


Investment Properties – Depreciation Issues

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The following provide a concise indication of how the Tax Office looks at these issues. We hope that it is helpful to you in your understanding of the complexity of tax law in relation to investment properties, however, please feel free to contact us if you would like more information.

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Status of this decision: Decision Current

ATO Interpretative Decision

ATO ID 2003/439 Capital Allowances: allocating jointly held depreciating assets to a low-value pool

FOI status: may be released

Status of this decision: Decision Current

Issue

Can the taxpayer choose, under subsection 40-425(1) of the *Income Tax Assessment Act 1997* (ITAA 1997), to allocate to a low-value pool their interest in a depreciating asset they start to hold jointly if the cost of their interest in the asset is less than \$1,000 even though the cost of the asset exceeds \$1,000?

Decision

Yes. The taxpayer can allocate their interest in the depreciating asset to a low-value pool because section 40-35 of the ITAA 1997 treats their interest in the asset as the asset for the purposes of Division 40 of the ITAA 1997.

Facts

The taxpayer jointly owns a rental property to the extent of 50%. In the 2001-02 income year, they jointly purchased for the property a new hot water system costing \$1200. In accordance with their ownership interest in the rental property, the taxpayer contributed \$600 to the purchase of the new hot water system.

Reasons for Decision

For a depreciating asset that is a 'partnership asset', the asset is held by the partnership and not by any particular partner (item 7 of the table in section 40-40 of the ITAA 1997). In this context, the words 'partnership asset' carry their common law meaning. That is, they refer to assets of a partnership that are used for the purpose of the business carried on by the partnership. The words 'partnership asset' do not extend to assets that are merely co-owned even though their co-ownership and their employment for the purpose of receiving income jointly may be enough to recognise a partnership for income tax purposes (see definition of partnership in subsection 995-1(1) of the ITAA 1997). In the circumstances of this case, the taxpayer is not carrying on a business in partnership (*Cripps v FC of T* 99 ATC 2428; (1999) 43 ATR 1202) but is merely undertaking a passive investment (Taxation Ruling IT 2423).

For depreciating assets that are co-owned but are not partnership assets, section 40-35 of the ITAA 1997 applies to the asset as if your interest in the asset is the relevant asset for the purposes of Division 40 of the ITAA 1997. This leads to the result that each co-owner must treat their depreciating asset (their interest in the underlying asset) in accordance with their own tax profile. In the present case, the taxpayer must work out the cost, effective life and choose a method to work out the decline in value of the depreciating asset that is their interest and to claim, in their own income tax return, the appropriate deduction for that decline in value. Provided the other requirements of the low-value pool provisions in Subdivision 40-E of the ITAA 1997 are satisfied, the taxpayer also may allocate their asset to a low-value pool because their interest in the underlying asset cost less than \$1,000.

Date of decision: 6 June 2003

Year of income: Year ended 30 June 2002

Legislative References:

Income Tax Assessment Act 1997

Section 40-35

Section 40-40

Subsection 40-425(1)
Subsection 995-1(1)

Case References:

Cripps v. FC of T
99 ATC 2428
43 ATR 1202

Related Public Rulings (including Determinations)

Taxation Ruling IT 2423

Keywords

Capital allowances CoE
Deduction for depreciating assets
Jointly held depreciating asset
Low value pool
Partnership asset
Pooling

Date of publication: 13 June 2003

ISSN: 1445-2782

ATO Interpretative Decision

ATO ID 2003/703 Capital works: insurance proceeds - deduction for undeducted construction expenditure for building destroyed

FOI status: may be released

Status of this decision: Decision Current

Issue

What is the amount of the deduction that can be claimed under section 43-40 of the *Income Tax Assessment Act 1997* (ITAA 1997) by a taxpayer where insurance proceeds received upon destruction of a taxpayer's building exceed that building's undeducted construction expenditure?

Decision

The amount of the deduction to which the taxpayer is entitled to under section 43-40 of the ITAA 1997 is nil.

Facts

A taxpayer owned a rental property. Capital works deductions were claimed under Division 43 of the ITAA 1997 from the 1995-96 income year when the rental property was originally constructed. The property has always been used for income producing purposes.

The rental property was destroyed by fire in March 2002. The undeducted construction expenditure for the building at the date of destruction was \$120,500. The total proceeds received from the taxpayer's insurance company for the construction of a new or replacement building were \$150,000.

