

TR 2017/D1 - Income tax: composite items and identifying the depreciating asset for the purposes of working out capital allowances

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Draft Taxation Ruling

Income tax: composite items and identifying the depreciating asset for the purposes of working out capital allowances

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What this draft Ruling is about

1. Division 40 of the *Income Tax Assessment Act 1997* (ITAA 1997)¹ provides a deduction for the decline in value of depreciating assets based on their effective life.² A ‘depreciating asset’ is an asset that has limited effective life and that can reasonably be expected to decline in value over the time it is used.³

2. This draft Ruling sets out the Commissioner’s views on:

- how to determine whether a composite item is itself a depreciating asset or whether its components are separate depreciating assets for the purposes of Division 40 (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 depreciating asset, or whether an interest in any part of the asset is enough.

3. This draft Ruling does not address Division 43 which provides deductions for certain capital works expenditure.⁴

¹ All legislative references in this draft Ruling are to the ITAA 1997 unless otherwise indicated.

² See sections 40-1 and 40-10.

³ Section 40-30. There are exceptions to this: see subsection 40-30(1).

⁴ Taxation Ruling TR 2007/9 *Income tax: circumstances when an item used to create a particular atmosphere or ambience for premises used in a cafe, restaurant,*

Ruling

Composite items

4. A 'composite item' is an item that is made up of a number of components that are capable of separate existence. Whether a particular composite item is itself a depreciating asset or whether one or more of its components are separate depreciating assets is a question of fact and degree to be determined in the circumstances of the particular case.⁵

Guiding principles

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

6. Purpose or function is generally a useful guide to the identification of an item.⁶ 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:

- (a) 'Identifiable': the depreciating asset will tend to be the item that performs a separate identifiable function, having regard to the purpose or function it serves in its business context.
- (b) 'Use': a depreciating asset will tend to be an item that performs a discrete function. However, the item need not be self-contained or able to be used on a stand-alone basis.
- (c) 'Degree of integration': the depreciating asset will tend to be the composite item where there is a high degree of physical integration of the components.
- (d) 'Effect of attachment': the item, when attached to another asset having its own independent function, varies the performance of that asset.
- (e) 'System': a depreciating asset will tend to be the multiple components that are purchased as a system to function together as a whole and which are necessarily connected in their operation.

7. The relevant function considered in this context is the actual function the item is to serve in the particular taxpayer's income

licensed club, hotel, motel or retail shopping business constitutes an item of plant discusses the interaction between Division 40 and Division 43 of the ITAA 1997.

⁵ Subsection 40-30(4).

⁶ See *Federal Commissioner of Taxation v. Tully Co-operative Sugar Milling Association Ltd* (1983) 68 CLR 39; (1983) 51 ALR 751; (1983) 14 ATR 495; (1983) 83 ATC 4495 (*Tully*) per Lockhart J at ATC 4504.

producing activity, rather than any theoretical function to which the item could be put in other circumstances. (See Example 5).

8. 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 in particular Examples 1, 2, 6, 11 and 13).

9. 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.

10. An item may be considered to be 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).

11. The mere fact that an item cannot operate on its own and has no commercial utility unless linked or connected to another item or items tends to indicate that it will form part of a composite item, rather than being a separate depreciating asset. An item that is designed to be functionally interchangeable, or is used in this way, with other items may indicate there are separate depreciating assets. (See Examples 3, 4, 6 and 13).

12. 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, 13 and 14).

13. 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).

Modifications

14. A modification or alteration to an existing asset can itself be a separate depreciating asset. (See Examples 6, 8 and 12). A modification to a depreciating asset which restructures or adds new parts to the existing item will result in the former depreciating asset being merged into a new depreciating asset, if the depreciating asset has a different purpose or performs a different function from the original asset.

15. By contrast, restorations and minor alterations that do not change the function of the depreciating asset will not create a new depreciating asset. Where expenditure on restoring a depreciating asset to its original condition constitutes a repair, no new depreciating asset is created, and the cost of the depreciating asset is unchanged

for the purposes of calculating decline in value deductions.⁷ (See Example 9).

16. 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 asset has been created.⁸

17. Where:

- a depreciating asset is substantially altered
- the original depreciating asset continues to perform its function, and
- the addition or attachment serves its own function,

both the original and new depreciating assets are recognised in working out deductions for decline in value under Division 40.

