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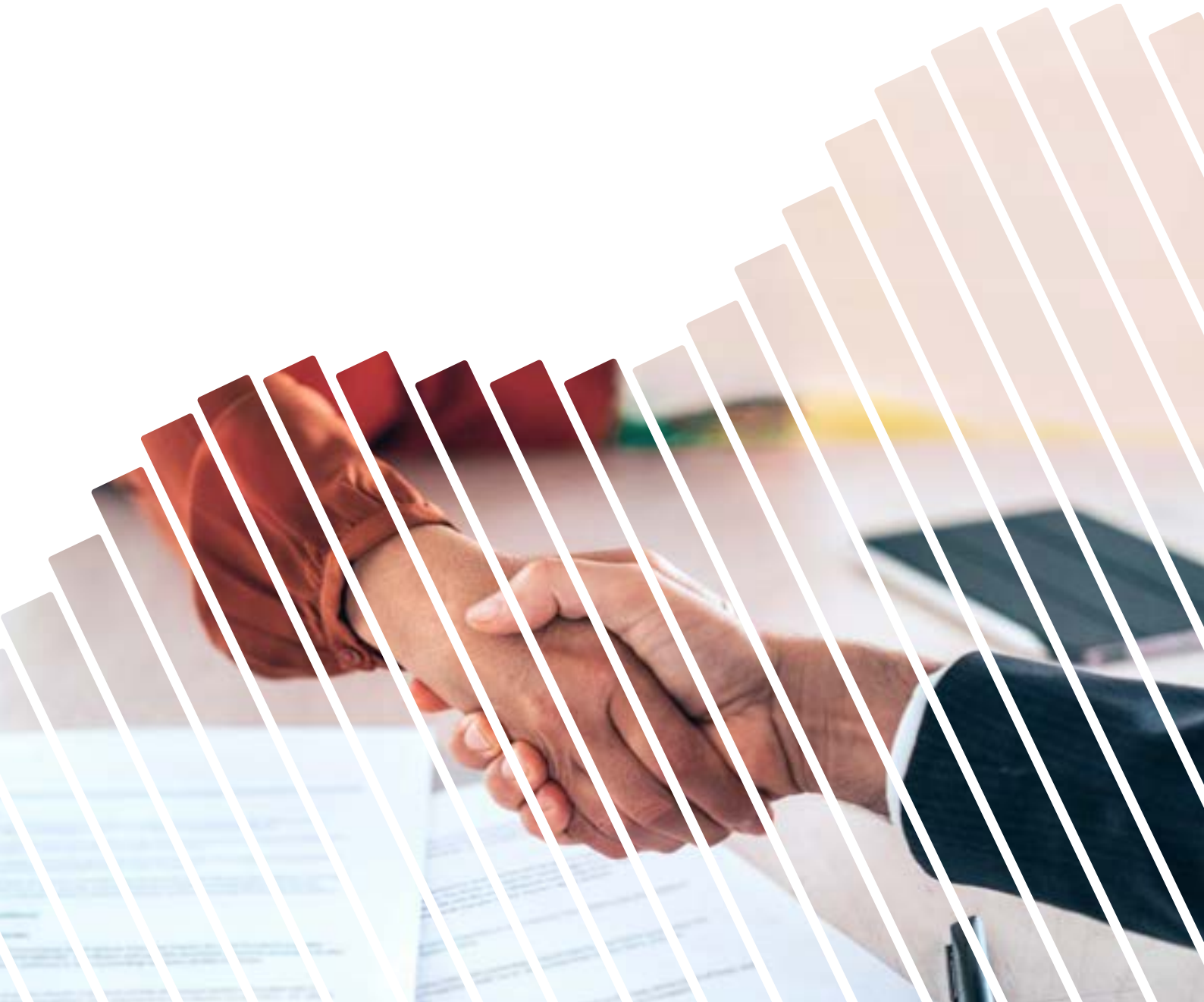
Has Division 7A changed forever post-*Bendel*?
Michael Butler, CTA

Depreciating assets: transactional tips and traps
Jackson Jury

Investing in US private credit
Peter Oliver, CTA, and Vanessa Kasbekar



Depreciating assets: transactional tips and traps

By Jackson Jury, Senior Associate, Cowell Clarke

Many depreciating assets, owing to having been fully expensed on acquisition, are now potentially "ticking time bombs" for income tax and, accordingly, advisers should be considering potential tax planning pitfalls and opportunities when dealing with these assets as part of any transaction. This article seeks to explore those issues, together with other contemporary transactional tips and challenging traps that may arise when dealing with depreciating assets as part of any transaction.

