

TR 2012/D3 - Income tax: capital allowances: treatment of open pit mine site improvements

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Draft Taxation Ruling

Income tax: capital allowances: treatment of open pit mine site improvements

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What this Ruling is about

1. This draft Ruling considers the operation of the capital allowance rules in Division 40 of the *Income Tax Assessment Act 1997* (ITAA 1997) to open pit mine site improvements.
2. All references in this draft Ruling are to the ITAA 1997 unless otherwise indicated.
3. This draft Ruling specifically considers:
 - whether an open pit mine site improvement is an ‘improvement to land’ as that phrase appears in subsection 40-30(3);
 - whether an open pit mine site improvement is a depreciating asset under section 40-30;
 - when an open pit mine site improvement is considered to be held by the taxpayer;
 - the characterisation of an open pit mine site improvement in the context of Division 40;
 - the start time of an open pit mine site improvement;
 - when an open pit mine site improvement is being used for a taxable purpose;
 - the determination of the effective life of an open pit mine site improvement;

- the cost of an open pit mine site improvement;
- whether the balancing adjustment provisions apply to an open pit mine site improvement;
- whether an open pit mine site improvement is an asset recognised by the consolidation cost setting rules in Part 3-90; and
- market valuation methodologies applicable to open pit mine site improvements.

Ruling

An open pit mine site improvement is an improvement to land

4. The phrase ‘open pit mine site improvement’ as it appears in this draft Ruling describes the changed configuration of land from its natural state created by earthworks carried on for the purpose of exposing and extracting a mineral deposit.

5. The phrase captures the extraction activities associated with the removal of waste overburden material and the mineral deposit and also the various structural features of a typical open pit such as batters, berms, benches, windrows and haulage roads.

6. In accordance with Division 40, a deduction may be allowed over time for the decline in value of a depreciating asset. Paragraph 40-30(1)(a) provides that land, *prima facie*, cannot constitute a depreciating asset. Subsection 40-30(3) operates to limit this exception by providing that an *improvement to land*, or a fixture on land, is to be recognised as an asset separate from the land for the purpose of applying Division 40.

7. The term improvement to land is not defined however the concept of an improvement to land has been widely considered in case law. The principles that can be extracted from the relevant cases, when considered in the context of Division 40, provide that an open pit mine site improvement that enhances the use of the land to the miner constitutes an improvement to land as that phrase appears in subsection 40-30(3).

An open pit mine site improvement is an improvement to land that is a depreciating asset¹

8. Subsection 40-25(1) outlines the two conditions that must be satisfied before a deduction for decline in value of an improvement to land is allowed. Firstly, the improvement must be a depreciating asset. Secondly, the depreciating asset must be held by the taxpayer seeking the deduction.

9. Subsection 40-30(1) provides the definition of a depreciating asset. The item must be *an asset* that has a *limited effective life* and can reasonably be *expected to decline in value over the time it is in use*. Further, the item *cannot be land*, trading stock or an intangible asset that is not mentioned in subsection 40-30(2).

10. The meaning of ‘an asset’ is not defined in the ITAA 1997. In the context of Division 40 an asset is taken to have the broad meaning of something that is capable of being put to use in the business of the holder. It is accepted that an open pit mine site improvement is an asset of the miner for the following reasons:

- subsection 40-30(3) requires that an open pit mine site improvement is considered to be *an asset* separate to the land; and
- an open pit mine site improvement is something recognised in the mining industry as having commercial and economic value to the miner.

11. An open pit mine site improvement has a limited effective life. A limited effective life is taken to mean there are a finite number of years that an asset can be used to produce income. It is accepted that a pit has a finite income producing life.

12. An open pit mine site improvement is expected to decline in value over the period it is used. The working expansion of the pit has the effect of reducing the valuable mineral deposit to which it provides access. In this sense, the pit is less valuable to the miner as its useful life carries on.

13. Subsection 40-30(3) proceeds on the basis that an improvement to land (or a fixture on the land) is an asset and deems it to be separate from the land itself. This deemed severance has the effect of causing the improvement or fixture to lose its character of being land. To treat the improvement otherwise would nullify the intended operation of subsection 40-30(3) in respect of land improvements.

14. It follows that an open pit mine site improvement is an improvement to land that meets the conditions to be a depreciating asset.

¹ the draft Ruling later provides (at paragraphs 18-24) that the identifiable depreciating asset will typically be the entire pit, being a composite item that is itself a depreciating asset, rather than any of the structural features of the pit being recognised as separate depreciating assets.

The open pit mine site improvement must be held

15. Subsection 40-25(1) provides that a depreciating asset must be held at some time during the income year before a deduction for a decline in the asset's value can be allowed. The table in section 40-40 is used to determine the holder of a depreciating asset.

16. If the miner owns the land into which the improvement is constructed, item 10 of the table in section 40-40 provides that the miner holds the improvement to land.

17. If the miner owns the mining right providing permission to extract the mineral deposit item 3 of the table in section 40-40 provides that the owner of the mining right holds the improvement to land. Where there is a change in identity of the miner the new miner will become the holder of the improvement to land that existed at the time the change occurred. It is not necessary that the mining right owner originally constructed the improvement in order for it to be identified as the holder of the improvement under item 3 of the table.

The entire open pit mine site improvement is the depreciating asset rather than its structural features constituting separate depreciating assets

18. The two recognisable improvements to land in the context of an open pit mining operation are the pit itself and the haulage roads constructed within the perimeter of the pit. It is these features that are recognised as delivering the enhancement to the land for the miner that attracts the operation of subsection 40-30(3). On this view, it is only those particular features within the pit that can meet the conditions to be a depreciating asset. No lesser element of either of these features could be considered to be its own improvement to land, and therefore no lesser element can satisfy the definition to be a separate depreciating asset.

19. That these lesser elements of a haulage road or pit wall (for example, batters, benches, switchbacks etcetera) are identified separately by the mining industry as features of a pit does not necessarily characterise these elements as individual improvements to land for the purposes of the capital allowance rules.

20. Alternatively, an open pit mine site improvement may be a composite asset made up of various structural elements that themselves may be considered an improvement to land, with each improvement then capable of satisfying the definition of depreciating asset. For composite assets, subsection 40-30(4) provides that whether the composite item itself is a depreciating asset or whether the components are separate depreciating assets is a question of fact and degree to be objectively determined in light of all of the particular circumstances.

21. An examination of the purpose or function an asset serves in its business context assists in making an objective consideration as to whether a particular composite item is itself a single depreciating asset. An open pit mine site improvement performs the single integrated function of providing access to an underlying mineral deposit such that the deposit can be safely and efficiently extracted and transported to the surface. This integrated mining function can only be performed by all of the structural features of the open pit working together in an interdependent manner. The structural features within the pit are not separately capable of achieving the recognised extraction function of the pit.

22. Based on this function, the entire pit, rather than any lesser combination of any of its component features, will constitute the depreciating asset for which a deduction for decline in value can be worked out, though facts and circumstances will ultimately be determinative. The open pit is identifiable as having its own life in effective use in enabling a mineral deposit to be extracted and can reasonably be expected to decline in value over that life. Accordingly, the entire pit is itself the depreciating asset within the meaning of that term in section 40-30.

23. Whilst the structural features are separately identifiable, these individual features serve no discrete purpose, rather they work together as a system to perform the recognised extraction function of the pit. For example, a haulage road on its own cannot safely provide vehicular access to enable the extraction activity to be carried out without the pit walls providing access to the working face of the mine and stabilising the pit. Similarly, without the haulage road, the mineral deposit exposed at the working face of the pit could not be transported to the surface. It is the pit taken as a whole that is capable of achieving the mining function.

24. It follows that the method used in expanding the pit (commonly referred to as a series of 'push-backs') would be expected to deliver improvements to the existing pit. Each push-back provides access to the remaining mineral deposit and thereby enhances an existing depreciating asset rather than creates a new one.

An open pit mine site improvement's start time occurs when construction of the open pit commences

25. Section 40-60 provides that a depreciating asset commences to decline in value from the time its 'start time' occurs. It is by reference to this time that a deduction for decline in value can be ascertained.

26. Section 40-60 defines the start time of a depreciating asset to be when you first use it, or have it installed ready for use, for any purpose. The start time for an open pit mine site improvement will be when the pit is first used. A pit is in use while it is being constructed.

An open pit mine site improvement is being used for a taxable purpose from its start time

27. Subsection 40-25(2) provides that a deduction for the decline in value of a depreciating asset is reduced by that part of the decline in value that is attributable to the use of the asset for a purpose other than a taxable purpose.

28. Paragraph 40-25(7)(a) defines a taxable purpose to be the purpose of producing taxable income. Subsection 995-1(1) defines the purpose of producing taxable income to mean something done for the purpose of gaining or producing assessable income or in carrying on a business for the purpose of gaining or producing assessable income.

29. It follows that an open pit mine site improvement is being used for a taxable purpose from the time it is being used as part of the miner's activities in conducting a mining business. This time will equate to the depreciating asset's start time, which is when the construction of the pit has commenced.