18. Changes to an existing depreciating asset which modify the depreciating asset, allowing the depreciating asset to perform additional tasks or improve its efficiency, will not necessarily cause a separate depreciating asset to come into existence. (See Examples 1 and 10).

Intangible depreciating assets

19. 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.

20. 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). A right that forms part of an intangible asset typically cannot be separated from that intangible asset. It follows that an entity cannot hold 'part' of an intangible asset as if it were a depreciating asset. Entities can only jointly hold (that is, have a share in), the entirety of the depreciating asset.⁹

21. Section 40-35, which relates to jointly held depreciating assets, can apply to intangible depreciating assets except for mining, quarrying or prospecting rights. An interest in a 'mining, quarrying or

⁷ See section 40-215.

⁸ This draft 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.

⁹ See *Mitsui and Company (Australia) Ltd v. Federal Commissioner of Taxation* [2012] FCAFC 109; (2012) 205 FCR 523; 2012 ATC 20-341; (2012) 6 ARLR 401; (2012) 90 ATR 171 (*Mitsui*).

prospecting right'¹⁰ is itself an intangible asset that is listed in subsection 40-30(2). Where a mining, quarrying or prospecting right is created by statute as an entirety, an entity's interest in such a right is itself a depreciating asset only if it holds a share in the entirety of the mining, quarrying or prospecting right.

Jointly held tangible assets

22. Section 40-35 applies in circumstances where a depreciating asset (the underlying asset) that an entity holds is also held by one or more other entities.

23. Section 40-35 refers to 'your interest in the underlying asset'. The word 'interest' is not defined and is read broadly. Section 40-35 facilitates working out deductions for decline in value irrespective of whether an entity's interest is a partial interest in the entirety of a composite item that is a depreciating asset or a 100 per cent interest in a particular component of that depreciating asset.

24. Where a composite item is the depreciating asset, an entity works out a deduction for the decline in value over an income year based on the cost of:

- (a) the single component that the entity holds in the composite item, or
- (b) the interest held by the entity in an otherwise undivided composite item (for example, shared ownership). (See Example 7).

Examples

Example 1 – Industrial storage racking

25. *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.*

26. *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 form part of the row. Any new rows that are acquired will be separate depreciating assets.¹¹*

¹⁰ Defined in subsection 995-1(1).

¹¹ If the storage racks support the roof and/or walls of the storage building, and that roof and/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.

27. *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 to an existing row is a modification to an existing asset, and that cost is included in the second element of cost under section 40-190.*

Example 2 – Desktop computer package

28. *Alyona buys a desktop computer package which consists of a tower computer, monitor, and wireless keyboard and mouse. This package of components is a single depreciating asset because:*

- *'Identifiable': The components function together as a whole computer terminal.*
- *'Use': Each element of the system is reliant upon the other elements of the system for its functionality. Alyona uses all of the components together as a combined asset.*
- *'Degree of integration': the ease with which the components are connected and separated suggests there is more than one depreciating asset but this is outweighed by other considerations.*
- *'Effect of attachment': When the computer package is connected, to a network or printer for example, it continues to function independently but its performance is enhanced.*
- *'System': The components were purchased as a system to function together as one. The tower computer and monitor are physically connected; the wireless keyboard and mouse are digitally connected.*

29. *These principles apply in the same way even if the various elements of the system had been acquired separately from separate suppliers.*

30. *The subsequent acquisition of discrete additional or replacement elements of the system, even though the purchaser is intending to use them with the existing system, will be the acquisition of separate depreciating assets. This is because each new element is sold as a discrete unit, capable of performing its function in a wide range of systems and circumstances, and is not necessary to complete the functionality of the system.*

31. *Printers are not part of the overall computer system. Their function is sufficiently discrete for them to be separate depreciating assets. This would be the case regardless of whether a printer was purchased as part of a package or separately.*

32. *By contrast, the acquisition of something that is physically incorporated into a computer (or element of a computer system) will become part of the computer upon installation and not a separate depreciating asset. That cost is included in the second element of*

cost of the computer system. 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.*

Example 3 – Mainframe computer

33. *Vitaly sets up a new mainframe computer system with 50 'slave' terminals that are only functional when connected to the mainframe because they lack a base unit or a separate central processing unit. Twelve months later Vitaly expands the system by purchasing another 20 slave terminals which are connected to the existing mainframe computer.*

