Australian Government
Australian Taxation Office

ATO Interpretative Decision

ATO ID 2006/328

Income Tax
Capital Allowances: cost - 'section 73BA depreciating asset' - new full-scale test model - re-use of components from earlier test model

FOI status: may be released

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Issue

Does the cost of the new full-scale test model of the taxpayer's 'section 73BA depreciating asset' include, pursuant to subsection 40-180(3) of the *Income Tax Assessment Act 1997* (ITAA 1997), the cost attributed to those components of an earlier test model that have been re-used in building the new test model?

Decision

Yes. The first element of cost of the new test model does include, pursuant to subsection 40-180(3) of the ITAA 1997, the cost attributed to those components of the earlier test model that have been re-used in building the new test model.

Facts

The taxpayer is an 'eligible company', as defined in subsection 73B(1) of the *Income Tax Assessment Act 1936* (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). However, testing revealed that the existing model could not operate in the manner required and that a major revision of the equipment's design and functionality was needed to successfully continue with the R&D activities. The existing 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. For the period of time that the taxpayer utilised the asset for monitoring and testing purposes in its R&D activities, deductions under subsection 73BA(2) of the ITAA 1936 have been allowed.

In view of the major revision required, any further use of the existing test model was abandoned in favour of building a completely new test model. This caused a balancing adjustment event to occur for the existing test model under paragraph 40-295(1)(b) of the ITAA 1997. As many of the components of the existing test model were of significant value, the existing test model was dismantled and those components of value retained and stored. Other less valuable components were discarded. Some of the components retained from the earlier test model were ultimately used as components in the new test model even though both the functionality and physicality of the new test model were materially different to the earlier test model. The new test model is also a 'section 73BA depreciating asset' which the taxpayer started to hold from when they first built it.

As with the earlier test model, the taxpayer's R&D activities encompass testing the performance of the new test model against the revised specifications. When completed, the new test model will also not be an item of trading stock of the taxpayer and the expenditure on it will not represent 'feedstock expenditure' within the meaning of that term in subsection 73B(1) of the ITAA 1936.

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 new 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 (subject to certain assumptions in subsection 73BC(4) of the ITAA 1936 that are not relevant here). 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 components from the earlier test model were used as components in the new test model and the taxpayer started to hold the new test model from when it was first built, the first element of cost of the new test model includes the cost of the components re-used.

As stated in the facts, abandoning any further use of the earlier test model caused a balancing adjustment event to occur for that asset under paragraph 40-295(1)(b) of the ITAA 1997 because the taxpayer stopped using the asset, or having it installed ready for use, for any purpose and expected never to use it, or install it ready for use, again. The termination value of the asset under this balancing adjustment event is prescribed by item 1 of the table in subsection 40-300(2) of the ITAA 1997 to be the market value of the asset when the taxpayer stopped using it or having it installed ready for use.

Even though a balancing adjustment event occurred for the earlier test model, the taxpayer continued to hold it. In these circumstances, the first element of cost of the earlier test model is effectively re-set by item 3 of the table in subsection 40-180(2) of the ITAA 1997 to be the asset's termination value at the time of the balancing adjustment event (see also subsections 40-285(3) and (4) of the ITAA 1997.

When the earlier test model was dismantled, it was split into two or more assets in the manner described in section 40-115 of the ITAA 1997 (although the split did not cause a balancing adjustment event to occur - see subsection 40-295(3) of the ITAA 1997). The cost of each separate asset is prescribed by item 1 of the table in subsection 40-180(2) of the ITAA 1997 to be the amount worked out under section 40-205 of the ITAA 1997. Section 40-205 states that the first element of cost of each separate asset includes a reasonable proportion of the original asset's adjustable value just before it was split. The adjustable value of the original asset at that time is, as stated earlier, the cost prescribed by item 3 of the table in subsection 40-180(2) (see also section 40-85 of the ITAA 1997 for the meaning of adjustable value of a depreciating asset at a particular time). Section 40-205 provides a mechanism for attributing the adjustable value of a depreciating asset to the other assets into which it is split even though the split assets may not, of themselves, be depreciating assets.

The taxpayer built the new test model from a variety of components - some were purchased from other parties and some of those retained from the earlier test model were re-used. Subsection 40-180(3) of the ITAA 1997 includes in the first element of cost of a depreciating asset amounts the holder of the asset is taken to have paid in relation to starting to hold the asset if those amounts are directly connected with holding the asset. The components of the earlier test model that are re-used in building the new test model are, clearly, directly connected with starting to hold the new test model. The cost of those components is taken, for the purposes of subsection 40-180(3), to be the amount attributed to them by the combined operation of item 1 of the table in subsection 40-180(2) and section 40-205 of the ITAA 1997.

Accordingly, the first element of cost of the new test model includes, pursuant to subsection 40-180(3) of the ITAA 1997, the cost attributed to the components of the earlier test model that have been re-used in building the new test model.

Date of decision: 25 August 2006

Year of income: 30 June 2004

Legislative References:
Income Tax Assessment Act 1936
subsection 73B(1)
subsection 73B(15AA)
subsection 73B(15AAAA)
section 73BA
subsection 73BA(2)
subsection 73BA(2)
section 73BB
subsection 73BC(2)
subsection 73BC(4)
subsection 73BD(1)

Income Tax Assessment Act 1997
section 40-25
section 40-85
section 40-115
section 40-175
section 40-180
subsection 40-180(2)
subsection 40-180(3)
section 40-190
section 40-205
subsection 40-285(3)
subsection 40-285(4)
paragraph 40-295(1)(b)
subsection 40-295(3)
subsection 40-300(2)

Related ATO Interpretative Decisions
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