The effective life of an open pit mine site improvement is likely to equate to the expected working life of the mine

30. Subsection 40-95(1) provides that the holder of a depreciating asset must:

- use an effective life determined by the Commissioner under section 40-100; or
- itself work out the effective life under section 40-105.

31. In making a determination, subsection 40-100(4) instructs the Commissioner to consider the period during which the depreciating asset can be used by any entity for a taxable purpose. This instruction supports a determination of the effective life of the pit corresponding to the estimated life of the mine.

32. Where a mining operation has within its boundaries two or more separate and distinct pits, each pit would constitute a separate depreciating asset. Each pit in this scenario will have its own effective life which will typically equate to the planned and therefore predictable useful life of that individual pit.

The cost of an open pit mine site improvement that is a depreciating asset

33. The cost of a depreciating asset is worked out in Subdivision 40-C. Sections 40-215 and 40-220 provide that the cost of a depreciating asset is reduced by amounts that would otherwise be included in its cost; either because the amount is deductible or taken into account in working out a deduction under another provision or is an amount not of a capital nature.

34. Any expenditure incurred in establishing or expanding an open pit mine site improvement that is deductible under section 8-1 as an outgoing incurred in producing assessable income would not form part of the cost of the pit.

35. Taxation Ruling TR 95/36² discusses the Commissioner's view as to extent of expenditure in establishing or expanding a pit that would be deductible to the miner on revenue account.

A balancing adjustment event arises where the holder of the open pit mine site improvement ceases to hold the pit

36. A balancing adjustment event happens if the holder of a depreciating asset ceases to hold the asset or stops using the asset for any purpose and expects never to use it again.³ It follows that a balancing adjustment event will arise to the miner where a pit is directly sold to another entity.

37. Section 40-285 describes the consequences of a balancing adjustment event. If a depreciating asset's termination value exceeds its adjustable value, the difference is included in the assessable income of the entity ceasing to hold the asset. If the asset's adjustable value exceeds its termination value, the difference is allowed as a deduction to the entity ceasing to hold the asset.

38. A condition that must be satisfied before a balancing adjustment can arise is that the entity ceasing to hold the depreciating asset worked out a decline in value for the asset under Subdivision 40-B.

39. It is considered that a decline in value is worked out for a depreciating asset even where the cost of the asset has been reduced by section 40-215 or 40-220 to nil. In this situation, the adjustable value of the depreciating asset will be nil.

An open pit mine site improvement is an asset recognised under Part 3-90 when the taxpayer holding the pit joins a consolidated (or MEC) group

40. Part 3-90 allows groups of certain wholly-owned entities to choose to form a consolidated group such that the members of the group are treated as a single entity for income tax purposes. The head company of the consolidated group is the recognised taxpayer of the group.

41. Division 701 contains tax cost setting rules that apply to establish the tax costs of each asset that a subsidiary member brings into the group when it joins. Subsection 701-10(3) provides that the object of the tax cost setting process is to set a cost for the assets of the joining entity that reflects the group's cost of acquiring that entity.

² TR 95/36: Income tax: characterisation of expenditure incurred in establishing and extending a mine.

³ paragraphs 40-295(1)(a) and (b).

42. Taxation Ruling TR 2004/13⁴ provides the Commissioner's view that anything recognised in commerce and business as having economic value to the joining entity would be an asset of that entity for purposes of the consolidation tax cost setting rules. Further, TR 2004/13 provides that assets recognised under the *Income Tax Assessment Act 1936* and the ITAA 1997 would come within the ordinary commercial or business meaning of an asset for Part 3-90 purposes⁵.

43. An open pit mine site improvement that is a depreciating asset would be an asset recognised where the miner joins a consolidated group.

44. The extent and degree to which the assets of the joining entity should be separately identified or treated as composite items for consolidation tax cost setting purposes mirrors the approach adopted under the capital allowance rules. It would be the entire pit that is a recognised asset of the joining entity for consolidation purposes rather than any of the structural features of the pit.

45. An open pit mine site improvement held by a joining entity will be a reset cost base asset and have its tax cost reset by the tax cost setting rules in Division 705. The tax cost setting amount for the pit will be worked out by allocating a portion of the joining entity's allocable cost amount to the pit by reference to the market values of all the reset cost base assets of the joining entity.

46. Section 701-55 describes how other provisions in the income tax law should be applied to an asset that has had its tax cost set under the consolidation tax cost setting rules.

47. Where the asset is a depreciating asset, paragraph 701-55(2)(a) provides that the capital allowance rules apply as if the head company had acquired the asset at the joining time for a payment equal to its tax cost setting amount.

48. It follows that an open pit mine site improvement held by a miner when it joins a consolidated group will be treated as if it were directly acquired by the head company at that time for a payment equal to its tax cost setting amount. This amount becomes the first element of the cost of the pit for which a deduction for decline in value can subsequently be worked out by the head company.

⁴ Income tax: the meaning of an asset for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*

⁵ paragraph 11.

Modified application of Part 3-90 where the miner is a continuing majority-owned entity

49. Section 701A-10 of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A) may apply to modify the operation of the consolidation tax cost setting rules to an open pit mine site improvement. The section applies if:

- the miner is a continuing majority-owned entity⁶ when it becomes a member of a consolidated group;
- the terminating value of the pit is less than the tax cost setting amount set for the pit;
- the pit existed at the start of 27 June 2002;
- more than 50% of the expenditure incurred in constructing the pit was of a revenue nature and allowable as a deduction to the miner; and
- if a balancing adjustment event happened in relation to the pit before the miner became a member of a consolidated group, there was roll-over relief obtained under section 40-340.

50. The most immediate modification for the head company of the consolidated group that the miner joins, where section 701A-10 of the IT(TP)A applies, is that the tax cost setting amount for the pit will be reduced to the terminating value of the pit just before the joining time. Subsection 705-30(3) provides that the terminating value for a depreciating asset is equal to the asset's adjustable value just before the joining time.

Example

51. *Hard Rock Co began the construction of an open pit, called the Samaerro Pit, on 1 July 2010. The initial mine plan indicates the Samaerro Pit will continue in operation until 2030.*

2010-11 income year

52. *Hard Rock Co incurs \$20million in constructing the Samaerro Pit. The pit is a depreciating asset. \$19million (or 95%) of the construction expenditure is immediately deductible to Hard Rock Co per TR 95/36 as a revenue expense. The remaining expenditure (\$1million) is of a capital nature and constitutes the cost of the pit for Division 40 purposes.*

⁶ as defined in subsection 701A-1 of the IT(TP)A.

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53. *Hard Rock Co chooses the prime cost method and self-assesses an effective life for the Samaerro Pit of 20 years.*

The deduction for the decline in value of the Samaerro Pit is \$50,000.⁷

The adjustable value of the Samaerro Pit at year-end is \$950,000.⁸

2011-12 income year

54. *Hard Rock Co incurs an additional \$28.5million in further constructing and expanding the Samaerro Pit. 95% of this expenditure is immediately deductible on revenue account. The remaining capital expenditure (\$1.425million) forms part of the second element of cost of the Samaerro Pit.*

The deduction for the decline in value of the Samaerro Pit is \$125,000.⁹

The adjustable value of the Samaerro Pit at year-end is \$2.25million.¹⁰

2012-13 income year

55. *Hard Rock Co is acquired by the Allway consolidated group on 1 July 2012. The Allway group pays \$500 million for Hard Rock Co. The consolidation cost setting rules apply such that a tax cost of \$50 million is set for the Samaerro Pit. This reset cost establishes a new cost for the pit for Division 40 purposes.*

56. *Allway incurs an additional \$26million on push-back expenditure at the Samaerro Pit. 95% of this expenditure is immediately deductible on revenue account. The remaining capital expenditure (\$1.3million) forms part of the second element of cost of the Samaerro Pit.*

Date of effect

57. 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 either:

- 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);
or

⁷ \$1m x [100%/20]. Refer subsection 40-75(1).

⁸ paragraph 40-85(1)(b).

⁹ [950,000 + 1,425,000] x [100%/19]. Refer paragraph 40-75(2)(b) and subsection 40-75(3).

¹⁰ [950,000 + 1,425,000] - 125,000. Refer paragraph 40-85(1)(c).

- is inconsistent with the ATO view expressed in ATO Interpretative Decisions ATOID 2007/11 or ATOID 2007/12 and that view has been followed by a taxpayer and is more favourable to that taxpayer than the view expressed in this draft Ruling.

Commissioner of Taxation

9 May 2012

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.*

An open pit mine site improvement

58. The phrase ‘open pit mine site improvement’ as it appears in this draft Ruling describes the changed configuration of land from its natural state created as a result of earthworks undertaken for the purpose of exposing and extracting a mineral deposit.

59. Planning a pit is done from the bottom-up after first ascertaining the economic limit of the base mineral deposit. A safe pit slope and road access must be maintained as the pit is expanded by making it first wider at the surface and then excavating the side walls outward such that the base can be deepened. Typically, a pit is mined by conventional drill and blast methods that require waste and valuable rock to be loaded onto heavy load vehicles that haul the material to the surface.