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

- *'Identifiable': The slave terminals are reliant upon the mainframe for their functionality. The individual components cannot perform a separate identifiable function.*
- *'System': The components were acquired at the same time as a functionally complete system to work together in that manner.*

35. *While the 20 new terminals are similarly dependent upon the mainframe for their functionality, they do have a separate existence and they are not part of the system as originally acquired and can function in conjunction with a range of mainframes or other controlling devices. Their function is to receive data from and transmit data to any compatible controlling unit to which they are connected. 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

36. *Nazar sets up a Local Area Network (LAN); a cable system network which links a server to ten computers. Users on each of the computers can access a shared database, but these computers can also operate independently. When operating independently, the computers in the LAN system run on their own software and can be connected directly to a printer.*

37. *Each computer has a separate existence and is a depreciating asset because:*

- *'Identifiable': Each computer has an identifiable function independent of the other computers and the server.*
- *'Use': Each computer has its own discrete function and can be used on its own.*
- *'Effect of attachment': When attached to the LAN, the computers' functionality increases but the nature of the computer as a separate asset does not change; they are not subsumed to become a component of another depreciating asset.*

38. *If the computers and LAN components had been purchased or set up simultaneously, the timing would indicate that the items are components of a system working together. In contrast to Example 3 though, the separate existence and independent functionality of the computers in this scenario mean that each computer is a depreciating asset.*

39. *The server and associated cabling is a single depreciating asset, separate to the computers.*

Example 5 – Aircraft engine and airframe in service on rotation

40. *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.*

41. *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.*

42. *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 the relevant depreciating asset:*

- *'Identifiable': 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.*

- *'Use': Airlease, and the industry broadly, deal separately with engines and airframes. The lease terms and the scheduled maintenance program demonstrate this.*
- *'Effect of attachment': 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.*

43. *Airlease's engines and airframes are separate depreciating assets.*

Example 6 – Car GPS

44. *Orson has a parcel delivery business including a delivery vehicle. He is contemplating what type of GPS to buy for it.*

45. *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 unit 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.*

46. *In the case of 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.*

47. *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 to 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

48. *An undersea communications cable system was constructed to transmit data between three countries. The system was constructed with two 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).*

49. *Each segment of the system consists of fibre optic cables and transmission and receiving equipment. Various associated entities own the fibre optic cables and the transmission and receiving equipment.*

50. *Fibropca Co owns the fibre optic cables in Segment 1.*

51. *The different entities have contractual relationships between each other which bring the complete cable system together to enable the carrying of traffic on the system (from country A to country B, from country B to country C, and from country A to country C via country B).*

52. *In this case, each of the two segments of the system, perform the function of carrying data between two places. While the two segments of the cable 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 two 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, rather than the components of each segment, is the depreciating asset in these circumstances.¹²*

53. *While each segment is a depreciating asset, the components of a segment are owned by different entities. For the purposes of section 40-35, Fibropca Co is a holder of two 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 components incorporated into the segment, 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 – an addition to an existing distribution line

54. *An electricity distribution network owner builds distribution lines and additions to existing distribution lines to supply customers who were not previously supplied by the network.*

55. *In both cases there is the addition of a new distribution line which is a new and separate depreciating asset from any existing distribution infrastructure.*

56. *An 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.*

57. *Whilst each of these items has its 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 by the addition. This function is only able to be performed when the system is complete. A new*

¹² Cf Lockhart J at FCA paragraphs 55-61 *Overseas Telecommunications Commission (Aust) v. Federal Commissioner of Taxation* (1989) 20 ATR 1482; (1989) 89 ATC 5200 (OTC).

