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Removal of accelerated depreciation

Recommendation

8.1 Removal of accelerated depreciation

Replacement with an effective life basis

(a) That current accelerated depreciation arrangements be replaced with a system under which the rates of taxation depreciation for depreciable assets acquired after the commencement date be determined by the effective life of the asset in line with Recommendation 8.5.

Application from date of announcement

(b) That accelerated depreciation no longer apply to assets acquired under contracts entered into after the date of announcement.

(c) That assets acquired before the date of announcement retain their existing treatment in respect of the rate of write-off.

Simplified arrangements for small business

(d) That paragraphs (a) to (c) not apply to relevant depreciable assets of small businesses that decide to use the simplified depreciation system under Recommendation 17.3.

Retention of specific primary producer provisions

(e) That paragraphs (a) to (c) not apply to specific primary producer provisions such as those relating to horticultural plantations, grape vines and water assets.

Removing accelerated depreciation will facilitate tax reform in the following three ways. It will:

- provide revenue to finance a reduction in the company tax rate to 30 per cent (see Recommendation 11.9);
- improve investment decision making by removing tax-induced distortions in investment decisions; and
- improve the integrity and the structure of the tax law.

Removal of tax-induced distortions to investment

In *A Platform for Consultation* (page 118), the Review noted that accelerated depreciation provides significant benefits to capital-intensive industries such as mining and manufacturing while being of little benefit to service industries such as finance, tourism or retailing. This means that (scarce) resources may be diverted away from activities that, in a tax-neutral environment, would have otherwise attracted them.

The implications for the economy of removing accelerated depreciation are difficult to gauge. In the absence of other specific government intervention (through outlays, for example), it is possible that some (perhaps significant) marginal projects may not proceed. It is also possible that other investment decisions may be deferred or shelved. The Review notes, however, that the Government has in place processes that can specifically and directly assist projects considered to be in the national interest. Nevertheless, the impact from the removal of accelerated depreciation could be that the level of investment, employment, and activity in the more capital-intensive sectors of the economy might decline. It would be more efficient to subsidise directly projects of major national significance, if such projects would not otherwise proceed, as a budget expenditure than to maintain accelerated depreciation generally — at the cost of forgoing a lower company tax rate.

The effect of eliminating acceleration needs to be balanced against the possibility of increased activity in other (less capital-intensive) sectors that will benefit from the lower company tax rate. The Review has endorsed an accelerated depreciation/company tax rate reduction trade-off, but found the decision to be a very difficult one. Ultimately it is a matter of judgment as to which option will provide the best outcome for the economy.

Improved tax law integrity and structure

Removing accelerated depreciation will do much to improve the integrity and structure of the tax law. It will provide the following benefits:

- It will remove the need to define the policy and legislative boundaries between those assets that qualify for accelerated depreciation and those that do not. For example, plant and equipment (as defined in the tax law), excluding cars, benefit from accelerated depreciation, but intangible assets do not.
- It will reduce the need for complex anti-avoidance rules. For example, section 51AD of the 1936 Act was primarily a response to the indirect accessing of accelerated capital allowances by tax-exempt bodies. Removing accelerated depreciation will remove the need for complex leasing rules to police the boundary between taxable and non-taxable entities.

Submissions and consultations

A clear majority of submissions favoured a reduction in the company tax rate over continuation of accelerated depreciation.

In contrast, capital-intensive firms generally favoured retention of accelerated depreciation while submissions from the services sector generally favoured its removal. Where analysis was provided, the trade-off was shown to lower the after-tax rates of return for capital-intensive investments and it was suggested that the removal of accelerated depreciation could result in some investments not proceeding.

Some submissions argued that accelerated depreciation was necessary because the effective lives of some investments were uncertain due to changing technology or other factors that could influence the rate of obsolescence. The Review noted these concerns and considers that taxpayers should be permitted to re-assess the rates of write-off of assets over their period of use to address such problems. Focus group participants agreed that a better structured and more flexible depreciation regime would make the removal of accelerated depreciation more acceptable (see Recommendation 8.6).

Implementation date

The Review is recommending that accelerated depreciation be removed with immediate effect. This means that all plant and equipment that was not acquired by the taxpayer under a contract entered into before the time and date of the announcement would be taxable under the new regime. It also means that all plant and equipment acquired before the date of effect would continue to be eligible for taxation depreciation that applied at the time of acquisition.

The recommendation for immediate effect is consistent with past practice where changes to capital allowance arrangements have been made — as was the case, in May 1988, when the 5/3 depreciation arrangements were replaced with a regime of effective life plus a 20 per cent loading.

In the absence of immediate implementation, there is a significant risk that taxpayers might bring forward investment decisions and enter into contracts for acquisitions beyond the date of implementation, at a cost to the revenue.

In addition, the immediate removal of accelerated depreciation would help finance the subsequent company tax rate cut.

Application to small business

Under Recommendation 17.3, small businesses electing to use the simplified tax system (STS) — which includes simplified depreciation arrangements — will continue to be eligible for accelerated depreciation until the relevant legislation enacting the new arrangements is implemented.

Details of how the simplified depreciation system will operate as part of the STS, including relevant transitional arrangements, are contained in Section 17.

Application to primary producers

The recommendation to retain accelerated depreciation for certain primary producer assets reflects the Government's commitment not to disturb specific primary producer concessions.

Implementing an effective life regime

Recommendation

8.2 Uniform treatment for depreciable assets

General principle

(a) That the taxation treatment of depreciable assets:

- **(i) be consistent across the range of different types of depreciable assets; and**
- **(ii) where not consistent, have a transparent basis for that differential treatment.**

Specific primary producer provisions retained

(b) That specific primary producer provisions continue to apply where they depart from the uniform treatment being proposed.

It was noted in *A Strong Foundation* (page 38) that the existing legislation contains over 37 different types of amortisation regimes, all aimed at providing annual write-off allowances for 'depreciable assets'. Rationalisation of these provisions would offer significant simplification benefits.