60. The waste material removed is typically described as ‘overburden’, which represents the layers of soil and rock and sub-grade mineralised material that covers a mineral deposit. Overburden is removed prior to and during the mining of the economically valuable deposit in an open pit operation.

61. The advantage of an open pit operation is that a large percentage of a mineral deposit is able to be extracted in a safe and efficient manner. The decision whether to adopt an open pit operation is dependent on the economic viability of the project, which will include an analysis of the amount of overburden to be removed and the revenues likely to be derived when the deposit is sold on the open market.

62. The viability of a mining operation is typically dependent on the layer of overburden being sufficiently thin relative to the value of the mineral deposit. In recent times, by virtue of significant increases in commodity prices, there has been an emergence of larger scale open pit operations being undertaken.

63. The emergence of these valuable ‘super-pits’ has coincided with the introduction of both the capital allowance rules in Division 40 and the consolidation regime in Part 3-90. This has necessitated a comprehensive ATO view being provided as to the appropriate income tax treatment of an open pit mine site improvement.

64. The primary features of a pit are haulage roads built into the pit walls, extraction benches and cutback benches. Both benches are the sites of current excavation, the first concerned with actual contact with the mineral deposit and the second with increasing the size of the pit. Each of these features has a number of sub-features.

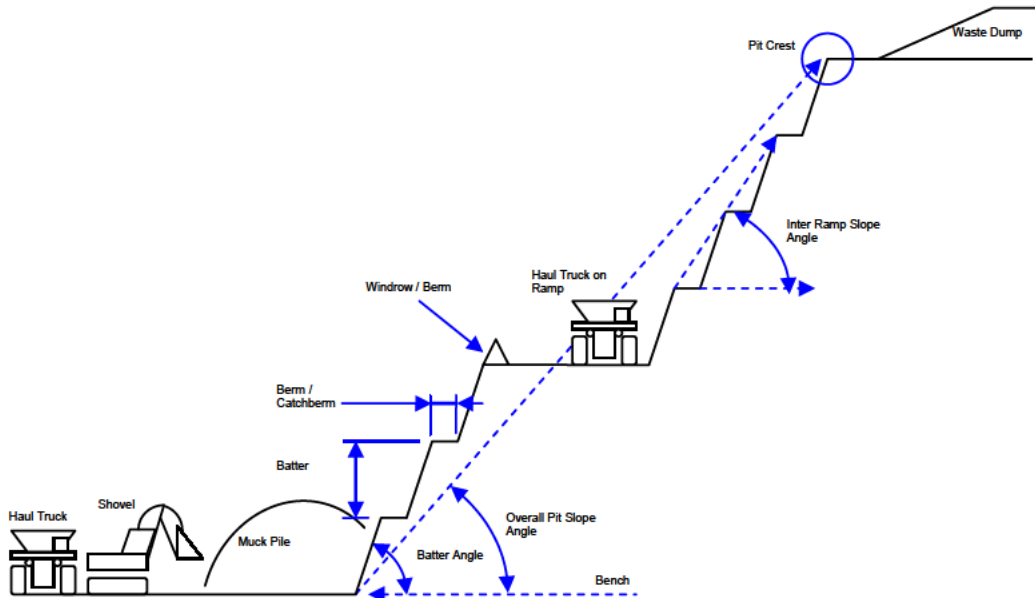
65. Haulage roads within a pit provide vehicular access from the surface to the working face of the mine. A haulage road features ramps and switchbacks. Ramps describe the connected inclined roads used to transport mining equipment and extraction vehicles. Switchbacks describe the part of the ramp where the direction of the road doubles back on itself. Haulage roads typically consist of a base layer of blasted waste rock upon which another layer of specifically selected waste rock is laid and compacted. A surface layer of gravel is then typically applied to complete the formation.

66. The pit is excavated as a series of benches at increased depths. Extraction benches represent the levelled areas where extraction of ore or minerals, along with waste, takes place. Cutback benches describe the current setting where excavation concerned with the removal of waste overburden alone is being undertaken for the purpose of increasing the size of the pit to expose further mineralised areas and to maintain adequate working space on the extraction bench. Benches feature windrows, batters, and berms or catchberms.

67. Windrows (also sometimes called berms) are shaped piles or mounds of material that function as a safety barrier at the edge of an elevated bench or haul road to prevent rock falls onto a lower bench or haul road. Batters are the sloped walls of the open pit. Generally, batters are shaped earth but can be further supported, where geotechnical properties of the rock require, by mesh or strapping. Berms or catchberms are flat areas of earth between batters that act as safety barriers by catching rock falls from above and, in concert with the angle of the shaped batters, contribute to maintaining the average safe pit wall slope.

68. Batters, berms, haulage roads, windrows and mining benches are each essential prerequisites for accessing the working face of the open pit. As well as improving the efficiency of mineral extraction, they are essential for a safe working environment at the mine face.

69. The following diagram illustrates the physical form of the typical features of an open pit:



The meaning of an improvement to land

70. In accordance with the terms of Division 40, a deduction may be allowable over time for the cost of a depreciating asset. A key element of the operation of Division 40 is the identification of a 'depreciating asset'.

71. The term depreciating asset is defined in section 40-30. Subsection 40-30(1) provides as follows:

A **depreciating asset** is an asset that has a limited ^{*}effective life and can reasonably be expected to decline in value over the time it is used, except:

- (a) land; or
- (b) an item of ^{*}trading stock; or
- (c) an intangible asset, unless it is mentioned in subsection (2).

72. Relevantly for the subject matter of this draft Ruling, subsection 40-30(3) provides as follows:

This Division applies to an improvement to land, or a fixture on land, whether the improvement or fixture is removable or not, as if it were an asset separate from the land.

73. It is noted that a depreciating asset, *prima facie*, does not include land (paragraph 40-30(1)(a)). The term 'land' is not defined for the purposes of section 40-30. The policy rationale for excluding land was that land does not usually have a limited effective life.¹¹

74. In its primary ordinary meaning, land is the solid part of the earth's surface.¹² The common law has recognised, however, that land includes more than the physical structure of the earth. Through the maxim *quicquid plantatur solo, solo cedit*, it recognised that 'whatever is affixed to the soil becomes part of the soil'. From this developed the notion that things affixed to the land (like trees, crops, buildings, walls, fences, etcetera) are a part of the land. These are called 'fixtures'.

75. In the context of Division 40, the Commissioner considers that the term 'land' as used in paragraph 40-30(1)(a) means land in this generally understood legal sense. The context provided by subsection 40-30(3) indicates that 'land' as used in paragraph 40-30(1)(a) was intended to draw in concepts developed by the common law and equity in relation to land, hence its need to treat fixtures as being separate to the land.

76. Subsection 40-30(3) then treats improvements and fixtures as being separate to land to ensure the paragraph 40-30(1)(a) exclusion of land as a depreciating asset did not apply to things that are treated by law to be part of the land.

77. The meaning of 'improvement' is not defined for the purposes of Division 40 and accordingly takes its ordinary meaning in the context in which it appears.

78. Various branches of the law have developed a concept of 'improvements' to land. In relation to land taxation, the concept of improvements is used in the context of statutes which impose tax on the 'unimproved value' of land. Improvements are those alterations which are disregarded in determining the value of land subject to tax.

79. In considering what constituted 'improvements' to land under the then existing Commonwealth land tax legislation Griffith CJ in *Morrison v Federal Commissioner of Land Tax* (1914) 17 CLR 498 (*Morrison*) said an improvement was:

Any operation of man on land which has the effect of enhancing its value...¹³

¹¹ See paragraph 1.16 of the revised Explanatory Memorandum to the New Business Tax System (Capital Allowances) Bill 2001.

¹² See definition of 'land' in the *Concise Oxford Australian Dictionary*, 4th Edition.