Reasons for Decision

Section 43-40 of the ITAA 1997 allows a taxpayer to deduct an amount if all or part of their building is destroyed in an income year and:

- they have been allowed or can claim a deduction for the building write off
- the building was used for income producing purposes before it was destroyed, and
- there is an amount of undeducted construction expenditure for the building.

The effect of this provision is to allow the taxpayer to deduct in the income year in which the building is destroyed, the amount of construction expenditure that has not yet been deducted. However, they must reduce the deduction by any insurance or salvage receipts received or receivable.

The amount deductible under section 43-40 of the ITAA 1997 is calculated by reducing the undeducted construction expenditure at the date of the building's destruction by the amount they received or have a right to receive for the destruction of the building (section 43-250 of the ITAA 1997).

As the insurance proceeds (\$150,000) received by the taxpayer for the destruction of the building exceed the undeducted construction expenditure (\$120,500), the amount available as a deduction under section 43-40 of the ITAA 1997 is nil.

History note: *The last paragraph of the 'Reasons for Decision' was removed on 7 October 2004*

Date of decision: 30 July 2003

Year of income: Year ended 30 June 2002
Year ended 30 June 2003

Legislative References:

Income Tax Assessment Act 1997

section 43-40

section 43-250

Related Public Rulings (including Determinations)

Taxation Ruling TR 97/25

Taxation Ruling TR 95/35

Related ATO Interpretative Decisions

ATO ID 2003/704

Keywords

Buildings

Building depreciation

Construction & real estate

Destruction of assets

Date of publication: 8 August 2003

ISSN: 1445-2782

ATO Interpretative Decision

ATO ID 2003/704 Capital works: deduction for capital works after rental property destroyed

FOI status: may be released

Status of this decision: Decision Current

Issue

Can a taxpayer deduct an amount for capital works under section 43-10 of the *Income Tax Assessment Act 1997* (ITAA 1997) after the rental property was destroyed even though the taxpayer received compensation for the loss of rent from their insurance company until the new building was constructed?

Decision

No. The taxpayer cannot deduct an amount for capital works under section 43-10 of the ITAA 1997 when the rental property was destroyed as the taxpayer could not use their area (or their building) for the purpose of producing assessable income as required by Table 43-140 (Current year use) in section 43-140 of the ITAA 1997.

Facts

A taxpayer owned a rental property. Capital works deductions were claimed under Division 43 of the ITAA 1997 from the 1995-96 income year when the rental property was originally constructed. The property has always been used for income producing purposes.

The rental property was destroyed by fire in March 2002. The undeducted construction expenditure for the building at the date of destruction was \$120,500. The total proceeds received from the taxpayer's insurance company for the construction of a new or replacement building were \$150,000.

In addition, the taxpayer received weekly compensation for the loss of rent from their insurance company until the end of December 2002.

Reasons for Decision

Section 43-10 of the ITAA 1997 allows a taxpayer to deduct an amount for capital works for an income year if:

- their capital works have a construction expenditure area
- there is a pool of construction of expenditure for that area, and
- they use that area in a deductible way as set out in Table 43-140 (Current year use).

[HISTORY: This ATO ID has been amended by replacing the phrase 'they incurred expenditure attributable to that area' in the reasons for decision with 'there is a pool of construction of expenditure for that area' in order to clarify the operation of section 43-10 of the ITAA 1997.]

Table 43-140 (Current year use) in section 43-140 of the ITAA 1997 sets out the various ways that an area can be used in order for it to be used in a deductible way for that income year. Common amongst the requirements of use for each time period is that an area is used in a deductible way if it is used to produce assessable income.

After the rental property was destroyed by fire in March 2002, the taxpayer could not use their area (or their building) in a deductible way as set out in Table 43-140 (Current year use). Therefore a deduction under Division 43 of the ITAA 1997 for the 2001-02 income year would not be available to the taxpayer for the number of days in

that year the building was not present and was, therefore, not available for use in a deductible way as set out in Table 43-140 (Current year use).