Options to reform the taxation of depreciable assets were canvassed in Chapter 1 of *A Platform for Consultation*. The Review noted that the present system of dealing with the taxation of depreciable assets is complex, inconsistent and involves significant replication. A new system structured upon a common set of principles was proposed.

Respondents to *A Platform for Consultation* generally recognised the need for, and the potential benefits of, a more consistent approach to the taxation of depreciable assets. The major area of disagreement concerned the removal of the balancing charge offset.

The Review has recognised that some variations to the consistent approach will be necessary for policy reasons — including commitments to preserve the current treatment for particular taxpayers, to enable the implementation of a simplified tax system for small businesses (see Section 17), as well as to protect the revenue.

Recommendation
8.3 Entitlement to write-off

That the entitlement to the write-off of depreciable assets for taxation purposes be given to the taxpayer who incurs the loss in value of the asset, not necessarily the legal owner of the asset.

Under the existing law, entitlement to depreciation allowances for plant and equipment depends on the taxpayer being the legal owner of the asset. Most other capital allowances do not have a 'legal ownership' condition.

The legal ownership test has caused difficulties where the asset is a tenant's fixture — because the landowner legally owns fixtures on the land — and where doubt exists about whether the person with the real economic interest in the asset qualifies as an owner.

The recommendation will ensure that only one eligible person would be entitled to tax depreciation with respect to an asset or interest in an asset. An eligible person (or economic owner) will be the person having the capacity to benefit from the asset and able to deny or regulate access by other entities to the future economic benefits that the asset embodies.

Consequently, persons will be entitled to tax depreciation in the following cases.

- A tenant who installs fixtures on a landlord's premises.
- A hire purchaser of a depreciable asset.
- A person who does not have legal title only because title is held as security under a chattel mortgage.
- The beneficiary of the interest in an asset, the legal title in which is held by a trustee under a bare trust.
- Persons who hold assets jointly such as co-owners or joint venture partners. Such taxpayers would be able to write off the cost of their share of depreciable assets regardless of how they paid for those shares.

Recommendation

8.4 Tax value of a depreciable asset

General absorption cost principle

(a) That as a general principle the actual cost of an asset to the person who acquires it:

(i) include all relevant costs — excluding financing costs — of acquiring and installing the asset; and

(ii) become the initial tax value for all classes of assets, including depreciable assets.

Exceptions to tax value principle

(b) That the general treatment not apply to:

(i) assets covered under provisions specific to primary producers, such as those relating to water reticulation;

(ii) assets being sold by government-owned tax-exempt entities; and

(iii) buildings and structures constructed before the commencement of the new law (see Recommendation 8.13).

General treatment

The existing income tax law is deficient because, in some circumstances, it does not recognise all expenditures incurred in acquiring or installing depreciable assets. Some non-financial costs are not included in the initial tax value, even though they contribute to the enduring value of the physical asset itself. With buildings and structures, the cost to the taxpayer is linked to the construction cost rather than to the expenditure incurred by the person who acquires the asset. In some other circumstances, the existing law allows immediate expensing for expenditure incurred in acquiring or installing depreciable assets.

Under the full absorption cost approach proposed for determining the tax value of an asset — including depreciable assets — all non-financial costs of acquiring and installing an asset will be included in its cost base. Full absorption costing is consistent with the accounting approach for the determination of the cost of assets.

The principles to determine the cost of an asset for tax purposes are discussed under Recommendation 4.18.

Net plant commissioning costs incurred as part of the installation process should be included in the cost base of a depreciable asset rather than being expensed. Under this approach, where income has been earned during the commissioning phase, such income would reduce the cost of commissioning rather then being taxed immediately.

Other costs incurred after commissioning to bring an item of plant to full production would be fully deducted as incurred.

Exceptions

Primary producer provisions

The existing treatment of certain specific primary producer assets will be maintained because of the Government's commitment not to disturb primary producer concessions.

Tax-exempt assets entering the tax net

The Parliament recently passed into law (Act 93 of 1999) provisions aimed at ensuring that the assets sold by tax-exempt government-owned enterprises are valued appropriately for taxation purposes.

It was noted in the accompanying Explanatory Memorandum that, given the magnitude and complexity of some of the privatisation transactions,

> there exists some potential or opportunity for shifting value from the non-depreciable assets including intangibles into the depreciable assets. This risk may be increased where the vendor is, from a taxation perspective, disinterested in the proportion of the total business price which is attributed to the cost or termination value of the depreciable assets as it is of no taxation consequence for the exempt vendor in terms of a balancing adjustment or capital gains tax.

As the provisions are designed for revenue protection reasons, the matter is a policy issue for the Government.

Buildings and structures

Because of the potentially large cost to the revenue of allowing all buildings and structures to be depreciated on the basis of their acquisition cost and effective lives upon resale, the Review is recommending that the current taxation treatment continue to apply to existing properties (see Recommendations 8.12 to 8.14).

Recommendation

8.5 Determining the 'effective life' of an asset

Action by Commissioner of Taxation

(a) That the Commissioner of Taxation institute:

(i) an ongoing revision of the effective life schedule; and

(ii) a review of the guidelines for self-assessment of effective life.

Taxpayer options

(b) That taxpayers:

(i) continue to be provided the option of:

- **using the Commissioner's effective life schedule; or**
- **self-assessing the effective life of their assets; and**

(ii) where self-assessing, be required to indicate this on their income tax returns.

Commissioner's schedule

Many taxpayers refer to the Commissioner of Taxation's depreciation rate schedule to determine the rate of write-off of their assets (either a straight line rate or declining balance rate). They do so for both convenience and certainty. The Commissioner's depreciation rates are based on the effective lives of assets.