¹³ at 503

80. This interpretation was subsequently followed in numerous land tax cases¹⁴ and adopted by the High Court in *Brisbane City Council v Valuer-General (Queensland)* [1978] HCA 40; (1978) 140 CLR 41 (*Brisbane City Council*) where the Court was asked to determine the value of land upon part of which a dam had been constructed. It considered that improvements:

...consist of something done which has enhanced the value of land. To build a dam, or to improve a watercourse, so that water may be collected on or flow over land may improve the land, but it is the dam or the watercourse, and not the water, that constitutes the improvement.¹⁵

81. That an improvement enhances the value of land on or to which it is made has been accepted and applied in other statutory contexts. In those cases, it appears an 'improvement' has been given a somewhat broader meaning to include an alteration that improves the use of the land to the user. In *Commonwealth of Australia v Oldfield* (1976) 133 CLR 612; 10 ALR 243, a lease allowed the lessor to take back land, subject to the requirement that it pay the lessee for improvements 'on or effected to' the land. Applying *Morrison, Jacobs J* held that 'improvements' should be given a meaning which 'would include what is done in improvement of quality of the soil and thereby the usefulness of the land'.¹⁶

82. In *Dampier Mining Co Ltd v Federal Commissioner of Taxation* (1979) 79 ATC 4469; 10 ATR 193, the Federal Court interpreted the meaning of improvement in relation to income tax. That case concerned the deductibility of expenditure on improvements made to the sea-bed. Brennan J, when discussing *Brisbane City Council*, said:

Though the facts of that case were significantly different from the facts of the present case, one cannot find an 'improvement' in the present case unless the dredging enhances the value of land, or *makes the use of land more efficient*. In my opinion, it does not. The dredging was not an improvement to the sea-bed and navigational aids, for the improving quality of the dredging consists in the removal of an obstruction to navigation, and the consequent deepening of the water available for ships. The improvement to navigation is found in the increased depth of the water, though that is a reciprocal effect of decreasing the height of the sea-bed. The land, notionally separated from the water, is made *no more efficient for man's use*, and no more valuable, by dredging.¹⁷ [*emphasis added*]

¹⁴ See *Campbell v Deputy Federal Commissioner of Land Tax (NSW)* (1915) 20 CLR 49; *Fisher v Deputy Federal Commissioner of Land Tax (NSW)* (1915) 20 CLR 242; *Keogh v Deputy Federal Commissioner of Land Tax (NSW)* (1915) 20 CLR 258; *McGeoch v Federal Commissioner of Land Tax* (1929) 43 CLR 277.

¹⁵ at 51.

¹⁶ 133 CLR 612 at 618.

¹⁷ 79 ATC 4469 at 4475.

Approach to be adopted in interpreting ‘improvement to land’ in subsection 40-30(3)

83. It is evident that subsection 40-30(3) treats improvements and fixtures as being separate to land because the Parliament did not want the paragraph 40-30(1)(a) exclusion of land as a depreciating asset to apply to certain things that are legally treated as part of the land.

84. It is apparent, therefore, that the meaning of the term ‘improvement’ in subsection 40-30(3) needs to be found principally in the concepts developed in land tax law and then expanded somewhat in the context of Division 40 to also capture those alterations that increase the usefulness of the land to the user.

85. The Commissioner’s view is that an improvement, as that word appears in Division 40, would constitute any alteration to land that is considered an enhancement to the user even if the alteration has not, in fact, increased the value of the land.

86. For the purposes of subsection 40-30(3), an improvement to land does not include a fixture on the land. Fixtures on land would usually be considered as an improvement to land under the approach set out above. However, the fact subsection 40-30(3) explicitly refers to fixtures, the term ‘improvement to land’ in that subsection is considered to evidence a drafting approach that emphasises that improvements other than fixtures can be depreciating assets.

An open pit mine site improvement is an improvement to land

87. As outlined, an open pit mine site improvement is an alteration to the natural shape of the land that is created by a miner to provide access to a mineral deposit. An open pit is also specifically shaped to provide a safe and efficient route for the extracted mineral deposit to be brought to the surface.

88. It follows that an open pit mine site improvement enhances the use of the land to the miner. Accordingly, the pit is an improvement to land to the miner for the purposes of Division 40.

When is an improvement to land a depreciating asset?

89. Having established that an alteration is an improvement to land it is then necessary to determine if the improvement is a depreciating asset. As the note to subsection 40-30(3) points out, an improvement to land will only be a depreciating asset if it falls within the definition in subsection 40-30(1).

90. Subsection 40-30(1) defines a depreciating asset to be:

40-30(1) A depreciating asset is an asset that has a limited effective life and can reasonably be expected to decline in value over the time it is used, except:

- (a) land; or

- (b) an item of trading stock; or
- (c) an intangible asset, unless it is mentioned in subsection (2).

91. Therefore, each of the following matters need to be considered in establishing whether a depreciating asset exists:

- there is an asset;
- that has a limited effective life;
- that can be expected to decline in value over the time it is used; and
- is not land, an item of trading stock or an intangible asset that is not mentioned in subsection 40-30(2).

Each of these matters will be examined in the context of an open pit mine site improvement.

An open pit mine site improvement is an asset

92. The concept of 'asset' is not defined for income tax purposes. It is therefore useful to consider the ordinary meaning of asset in the context of the capital allowance rules. The *Macquarie Dictionary (3rd revised edition)* defines an asset to be a 'useful thing or quality' or 'an item of property; an economic resource'.

93. In the context of Division 40, which provides a deduction for the cost of an asset over the time of its useful life, an asset is considered something that is capable of being put to use in the taxpayer's business.

94. Further, in the context of improvements to land, subsection 40-30(3) operates to sever the improvement from the land and treats the improvement '...as if it were an asset separate from the land'. This statutory severance therefore deems the improvement to be a separately identifiable asset in its own right.

95. It follows that an open pit mine site improvement is an asset of the miner for the following reasons:

- an open pit mine site improvement is something used by the miner to conduct their business and is therefore recognised as having commercial and economic value to the miner; and
- subsection 40-30(3) requires that an open pit mine site improvement is treated by the capital allowance provisions as if it were *an asset* separate to the land.

96. The fact that an open pit mine site improvement is not something that can be physically separated and sold does not prevent the pit from being an asset for the purposes of the capital allowance rules.

An open pit mine site improvement has a limited effective life

97. The phrase ‘limited effective life’ as it appears in subsection 40-30(1) is interpreted as meaning that the asset can be used for a limited time only.

98. The period for which an open pit mine site improvement will exist and function to provide access to a mineral deposit is planned and predictable notwithstanding taxpayers’ mine plans are subject to constant review and variation because of various technical and market factors. The fact that mining will only continue for the period the operation remains economically viable or the mineral deposit is exhausted provides the necessary evidence that the pit will have a limited useful life.

An open pit mine site improvement will decline in value over the time it is used

99. This element of the depreciating asset definition requires that the identified improvement to land is capable of use. An improvement to land can only be used if it is tangible and physically identifiable as separate from the land in its natural state and also capable of use as a discrete thing. Only improvements to land with that character could be used in and of themselves.

100. The law has recognised as improvements to land a range of things done to improve the land. For example, the removal of noxious weeds, the felling of trees and removal of rocks could all be described in some contexts as improvements to land because they improve the profit yielding capability of the land. However, improvements of that kind do not exist in a state that is capable of use separately from the land itself. For example, the felling of trees on agricultural land may make the land capable of use in farming. However, that benefit is intangible and incapable of use in its own right.

101. On the other hand, improvements to the shape of the land other than mere earthworks, such as through the construction of roads, dams, levees, and drains, all create tangible physically identifiable artefacts. Such items can be recognised as having a character separate from the land of which they are part and which are capable of being put to use in that sense separately to the land of which they are part in a taxpayer’s business. Such items are therefore capable of recognition as assets that could also be depreciating assets if they have a limited effective life and could reasonably be expected to decline in value over the time they are used.

102. As a consequence and despite its constantly altering physical manifestation, an open pit mine site improvement is capable of being viewed as a tangible and identifiable asset that is used by performing its discrete identifiable function of providing safe and efficient access that enables a mineral deposit to be extracted.

103. The requirement that an asset decline in value over the time that it is used does not mean that this must occur uniformly over that time. This is confirmed by the following extract from the revised Explanatory Memorandum (EM) to the New Business Tax System (Capital Allowances) Bill 2001, discussing this element of the depreciating asset definition:

This does not limit depreciating assets to things that lose value steadily over their effective lives. Nor are depreciating assets limited to things that only ever decline in value. Depreciating assets may hold their value for a time, or even increase it for a time. The test of a depreciating asset requires only that the asset lose its value overall (or down to no more than scrap value) by the end of its effective life.¹⁸

104. It is accepted that an open pit mine site improvement will decline in value over the period it is in use. Typically, there will be times when the value of a remaining deposit will increase, for example during a period when the demand (and therefore price) for the minerals being extracted increases. However, as the deposit continues to be depleted over the life of the mine it is clear enough that the open pit mine site improvement will consequently also decline in value over that time.

An open pit mine site improvement is not land, trading stock or an intangible asset

105. The exclusion of land from being a depreciating asset under paragraph 40-30(1)(a) has no application to improvements to land under subsection 40-30(3). That is because subsection 40-30(3) deems such improvements to be separate from the land for the purposes of Division 40. Something separated from land in this way causes the improvement to lose its character as being land for the purposes of considering whether it can be a depreciating asset.

106. This interpretation is in accordance with the following extract from the revised EM to the New Business Tax System (Capital Allowances) Bill 2001:

Land is excluded from the definition of depreciating asset as it is not generally considered to have a limited effective life [**Schedule 1, item 1, paragraph 40-30(1)(a)**]. However improvements to land or fixtures on land may still qualify as depreciating assets. For the purposes of Division 40, these improvements or fixtures are treated as separate assets, not as part of the land, regardless of whether they can be removed from the land or are permanently attached.¹⁹

107. It follows that an open pit mine site improvement that is recognised as an improvement to land is not prevented by paragraph 40-30(1)(a) from being a depreciating asset because it is land.