Overview

Australia's capital allowance regime in recent years has been the subject of some of the most significant legislative amendments in the history of modern tax reform. These changes have been largely temporary in nature owing to them being part of the federal government's economic response to COVID-19. Nonetheless, taxpayers are now starting to feel the negative "hangover" effect of measures such as the temporary full expensing measures,[1] backing business investment measures[2] and instant asset write-off.[3]

Many depreciating assets, owing to having been fully expensed on acquisition, are now potentially "ticking time bombs" for income tax and, accordingly, advisers should be considering potential tax planning pitfalls and opportunities when dealing with these assets as part of any transaction.

As a separate point, Australia has seen substantial growth in the value of land across the country. Where certain works have been made to land in circumstances where those works qualify for deductions as depreciating assets, or if primary production depreciating asset write-offs are involved, it is important for advisers to understand the correct income tax treatment of these assets to manage any tax imposts on the disposal of those assets.

Advisers are highly familiar with the general concepts and criteria regarding the general capital allowance and simplified capital allowance framework for small businesses in the *Income Tax Assessment Act 1997* (Cth) (ITAA97), and so this article does not revisit the general criteria of those measures in detail.

Rather, this article seeks to explore a number of contemporary transactional tips and challenging traps that may arise from transactions dealing with depreciating assets.

Particular attention has also been given in this article to depreciating asset transactions occurring in the context of a post-COVID-19 economic stimulus climate, and some observations and planning issues in this regard are provided.

All statutory references in this article are to the ITAA97 unless stated otherwise.

Framework of depreciating assets

Before reviewing the transactional issues, it is first necessary to set out the broad principles of the framework for capital allowance deductions for depreciating assets.

The three core capital allowance regimes of relevance to deducting the decline in value of depreciating assets for the purposes of this article are contained in the:

- core general capital allowance regime under Subdiv 40-B;
- simplified capital allowance regime for small business entities under Subdiv 328-D; and
- primary production write-offs under Subdivs 40-F and 40-G.

Each of these regimes have been expanded on in turn below.

General capital allowance regime

The general capital allowance regime is contained under Div 40 (more specifically, Subdiv 40-B) and allows a taxpayer to deduct an amount equal to the decline in value for an income year of a depreciating asset that the taxpayer "holds" at any time during the year and uses for a taxable purpose (eg producing assessable income).[4]

The term "depreciating asset" for the above purposes is defined as an asset that has a limited effective life and can reasonably be expected to decline in value over the time it is used.[5]

"Land" is expressly excluded from the definition of a depreciating asset.[6] However, Div 40 applies to an improvement to land or a fixture on land that falls within the above definition of a depreciating asset, whether the improvement or fixture is removable or not, as if it were an asset separate from the land (however, see the comments below regarding exclusions of capital works).[7]

"Trading stock" and "intangible assets" are also excluded from the definition of depreciating assets, except for certain intangible assets not held as trading stock and which are specifically listed under s 40-30(2).[8]

As mentioned above, a taxpayer may only deduct the decline in value of a depreciating asset if the taxpayer "holds" the asset in the income year.

Section 40-40 provides a table to determine who is taken to be the holder of a depreciating asset in an income year.

The table has different applications depending on the nature of the asset involved. Nonetheless, generally, it is the economic owner of a depreciating asset who is deemed to be the holder of the asset, which is also often the legal owner of the asset.

Difficulties can, however, arise in determining who is the holder of a depreciating asset where the asset has more than one economic owner or is subject to a lease.[9] The latter issue is revisited later in this article.

Broadly, where a depreciating asset ceases to be held or used by the taxpayer as a depreciating asset (among other specified events), a balance adjustment event arises for the asset.[10]

Upon a balancing adjustment event arising, an amount of assessable income or a deduction arises to the taxpayer by comparing the termination value of the asset against its adjustable value.[11]

The termination value of a depreciating asset will be an amount determined under the table in s 40-300(2), otherwise the amount the taxpayer is taken to have received for the asset. Practically, save for a handful of limited exceptions, the termination value of a depreciating asset is typically taken to be its market value.

The adjustable value of a depreciating asset is its written down value at the time the balancing adjustment event occurs.[12] This amount is generally the cost of the asset less the decline in value of that asset as calculated under the capital allowance regime.

If the termination value exceeds the adjustable value of a depreciating asset, the taxpayer recognises an amount of assessable income from the balancing adjustment event, and the taxpayer recognises a deduction in the opposite circumstance.[13]

There are a number of other aspects to the framework of the core general capital allowance measures; however, for the purposes of this article, the above points are sufficient to provide context to the transactional issues discussed further below.

Capital allowance regime for small businesses

Entities that qualify as "small business entities" may choose to apply the simplified capital allowance regime for small businesses under Subdiv 328-D.