In many cases the schedule cannot be used, either because the particular asset is not listed, or because it would simply not be possible to ascribe a rate of write-off to an asset because of its unique nature — a mine, for example — or because of its particular circumstances of use.

As noted in *A Platform for Consultation* (page 91), the Commissioner of Taxation is, as a matter of good administration, working to update and expand the depreciation rate schedule to ensure that it is as representative and comprehensive as possible. An updated schedule will provide taxpayers with information on assets to assist them in determining write-off rates for taxation purposes.

The Commissioner is working to publish a revised schedule by 30 June 2000, with those revisions to be undertaken in consultation with relevant groups of industry bodies.

Self-assessment

Because additional assets will be brought into the effective life regime, revised guidelines are required to provide taxpayers with an appropriate basis upon which self-assessment can apply in relation to those assets and upon which the Commissioner of Taxation could provide rulings in particular cases. For example, taxpayers will require guidance to self-assess the depreciation rates of particular assets (such as new buildings), other structures (such as runways) and particular projects (such as a mine). While in some cases the accounting standards may provide some guidance, taxpayers will need to be confident that these are regarded as appropriate for taxation purposes.

Requiring taxpayers to indicate on their income tax returns that they have elected to self-assess depreciation rates would provide a reference point for ATO audits.

Date of commencement

Consistent with Recommendation 8.1, the revised effective life schedule will only apply to plant acquired after the date the revised schedule comes into effect.

Recommendation
8.6 Variations to the depreciation rate of an asset

That in relation to depreciable assets held for business purposes:

(i) taxpayers be permitted to vary depreciation rates, either up or down;

(ii) the Commissioner of Taxation publish separate guidelines to assist taxpayers to determine the conditions under which depreciation rates can be varied; and

(iii) taxpayers be required to indicate in their income tax returns whether there has been any variation to the depreciation rates of their assets since their previous return.

Market or technological developments, or other factors connected with usage, can influence the rate at which an asset may lose economic value. It is, therefore, appropriate that such factors be recognised by the tax law.

Where the effective life of an asset has been reduced below that determined at the time of acquisition or construction, the taxpayer should be able to increase the rate of write-off by re-assessing the effective life of the asset. Variation of depreciation rates is also a requirement for accounting purposes.

Where an asset has been improved (or modified), rather than treating the improvement as a new asset, the impact of the improvement on the remaining effective life of the original asset should be assessed and, if its life has been extended, its rate of write-off modified accordingly. In such cases, the tax value of the improved asset will be the cost of the improvement plus its opening tax value in that year. Such an approach is consistent with accounting practice.

Where taxpayers choose to re-assess the effective lives of their assets, that re-assessment should be indicated on their annual returns. This will provide information for the ATO to assess the extent to which this mechanism is being used and to audit the way in which it is being used.

Recommendation
8.7 Commencement of deductions

(a) That deductions commence:

- **(i) consistent with existing law — at the time the depreciable asset is first used for business purposes or installed ready for use; and**

- **(ii) in the case of partially completed assets, where some separately identifiable part or segment of the asset is in use — from the time such use commences, with deductions allowed in respect of the portion being so used.**

(b) That paragraph (a) not override specific primary producer provisions.

Taxation depreciation is provided because economic losses are incurred where an asset is being used up. Normally, such losses do not arise while an asset is being constructed. On the contrary, the economic value might be expected to increase during construction. Allowing tax deductions in these circumstances would generally be inappropriate.

Buildings and structures are sometimes brought into income-producing use before their overall construction is completed — for example, car parks in a shopping centre. Consistent with the accounting treatment, deductions will be allowable for the construction costs attributable to the part brought into use.

Recommendation
8.8 Write-off method

That taxpayers be given the option of writing off depreciable assets on the basis of prime cost or diminishing value.

For plant and equipment, taxpayers may depreciate particular assets on either the prime cost (straight line) or diminishing value methods. Once an election is made, it is irrevocable. Other capital allowances use the prime cost method only.

There is a case for providing taxpayers with a choice between the two approaches for all depreciable assets — including new buildings, structures, assets subject to the prime cost rules under the existing mining provisions and some intangible assets that attract write-off allowances, such as patents and copyright.

Such an approach would provide neutral treatment between the taxation of different classes of assets, including where an asset is a right to use a physical asset.

Recommendation
8.9 Pooled deductions for project development costs

That project development costs:

(i) be eligible for depreciation through pooling arrangements;

(ii) be pooled only where expenditures do not form part of the tax value of other assets; and

(iii) if pooled, be written off on a diminishing value basis at a rate determined by the effective life of the project.

Enabling taxpayers to write off a range of expenditures through a project development pool provides a mechanism to address one part of the blackhole problem referred to in *A Platform for Consultation* (pages 100-102) and addressed generally at Recommendation 4.14 of this report.

Many project development costs are blackhole expenditures or are subject to special provisions, such as those relating to mining. Expenditures to be covered by the 'project development pools' would include costs for public roads, feasibility studies, costs of acquiring mining and prospecting information, site preparation, government approvals and contributions, and so on.

Separate pools could be employed where expenditures are more appropriately ascribed to sub-projects, which may have different effective lives from the project as a whole — for example, expenditures relating to a discrete ore body within a larger mining project. Separate pools would address problems in the mining sector where, under the existing provisions, certain assets have a much shorter life than the whole project but are required to be linked to the life of the whole project.

It is expected that project-related plant and equipment would be written off in the normal way where their working lives are not directly related to the project in which they are employed.

The concept of the pool would include the polar case of a single item of eligible expenditure. For example, where expenditure linked to a particular activity has been incurred and that expenditure cannot be linked directly to a physical asset or right and where the associated asset has a significantly different life to that of the overall project.

Where an item from the pool is disposed of, the receipts would reduce the value of the pool. If the pool were to have a negative value, that amount would be taxed. Where the project is disposed of, the project development cost pool is to be ascribed value for disposal purposes and the difference between that value and the tax value of the pool would be treated as a single asset in the normal way.