¹⁸ paragraph 1.14.

¹⁹ paragraph 1.16.

108. An open pit mine site improvement is unlikely to constitute trading stock of the miner. Trading stock is defined in section 70-10 to include anything produced, manufactured or acquired for the purpose of subsequent manufacture, sale or exchange in the ordinary course of a business. A pit is typically constructed to provide for the safe and efficient access that enables a mineral deposit to be extracted, and as such typically will not constitute trading stock of the miner.

109. An open pit mine site improvement does not constitute an intangible asset within the ordinary meaning of that word as the pit is a tangible artefact and is capable of physical use.

110. It follows that the Commissioner considers that an open pit mine site improvement has the necessary characteristics to be an improvement to land that is able to satisfy the definition to be identified as a depreciating asset from the time construction on the open pit begins.

An open pit mine site improvement must be held

111. Subsection 40-25(1) provides that a miner will only be allowed a deduction for the decline in value of an open pit mine site improvement that is a depreciating asset if it held the pit at any time during the income year for which the deduction is being worked out.

112. The table in section 40-40 identifies the holder of particular kinds of depreciating assets. Item 3 of the table identifies the holder of a depreciating asset that is an improvement to land subject to a quasi-ownership right.

113. A quasi-ownership right over land is defined in subsection 995-1(1) as meaning:

- a lease of the land; or
- an easement in connection with the land; or
- any other right, power or privilege over the land, or in connection with the land.

114. Paragraph 1.42 of the revised EM to the New Business Tax System (Capital Allowances) Bill 2001 explains that:

Where the owner of the quasi-ownership right improves the land with a depreciating asset, or improves a depreciating asset that is itself an improvement to land, and where that improvement is for their own use but they *cannot* remove that asset from the land, they are nonetheless the holder while their quasi-ownership right exists.

115. This extract covers the scenario whereby a miner, holding a right to mine from a relevant government authority, establishes and further develops an open pit mine site improvement to the land over which the right exists. The miner is treated as the holder of the depreciating asset, notwithstanding that the miner does not own the land to which the improvement has been made.

116. A subsequent miner would also be identified as the holder of an open pit mine site improvement, in a scenario where the ownership of the quasi-ownership right changed. The presence of the words, 'by any owner of the right' in column 2 of item 3 in the table in section 40-40 provides that the holder of a pit will be the new miner where the mining operation is directly acquired. This interpretation is supported by a plain reading of the words in item 3 and in accordance with the perceived policy intent of the capital allowance rules.

117. Where the miner owns the land to which the pit has been constructed, the miner will be identified as the holder of the open pit mine site improvement under item 10 of the table in section 40-40. This is because the miner will be the legal owner of the pit depreciating asset.

Characterisation of an open pit mine site improvement

118. To operate, the capital allowance rules require an identification of *the* depreciating asset for which a decline in value deduction can be determined. Where the item being tested is an improvement to land, the first step in identification is ascertaining the alteration to land that delivers the enhancement of that land to the user. This first step will thereby identify the improvement that is being tested to determine whether it meets the conditions to be a depreciating asset.

119. For an open pit mine site improvement, there are considered to be two immediately recognisable improvements to land; the haulage roads and the pit walls taken together as the whole pit. It is these features that are recognised as delivering the enhancement of the land that attracts the operation of subsection 40-30(3). On this view, it is only those particular features within the pit that can meet the conditions to be a depreciating asset. No lesser element of these features can be considered to be its own improvement to land, and therefore no lesser element can satisfy the definition to be a separate depreciating asset.

120. That the lesser features of a haulage road or pit wall (for example, batters, benches, switchbacks etcetera) are identified as structural elements of the pit does not necessarily characterise these features as individual improvements to land for the purposes of the capital allowance rules. These features of a pit are recognised in the mining industry primarily in an engineering context. It does not follow that because these features are recognised for that particular purpose that each feature, or some combination of features, possess the necessary character to be considered a separate depreciating asset.

121. That said, the Commissioner recognises that the question is finely balanced and that ultimately facts and circumstances will be determinative. In the alternative, it is possible that various structural elements of the pit could constitute separate improvements to land and therefore meet the conditions to be individual depreciating assets. If this is the case, the pit will be recognised by the capital allowance rules as a composite item.

122. Once a depreciating asset that is a composite item has been identified it is necessary to establish whether the composite item itself is a single depreciating asset or whether its components should be identified as being separate depreciating assets.

123. A composite item is one made up of various parts or elements. Subsection 40-30(4) provides that:

40-30(4) Whether a particular composite item is itself a *depreciating asset* or whether its components are separate *depreciating assets* is a question of fact and degree which can only be determined in light of all the circumstances of the particular case.

Example 1:

A car is made up of many separate components, but usually the car is the depreciating asset rather than each component.

Example 2:

A floating restaurant consists of many separate components (like the ship itself, stoves, fridges, furniture, crockery and cutlery), but usually these components are treated as separate depreciating assets.

124. The statute thereby directs that an objective consideration is made of something that is a composite item to identify either that (single) thing as a depreciating asset, or its components (or some combination of those components) as separate depreciating assets. The test is directed at appropriately identifying the depreciating asset for the purposes of Division 40, which is to allow a deduction over the effective life of the identified asset which reflects the diminution of economic value of that asset over its period of use.

125. The examples provided in subsection 40-30(4) assist in framing how that objective consideration ought to be applied. The first example illustrates a composite item constituting a single depreciating asset, the second illustrating a composite item that is not identified as a single depreciating asset. Examples have an important role in aiding the interpretation of the provision in which they are located. Section 2-45 confirms that examples form part of the ITAA 1997, are operative and are purposely not separated from the operative provision in which they are located. Section 15AD of the *Acts Interpretation Act 1901* (AIA) has recently been amended²⁰ to strengthen the status of examples by providing that an example is capable of extending the operation of the provision where there is conflict between the provision and the example.²¹

126. The examples provide some indication of the factors to consider in identifying the appropriate asset. The first example notes that a car that is made up of many different components will usually be treated as a single composite depreciating asset. The indication here is that the component parts of the car all contribute towards the ultimate purpose to what a car is put; the safe and comfortable transportation of its passengers. Therefore, a principle that can be taken from the first example is that components are unlikely to be recognised as separate depreciating assets where those components operate in an integrated manner in providing the function of the composite item. Another principle to be taken from the first example is that a composite item is more likely to constitute a single depreciating asset if the function of the item would be compromised by the removal of one of its component parts.

127. The second example provides that component parts of a floating restaurant would be identified as separate depreciating assets. Importantly, the example notes the ship itself would be considered to be a single depreciating asset, with elements of the restaurant constituting separate depreciating assets. The function of travel by water seems to predicate the ship being identified as a single asset notwithstanding that the ship itself is made up of many component parts. That the other items constitute separate depreciating assets indicates that physical separability is another factor to take into consideration. Here, the removal of a fridge or crockery would not affect the ability of the ship to perform its function. The functions the components of the restaurant provide are independent and differentiable from each other and from the function of the ship.

²⁰ by Act No 46 of 2011.

²¹ paragraph 15AD(b) of the AIA.

128. The revised EM to the New Business Tax System (Capital Allowances) Bill 2001 supports the notion that a function test can be adopted in objectively applying subsection 40-30(4):

Taxpayers will be required to exercise judgement in identifying the depreciating asset where the asset itself is made up of different parts and components. In doing this, the functionality test [*sic*] that is used as a basis of identifying a unit of plant in the existing plant depreciation rules can be used.²²

129. The Commissioner outlines what is considered to be an appropriate function test in Taxation Ruling TR 94/11.²³ That Ruling outlines a function test in the context of identifying a separate unit of property for the purpose of the (then operable) general investment allowance. The Ruling outlines, on the basis of the authorities summarised therein, that a function test is a factual examination of the function that an item serves in the particular taxpayer's income producing activity.

130. TR 94/11 provides that an item is generally identified as a single item if it has one or more of the following characteristics:

- the asset performs a separately identifiable function, where 'function' in this context refers to the kind of action or activity it allows or facilitates, or what it performs, acts, serves or operates as,
- the asset being functionally complete in itself, and
- the asset varies the performance of another asset that has its own independent function.²⁴

An open pit mine site improvement is a single depreciating asset

131. An objective application of the function test provides that an open pit mine site improvement is identifiable as a single depreciating asset. The Commissioner views the relevant function of a pit as providing access to an underlying mineral deposit such that the deposit can be safely and efficiently extracted and brought to the surface.

132. The Commissioner considers that neither any of the individual features of an open pit, nor any lesser combination of those features than the entire pit itself, can constitute separate depreciating assets. What these features contribute to the function of the pit are insufficiently complete, definable and identifiable in themselves so as to identify those features as depreciating assets in the context of a mining operation.

²² paragraph 1.15.

²³ TR 94/11: Income tax: general investment allowance - what is a unit of property?

²⁴ as set out at paragraph 3 of TR 94/11.