A small business entity for an income year (current year) is an entity that:

- carries on a business in the current year; and
- one or both of the following applies:
  - the entity carried on a business in the previous income year and had an aggregated turnover for the previous income year of less than $10m; or
  - the entity's aggregated turnover for the current year is likely to be less than $10m.[14]

Subdivision 328-D broadly allows for a small business entity to:

- instantly deduct the business portion of the cost of an asset where that cost is less than the relevant threshold amount for the year the asset is first used or installed ready for use ($20,000 for the income year ending 30 June 2025, but it is anticipated to revert to $1,000 for future income years subject to Labor fulfilling its 2025 federal election commitment to legislate an extension of the $20,000 threshold to the income year ending 30 June 2026);[15] and
- deduct amounts for the decline in value of depreciating assets pursuant to a general small business pool to which the asset is assigned, which is depreciated on a diminishing value basis at a pool rate of 15% for the first year that the asset is assigned to the pool, and 30% for all subsequent years (similarly pool balances less than the abovementioned instant asset write-off threshold are also fully expensed).[16]

Where an eligible taxpayer makes a choice to apply Subdiv 328-D, it applies in respect of all eligible assets that started to be used, or installed ready for use, for a taxable purpose during or before the income year that the choice is made.[17]

Once a depreciating asset becomes subject to Subdiv 328-D, it remains subject to Subdiv 328-D and cannot be depreciated pursuant to any other capital allowance measure for the remainder of its effective life.[18] This applies even in circumstances where the taxpayer no longer qualifies as a small business entity in later income years.

In addition, should a taxpayer choose to no longer use Subdiv 328-D for a later income year where the taxpayer satisfies the requirements to make that choice, the taxpayer is effectively "locked out" of making that choice again for five income years after the first later income year from which the taxpayer did not make that choice (but was able to do so).[19] As mentioned above, those assets that were elected to be subject to Subdiv 328-D remain subject to the provisions despite the above lock-out period being in force.

Similarly to Div 40, the disposal of assets subject to Subdiv 328-D gives rise to balancing adjustment event consequences in certain circumstances.

In respect of depreciating assets that, when acquired, had a cost of less than the relevant instant asset write-off threshold, the entirety of the taxable purpose proportion[20] of the assets' termination value is included in the taxpayer's assessable income.[21]

For those assets that had a cost in excess of the relevant write-off threshold on acquisition and were thus allocated to the taxpayer's general small business pool, the general small business pool broadly works on the basis that:

- the general small business pool is increased by the sum of the taxable purpose proportions of the adjustable values (eg cost) of depreciating assets that are allocated to the general small business pool and any cost additions to those assets;

- the pool balance is reduced by deductions claimed on the pool for the income year (eg at a rate of 15% for the first year and 30% each subsequent year on a diminishing value basis); and
- the pool balance is also reduced where an asset allocated to the pool is subject to a balancing adjustment event with that reduction being equal to the taxable purpose proportion of the termination value of the asset subject to the event.[22]

In circumstances where the taxpayer has a negative closing balance in their pool at the end of an income year, that negative amount is included as assessable income of the taxpayer and the negative balance is thus eliminated, with the taxpayer recording an opening balance of nil for the following income year.[23]

A short example demonstrating the calculation of a general small business pool's closing balance at year end is set out further below.

Primary production write-offs

Subdivision 40-F contains provisions for accelerated deductions for the decline in value of the following primary production depreciating assets:

- water facilities;
- fencing assets;
- fodder storage assets; and
- horticultural plants.

Each of the above different category of assets have their own specific provisions that need to be met to depreciate expenditure pursuant to the above measures (see further below).

Eligible expenditure on water facilities, fencing assets and fodder storage assets is able to be fully deducted immediately in the year that the expenditure is incurred.[24]

Horticultural plants, on the other hand, are provided with an immediate deduction for the full cost of the asset if the effective life of the plant is less than three years.[25] Otherwise, there is a cascading write-off rate ranging from 40% to 7% per year, depending on the effective life of the plant.[26]

Importantly, where an asset is eligible to be deducted under Subdiv 40-F, it cannot be deducted under Subdiv 40-B.[27] Having said this, where water facilities, fencing assets and fodder storage assets are eligible to be deducted by small business entities under Subdiv 328-D (small business capital allowance measures) as well, a choice exists that permits the taxpayer to choose which measure is to apply in respect of each asset qualifying for both measures.[28] This same choice between the regimes does not apply to horticultural plants (including grapevines), which must be deducted under Subdiv 40-F.[29]

Additionally, depreciating assets that are depreciated under Subdiv 40-F do not give rise to balancing adjustment events on their disposal, unlike assets depreciated under the general capital allowance measures.