Recommendation

8.10 Pooling for low-value items

Optional pooling of all low-value assets

(a) That taxpayers be given the option to pool all (and only all) individual depreciable assets costing $1,000 or less.

Treatment of pooled items

(b) Where taxpayers elect to pool low-value items, the following treatment apply:

(i) depreciate the pool, using the declining value method, at the rate of 37½ per cent;

(ii) in the year of acquisition, write off items at half the rate applicable to the pool — that is, 18¾ per cent;

(iii) include in the low-value pool, at the taxpayer's option, existing assets with an opening tax value of $1,000 or less which are being depreciated under the declining value method;

(iv) if a low-value pool asset is disposed of, reduce the closing tax value of the pool in the year of disposal by the amount of proceeds; and

(v) if the pool has a negative value at the end of an income year, include a corresponding amount in taxable income.

Treatment where election not made

(c) That where taxpayers elect not to use the pool, all items costing less than $1,000 be required to be written off over their effective lives.

The question was raised in *A Platform for Consultation* (pages 95-96) whether there should be immediate write-off for low-value items. Maintaining individual records for low-cost items for taxation purposes can impose significant compliance costs. Providing immediate write-off for such items would, however, provide undue tax benefits for those who are significant investors in low-value items and provide scope for tax avoidance.

The recommended pooling approach is designed to strike an appropriate balance between taxpayer equity and tax system integrity, while also achieving the principal objective of reducing compliance costs.

Items to be pooled

Taxpayers will be allowed to pool assets where they cost $1,000 or less. This option will replace the existing provision under which items costing less than $300 can be expensed. The use of pooling for assets costing $1,000 or less will not be mandatory, but where taxpayers elect not to use the pool they will be required to depreciate each item separately according to the rate of depreciation determined by its effective life.

Under the diminishing value depreciation method, taxpayers have to continue to depreciate assets until disposed of, or scrapped. This can impose compliance costs upon taxpayers. Providing taxpayers with an option to include assets with opening tax values of $1,000 or less in the low-value pool will provide a mechanism for taxpayers to simplify the record keeping in relation to low-value assets for taxation purposes. Under the accounting standards, depreciation of assets is only required where it is material.

Private use of pooled assets

Where a pooled item is expected to be partially used for private purposes, only that proportion of the asset reasonably expected to be used for business purposes will be eligible for pooling. For example, if there is a reasonable expectation that a mobile phone costing $500 will be used 30 per cent for private purposes, $350 would be eligible for pooling. If such an item is disposed of, the proceeds would reduce the closing tax value of the pool by the proportion of the cost taken into the pool. If that proportion cannot be reasonably determined, the closing tax value of the pool will be reduced by the total amount.

The pool write-off rate

The 37½ per cent depreciation rate being recommended is equivalent to a 4-year prime cost write-off. For some assets, this rate of depreciation may be accelerated from effective life, for others it may be less generous. The trade-off recognises that the existing $300 limit is being removed.

Applying 50 per cent of the pool depreciation rate to assets in the year of purchase overcomes the need to pro-rate deductions and is consistent with the simplification aim of this measure.

Providing for the proceeds of disposals of low-value items to reduce the value of the pool is also consistent with lowering compliance borders. Items will only need to be identified as low-value items at the time of disposal. No other details, such as dates, or values at time of purchase, will be required.

Recommendation

8.11 Taxation upon disposal of depreciable asset

Income recognition principle for 'balancing adjustment'

(a) That when wasting assets are disposed of, the balancing adjustment difference between their opening tax value in the year of disposal and their disposal proceeds add to or subtract from taxable income in the year of disposal.

Exceptions to income recognition

(b) That exceptions to paragraph (a) apply where:

(i) an asset is involuntarily disposed of — see Recommendations 5.8 and 5.12;

(ii) certain primary producer provisions apply; and

(iii) assets are subject to special pooling arrangements — see Recommendations 8.9, 8.10 and 17.3.

Exclusion from capital gains taxation

(c) That assets eligible for depreciation allowances not be eligible for the capital gains treatment set out in Section 18.

Transition on removal of indexation

(d) That, for depreciable assets acquired before the date of effect in paragraph (e), the balancing adjustments in paragraph (a) exclude any indexation slice as at the date of effect — that is, any amount of the disposal proceeds between the original cost base and the indexed cost base for current CGT purposes.

Date of effect

(e) That these new arrangements apply with respect to disposals of all depreciable assets made after the date of announcement.

Existing balancing charge offset

Under existing law, when an asset is disposed of, the depreciation balancing adjustment allows a deduction for the excess of depreciated value over disposal price or includes in assessable income the excess of disposal price (up to original cost) over depreciated value. Any excess of disposal price over the indexed CGT cost base is also included in assessable income. However, taxpayers can defer tax on additions to assessable income from the balancing adjustment by electing for balancing charge offset.

The offset allows taxpayers to set otherwise assessable balancing charges successively against the cost of replacement assets, the cost of other new assets or the depreciated value of other assets. Balancing charge offset, however, does not apply uniformly to all classes of assets — it applies only to plant and equipment.

No conceptual basis supports the availability of balancing charge offset. It allows some taxpayers duplicate tax benefits: from tax deferral on their assets attracting accelerated depreciation allowances; and the further tax deferral provided by the offset if the assets are sold on the second-hand market. But taxpayers with assets which attract little acceleration of depreciation or have no effective second-hand market do not benefit from the offset.

The current arrangements are inequitable, add complexity and underwrite duplication of tax benefits. Duplicate tax benefits arise because not only do some taxpayers get the benefit of accelerated depreciation, but they also get an additional tax deferral when they sell the asset.

The recommendations will not disturb certain specific primary producer provisions, such as those relating to water storage and reticulation expenditure, where special provisions will continue to apply. Those provisions operate to attach eligibility for deductions to the taxpayer who incurs the expenditure, such that no balancing adjustment is made upon disposal.