133. The mining operation can only be performed by each structural feature of the open pit working in an integrated manner. The identifiable features themselves merely enable the function served by the pit to be carried out. These features are integrally linked in constructing the pit; the efficient functioning of which is the identifiable use which enables the pit to be recognised as a depreciating asset.

134. This application of the function test to a pit is akin to other precedential decisions made by the Commissioner. In one decision,²⁵ it was found that a rail transport trackwork was itself a single depreciating asset, rather than each of the individual trackwork components constituting separate depreciating assets. In another decision²⁶ each 'segment' of a telecommunications system, rather than the components of each segment, was considered to be the depreciating asset.

135. In both decisions, it was found that the relevant function could only be derived from the integration of the components in a particular way. This is analogous with the contributions made by the structural features of a pit to the mining function.

136. The fact that the components of a rail trackwork or the components of a segment of a telecommunications cable system perform their own roles within their respective networks and can be physically separated did not result in those components being considered separate depreciating assets. The features of a pit cannot be physically separated from the pit itself, which presents a stronger argument that the entire pit is the depreciating asset rather than any of its component parts constituting separate depreciating assets.

An expansion of the pit is an improvement of the depreciating asset

137. A pit typically has a conical profile that is expanded via a series of 'push-backs'. A push-back describes the process of first expanding the surface area of the open pit and then excavating downward to expand the diameter of the base of the pit. The process of excavation involves the periodic but continuous construction and destruction of the various features of the pit. The features are temporary in nature in the sense that those constructed as part of an earlier push-back are obliterated with new features being constructed as the wall of the pit is pushed back.

138. The Commissioner considers that each push-back improves the single depreciating asset, in the sense that each expansion of the pit is considered to improve access to the remaining mineral deposit. Viewed in this way, the expansion of a pit is analogous in a mining operation to an expansion of an existing processing plant facilitated by the destruction of some features of the existing structure when improvements are made to the plant.

²⁵ in ATO Interpretative Decision ATOID 2003/489.

²⁶ in ATO Interpretative Decision ATOID 2011/2.

139. On this view, the pit continues to be held by the miner, even though its structural features are destroyed or come to an end as the pit is expanded. This view thereby prevents balancing adjustment events arising when the various features of the pit are destroyed and then recreated within the enlarged profile of the pit.

An expansion of the pit can increase the cost of the depreciating asset

140. Paragraph 40-190(2)(a) operates such that expenditure incurred in expanding the pit via the push-back process is included in the second element of the pit's cost. Paragraph 40-190(2)(a) is worded as follows:

40-190(2) The second element is:

- (a) the amount you are taken to have paid under section 40-185 for each economic benefit that has contributed to bringing the asset to its present condition and location from time to time since you started to hold the asset; and

141. The expenditure incurred in undertaking the push-back process provides economic benefits to the miner in the sense the expenditure contributes to the enhancement of the pit.

Establishing the cost of a depreciating asset that is an open pit mine site improvement

142. The cost of a depreciating asset is worked out in Subdivision 40-C. Subsection 40-215(1) requires the cost of a depreciating asset to be reduced by amounts that are deductible or taken into account in working out a deduction under provisions other than Division 40, Division 41 or Division 328. Section 40-220 provides that the cost of a depreciating asset must be reduced by any portion of it that consists of an amount that is not of a capital nature.

143. Expenditure incurred in establishing a pit that is deductible under section 8-1 as an outgoing incurred in producing assessable income would not form part of the first element of the cost of the pit.

144. Further, any expenditure incurred in expanding and improving an open pit mine site improvement that is deductible under section 8-1 would not form part of the second element of the cost of the pit.

145. Taxation Ruling TR 95/36²⁷ discusses the Commissioner's view as to extent of expenditure in establishing or expanding a pit that would be of a capital nature. The Ruling provides that much of the expenditure incurred in creating and expanding a pit is deductible under section 8-1 to the miner as a working expense of mining.²⁸

Other features located within a pit can constitute separate depreciating assets

146. That the entire pit is typically recognised as a single depreciating asset does not prevent other assets, located within the perimeter of the pit, from being recognised as separate depreciating assets.

147. For example, some pits might be of sufficient depth to require that temporary storage facilities or employee amenity facilities are constructed near the working face of the pit. Such facilities would clearly be identified as separate depreciating assets. The function a storage facility provides in housing mining equipment or consumables used in the mining operation is sufficiently distinguishable from the mining function of the pit itself to constitute the facility being identified as a separate depreciating asset.

A balancing adjustment arises if the miner ceases to hold a pit that does not have a cost

148. That an asset can have a nil cost as a result of the operation of section 40-215 or 40-220 does not prevent that asset from satisfying the conditions to be a depreciating asset as defined in section 40-30.

149. Once it is established a depreciating asset exists for which a start time has commenced, the holder of the asset must apply the relevant provisions in Subdivision 40-B that work out the decline in value of the asset. In respect of an open pit mine site improvement, the holder has the choice to use either the diminishing value method or the prime cost method. Each method establishes the deduction for the decline in value on the basis of the asset's cost.²⁹

150. A condition that must be satisfied before a balancing adjustment can arise is that the entity that held the depreciating asset worked out a decline in value for the asset under Subdivision 40-B.³⁰

151. The Commissioner considers that a balancing adjustment amount arises where an open pit mine site improvement with a nil cost is disposed of as part of a direct sale of a mine site.

²⁷ TR 95/36: Income tax: characterisation of expenditure incurred in establishing and extending a mine

²⁸ refer to paragraphs 59-75 of the Explanations.

²⁹ For the diminishing value method, see sections 40-70 and 40-72. For the prime cost method, see section 40-75.

³⁰ subparagraphs 40-285(1)(a)(i), 40-285(2)(a)(i) and 40-292(1)(a)(i).

152. It is considered that Subdivision 40-B applies to work out the decline in value in a situation where the cost of a depreciating asset is nil. Subdivision 40-B contains the core capital allowance provisions that apply to work out the decline in value of all depreciating assets, irrespective of their cost. These core provisions are operative in that they require for the holder of the depreciating asset to have worked out the asset's cost such that a deduction for the decline in value can be ascertained.

153. Where the depreciating asset's termination value is more than its adjustable value³¹ just before the balancing adjustment event occurred, an amount equal to the excess is included in the assessable income of the entity that held the asset. If the asset's cost is nil just before the balancing adjustment event, the amount of the excess that is included in the assessable income of the entity that held the asset will equal the asset's termination value; as the adjustable value of the asset will also be nil.

154. The meaning of termination value is provided in section 40-300. Where the open pit mine site improvement is disposed of as part of the direct sale of a mining operation, the termination value of the pit will be that amount of the purchase price that is reasonably attributable to the asset.³²

The start time of an open pit mine site improvement

155. Section 40-60 defines the start time of a depreciating asset to be when you first use it, or have it installed ready for use, for any purpose.

156. The words 'for any purpose' ensures that a start time can occur where the asset begins to be used for a non-taxable purpose. The revised EM to the New Business Tax System (Capital Allowances) Bill 2001 suggests this was the intention where it states:

...It is irrelevant that the depreciating asset may first be used for a non-taxable purpose. The current law expressly refers to assets installed ready for use and held in reserve, but the express words are reproduced here, as an unused asset is not installed ready for use unless it is held in reserve. Conversely, an asset which begins to be used must be installed ready for use. There are some assets which by their nature cannot be installed. Their start time will occur once they begin to be used...³³

157. An open pit mine site improvement cannot be installed. It is rather constructed by the continual removal of overburden and deliberate shaping of the land to provide the enhancement to the land that enables the miner to carry on the extraction activity. The start time for a pit will therefore occur once the pit is 'in use'.

³¹ the adjustable value of a depreciating asset set by section 40-85.

³² see paragraph 40-300(1)(b) and the link through that paragraph to Item 1 in the table in paragraph 40-305(1)(b).

³³ paragraph 1.64.

158. The Commissioner considers an open pit mine site improvement can be 'in use' even if that use is only for the purpose of the pit's own (further) construction. Practically, the start time will typically occur at the time the pit assists with the extractive activities for which it has been designed, for example, when the pit walls begin to take shape and haulage roads and ramps are first constructed. This will be the time the pit first exists as a depreciating asset. It is at this point of time that the pit can be identified as performing its specific function of providing for the safe and efficient extraction of both waste material and the underlying mineral deposit.

159. A deduction for the decline in value of an open pit mine site improvement will be allowed for the income year in which the start time occurs.

An open pit mine site improvement is being used for a taxable purpose from its start time

160. A depreciating asset's start time sets the time from which the asset begins to decline in value. Subsection 40-25(2) provides that a deduction in respect of that decline in value must be reduced by the part of the asset's decline in value that is attributable to a use of the asset for a purpose other than a taxable purpose.

161. It is therefore necessary to consider whether an open pit mine site improvement is being used for a taxable purpose from its start time. The meaning of taxable purpose is set out in subsection 40-25(7) to include *the purpose of producing assessable income*. This phrase is further defined in subsection 995-1(1) as:

something is done for the ***purpose of producing assessable income*** if it is done:

- (a) for the purpose of gaining or producing assessable income; or
- (b) in carrying on a *business for the purpose of gaining or producing assessable income.