Instead, expenditure incurred in relation to these assets either forms part of the land to which the expenditure relates or comprises a separate capital gains tax (CGT) asset.[30] As such, any expenditure claimed is treated as an erosion of the cost base of the CGT asset to which the expenditure relates, and any proceeds received on the disposal of these assets are subject to the CGT regime.[31]

For completeness, in addition to Subdiv 40-F, Subdiv 40-G provides deductions for capital expenditure on landcare operations concerning land used for a primary production business or rural land used for a business, including capital expenditure on connecting electricity and phone lines. Similarly to Subdiv 40-F, where assets are eligible to be deducted under Subdiv 40-G and Subdiv 328-D, a choice exists to apply one of either regime to the asset for the purposes of calculating its decline in value for its effective life.[32]

Water facilities

The definition of a "water facility" broadly includes plant or structural improvements, or repair of a capital nature, or an alteration, addition or extension, to plant or a structural improvement that is primarily and principally for the purposes of conserving or conveying water (or reasonably incidental to conserving or conveying water).[33]

Taxpayers can only claim a deduction for expenditure on a water facility to the extent it is incurred on the construction, manufacture, installation or acquisition of the water facility and the expenditure is:

- primarily and principally for conserving or conveying water; and
- is incurred either for use in a primary production business carried on by the taxpayer on the land or by an irrigation water provider for other taxpayers' primary production businesses.[34]

In relation to the last requirement, since the taxpayer must be carrying on a primary production business, expenditure incurred by a lessor who does not carry on any primary production activities on the land would be ineligible to claim expenditure on water facilities under Subdiv 40-F. These deductions may, however, still be claimed by the lessor under the other capital allowance regimes.

Expenditure on the construction of dams, tanks, tank stands, bores, wells and irrigation channels by a taxpayer for use in their primary production business would be examples of expenditure on water facilities.

Fences

The term "fence" takes its ordinary meaning and includes an asset or structural improvement that is a fence or is a repair of a capital nature, or an alteration, addition or extension to a fence.

Taxpayers can deduct capital expenditure on fencing to the extent it is incurred on the construction, manufacture, installation or acquisition of the fencing asset. It also must be incurred primarily or principally for use in a primary production business that is carried on by the taxpayer on the land.

It is worth briefly noting here that a fence that is part of a landcare operation will be deductible under Subdiv 40-G instead of Subdiv 40-F.[35]

Fodder storage assets

"Fodder storage assets" are defined to include an asset or a structural improvement, or a repair of a capital nature, or an alteration, addition or extension, to an asset or a structural improvement that is primarily and principally for the purpose of storing fodder.[36]

The explanatory memorandum to the legislation that introduced the fodder storage measures[37] provides that the term "fodder" takes its ordinary meaning and refers to food for livestock, usually dried such as grain, hay or silage. Common examples of fodder storage assets would therefore include silos, liquid feed supplement storage tanks, bins for storing dried grain, hay sheds, grain storage sheds and above-ground bunkers for silage.

Curiously, the explanatory memorandum also provides that although a fodder storage asset will be primarily used to store food for livestock, it may also store fodder that can be used for human consumption.[38]

Similarly to water facilities, to immediately deduct the decline in value of expenditure incurred on the construction, manufacture, installation or acquisition of a fodder storage asset, it must have been incurred primarily and principally for use in a primary production business that is conducted on land in Australia.[39]

Horticultural plant

The term "horticultural plant" means a live plant or fungus that is cultivated or propagated for any of its products or parts. Examples of horticultural plant would include fruit trees, grapevines, nut trees, flowers and vegetables.

Taxpayers can deduct capital expenditure relating to horticultural plant provided that the taxpayer carries on a horticultural business (as opposed to a primary production business). The taxpayer must also relevantly:

- own the plant, and any taxpayer that holds a lease or licence relating to the land does not use the land for the business of horticulture; or
- have a licence in relation to land to which the plant is attached and carry on a business of horticulture on the land as a result of holding the licence.

For completeness, there is also a further basis relating to leases and quasi-ownership rights granted by exempt Australian government agencies and exempt foreign government agencies, which is detailed in item 2 of the table in s 40-525(2).

Generally, the deduction for horticultural plants is in the year that is the later of when the first commercial season begins for the horticultural business or when the taxpayer satisfies a condition of ownership or quasi-ownership for the plant.[40] The phrase "first commercial season" is not defined and therefore takes its ordinary meaning. According to the Commissioner, this is the income year in which the horticultural plant's products or parts are first able to be harvested and sold commercially.[41]

Capital works exclusion

Some of the above capital allowance regimes do not apply to assets that qualify as capital works deductible under Div 43.[42]

Division 43 is not the focus of this article; nonetheless, the author has set out below some key elements of the capital works regime to the extent that the framework overlaps with the issues discussed.

Division 43 operates to allow taxpayers to deduct amounts for certain capital works, typically at a rate of 2.5% per annum over 40 years. In the event buildings or structural improvements to which Div 43 deductions apply are sold, the proceeds are brought to tax under the CGT regime.

Division 43 is limited in its application to capital works being either:

- a building, or an extension, alteration or improvement to a building, begun in Australia after 21 August 1979 (or outside Australia after 21 August 1990); or
- structural improvements, or extensions, alterations or improvements to structural improvements, begun after 26 February 1992.[43]

It is relevant to note that Div 40 is given precedence over Div 43 for expenditure on the following assets:

- capital expenditure under which a deduction is available under Subdivs 40-F and 40-G;[44] and
- capital expenditure that constitutes "plant".[45]

The latter concept of "plant" is revisited in further detail later in this article.

