Australian Government
Australian Taxation Office

ATO Interpretative Decision

ATO ID 2006/260

Income Tax
Capital Allowances: cost - section 73BA depreciating asset - full-scale test model - refinement expenses

FOI status: may be released

Issue

Does the taxpayer's capital expenditure on refining the full-scale test model of their 'section 73BA depreciating asset' form part of the asset's cost for the purpose of working out the taxpayer's 'notional Division 40 deduction' under section 73BC of the *Income Tax Assessment Act 1936* (ITAA 1936)?

Decision

Yes. The taxpayer's capital expenditure on refining the full-scale test model of their 'section 73BA depreciating asset' does form part of the asset's cost because the expenditure constitutes a second element of cost of the asset under section 40-190 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Facts

The taxpayer is an 'eligible company', as defined in subsection 73B(1) of the ITAA 1936, that carries on 'research and development activities' (R&D 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). The test model is a 'section

73BA depreciating asset' as defined in section 73BB of the ITAA 1936 and the taxpayer started to hold that asset from when they first built it. However, testing revealed that the model did not operate at the requisite level and required some refinement of its functionality. Capital expenditure on labour and materials was incurred for this purpose.

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

Subsection 73BA(2) of the ITAA 1936 provides a deduction to an 'eligible company' for a 'section 73BA depreciating asset' if the company has a 'notional Division 40 deduction' for the asset.

As stated in the facts, the taxpayer is an 'eligible company', the full-scale test model is a 'section 73BA depreciating asset' and the taxpayer started to hold the asset from when they first built it.

An 'eligible company' has a 'notional Division 40 deduction' for a 'section 73BA depreciating asset' if, taking into account certain assumptions, it would be entitled to a deduction for the asset under section 40-25 of the ITAA 1997. One of those assumptions is contained in subsection 73BC(2) of the ITAA 1936 and requires the asset to be used for the purpose of carrying on the eligible company's R&D activities. As stated in the facts, the taxpayer satisfies this requirement.

Deductions under section 40-25 of the ITAA 1997 are worked out by reference to, inter alia, the concept of cost in Subdivision 40-C of the ITAA 1997. It follows that a deduction under section 73BA of the ITAA 1936 is also worked out by reference to the concept of cost in Subdivision 40-C of the ITAA 1997. Although not relevant here, another assumption in subsection 73BC(4) of the ITAA 1936 requires certain 'section 73BA depreciating asset expenditure' that would otherwise form part of cost under Subdivision 40-C of the ITAA 1997 to be ignored or treated in some other way.

Under Subdivision 40-C of the ITAA 1997, the cost of a depreciating asset consists of two elements (section 40-175 of the ITAA 1997). The first element of cost is worked out as at the time when the holder of the asset starts to hold it (section 40-180 of the ITAA 1997) while the second element of cost is worked out by the holder after that time (section 40-190 of the ITAA 1997). As the taxpayer started to hold the test model from when it was first built and the capital expenditure to refine it was incurred after that time, the expenditure does not form part of the first element of cost of the test model.

The second element of cost of a depreciating asset is the amount a holder of the asset is taken to have paid under section 40-185 of the ITAA 1997 for each economic benefit that has contributed to bringing the asset to its present condition and location from time to time since they started to hold the asset.

The taxpayer's capital expenditure on refining the test model did not materially alter the asset's functionality or physicality. Therefore, the expenditure did not create a new or separate depreciating asset. The expenditure merely improved the existing functionality of the existing test model to a commercially viable level. An improvement of this nature impacts on the 'condition' of the existing test model. The condition of a depreciating asset refers to its form, state or order.

Accordingly, the taxpayer's capital expenditure on refining the full-scale test model of their 'section 73BA depreciating asset' does form part of the asset's cost for the purpose of working out the taxpayer's 'notional Division 40 deduction' under section 73BC of the ITAA 1936 because the expenditure constitutes a second element of cost of the asset pursuant to section 40-190 of the ITAA 1997.

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 73BA
subsection 73BA(2)
section 73BB
section 73BC
subsection 73BC(2)
subsection 73BC(4)
subsection 73BD(1)

Income Tax Assessment Act 1997
section 40-25
section 40-175
section 40-180
section 40-185
section 40-190

Related ATO Interpretative Decisions
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Keywords
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Uniform capital allowances system

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