162. This definition indicates there needs to be some connection with the use of the depreciating asset to the derivation of the assessable income of the holder of the asset. A depreciating asset may be being used for the purpose of producing taxable income even though it does not of itself generate assessable income. It is sufficient that the depreciating asset contributes to the income producing activity or business of the holder.

163. Accordingly, an open pit mine site improvement is being used for a taxable purpose from the time its construction commences, as its use in the further construction of the pit is a necessary step in the process of ultimately extracting the underlying mineral deposit.

164. The phrase ‘for a purpose other than a taxable purpose’ as it appears in subsection 40-25(2) is taken principally to mean a use of a depreciating asset for a private purpose or for the purpose of deriving exempt income. The activity associated with the construction of an open pit mine site improvement is a necessary preliminary step to the derivation of assessable income that will arise once the mineral deposit begins to be extracted. There is a sufficient connection in this initial use of the pit to establish that the depreciating asset has commenced to be used for a taxable purpose.

165. Further, the inclusion of ‘the purpose of exploration or prospecting’ in the definition of taxable purpose in paragraph 40-25(7)(b) indicates an intention of Parliament to provide capital allowance relief where a depreciating asset is used in a mining business prior to the derivation of assessable income. This supports an interpretation that all uses of depreciating assets in a mine site owner’s business that are preliminary to the extractive activity would constitute a use of the asset for a taxable purpose.

The effective life of an open pit mine site improvement

166. The calculation of the decline in value of a depreciating asset for an income year is based on, among other things, its effective life. Subsection 40-95(1) provides that the holder of a depreciating asset must:

- use an effective life determined by the Commissioner under section 40-100; or
- itself work out the effective life under section 40-105.

167. Subsection 40-95(3) stipulates that the choice of determining an effective life must be made for the income year in which the asset’s start time occurs.

168. In making a determination, subsection 40-100(4) instructs the Commissioner to consider the period during which the depreciating asset can be used by any entity for a taxable purpose. This instruction, together with the view as set out above that the entire open pit mine site improvement is a single depreciating asset, would support a determination of effective life of the pit corresponding to the estimated life of the mine.

169. Where a mine site has within its boundaries two or more separate and distinct open pits, each pit would constitute a separate depreciating asset. Each pit in this scenario will have its own effective life which will typically equate to the planned and therefore predictable useful life of that individual pit.

The operation of the consolidation tax cost setting rules when an open pit miner joins a consolidated group³⁴

170. The consolidation regime in Part 3-90 operates to treat wholly-owned corporate groups as a single entity for income tax purposes. This means that the subsidiary members of the group lose their individual income tax identity and are treated as parts of the head company during the period in which they are members of the group. The assets and liabilities of the subsidiary members are treated as assets and liabilities of the head company.

171. The consolidation regime contains tax cost setting rules that apply when an entity becomes a subsidiary member of the group either on the group's formation or when the entity joins an existing consolidated group. The purpose of these rules is to align the cost to the head company of acquiring the membership interests in the joining entity to the assets that the joining entity brings with it into the group.

172. The tax cost setting rules contain supporting provisions that determine the subsequent income tax treatment of assets that are brought into the group by a subsidiary member, including what history relating to the asset is relevant to the head company.

173. The first step in applying the tax cost setting rules is to identify the assets the joining entity is bringing into the consolidated group.

An open pit mine site improvement is an asset for Part 3-90 purposes

174. The concept of 'asset' is not defined by Part 3-90. Taxation Ruling TR 2004/13³⁵ provides the ATO view as to what is an asset for the purposes of the tax cost setting rules in Part 3-90.

175. TR 2004/13 provides for a wide view of the recognition of assets, stating that:

...an asset for the purpose of the tax cost setting rules is anything recognised in commerce and business as having economic value to the joining entity at the joining time for which a purchaser of its membership interests would be willing to pay. The business or commercial assets of a joining entity would include the things that would be expected to be identified by a prudent vendor and purchaser as having value in the making of a sale agreement in respect of all the membership interests in an entity and its business.³⁶

³⁴ Reference to a consolidated group in this Explanation includes reference to a multiple entry consolidated group (a MEC group).

³⁵ Income Tax: the meaning of an asset for the purposes of Part 3-90 of the ITAA 1997.

³⁶ at paragraph 5.

176. TR 2004/13 outlines further that:

Assets recognised under the *Income Tax Assessment Act 1936* (ITAA 1936) and the ITAA 1997 would come within the ordinary commercial or business meaning of an asset for Part 3-90 of the ITAA 1997. Assets within these categories would include items of trading stock, revenue assets, traditional and qualifying securities, depreciating assets and CGT assets.³⁷

177. Accordingly, an open pit mine site improvement would be recognised as an asset of a joining entity holding the improvement upon joining a consolidated group, for the following reasons:

- geotechnical engineers view mine site improvements as assets of commercial and engineering value,
- the acquirer of a miner will specifically recognise and pay for mine site improvements, as the presence of the open pit enables mining to continue and prevents the acquirer from itself having to construct the improvement, and
- an open pit mine site improvement is a depreciating asset for the purposes of Division 40.

178. TR 2004/13 goes on to comment on whether a larger composite asset should be recognised for Part 3-90 purposes, as opposed to the individual component parts. The Ruling provides:

The extent and degree to which the assets of the entity should be separately identified or treated as composite items would depend on the nature of the asset and the business being carried on by the entity and the circumstances of the particular case.³⁸

179. This indicates that the asset recognised under the capital allowance rules would similarly be the asset recognised by the consolidation tax cost setting rules. As such, a tax cost setting amount will be established for the entire pit as opposed to any of its structural features.

Treatment of the tax cost setting amount set for an open pit mine site improvement

180. Subsection 701-10(4) provides that each asset of a joining entity is required to have its tax cost set at the joining time at the asset's 'tax cost setting amount'.

181. Item 1 in the table in subsection 701-60(1) instructs that the tax cost setting amount, where the asset's tax cost is set by section 701-10, is worked out in accordance with Division 705.

182. Subsection 701-10(3) provides that the object of Division 705 '...is to recognise the cost to the head company of such assets as an amount reflecting the group's cost of acquiring the entity'.

³⁷ at paragraph 11.

³⁸ at paragraph 26 of the Explanation.

183. Further detail is provided in the Objects clauses to Subdivision 705-A in section 705-10 which state:

705-10(2) The object of this Subdivision is to recognise the head company's cost of becoming the holder of the joining entity's assets as an amount reflecting the group's cost of acquiring the entity. That amount consists of the cost of the group's membership interests in the joining entity, increased by the joining entity's liabilities and adjusted to take account of the joining entity's retained profits, distributions of profits, deductions and losses.

705-10(3) The reason for recognising the head company's cost in this way is to align the costs of assets with the costs of membership interests, and to allow for the preservation of this alignment until the entity ceases to be a subsidiary member.

184. Paragraph 5.18 of the EM to the New Business Tax System (Consolidation) Bill (No. 1) 2002 confirms that:

A joined group's cost of acquiring a joining entity is treated as the head company's cost of acquiring the assets of the joining entity.

185. The cost of acquiring the joining entity that is then allocated to the joining entity's assets is established by working out an allocable cost amount (ACA) for the joining entity, which is an 8-step calculation as described in section 705-60.

186. The ACA is allocated to the assets of the joining entity by first allocating amounts to retained cost base assets. The remaining ACA is then allocated to the reset cost base assets of the joining entity in proportion to their market values.

187. Section 705-35 provides that an open pit mine site improvement asset will be a reset cost base asset of the joining entity as it is not a retained cost base asset.³⁹

188. Section 701-55 provides the legislative meaning of setting the tax cost of a joining entity's assets in this way. The intention is that the head company uses the tax cost setting amount to determine the subsequent tax consequences that arise in respect of the asset. The exact meaning of the expression depends on which provisions of the income tax law are to subsequently apply to the asset. For example:

- If the trading stock provisions in Division 70 are to apply to the asset, subsection 701-55(3) applies to deem the head company to have held the trading stock from the start of the income year in which the joining time occurs and sets the value of that stock at that time at the asset's tax cost setting amount,
- if the CGT provisions in Part 3-1 or Part 3-3 subsequently apply to the asset, subsection 701-55(5) applies to replace the asset's cost base or reduced cost base at the joining time with the asset's tax cost setting amount.

³⁹ retained cost base assets are defined in section 705-25.