*depreciating asset in the form of a distribution line comes into being when all its components have been assembled.*¹³

58. *The new distribution line (or addition) is a separate asset from any existing distribution infrastructure. 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 a distribution line is physically connected and commences its function of distribution of electricity at a different time to the original distribution line 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. It does not matter that the new distribution line may be incapable of independent operation without connection to an existing distribution line or other element of the network.*

59. *Therefore the depreciating asset is the electricity distribution line at the time it is first used or installed ready for use ('its start time'¹⁴) and not the individual parts. The components that make up the new distribution line at its start time identify the limit of that distribution line.*

Example 9 – Replacing electricity pole

60. *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.*

61. *The replacement of a pole does not create a new depreciating asset separate from the distribution line of which it is a part. There has been no substantial alteration to the function of the distribution line of which the relevant pole is a part.¹⁵ The replacement of the pole gives rise to a deductible repair expense.*

Example 10 – Upgrade of transformer

62. *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.*

63. *The function of the electricity distribution transformer is to transform high voltage electrical current to a usable voltage for*

¹³ See the example of the erection of a farm fence in *Tully* per Lockhart J at ATC 4504; ATR 505.

¹⁴ Section 40-60.

¹⁵ See *Tully*, Case S51 85 ATC 380 and Case T33 86 ATC 293 (Case T33).

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, 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 are subsumed into the larger system when it is constructed. Therefore the overall function of the distribution line is to transmit electricity to consumers.

64. Once the function of the system is determined to be an electricity distribution line, an improvement of an element of that system will constitute an improvement to the distribution line itself, rather than constituting the acquisition and installation of a separate depreciating asset. In this case, the original transformer was integral to the function of the distribution line. The replacement of the existing transformer with a transformer that has greater electricity load capacity does not change the function of the distribution line.

65. This upgrade is an improvement to the depreciating asset and not a separate asset. The costs of purchasing, installing and connecting the transformer ready for use are included in the second element of cost of the distribution line that was delineated as a depreciating asset at the time the distribution line was connected ready for use to the electricity distribution network.

Example 11 – Rail transport infrastructure

66. 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, and the earthworks or embankments on which the ballast, sleepers and rails are laid, and integral bridges, girders, culverts and tunnels.

67. 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 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. Based on this functionality the entire track work, rather than each of its components, is the depreciating asset. This includes the earthworks and embankments referred to as the

'permanent way' and the track foundation.¹⁶ Accordingly, the rail transport track work is a depreciating asset within the meaning of that term in section 40-30.

Example 12 – New railway branch line

68. *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.*

69. *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 mainline 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

70. *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.*

71. *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.*

72. *Twelve months later, SM Co expands the system by purchasing two additional solar panels. They are connected to the system that was already in operation. The panels are not part of the original system; they have a separate existence and can function with a range of solar electricity systems. The separate acquisition of the additional panels and their adaptability to work with other systems are factors sufficient to treat each new panel as a separate depreciating asset for Division 40 purposes.*

¹⁶ See cf. *Inland Revenue Commissioners v. Barclay, Curle & Co Ltd* (1969) 48 ATC 17; [1969] 1 All ER 732; [1969] 1 Lloyd's Rep 169; 1969 Sess Cas (HL) 30; [1969] 1 WLR 675; (1969) SLT 122.

Example 14 – Photographic lighting equipment

73. *Georgia is a keen photographer who during the income year 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 particular generator distributes and regulates power and contains three 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: include 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 whilst in transit.*

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

75. *All of the items are physically detachable and interchangeable with other generators and/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 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.*

Date of effect

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

Appendix 1 – Explanation

❶ ***This Appendix 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.***

Guiding principles

77. The enquiry into whether a composite item is itself a depreciating asset or whether its components are separate depreciating assets is relevant to determining the effective life of the asset, 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.

78. The question of whether a composite item is itself a depreciating asset or some components are separate depreciating assets is a question of fact and degree to be determined in the circumstances of the particular case.¹⁷

79. The Revised Explanatory Memorandum¹⁸(EM) that accompanied the Bill to insert subsection 40-30(4) states:

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)]**

80. 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 the former section 82AT of the *Income Tax Assessment Act 1936*.

81. 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.

82. 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 at ATC 4504:

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

¹⁷ Subsection 40-30(4).

¹⁸ Revised Explanatory Memorandum to the New Business Tax System (Capital Allowances) Bill 2001.

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.