Indexation and capital allowances

Currently, capital gains indexation of depreciable assets that also receive accelerated depreciation can result in a triple benefit for those taxpayers that dispose of assets for more than their original cost. This arises from the tax deferral from accelerated depreciation, the balancing charge offset and the tax-free indexation slice. There is no apparent reason in equity for such treatment.

The current treatment of disposals of depreciable assets also can be complex to comply with because some disposals can be subject to both the capital allowance and CGT provisions of the law. This means that even though the assets are depreciable, records of original cost must be maintained on the chance that it may be disposed of for a consideration in excess of its original cost base.

Under the Review's recommendations, continuing indexation will no longer be available (indexation to 30 September 1999 will still apply) and balancing adjustments will be recognised at the time of disposal, with a consequent reduction in record keeping requirements. Only the annual tax value will need to be tracked with the final tax position determined by comparing sale value with tax value.

Transitional arrangements

Balancing charge offset

Under existing law, taxpayers have the option to elect to use the offset at the time of disposal. That election will be removed from the time the new law takes effect. Its removal will contribute to the funding of the transitional costs of moving to a lower corporate rate.

Small businesses that decide to use the simplified depreciation system under Recommendation 17.3 will be able to continue to elect to use the balancing charge offset for eligible assets.

Indexation

Taxpayers will be able to retain the indexation benefits up to the date of effect of the removal of the balancing charge offset — with those indexation benefits taken into account in the event that the depreciable assets are disposed of for more than the indexed cost base as at the date of effect.

Pre-1985 assets

Capital gains realised on the disposal of pre-1985 depreciable assets will continue to be exempt from taxation. However, as with other depreciable assets, the option to offset any balancing charge will be removed.

Application to buildings and structures

Recommendation
8.12 New buildings and structures

That buildings and structures commenced to be constructed on or after the date of effect of the new legislation be subject to the general depreciation regime applying to depreciable assets, including effective life write-off.

Recommendation
8.13 Existing buildings and structures

That existing buildings and structures (being those buildings and structures not subject to Recommendation 8.12), and improvements to them, continue to be subject to the operation of the existing law.

Recommendation
8.14 Further processes desirable

That the Government undertake further consultation with the objectives of:

(i) simplifying the law as it applies to existing buildings and structures; and

(ii) developing options to bring existing buildings and structures into the general depreciation regime.

A Platform for Consultation (pages 109-110) noted that a range of problems would be resolved were the taxation treatment of buildings and structures to be folded into a general depreciation regime.

As a general proposition, the Review considers it is appropriate for buildings and structures to be accorded the same taxation treatment as other depreciable assets. Those parties making submissions to the Review shared this view.

The current treatment that provides a fixed annual rate of taxation depreciation based on the original cost of a building or structure can distort investment decisions and reduce economic efficiency. As noted in *An International*

Perspective (pages 74-76) the majority of countries, including the United States, allow deductions based on actual acquisition cost to the taxpayer.

A Platform for Consultation (page 94) canvassed two options for the taxation treatment of buildings and structures:

(i) to apply the standard depreciation treatment only to new buildings and structures; or

(ii) to apply the standard depreciation treatment to all buildings and structures constructed or acquired after the commencement of the new law.

Ideally, the Review would have preferred Option (ii). However, the additional revenue cost of bringing all existing buildings and structures upon resale into the new regime — on the basis of limited data, possibly building up to about $1,500 million by 2009-10 — would have seriously compromised the Review's revenue neutrality constraint.

Existing buildings and structures

The Review's recommendation concerning the taxation of existing buildings and structures is that they would retain their existing treatment. Accordingly, disposals would continue to be subject to capital gains tax treatment, including the reforms being recommended by the Review (see Section 18).

The Review accepts that continuing the existing taxation treatment for the existing stock of buildings and structures will continue to distort the market for such assets. However, as noted below, the existing law is very complex and to add a further layer of complexity at this time would be unacceptable. It is for this reason that the Review is not recommending that taxpayers be required to separately calculate the gains and/or losses from the separate land and building components where the composite asset is being disposed of. To do so could impose significant additional compliance costs on taxpayers.

Current law is complex

A range of taxation treatments applies to buildings and structures depending on when the property was constructed or acquired.

- Buildings and structures constructed before 1979 generally do not receive taxation amortisation.
- Improvements to existing buildings and structures (including pre-1979 buildings) are treated as separate assets and accorded separate taxation treatment.
- Buildings and structures acquired before 20 September 1985 are not subject to any tax if a gain is made upon disposal.

- Subject to certain thresholds, improvements to pre-1985 assets are regarded as post-CGT assets.
- Any excess deductions claimed on buildings and structures acquired before 13 May 1997 are not taxed if the disposal price exceeds the reduced CGT cost base.
- Improvements to buildings and structures made before 1 July 1999 on property acquired before 13 May 1997 are not taxed if the disposal price of those improvements exceeds their reduced CGT cost base.

The range of taxation treatments applying to buildings and structures creates considerable compliance complexity where a property is improved — for both the original and subsequent owners. For example, taxpayers have to maintain records for each improvement as if it were a separate asset for depreciation purposes and such records must be passed on to each subsequent owner. The law provides no mechanism for records to be amalgamated or simplified for subsequent owners.

Full depreciation would be costly

As noted, the revenue neutrality constraint means that the Review is unable to recommend that existing buildings and structures be brought into the general depreciation regime. The preliminary estimate of a high cost to revenue arises because, based on the advice from the property sector, commercial buildings may depreciate at a rate higher than that implied by the current 40-year write-off. An element of the potentially high cost to revenue is the lack of full taxation on the disposal of existing commercial buildings and structures. Providing declining balance depreciation, available under the general depreciation regime, would also contribute to the relatively high cost to revenue.