Asset trade-ins and the sting in the tail

The application of the temporary full expensing and instant asset write-off measures for the period of 6 October 2020 to 30 June 2023 has resulted in a number of depreciating assets being left with nil adjustable values.

This poses a particular concern when these assets are subject to a balancing adjustment event, since it can be expected in almost all circumstances that those assets' termination values (eg market value) will exceed their nil adjustable value, potentially giving rise to substantial assessable income.

Clients and tax professionals would therefore be well advised to be cautious of the transactional issues now posed for these assets on their disposal.

The negative long-term impact of a depreciating asset having been fully expensed under the temporary full expensing measures is best demonstrated in the context of asset trade-ins.

When an asset is traded in for another asset, the agreed price of the traded-in asset is deducted from the cost of the newly acquired asset. Although this may appear as one transaction, for income tax purposes, there are two separate transactions occurring, namely:

- the purchase of a new asset; and
- the disposal of an existing asset.

The significance of the above is that the termination value of the old asset is its agreed value (in other terms, its market value),[46] and the cost of the new asset is its purchase price (ie market value), as opposed to the net consideration that changes hands for the new asset.[47]

In this regard, consider the following circumstances:

- ABC Demolitions Trust owns demolition machinery that was fully depreciated under the general capital allowance measures (Subdiv 40-B) pursuant to the temporary full expensing measures.
- ABC Demolitions Trust wishes to trade in an old excavator for a new excavator worth $400,000.
- The new excavator has an effective life of approximately six years.
- ABC Demolitions Trust proposes to deduct the new excavator under the "straight-line" method.[48]
- The agreed trade-in value of the old excavator is $250,000.

The income tax consequences of the above circumstances are as shown in Table 1.

Table 1. Sting in the tail – asset trade-ins

Tax calculation	
Termination value of old excavator	$250,000
Less adjustable value of old excavator	(Nil)
Assessable income	$250,000
Less deduction for new excavator ($400,000/6 years)	($66,667)[49]
Taxable income	$183,333
Tax payable at 47%[50]	**$86,166**

It can be seen from the above example that, in circumstances where asset trade-ins are occurring for assets with nil adjustable values (owing to the temporary full expensing measures), this can give rise to a considerable tax impost for taxpayers. This may of course affect the commercial decision-making process of a taxpayer that may rely on asset trade-ins for the continued operation of their business activities using assets that are fit for purpose and in proper working order.

The author considers that there are a handful of tax planning opportunities that might be available to assist in mitigating the adverse tax consequences of the temporary full expensing measures. Some of these opportunities have been explored in further detail below.

Restructure prior to disposal

One way in which the "sting in the tail" of the temporary full expensing measures might be mitigated is by restructuring fully depreciated assets to a more tax effective structure prior to their disposal.

For example, if the depreciating asset is held in an individual, partnership or trust structure, it could be restructured to a company structure pursuant to the wholly owned company roll-over relief under either of:

- Subdiv 122-A (individual or trustee to company roll-over); or
- Subdiv 122-B (partnership to company roll-over).

This would only be considered with the objective of capping the effective tax rate arising on the disposal of the depreciating asset to a flat corporate tax rate of 30% (or 25% where the company qualifies as a base rate entity).

If the structure being utilised is a partnership, depreciating asset roll-over relief under either s 40-340(3) (for assets depreciated under Subdiv 40-B) or s 328-243(1) (for assets depreciated under Subdiv 328-D) might also be utilised in a "double-shuffle"-style structure to restructure the assets to a more tax effective structure such as a company, or even a trust.

A "double-shuffle"-style roll-over broadly involves a restructure of depreciating assets in a two-step process utilising the following roll-over relief in s 40-340(3) in each instance:

- there is a balancing adjustment event for a depreciating asset because of s 40-295(2) (about a change in the holding of, or interests in, the asset); and
- the entity or entities that had an interest in the asset before the change, and the entity or entities that have an interest in the asset after the change jointly choose the roll-over relief.