83. To assist in determining whether a composite item is a single depreciating asset or more than one depreciating asset, subsection 40-30(4) provides the example of a car as an instance of where a composite item is considered to be a single depreciating asset rather than a number of components. It also provides a floating restaurant as an example of where the components of a composite item are separate depreciating assets; being the ship itself, stoves, fridges, furniture, crockery and cutlery.¹⁹

Relevant case law – the function test

84. Ascertaining purpose or function can be difficult. Cases including *Ready Mixed Concrete*²⁰, *Tully*²¹ and *Monier Colourtile*²² explain that a separate 'unit of property' is one which has an identifiable separate function. For example, in *Monier Colourtile Pty Ltd v. Federal Commissioner of Taxation*, Lee J, in determining that pallets that conveyed concrete through a tile making machine were separate units of property 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 5150 pallets remained 5150 individual pallets, each one performing its individual function ... The total number of pallets, i.e. 5150 never took on or performed a function additional to and distinguishable from that of the individual pallets making up that total.

85. Also, in *Monier Colourtile* each of several mobile radio stations, and the base station, were held to be functionally complete

¹⁹ The Commissioner discusses these examples at paragraphs 129 to 133 of Taxation Ruling TR 2012/7 *Income tax: capital allowances: treatment of open pit mine site improvements*.

²⁰ *Ready Mixed Concrete (Victoria) Pty Ltd v. Federal Commissioner of Taxation* (1969) 118 CLR 177; (1969) 43 ALJR 153; (1969) 15 ATD 215; (1969) 1 ATR 123; (1969) 69 ATC 4038; [1969] LB Co's Tax Serv 276; [1969] HCA 12.

²¹ *Federal Commissioner of Taxation v. Tully Co-operative Sugar Milling Association Ltd.* (1983) 68 FLR 39; (1983) 51 ALR 751; (1983) 14 ATR 495; (1983) 83 ATC 4495.

²² *Monier Colourtile Pty Ltd v. Federal Commissioner of Taxation* (1983) 68 FLR 111; (1983) 14 ATR 379; (1983) 83 ATC 4399.

in themselves and therefore separate units of property. Each had a separate independent existence. The trial judge said that even though the base station was useless without one or more mobile stations and vice versa, this 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 someone is broadcasting a television signal. 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.

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

...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.

87. 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.

88. 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 two items are not single depreciating assets (see *Tully*, discussed below).

89. In *Tully's* case Fitzgerald J said at ATC 4506; ATR 506:

... 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 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.

90. 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

²³ (1988) 19 ATR 1593; (1988) 88 ATC 4642.

²⁴ At ATC 4648; ATR 1600.

prevent the individual items from being separate units for tax purposes. Fox J, said at ATC 4500; ATR 500:

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.

91. 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.

92. 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 at ATC 4042; ATR 127:

Notwithstanding the mode and degree of annexation, the truck and the mixer are functionally separate and independent units of property. The function of the 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 ...

93. However, it is not necessary that a depreciating asset be functionally operative provided that the asset is capable of fulfilling an independent function.

94. This is evident where the various units each perform a discrete function. The fact goods move along a conveyor belt from apparatus to apparatus (and this is not possible until the units are connected) does not change that. However, in *Tully's case* Lockhart J also said at ATC 4504; ATR 505:

Yet at other times a 'unit' may not come into being until all 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.

95. In this case, each and every post, rail and wire serves an identical single 'minded' 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.

96. In *BP Oil Refinery (Bulwer Island) Ltd v. Federal Commissioner of Taxation* (1992) 33 FCR 594; (1992) 23 ATR 65; (1992) 92 ATC 4031, 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) 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.

97. The issues of physical separability, mechanical independence and the separateness of the purchases are also relevant when considering whether the item has an independent function sufficient for it to be treated as a depreciating asset. In *Case M98* 80 ATC 689 a tractor, carry-all and ripper were each held to be separate units of property. The Board of Review in reaching its decision referred to the two 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 at ATC 690:

... 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.

Modifications

98. The question of modifications to an existing unit was considered in *Wangaratta Woollen Mills Ltd v. Federal Commissioner of Taxation* (1969) 119 CLR 1; (1969) 43 ALJR 324; (1969) 1 ATR 329; (1969) 69 ATC 4095; [1969] HCA 39. An electrical device which enabled the temperature of the liquid in the vats to be raised was fitted to a Fulscope controller. The modification enabled the item to regulate cooling as well as heating. The modification consisted of the addition of a few small pieces of electrical equipment to the controller. Most of the expense related to the workmanship involved in fitting small electrical parts to the controller. Therefore, the modification was not considered to involve the creation, or installation or attachment, of a separate unit of property. McTiernan J, in reaching his decision, said at ATC 4103; ATR 338:

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 ...