The law could be improved

The Review notes that the high cost of bringing existing buildings and structures into the general depreciation regime could be lowered — but not eliminated — if all existing buildings and structures (excluding land) were subject to full taxation upon disposal. Full taxation would mean all gains upon disposal, including those applying to pre-1997 and pre-1985 buildings and structures, would be taxed.

Such an approach would simplify the operation of the law for subsequent owners of existing buildings and structures. However, removing or modifying tax preferences on existing assets would be contentious because it could be regarded as being retrospective.

Depreciation rate issues for new buildings and structures

Bringing new buildings and structures into the general depreciation regime raises several practical, administrative and taxpayer compliance issues that will need to be considered before the measures can be implemented.

The Review has been advised that the majority of taxpayers would be likely to adopt the Commissioner of Taxation's depreciation rate schedule for buildings and structures.

The compiling of a depreciation rate schedule for buildings and structures is, therefore, an important issue.

Research is being undertaken by the industry, which will be forwarded to the Government when completed. That will assist the Commissioner of Taxation in updating the depreciation rate schedule to include buildings and structures.

Consistent with the depreciable assets regime, taxpayers would also have the option to self-assess the depreciation rates if those rates were not appropriate to their individual circumstances. Guidelines will also need to be developed to enable taxpayers to self-assess on a basis that will be acceptable to the Commissioner of Taxation.

Valuation issues

Subjecting buildings and structures to the normal depreciation provisions will mean that taxpayers would need to undertake separate valuations for the land, on the one hand, and the building and other depreciable asset components on the other. Of particular importance would be mechanisms to apportion the value of land to high-rise strata title properties. Taxpayers would need guidelines to assist them in providing valuations that are acceptable for taxation purposes. Such guidelines would need to have regard to the integrity of the tax system and relevant commercial considerations.

Further consultation required

The Review considers that before there can be a comprehensive reform of the taxation treatment of buildings and structures, more comprehensive data need to be assembled and various options for simplifying the existing law need to be explored with taxpayer groups.

Improving the data base

To provide a reliable basis for estimates of the tax revenue consequences of bringing the existing stock of buildings and structures into the general depreciable assets regime, more comprehensive and reliable information is needed about effective lives and market values of the properties and their rate of turnover. Such information is currently not available from the ATO or other official sources.

Simplifying the law

One option to simplify the law could be to amalgamate the various provisions applying to existing buildings and structures, and improvements to them. Matters to be considered could include, but need not be limited to, the following:

- eliminating the grandfathering of existing arrangements as mentioned above;
- consolidating existing buildings and structures and their improvements into single assets to which common depreciation rates and disposal rules could be applied; and
- an optional pooling of all costs comprising the depreciable component of buildings and structures to which a common rate of depreciation might be applied.

Establishing a group of specialists

Consultation on reform of the taxation of existing buildings and structures could be conducted through a working group of specialists with detailed knowledge of the property market. Among other tasks, the group could:

- develop the appropriate criteria for the determination of effective lives from which taxpayers could self-assess should they so elect; and
- consider valuation issues, and in particular the development of guidelines to assist taxpayers to allocate the cost of a building between its various components — namely, land, the structure and plant.

Proposed commencement date

The proposed commencement date for bringing new buildings and structures into the comprehensive wasting assets regime is recommended to be the date of effect of the new legislation.

The reform of the taxation treatment of existing buildings and structures would depend on progress made with respect to the range of issues identified by the Review and subsequent decisions by the Government.

Application to mining and resources

Recommendation

8.15 Mining, quarrying and petroleum expenditures

That expenditures incurred by the mining, quarrying and petroleum sectors generally be taxed on the same basis as expenditures incurred by other sectors.

Current taxation treatment

In *A Platform for Consultation* (pages 111-114), the Review noted that the current taxation treatment of expenditure on, and income from, the exploitation of minerals and petroleum resources is inconsistent and distortionary.

Currently, expenditure on plant is deductible in the same manner as for other taxpayers generally. Other capital expenditure on developing and operating a project (allowable capital expenditure) is deductible over the shorter of the life of the project or 10 years, or 20 years in the case of quarrying. Expenditure on infrastructure for transporting mineral and quarry materials away from the site is deductible over 10 years in the case of mining and 20 years for quarrying, irrespective of the effective life of the assets.

In principle, the cost of all such assets should be deductible over the shorter of the effective life of each asset and, where the asset will be abandoned at the end of the project, the life of the project. That means that assets with an effective life shorter than project life or the 10/20 year 'cap' ought to have higher write-off rates than at present while those with effective lives longer than project life or the cap ought to have lower rates than at present.

Undeducted or unattributable expenditures

Under the current law, where only a part of a mining or quarrying site is closed down or abandoned, the undeducted costs in relation to that part have to be deducted over the remaining life of the continuing part. Under the effective life model proposed for depreciable assets, such undeducted costs will immediately reduce taxable income.

In some instances, expenditures incurred to develop and operate a project might not be readily attributable to particular assets — for example, contributions to local authorities for access road maintenance. Such expenditures will be able to be written off under Recommendation 8.9 through the 'project development cost pools'. This approach will also enable other blackhole expenditures, where they relate to the life of the project, to be written off over the life of the project — for example, a feasibility study for a new mine. As with other assets subject to the depreciation rules, such expenditures will be able to be written off using the diminishing value method.

Mining, quarrying or prospecting rights

Currently, expenditure on acquiring mining, quarrying or prospecting rights or information from another person is treated as development expenditure and so is deductible over the shorter of the project life and the 10/20 year cap irrespective of the actual benefit produced by the expenditure. As well, a limit applies to the deductible amount. Broadly, the deductible amount is the lower of the price paid and the sum of deductible development expenditure incurred by the vendor in respect of the asset and any other undeducted exploration and prospecting expenditure that the vendor agrees to transfer to the purchaser. Any excess is either deductible as a capital loss at the end of the project or is not deductible at all.