Date of decision: 30 July 2003

Year of income: Year ended 30 June 2002

Year ended 30 June 2003

Legislative References:

Income Tax Assessment Act 1997

section 43-10

section 43-140

Division 43

Related ATO Interpretative Decisions

ATO ID 2003/703

Keywords

Building depreciation

Construction expenditure area

Depreciation of new buildings

Destruction of assets

Newly constructed buildings and structures

Pool of construction expenditure

Date of publication: 8 August 2003

ISSN: 1445-2782

ATO Interpretative Decision

ATO ID 2003/946 Capital Allowances: Low-value pools - allocating substantially identical assets

FOI status: may be released

Status of this decision: Decision Current

Issue

Can a depreciating asset which cost less than \$1,000 be allocated to a low-value pool under section 40-425 of the *Income Tax Assessment Act 1997* (ITAA 1997) even if the total cost of all substantially identical items acquired by the taxpayer in that income year exceeded \$1,000?

Decision

Yes. Regardless of the total cost of all substantially identical items acquired during the income year, if the item is a depreciating asset which cost less than \$1,000 and the cost is not immediately deductible under subsection 40-80(2) of the ITAA 1997, it can be allocated to the low-value pool under section 40-425 of the ITAA 1997, provided the other conditions of the provision are met.

Facts

A taxpayer acquired, in one purchase, several blinds for the windows in a rental property. The cost of each blind was between \$100 and \$500, but the total cost of the blinds exceeded \$1,000.

The blinds are substantially identical as they are:

- all venetian blinds
- attached to the window in the same way and
- made by the same company in the same colour and material.

The only difference between the blinds is their size, which is dictated by the size of the window in the relevant room.

Reason for Decision

Subsection 40-425(1) of the ITAA 1997 gives taxpayers the choice to allocate low-cost assets to a low-value pool for the income year in which they start to use them, or have them installed ready for use, for a taxable purpose.

A low-cost asset is a depreciating asset, except a horticultural plant, whose cost is less than \$1,000 (after GST credits or adjustments) as at the end of the income year in which you start to use it, or have it installed ready for use, for a taxable purpose (subsection 40-425(2) of the ITAA 1997).

Whether a particular item is a depreciating asset is a question of fact and degree which is determined in the light of all of the circumstances of the particular case. In some situations an item may be part of a larger depreciating asset and not be a depreciating asset by itself.

In this case, each of the blinds is a separate depreciating asset. As their costs range from \$100 to \$500, each of the blinds meets the definition of a low-cost asset provided in subsection 40-425(2) of the ITAA 1997.

A deduction is not allowable under section 40-425 of the ITAA 1997 if the expenditure meets the requirements for an immediate deduction under subsection 40-80(2) of the ITAA 1997.

The taxpayer's expenditure on the blinds does not qualify for an immediate deduction under subsection 40-80(2) of the ITAA 1997. The expenditure fails to meet the conditions of that provision. In particular, the total cost of substantially identical items that the taxpayer started to hold in the income year exceeds \$300.

As each depreciating asset has cost less than \$1,000 it can be allocated to the low-value pool under section 40-425 of the ITAA 1997.

For the purposes of allocating depreciating assets to the low-value pool under section 40-425 of the ITAA 1997, it is not by itself determinative if identical, or substantially identical, low-cost assets are acquired by the taxpayer during the income year.

Related Public Ruling

Taxation Ruling TR 94/11

Date of decision: 10 September 2003

Year of income: Year ended 30 June 2003

Legislative References:

Income Tax Assessment Act 1997

section 40-425.

subsection 40-425(1).

subsection 40-425(2).

subsection 40-425(4).

subsection 40-80(2).

Related ATO Interpretative Decisions

ATO ID 2003/80

Keywords

Capital Allowances CoE

Low value pool

Substantially identical depreciating assets

Uniform capital allowances system

Date of publication: 17 October 2003

ISSN: 1445-2782

ATO Interpretative Decision

ATO ID 2004/137 Capital Works: application of Division 43 - pre-1979 building - relocation

FOI status: may be released

Status of this decision: Decision Current

Issue

Can the taxpayer deduct an amount under Division 43 of the *Income Tax Assessment Act 1997* (ITAA 1997) for the purchase price or original construction expenditure of a second hand house that is relocated to the taxpayer's land where it is subsequently altered and improved?

Decision

No. The taxpayer cannot deduct an amount under Division 43 of the ITAA 1997 for the purchase price or original construction expenditure of the house because it is a building that was begun in Australia before 21 August 1979 and Division 43 does not apply (paragraph 43-20(1)(a) of the ITAA 1997).