99. 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*. 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.

100. There will be instances where an item has a function of its own and is a depreciating asset in its own right but changes and

modifications are made to that depreciating asset such that the function of the item is materially different from that of the original unit. In those cases a new depreciating asset may have evolved from the original depreciating asset or come into existence as a result of the merger of two or more existing depreciating assets.²⁵

101. When ascertaining what is the relevant function or purpose of an item to determine what is the relevant depreciating asset, the assessment is based on the facts surrounding the item such as whether it is purchased as a separate item, the timing of the purchase, the degree of modification an asset makes to an existing asset, whether it is able to be used independently, the connection between the items, and the degree of dependence between the items.

Intangible depreciating assets

102. Division 40 only applies to intangible assets that are listed in subsection 40-30(2) and are not trading stock. 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. 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.

103. 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 holder of the production licence was authorised under that licence to:

- recover petroleum in the area constituted by the blocks that are the subject of the licence
- explore for petroleum in that area, and
- carry on such operations and execute such works in that area as are necessary for those purposes.

104. Relevantly, subsection 995-1(1) defined a ***mining, quarrying or prospecting right*** as:

- (a) an authority, licence, permit or right under an *Australian law to mine, quarry or prospect for *minerals, *petroleum or quarry materials; or
- (b) a lease of land that allows the lessee to mine, quarry or prospect for minerals, petroleum or quarry materials on the land; or
- (c) an interest in such an authority, licence, permit, right or lease; ...

²⁵ See Taxation Ruling TR 2002/1 *Income tax: research and development: plant expenditure (pre 29 January 2001)*.

105. As the entity had an interest in the production licence, it was the licence itself (or interest in the licence) that was the depreciating asset and subsection 40-30(4) could not apply to allow it to be divided. The intangible asset for the purposes of subsection 40-30(2) was not the underlying rights, but the interest in the licence itself.²⁶

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 entities. Each holder of the asset owns a depreciating asset commensurate with the owner's interest in the underlying 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, or whether it extends to circumstances where the entity only owns part or all of a discrete part of the underlying asset.

108. The phrase 'interest in the underlying asset' is not defined and 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*. *OTC* 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 off shore and not in territorial waters were jointly owned by tenants in common (per Lockhart J at FCA [16]). 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 the *OTC* case 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.

²⁶ Also refer to paragraph 121 to 125 of TR 2012/7 for further discussion on this case.

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112. Further support for the application of the finding in the *OTC* case to section 40-35 is provided in paragraph 1.58 of the Explanatory Memorandum to New Business Tax System (Capital Allowances) Bill 2001:

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*. [Emphasis added]

113. In the instance of an item consisting of several parts, where the different parts are owned by different entities and the item is determined to be a single depreciating asset under subsection 40-30(4), subsection 40-35(1) applies to the single depreciating asset as it is held by more than one entity.²⁷

114. The single depreciating asset is jointly held by the entities who own the parts of the asset for the purposes of section 40-35. Each entity is able to take into account the decline in value of the entity's 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).

²⁷ Note, in the case of a partnership, the partnership holds the partnership asset not the individual partners; see section 40-40.

Appendix 2 – Your comments

115. You are invited to comment on this draft Ruling. Please forward your comments to the contact officer by the due date.

116. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- be published on the ATO website at www.ato.gov.au.

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

Due date: 17 February 2017

Contact officer details have been removed.

Appendix 3 – Detailed contents list

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References

Previous draft:

Not previously issued as a draft

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TR 97/23; TR 2002/1;
TR 2006/10; TR 2007/9;
TR 2012/7

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Cases relied upon:

- BP Oil Refinery (Bulwer Island) Ltd v. Federal Commissioner of Taxation (1992) 33 FCR 594; (1992) 23 ATR 65; (1992) 92 ATC 4031
- Case M98 80 ATC 689
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- Utah Development Co v. Federal Commissioner of Taxation (1983) 76 FLR 11; (1983) 14 ATR 601; (1983) 83 ATC 4545
- Wangaratta Woollen Mills Ltd v. Federal Commissioner of Taxation (1969) 119 CLR 1; (1969) 43 ALJR 324; (1969) 1 ATR 329; (1969) 69 ATC 4095; [1969] HCA 39

Other references:

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

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