Such expenditure ought to be treated consistently with other expenditure and without a limit applying. For example, so much of the expenditure that relates to tangible assets such as access roads, mineshafts and buildings ought to be deductible over the shorter of the asset's effective life and project life, where the asset has no further effective life beyond that of the project. Expenditure on information should be treated according to the benefit obtained from that information. If the information relates to exploration and prospecting activities, it should be immediately deductible (consistent with retaining the current immediate write-off of the treatment of exploration and prospecting expenditure — see Recommendation 4.3(v)). If it relates to an existing mine, it should be deductible over the life of that mine. Otherwise, it should be immediately deductible.

Self-assessment of effective life

The effective life of a mining or resource project will be self-assessed by taxpayers in accordance with guidelines which it is recommended should be developed in consultation with the industry and published by the Commissioner of Taxation.

Submissions received from the mining industry argued that, in recognition of the higher risks often associated with mining projects, a limit ought to be placed on the period of write-off of expenditure on developing and operating mining projects. This particular concern is addressed more generally through Recommendation 8.6, which would allow taxpayers to reassess effective lives — and hence write-off rates — during the life of a project should economic circumstances change.

Recommendation

8.16 Receipts from sale of mining information

That all receipts from the sale of mining information be subject to taxation.

Currently, many receipts from the sale of mining/quarrying information are not taxable under either the ordinary income or capital gains tax provisions. In principle, all business receipts should be taxable with deductions being allowed for the costs of earning those receipts.

Much expenditure on acquiring information for future mining/quarrying is currently not deductible. Nor would such expenditure create a loss for capital gains tax purposes. Under the cashflow/tax value approach, all expenditure on mining/quarrying information will be deductible. Expenditure on creating information through exploration and prospecting is to remain immediately deductible. Expenditure on acquiring information from another person will be deductible (see Recommendation 8.15).

Recommendation

8.17 Repeal of excess deduction rules

That the excess deduction rules be repealed from the date of announcement.

Unless an election is made, deductions for exploration and prospecting expenditure and allowable capital expenditure are currently limited to the amount of available income. The excess deductions are carried forward for successive deduction in following years until fully absorbed.

Where an election is made, the limits do not apply, and any resultant losses are available for transfer under the group company loss transfer provisions.

The excess deduction rules are, in effect, a loss carry-forward mechanism, separate from the general provisions for company and trust losses. They were enacted before the 1990 removal of the 7-year limit on the carry forward of non-primary production losses to recognise that the mining sector might not be able to use early year losses fully within 7 years.

As well, the excess deduction rules facilitate agreements for the transfer of deduction entitlements from vendors to purchasers of mining, quarrying or prospecting rights and information. A vendor of such assets can agree to attach undeducted unsuccessful exploration and prospecting expenditure to assets being disposed of. The Review is recommending that the full cost of acquiring mining or quarrying rights and information be deductible as outlined in Recommendation 8.15 — so the remaining reason for retention of the excess deduction rules will be removed.

Submissions to the Review stated that the excess deduction rules ought to be retained, but provided no reasoning to support this proposition. As the rules have been open to exploitation and are no longer necessary, the Review is recommending that they be repealed from the date of announcement. To defer implementation would allow taxpayers to further exploit the provisions, to the detriment of the revenue.

Recommendation

8.18 Advance work on removal of minerals

That taxpayers be required to bring to account the cost of 'advance work' on the removal of minerals performed on or after 1 July 2000.

Mining operations often necessitate significant levels of advance work on the removal of overburden. Currently, the cost of such work is immediately deductible to the taxpayer performing the work — contributing to the cost of 'trading stock' at the time — even though the benefit is sometimes consumed only as the minerals are extracted.

Despite this, the value of 'unconsumed' removal of overburden would be included in the cost of acquiring a property. This value is then part of the cost base of the purchaser and is effectively not deductible to the purchaser until the property is disposed of.

The benefit arising from advance work on the removal of overburden will be an asset under the cashflow/tax value approach. As such, deductions should only be taken when the asset is consumed. That occurs when the prior removal of overburden assists the extraction of minerals for sale or consumption. The 'consumption' of the relevant part of prior overburden removal would be included in the cost of the trading stock at that time. This approach is consistent with that adopted for accounting purposes.

Under the cashflow/tax value approach, the unconsumed benefit of removing overburden at year-end is to be valued at cost. That cost would be absorbed into the cost of the minerals as they are extracted so that a deduction would be allowable, in effect, only at the time that the minerals are either sold or consumed.

In some forms of mining, overburden is removed so as to access the whole of the ore body. It might be simpler in that case to allow the cost of overburden removal to be amortised over the life of the ore body rather than requiring it to be allocated to the cost of production.

Under the cashflow/tax value approach, the treatment of the sale and purchase of properties upon which there is an unconsumed benefit of removed overburden at the time of sale will be as follows.

- For the vendor, the portion of the disposal proceeds attributable to the benefit will be assessable and the undeducted cost of the work will be deductible. Currently, the amount attributable to the benefit would be taxable under the capital gains tax provisions.
- For the purchaser, the price paid for the benefit will be either allocated to the cost of production or amortised over the life of the ore body, as appropriate. The method chosen will be at the election of the taxpayer. Currently, the cost of the benefit is effectively not deductible until the property is disposed of.

The reform might have a significant impact on some taxpayers if it were to apply to work already performed. Accordingly, the Review recommends that it apply only to work performed on or after 1 July 2000.

Retaining the current R&D tax concession

Recommendation
8.19 R&D tax concession retained

That the 125 per cent research and development (R&D) tax concession be retained and be made available to all entities that are taxed as companies.