Facts

In the year ending 30 June 2003, the taxpayer was successful in a tender to purchase and remove a second hand timber house from a block of land. The amount paid by the taxpayer for the house was similar to the market value of second hand building materials. The house had been built prior to 21 August 1979.

The taxpayer paid a lump sum to a licensed builder to remove and relocate the house onto the taxpayer's block of land, so that it could be used as residential rental property.

The relocated house was subsequently placed on new stumps at the new location, with construction works then carried out to improve the house to a rentable state.

The house was available for rent after all of the construction activity was completed.

Reasons for Decision

Division 43 of the ITAA 1997 allows a deduction for certain construction expenditure on some income producing capital works. A deduction under this Division is dependent, among other things, on whether there are capital works to which the Division applies and whether the capital works have construction expenditure, as defined in section 43-70 of the ITAA 1997.

Subsection 43-20(1) states that Division 43 of the ITAA 1997 applies to capital works begun in Australia after 21 August 1979 and being a building, or an extension, alteration or improvement to a building.

A deduction for capital works under Division 43 of the ITAA 1997 is based on the amount of construction expenditure, rather than the acquisition costs of a capital work.

The relocation of the house does not alter the time when the capital works were constructed. The previously constructed building continues to exist, but has simply changed location.

As the house was built before 21 August 1979, it is a building that is a capital work to which Division 43 of the ITAA 1997 does not apply. Therefore, the taxpayer cannot deduct an amount for the original construction expenditure in respect of the relocated building.

As the taxpayer did not construct a new building, the purchase price, even though it was similar to the market value of second hand material, is not construction expenditure in respect of the relocated building, and therefore the taxpayer cannot deduct an amount for the purchase price of the relocated building.

However, the alterations or improvements carried out on the building at the new location are separate capital works from the relocated building. An amount for the construction expenditure in respect of these new capital works may be deductible under Division 43 of the ITAA 1997.

Date of decision: 2 February 2004

Year of income: Year ended 30 June 2003

Legislative References:

Income Tax Assessment Act 1997

subsection 43-20(1)

paragraph 43-20(1)(a)

section 43-70

Division 43

Related ATO Interpretative Decisions

ATO ID 2004/136

ATO ID 2004/138

Keywords

Buildings

Removal & relocation expenses

Capital expenditure

Construction expenses

Date of publication: 13 February 2004

ISSN: 1445-2782

ATO Interpretative Decision

ATO ID 2004/579 Capital Allowances: depreciating assets - rental property - waste water system items

FOI status: may be released

Status of this decision: Decision Current

Issue

Does the taxpayer's waste disposal system comprising a water tank and piping, pump and hose, constitute a single depreciating asset within the meaning of that term in section 40-30 of the *Income Tax Assessment Act 1997* (ITAA 1997)?

Decision

No. Within the meaning of a depreciating asset in section 40-30 of the ITAA 1997, the waste disposal system consists of separate depreciating assets being the piping and water tank, the pump and the hose.

Facts

The taxpayer owns a rental property. There is no council supplied sewerage system in the area and the property's soakage trenches were unable to cope with the amount of waste water produced on the property. The taxpayer purchased and installed, in compliance with council regulations, a polyethylene water tank connected by a pipe to the house, a pump and a hose from the pump to the garden. The purpose of the tank, which was installed underground, is to collect waste water to be pumped onto gardens on the property.

The piping is an underground pipe that connects the tank to the building. The pump sits in the tank and is used to pump the waste water onto the gardens.

Reasons for Decision

For the purpose of applying the capital allowance provisions in Division 40 of the ITAA 1997, whether a composite item is itself a depreciating asset or whether its components are separate depreciating assets is a question of fact and degree to be determined in the light of all of the circumstances of the particular case (subsection 40-30 (4) of the ITAA 1997).

A test used in determining that outcome is a test of function, the functional test.

The Commissioner's views as to the application of the functional test are set out in Taxation Ruling TR 94/11. Some of the factors to be considered in applying the functional test include:

- being separately identifiable
- being capable of performing its own separate function, and
- the item varies the performance of another item.

Factors such as the mechanical independence of an item, physical separability and whether an item can be separately acquired, need also to be considered in deciding whether an item may be a separate depreciating asset.

It is considered that each of the water tank and piping, and the pump and hose, is a separately identifiable unit performing its own intended discrete function. Functionally, they are separate items. The piping transfers the waste water from the rental property to the water tank. The water tank captures the waste water from the rental

property. The pump acts as the mechanism of getting the waste water from the tank, and the hose transfers the water to the garden.