In terms of the joint choice to apply the roll-over relief, this choice must, under s 40-340(4):

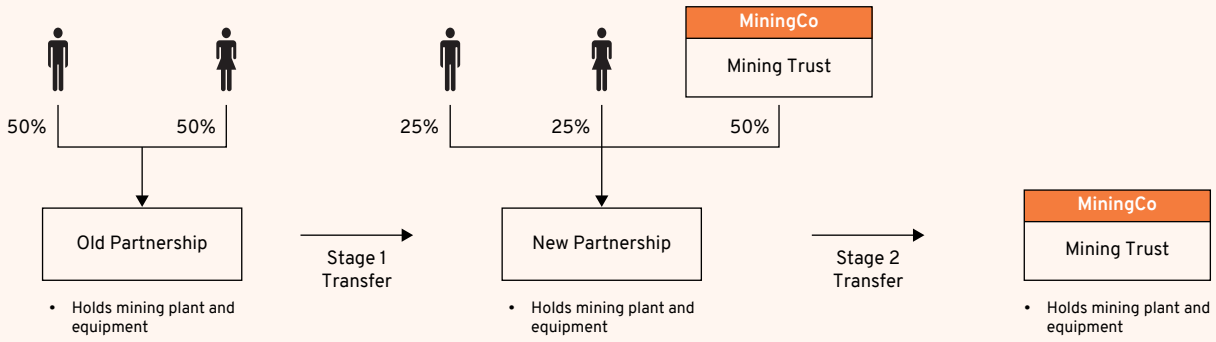
- be made in writing;
- contain enough information about the transferor's holding of the property for the transferee to work out how Div 40 (or Subdiv 328-D if applicable) applies to the transferee's holding of the depreciating asset; and
- be made within six months after the end of the transferee's income year in which the balancing adjustment event occurs.

Diagrammatically, the application of a double-shuffle roll-over might be applied as follows to a two-stage restructure of depreciating assets from a partnership of two natural persons to a discretionary trust structure (see Diagram 1).

Of course, with any restructure, there may be arguments that some of the above options could be regarded as a scheme entered into for the sole or dominant purpose of obtaining a tax benefit, depending on the circumstances. As such, the possible application of Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) would need to be considered on a case-by-case basis.

In the above example, the depreciating assets have been restructured to a trust structure. If the trust were a discretionary trust, this might afford the advantage of either:

Diagram 1. Mitigating the "sting" in the tail



- distributing the balancing adjustment assessable income to a corporate beneficiary in the group to utilise the corporate tax rate; or
- distributing the balancing adjustment assessable income to an entity so as to absorb tax losses elsewhere in the trust's wider private group (subject to the rules concerning the availability of losses).

Either of the above choices would be effective ways of managing the "sting in the tail" of disposing of fully expensed depreciating assets.

Mismatches in trust income

A planning issue that might arise when dealing with fully expensed depreciating assets concerns mismatches arising between trust and tax net income when disposing of fully expensed depreciating assets held in trusts. Although perhaps narrow in its application, it presents an interesting opportunity where such circumstances arise.

Consider the following circumstances:

- Golden Textiles Trust sells manufacturing machinery for $1.9m.
- The machinery has an adjustable value of nil owing to it being fully expensed under the temporary full expensing measures.
- Golden Textiles Trust generates a balancing adjustment assessable income of $1.9m, which is included in the tax net income of the trust.
- Golden Textiles Trust also has trading income of $100,000 for the year that is included in the tax net income of the trust.
- The trust deed since the date of establishment of the trust has defined trust "income" by reference to trust law principles, so only $100,000 of trading income is treated as trust income.
- Pursuant to the definition of "income" under the trust deed, the balancing adjustment assessable income might typically be regarded as a capital receipt as opposed to an income receipt for trust law purposes.
- Golden Textiles Trust distribute 100% of the trust income to a corporate beneficiary.

In the above situation, the corporate beneficiary has been assessed under the "proportionate method"[51] to 100% of the tax net income of the trust, being equal to $2m.

In reality, however, the corporate beneficiary is only entitled to receive $100,00 of the income of the trust by way of its entitlement under the trust deed.

On the basis that the corporate beneficiary can meet the tax liability on the amount of assessable income the company has been taken to receive for tax purposes, this presents a favourable position for the trust that is able to retain the $1.9m as trust capital for its own use as working capital.

If the corporate beneficiary does require assistance in funding the tax liability, the trust may lend an amount to the company that (without more) should not be caught by Div 7A ITAA36.

Importantly, s 100A ITAA36 would need to be carefully considered to ensure that any mismatches arising in trust income do not offend s 100A, particularly in light of the decision in *B&F Investments Pty Ltd (as trustee for the Illuka Park Trust) v FCT*[52] (*Bblood*) and the Commissioner's PCG 2022/2. Both *Bblood* and the PCG highlight that schemes that seek to create a situation in which a mismatch in trust income and tax net income gives rise to a benefit for a taxpayer may attract s 100A.[53]

Despite the above, the facts here clearly differ from the concerns raised in both *Bblood* and PCG 2022/2, since no amendment to the trust deed or other scheme has arguably taken place to bring about the difference in trust and tax net income. Rather, the mismatch in trust income has resulted as a mere incidence of the mechanics of the trust deed as brought into existence as at the date of establishment of the trust.

Effectively utilising the small business pool

The last planning tip the author wishes to raise for mitigating the "sting in the tail" of the temporary full expensing measures involves the potential ability to offset balancing adjustments arising from the disposal of pooled depreciating assets that are subject to the general small business pool.