The objective of the 125 per cent R&D tax concession is to encourage innovation. Government support to the R&D sector has been the subject of a series of reports and studies over the years culminating in the Mortimer review of industry policy. In the subsequent release in December 1996 of the *Investing in Growth* policy statement, the Government decided to retain the tax concession at 125 per cent, but to increase outlays to the sector through the *Innovation Investment Fund* program.

The Government has indicated its policy intention to retain the R&D tax concession. The Review has not attempted to assess the merits of the current arrangements. However, including trusts in a consistent entity tax regime requires the extension of eligibility for the R&D concession to trusts.

The luxury car depreciation limit

Recommendation

8.20 Allowing full depreciation for luxury cars used by hire firms

Short-term multiple hire

(a) That taxpayers using luxury cars in the business of short-term multiple hire — defined as a period of one month or less — not be subject to the luxury car limit.

Date of effect

(b) That the commencement date be 1 July 2000.

The luxury car limit has been a feature of the law since 1979. The policy recognises that there is an element of private consumption where luxury cars are otherwise being used for business purposes. The current law is drafted so that the restriction applies irrespective of the use of such vehicles.

Under the existing law, cars that have an opening tax value in excess of a specified limit — $55,134 for 1998-99 — may only claim tax depreciation based on that limit. The limit is indexed annually. For example, if a car costs $70,000, its opening tax value would be $55,134.

Except where cars have been modified to transport disabled persons in wheelchairs (see below), this limit applies even where the car is used directly by a business — such as a hire car firm — to earn income.

The Review's recommendation will allow the full cost of acquisition to be the opening tax value. It will apply only to taxpayers that are either in the business of conveying passengers on a short-term hire basis, or hiring out vehicles on a short-term basis to unrelated persons. The Review considers that to deny taxation based on the full cost of their business investment is inconsistent with reform measures to allow taxpayers to base their tax depreciation on the cost of their assets.

The Review, however, recognises that to remove the limit in all cases would be inconsistent with the long-standing policy with respect to luxury cars. Accordingly, the removal of the limit will not extend to cases where a taxpayer uses a luxury car — chauffeur driven or otherwise — in his or her business where that business is not primarily one of short-term hire for reward. 'Short-term' will be defined as a period of one month or less.

Recommendation
8.21 Increasing the threshold for disabled owners

Modifications to non-luxury cars

(a) That the luxury car limit not apply:

(i) where a non-luxury car has been modified by a taxpayer with a disability to enable it to be used for business purposes; and

(ii) as a result, the opening tax value of the car exceeds the luxury car limit.

Date of effect

(b) That the commencement date be 1 July 2000.

Under the existing law, the luxury car limit does not apply where a car has been modified to transport people with disabilities in wheelchairs. The limit, however, applies where a car has been modified for use by a person with a disability in his or her business.

The Review considers that where a non-luxury car has been modified to enable a disabled person to use it for business purposes so that the opening tax value of the vehicle exceeds the luxury car limit, that limit should be increased to cover the cost of modifications necessary to enable the car to be used by the disabled person. To qualify for increased tax depreciation, the modifications should be associated with the disability of the taxpayer and not other purposes.

Maintaining the current treatment of acquired goodwill

Recommendation
8.22 Maintain treatment of acquired goodwill

That acquired goodwill be taxed on a realisation basis rather than being amortised over a specified period.

Current treatment

The recommendation means that the existing taxation treatment of goodwill would continue.

As noted in Chapter 4 of *A Platform for Consultation* (page 136), under the current law acquired goodwill is taxed as follows under the CGT provisions:

- the proceeds are taxed as capital income to the vendor; and
- the consideration forms the cost base to the acquirer.

There are no provisions to allow taxpayers to deduct or amortise the cost of acquired goodwill.

As goodwill (however defined) can only be accurately valued upon realisation, attempting to estimate the annual change in value of goodwill does not appear to be a practical proposition. It would also conflict with the Review's support for generally taxing gains on assets, other than some financial assets, on a realisation basis.

From a practical perspective, acquired goodwill is normally purchased along with other assets (both tangible and intangible) of a business. As goodwill has no precise meaning, its acquisition cost is the residual amount remaining, consistent with the accounting treatment, after precise values have been allocated to other assets.

Experience with the CGT goodwill provisions points to significant practical difficulties in ascribing valuations to goodwill in particular cases; so much so, that cases have been litigated as far as the full bench of the High Court (*A Platform for Consultation,* pages 136-137).

Accounting treatment

Under the AASB 1013 *Accounting for Goodwill* issued in June 1996, purchased goodwill must be amortised on a straight line basis, over the period during which the benefits are expected to arise. This period must not exceed 20 years from the date of acquisition (A *Platform for Consultation,* page 139).

International treatment

There is no common approach to the taxation of goodwill internationally. The international treatment of goodwill is set out on pages 74 and 75 of *An International Perspective.* In half of the jurisdictions surveyed, acquired goodwill is not deductible. Other countries — including the United States, Canada, Germany and Japan — allow amortisation over periods ranging from 5 to 20 years.

Linkages with other measures

The reforms to the taxation of certain rights (such as restrictive covenants) will mean that in some cases taxpayers will be able to write off expenditure that previously may have been loosely characterised as goodwill.

Recommended changes to the treatment of capital gains will mean that, in some cases, more generous relief may be available where acquired goodwill is disposed of.

Conclusion

Submissions to the Review generally, but not exclusively, favoured allowance for tax depreciation of acquired goodwill. On balance, because of the cost to revenue — which, it has been estimated, could run into billions of dollars over time — and the granting of deductibility to blackhole expenditures, the Review has decided that the existing treatment be retained. It does so with the proviso that the scope for amortisation treatment be re-examined should the current reforms prove to be more revenue positive than the estimates included in this report.

In coming to this conclusion, the Review recognises that this treatment disadvantages Australian entities in competitive takeover situations where they are competing with bidders based in jurisdictions that provide taxation depreciation for acquired goodwill. This has become more significant with the change in accounting standards referred to above.