The pump and hose are separate items that are depreciating assets for which a decline in value deduction is allowable under section 40-25 of the ITAA 1997.

The piping and tank are functionally separate from the pump and hosing, and are not part of the same depreciating asset as the pump or hosing.

Because the piping and tank are also capital works for which a deduction is available under section 43-10 of the ITAA 1997, subsection 40-45(2) of the ITAA 1997 provides that no decline in value deduction is available for these assets under section 40-25 of the ITAA 1997.

Date of decision: 18 June 2004

Year of income: Year ended 30 June 2004

Legislative References:

Income Tax Assessment Act 1997

section 40-25

section 40-30

subsection 40-30(4)

subsection 40-45(2)

section 43-10

Related Public Rulings (including Determinations)

Taxation Ruling TR 94/11

Keywords

Depreciating assets

Structural improvement expenses

Date of publication: 16 July 2004

ISSN: 1445-2782

ATO Interpretative Decision

ATO ID 2003/223 Capital works: replacement of kitchen cupboards in a rental property

FOI status: may be released

Status of this decision: Decision Current

Issue

Can the taxpayer deduct expenditure on the replacement of kitchen cupboards installed in a rental property under the capital works provision of section 43-10 of the *Income Tax Assessment Act 1997* (ITAA 1997)?

Decision

Yes. The taxpayer can write off the expenditure under the capital works provision of section 43-10 of the ITAA 1997.

Facts

The taxpayer has owned and rented a residential property for many years. While the property was tenanted, the taxpayer replaced the old kitchen fittings, including the cupboards. The old cupboards had deteriorated through water damage and wear and tear.

The new fittings are of a similar size, design and quality as the originals. The new cupboards are of the same type and standard of material (or the modern equivalent of that material). The layout and design of the kitchen did not alter substantially from that of the original. The differences are:

- the old sink was replaced with a smaller sink and, as a consequence, provided more bench top space; and
- a removable cupboard replaced the space previously available for a dishwasher.

Reasons for Decision

Broadly speaking, section 43-10 of the ITAA 1997 provides a deduction for capital expenditure on capital works used to produce assessable income. Capital works include a building or an extension, alteration or improvement to a building and includes the kitchen cupboards.

The kitchen cupboards are separately identifiable items with their own function. As a consequence, they are an entirety in themselves and their replacement is a renewal of the entirety. The expenditure is capital in nature (*Lindsay v. Federal Commissioner of Taxation* (1960) 106 CLR 377; 12 ATD 197; (1960) 8 AITR 99).

The cupboards are fixtures and, therefore, a part of the building because they satisfy the 'degree of annexation' and the 'object of annexation' tests that are generally applied to determine whether there is a fixture at common law. The cupboards are not in place simply by their own weight but are screwed to the walls of the building and they are fixed with the intention that they shall remain there indefinitely.

The deduction under section 43-10 of the ITAA 1997 is based on the amount of construction expenditure. This is defined in subsection 43-70(1) of the ITAA 1997 as capital expenditure incurred in respect of the construction of the capital works. Paragraph 43-70(2)(e) of the ITAA 1997 excludes expenditure on plant from construction expenditure.

The role and function of the cupboards in relation to the income producing activities do not go beyond being part of the setting of an income producing operation when they are installed in a residential rental property. As a result, they are not plant.

The expenditure on the kitchen cupboards is construction expenditure for which a deduction is available under section 43-10 of the ITAA 1997. A deduction for the expenditure is not available under Division 40 of the ITAA 1997 because a deduction is available under Division 43 of the ITAA 1997 (see subsection 40-45(2) of the ITAA 1997).

Date of decision: 24 December 2002

Year of income: Year ended 30 June 2002

Legislative References:

Income Tax Assessment Act 1997

Division 40

subsection 40-45(2)

Division 43

section 43-10

subsection 43-70(1)

paragraph 43-70(2)(e)

Case References:

Lindsay v. Federal Commissioner of Taxation

(1960) 106 CLR 377

12 ATD 197

Related ATO Interpretative Decisions

ATO ID 2003/222

Keywords

Repairs in entirety

Rental property

Capital expenditure

Date of publication: 4 April 2003

ISSN: 1445-2782