility under that section.

The taxpayer's item of equipment is, clearly, a tangible asset.

An 'eligible company' is defined in subsection 73B(1) of the ITAA 1936 to mean a body corporate incorporated under a law of the Commonwealth or of a State or Territory. As stated in the facts, the taxpayer is an 'eligible company'.

Section 40-25 of the ITAA 1997 provides an annual deduction to a holder of a depreciating asset for the decline in value of the asset as worked out under Division 40 of the ITAA 1997. Subject to some specific exclusions, a depreciating asset is an asset that has a limited effective life and can reasonably be expected to decline in value over the time it is used (subsection 40-30(1) of the ITAA 1997). The definition of depreciating asset is, therefore, based on a life in effective use such that a depreciating asset is identified by having its own life in that use. This means that a depreciating asset will generally be identified by its functionality. It follows that an asset may be a depreciating asset if it is in a condition that enables it to function or to be used as a depreciating asset even though the asset requires further refinement to its functionality or use.

'Used' is a word of wide import and its meaning in any particular case will depend on the context in which the word is employed and the purpose for which the thing in question has been acquired or created (see *Newcastle City Council v. Royal Newcastle Hospital* (1956) 96 CLR 493). In the context of carrying on R&D activities, it is sufficient that the asset can perform the functionality for which it was designed for the asset to be used. For the full-scale test model that the taxpayer built, functions that are relevant to the asset being used include: testing the functionality of the item of equipment; monitoring the performance of the item of equipment; providing data on each of these matters for further analysis; and modifying or adapting the asset as part of the refinement process.

Accordingly, the full-scale test model built by the taxpayer is a depreciating asset. This is the case even though the test model was commercially incomplete in the sense that it needed further refinement before it could be commercially exploited. As the legal owner of the asset, the taxpayer also holds the asset under item 10 of the table in section 40-40 of the ITAA 1997.

As far as is relevant here, a 'notional Division 40 deduction' is available for a 'section 73BA depreciating asset' if, pursuant to section 73BC of the ITAA 1936, the asset is used for the purpose of carrying on the eligible company's R&D activities. As stated in the facts, the taxpayer does use the asset for this purpose.

Accordingly, the full-scale test model is a 'section 73BA depreciating asset' because the asset is a tangible depreciating asset and the taxpayer is entitled to a 'notional Division 40 deduction' for the asset when the taxpayer, an eligible company, uses it for the purpose of carrying on its R&D activities.

**Date of decision:** 11 August 2006

**Year of income:** Year ended 30 June 2004

### Legislative References:

*Income Tax Assessment Act 1936*

subsection 73B(1)  
subsection 73B(15AA)  
subsection 73B(15AAAA)  
section 73BB  
section 73BC  
subsection 73BD(1)

*Income Tax Assessment Act 1997*

section 40-25  
subsection 40-30(1)  
section 40-40

**Case References:**

*Newcastle City Council v. Royal Newcastle Hospital*  
(1956) 96 CLR 493

**Related ATO Interpretative Decisions**

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**Keywords**

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