189. The legislative meaning of setting the tax cost of depreciating assets is provided in subsection 701-55(2). That subsection states:

Depreciating asset provisions

701-55 (2) If any of Subdivision 40-A to 40-D, sections 40-425 to 40-445 and Subdivision 328-D, and sections 73BA and 73BF of the *Income Tax Assessment Act 1936*, is to apply in relation to the asset, the expression means that the provisions apply as if:

- (a) the asset were acquired at the particular time for a payment equal to its tax cost setting amount; and
- (b) at the time the same method of working out the decline in value were chosen for the asset as applied to it just before that time; and
- (c) where just before that time the prime cost method applied for working out the asset's decline in value and the asset's tax cost setting amount does not exceed the joining entity's terminating value for the asset – at that time an effective life were chosen for the asset equal to the remainder of the effective life of the asset just before that time; and
- (d) where just before that time the prime cost method applied for working out the asset's decline in value and the asset's tax cost setting amount exceeds the joining entity's terminating value for the asset – the head company were required to choose at that time an effective life for the asset in accordance with subsections 40-95(1) and (3) and any choice of an effective life determined by the Commissioner were limited to one in force at that time; and
- (e) where neither paragraph (c) nor (d) applies – at that time an effective life were chosen for the asset equal to the asset's effective life just before that time.

190. The effect of paragraph 701-55(2)(a) is to deem an acquisition of the depreciating asset by the head company for a payment equivalent to the asset's tax cost setting amount. In a scenario where the joining entity holds an open pit mine site improvement that is a depreciating asset, the effect of this deemed acquisition is as follows:

- the head company of the consolidated group is treated as holding the open pit mine site improvement from the joining time,
- the head company of the consolidated group is taken to have acquired the open pit mine site improvement at the joining time for a payment equal to the asset's tax cost setting amount. This amount becomes the first element of the cost of the open pit mine site improvement for the head company under section 40-180, and

- the 'start time' under section 40-60 for the open pit mine site improvement will begin when the head company starts to use the open pit mine site improvement, which practically is likely to be the joining time.

191. Paragraph 701-55(2)(b) limits the choice of the method of working out the decline in value to the method that applied to the asset just before the joining time. Where no method has been actually chosen just before the joining time, the head company is permitted to choose a method under section 40-65.⁴⁰

192. The effective life set for the asset will depend on whether paragraph 701-55(2)(c), (d) or (e) applies. Where paragraph 701-55(2)(e) applies, the head company will be required to determine the effective life of the asset under subsection 40-95(1).

A balancing charge does not arise for the joining entity

193. A balancing adjustment event does not arise under either paragraph 40-295(1)(a) or (b) as a result of the subsidiary member ceasing to hold the asset at the joining time.

194. The single entity rule in section 701-1 operates to treat a subsidiary member as being a part of the head company. It does not operate to deem a disposal of the joining entity's assets such that a balancing adjustment event would trigger in respect of the depreciating assets of the joining entity. This interpretation is supported by the note to subsection 701-35(3), which states:

Note: In the case of assets other than trading stock, the fact that the entity ceases to hold them when the single entity rule begins to apply to them would not constitute a disposal or other event having tax consequences for the entity.

Determining the market value of an open pit mine improvement

195. As outlined at paragraph 186, the ACA remaining after amounts are allocated to retained cost base assets is spread across the reset cost base assets of the joining entity in proportion to their market values. The Commissioner recognises the difficulty in valuing an improvement to land that is statutorily separated from the land.

196. Where a miner who conducts an open pit mining operation joins a consolidated group, there is a need to establish what value ascribes to the mining right (that represents the net present value of the mineral deposit covered by the right) and what value ascribes to the associated open pit mine site improvement.

197. The methodology applied in valuing these assets should resolve any overlapping market value by having regard to the appropriate market value of each asset.

⁴⁰ see reasoning in ATO Interpretative Decision ATOID 2011/51.

198. Further, in looking to apply a depreciated replacement cost methodology in valuing the improvement, one needs to consider whether a simple application is wholly appropriate in the unusual circumstances presented in a case where the asset for which a market value is sought is a construct of the law, and in many respects lacking a market.

199. A most direct indicator of the market value of a unique asset is available if the asset has recently been acquired in the marketplace. It is apparent that the market value will be indicated by the cost, and this holds true for assets that are constructed. The buyer has made an expenditure wholly to acquire the asset. The asset has a value (certainly in the mind of the acquirer) in line with the amount of the expenditure. And even at a later time, the earlier acquisition on market can still afford a valid (though less precise) basis of market value if the cost amount was to be depreciated at an appropriate rate.

200. But such an approach is seriously compromised in the case of the valuation of a pit. There might be no problem in identifying the cost of the pit, but typically this expenditure would not have been made wholly to acquire the asset. Once the mineral deposit has been reached, many of the costs of building the pit are at the same time the costs of retrieval of the mineral deposit. Note that this does not necessarily mean that the value of the pit would be less than the total expenditure (this is not an apportionment issue), but it does mean that the miner may well not have made the total amount of the expenditure if the only advantage accruing to it was the pit, in the form in which it presents at the time relevant for the valuation. There is, in these kinds of cases, a serious decoupling of the identity that usually obtains as between what a taxpayer paid for an asset and what a taxpayer would have paid for (merely) the asset. It is the latter that provides the link to market value.

201. One response to the awkwardness in arriving at the market value of a pit is the notion of optimised replacement cost. This approach observes that a mature pit may comprise a part that is redundant, in the sense that it has been entirely worked out and that mining activity and pit development continues 'at the other end'. Optimised replacement cost assumes (1.) the existence of no pit, but (2.) the mineral deposit consists of only the part that still remains in the ground at the time for the market valuation of the pit. The optimised replacement cost is the minimum cost of obtaining equivalent access to the remaining deposit, and in a reasonably mature mine this would often be less than the actual cost (and a *fortiori* the replacement cost) of the presently existing pit.

202. But it should be borne in mind that an optimised cost is merely that – a cost. Nobody has chosen to pay such a cost, so there is no link with the market. Obversely it can readily be appreciated that one can incur much expenditure in the construction of an ‘asset’ that the market cares little for. More particularly, it can be appreciated if there is only a very small percentage of ore remaining, the value of ready access to it might be very much less than the cost of digging a new pit, however optimal. Optimised replacement cost may have some part to play in arriving at market value, though. If a purported market value of a pit arrived at by some other method were in excess of the optimised replacement cost, it may well be appropriate to see the optimised replacement cost as setting a cap on the market value amount.

Appendix 2 – Alternative views

❶ *This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.*

An improvement to land cannot be a depreciating asset if the improvement is merely land in the ordinary sense

203. Land is specifically excluded by paragraph 40-30(1)(a) from being a depreciating asset. ATO Interpretative Decision ATOID 2007/12 expresses the view that the meaning of 'land' in this paragraph should be given its ordinary and conventional meaning, rather than its legal meaning (where improvements are treated as part of the land).

204. ATOID 2007/12 goes on to reason that an improvement to land, treated as separate to the land by subsection 40-30(3), must be identifiable as having a discrete function other than merely existing as reshaped earth to avoid being excluded from being a depreciating asset under paragraph 40-30(1)(a). ATOID 2007/12 expresses the view that particular open pit features created by earthworks conducted within the pit were merely existing and functioning as land within its ordinary meaning and were therefore not depreciating assets.

205. The Commissioner now considers this interpretation to be incorrect. The exclusion of land from being a depreciating asset under paragraph 40-30(1)(a) has no application to improvements to land that are separated from land by subsection 40-30(3). The better view is that something treated by subsection 40-30(3) to be separate from the land cannot be prevented from being a depreciating asset because it is land. A natural reading of the provisions is to view subsection 40-30(3) as switching-off the operation of paragraph 40-30(1)(a) in relation to improvements to land and fixtures on land.

206. The Commissioner considers the note to subsection 40-30(3) simply refers to the need for the other elements of subsection 40-30(1) to be satisfied for the improvement or fixture to be a depreciating asset.

Components of an open pit mine site improvement are capable of being identified as separate depreciating assets

207. An alternate view with regard to characterisation is that components of a pit are capable of separate identification as depreciating assets. It has been contended that haulage road systems or subsystems along with particular pit walls constructed within the pit can be identified as discrete depreciating assets.

208. It is contended that the purpose and function of these structural features can be sufficiently distinguished such that each feature constitutes a separate depreciating asset. The haulage roads are said to provide for the efficient and safe transportation of both extracted material and mining equipment to and from the pit. The pit walls are said to provide the setting by which the mineral deposit can be extracted through the use of the push-back process. The walls maintain a safe pit slope and prevent rock falls endangering workers and mining equipment. It is said that these functions evidence the discrete objectives of each component in the context of an open pit mining operation.

209. It is also contended that each feature contributes a different economic value to the mining operation while they exist in that they provide access to a particular area of an underlying mineral deposit. That these economic values can be separately identified and are likely to be delivered over discrete periods of time is said to promote an identification of the feature as a separate depreciating asset.

210. The Commissioner does not consider this alternate view to represent an appropriate objective application of subsection 40-30(4). The Commissioner's approach to objectively identifying the appropriate depreciating asset, as set out at paragraphs 118-136, provides that an entire pit will typically be identified as a single depreciating asset.

Appendix 3 – Your comments

211. You are invited to comment on this draft Ruling, including the proposed date of effect. Please forward your comments to the contact officer by the due date.

212. 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:	20 June 2012
Contact officer:	Daryl Brigham
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Previous draft:

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