As explained above, an amount of assessable income from the disposal of a depreciating asset subject to a taxpayer's general small business pool only arises where the pool balance at the end of the year is less than zero.[54]

Therefore, to the extent that an asset subject to the pool is disposed of during an income year, the subtraction of the termination value of that asset against the pool can be offset by way of the acquisition of a new asset so as to increase the pool's balance and preclude a negative pool balance from arising at year end. This can therefore be a particularly effective strategy to prevent adverse balancing adjustment event consequences arising from a trade-in arrangement for a depreciating asset.

An example of how this might work in practice is shown in Table 2.

Table 2. A solution for pooled assets?

Calculation item	Pool balance	Notes
Opening balance	Nil	Fully written off in prior years
Less: proceeds of asset sale or disposal	($150,000)	Trade in of old excavator for $150,000
Add: new asset purchase	$500,000	Purchase of new excavator
Subtotal:	$350,000	
Deduction for new asset (15%)	($75,000)	
Closing pool balance	$275,000	Closing pool balance not in a negative position, hence no balancing adjustment event

Importantly, the above planning tip only applies to assets that have become *subject to* the general small business pool. This only occurs in circumstances where, on acquisition, the asset's cost is in excess of the relevant instant asset write-off threshold for the income year.[55]

If the asset was acquired during the period between 7:30 pm AEDT on 6 October 2020 and 30 June 2023, the asset would have been fully expensed on acquisition pursuant to s 328-180(1) since there was no threshold for the instant asset write-off mechanism to apply.[56] That asset would, therefore, not have been allocated to the general small business pool,[57] and, as such, its disposal automatically results in an amount equal to the termination value of the asset being included in the taxpayer's assessable income.[58] This amount therefore cannot be offset by way of careful management of the closing balance of the general small business pool.

Instead, the taxpayer may wish to give consideration to incurring expenditure on new depreciating assets or capital works in the same income year where such expenditure is eligible for accelerated deductions or write-offs (eg the primary production write-offs under Subdiv 40-F or 40-G).

A similar planning tip would also be relevant for assets fully expensed that were depreciated under Subdiv 40-B.

Sale of land with primary production write-offs

Another issue that often arises when dealing with the capital allowance regime is the interaction between primary production write-offs under Subdiv 40-F and the CGT regime.

As mentioned above, where capital improvements to land are subject to primary production write-offs, their disposal does not give rise to balancing adjustment event consequences.

Instead, these assets, such as horticultural plant, water facilities and fodder storage assets, are treated as CGT assets on their disposal, and thus give rise to CGT consequences under the CGT regime.

The particular characterisation of these types of assets under the CGT regime can broadly fall into one of two different categories:

- for improvements made to land acquired prior to 20 September 1985—the improvements form a separate CGT asset where a CGT event occurs in relation to the land and either the asset constitutes a "building" or "structure" within the ordinary meaning of those terms,[59] or, if not a building or structure, the requirements of Subdiv 108-D are satisfied; and
- for improvements made to land acquired after 20 September 1985—the improvements form part of the cost base of the underlying land and do not form a separate CGT asset.

In relation to Subdiv 108-D, it will operate to treat a capital improvement in relation to pre-CGT land as a separate post-CGT asset where the cost base of the improvements at the time of disposal is in excess of:

- the improvements threshold ($182,665 for the year ended 30 June 2025); and
- 5% of the capital proceeds from the event.[60]

If Subdiv 108-D is not met, simply put, the improvements do not form a separate CGT asset and can be disposed of without CGT consequences where the land is pre-CGT in nature.

The upshot of this treatment is that the pre-CGT status of the land is preserved, even though post-CGT improvements have been effected to the land. Although this may not be ideal in the context of the post-CGT improvements being subject to CGT, this may afford opportunities on the sale of land containing improvements to seek to apportion on a reasonable basis any purchase price to the pre-CGT land, as opposed to the post-CGT improvements, to obtain a more favourable tax outcome on the sale. These issues are discussed in further detail below.

As mentioned previously, any deductions claimed under the primary production write-offs generally have the result of

eroding the cost base of the relevant CGT asset (be it the land to which the improvement relates or the improvement itself if it constitutes a separate CGT asset).[61] There are, however, certain specific timing rules with these provisions that can give rise to various quirks based on the different elements of the cost base of an asset.

For example, s 110-45 will only reduce the cost base of a post-CGT asset where the capital improvements constitute the fourth element of the cost base of the asset where:

- the land was acquired after 7:30 pm ACT legal time on 13 May 1997; or
- if the land was acquired before the above time, the capital improvements must have been incurred after 30 June 1999.

Therefore, in circumstances where expenditure constitutes fourth element cost base expenditure (ie to preserve or increase the asset's value) and is incurred on or before 30 June 1999 to post-CGT land acquired prior to 13 May 1997, it will not cause an erosion of the cost base of the land.

This small window of opportunity therefore presents a potentially significant benefit for the taxpayer where, for example, vineyards (being in the nature of a fourth element expenditure) are concessionally claimed under the primary production write-offs but still form part of the cost base of the asset.

Take, for instance, the following example:

- Land is acquired by the Vineyard Trust on 1 June 1995 for $800,000.
- $2m in vineyard improvements are made to the land on 16 December 1998 and have now been fully expensed under the Subdiv 40-F primary production write-offs.
- The Vineyard Trust is approached by an arm's length purchaser to acquire the vineyard for $5.5m.

The income tax consequences of the above sale would be as shown in Table 3.

Table 3. Primary production write-offs

Capital proceeds	$5.5m
Cost base	$2.8m ($800,000 plus $2m)
Less amounts claimed under Subdiv 40-F	Nil (no reduction owing to timing of improvements)
Net cost base	$2.8m
Gross capital gain	$2.7m
Less 50% CGT discount	($1.35m)
Net capital gain	$1.35m
Tax payable (assuming top marginal tax rate of 45% plus Medicare levy of 2%)	$634,500

If, on the other hand, the improvements had been made to the land after 30 June 1999, the cost base would have been eroded by an amount equal to $2m, resulting in a larger capital gain being assessed to the Vineyard Trust.

One final planning point to raise is that if the land held by the Vineyard Trust would have been pre-CGT land such that Subdiv 108-D is of relevance, in determining whether the improvements themselves constitute a separate CGT asset, one issue to consider is the interplay between the improvements threshold and the cost base erosion provisions.

For the vineyard improvements to constitute a separate CGT asset under Subdiv 108-D, as mentioned, the cost base of the improvements must surpass the improvements threshold and comprise at least 5% of the capital proceeds from the event.

If, say, at the date of disposal, after the application of s 110-45, the improvements only had a cost base of $100,000 remaining, the improvements threshold would not be exceeded (or for that matter, the 5% capital proceeds threshold). As such, Subdiv 108-D would not apply to deem the post-CGT improvements to be separate CGT assets.

On that basis, it follows that the Vineyard Trust's land and vineyard improvements could be sold on the basis that only one asset exists (being the land), and that asset was acquired before 20 September 1985. Hence, any capital gain on the sale of the land and vineyard improvements is disregarded.

Purchase price/sale price allocation issues

One of the perennial transactional issues for depreciating assets is the allocation of the sale and purchase price of assets. Advisers turning their minds to these issues from the outset of any transaction involving the acquisition or disposal of depreciating assets alongside other classes of assets can potentially risk manage unpalatable tax outcomes arising for clients.

Some of the key issues to consider when negotiating the allocation of a purchase price of assets are as follows:

- Ordinarily, a price allocation as negotiated between arm's length parties is accepted as the market value of the relevant assets. There is extensive case law supporting this general point of law that broadly turns on whether the parties have dealt with each other in a manner as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining.[62]
- The above situation is to be contrasted with a transaction in which the parties collude to achieve a particular result, or in which one of the parties submits the exercise of its will to the dictation of the other.[63]
- If acting for a vendor in relation to the sale of pre-CGT land with post-CGT improvements, for the reasons mentioned above, to the extent the purchase price can be reasonably assigned primarily to the land, this should provide a more advantageous tax outcome for the vendor from a CGT perspective. In this regard, the allocation of

value to pre-CGT assets over post-CGT assets will result in most of the proceeds being rendered non-assessable.

- Similarly, as a general point, if acting for a vendor selling post-CGT assets together with depreciating assets and trading stock, it will still be advantageous to negotiate a lower assignment of the purchase price to the non-CGT assets so that greater value is assessed under the CGT regime, and therefore potentially subject to concessions such as the 50% CGT discount[64] and potentially small business CGT concessions if available.[65]
- If acting for the purchaser, there may be an opposite tension with the purchaser seeking to assign a greater amount of the purchase price to trading stock and depreciating assets to increase the amount of deductions on those assets that can be claimed up front.
- The above position may not always be the case for the purchaser, and it will depend on the particular facts and circumstances of each case. For example, the goals of the vendor and purchaser may be relatively aligned in some cases on the assignment of the purchase price between assets subject to the CGT regime and assets subject to the capital allowance and trading stock regimes. In this regard, the purchaser may desire to recognise a greater cost base for CGT assets where it is expected that those assets will increase in value significantly over time to gain a better tax outcome on any eventual disposal of those CGT assets in the future.
- The Commissioner of Taxation will generally accept an apportionment set out in writing in the relevant contract for the sale or purchase of assets on the basis that the parties are dealing at arm's length.[66]
- Where the parties cannot agree on the allocation of the purchase price contractually such that a "global purchase price" is adopted, it may be acceptable for either party, acting reasonably, to make their own determination of the apportionment of the purchase price for income tax purposes. The Commissioner will accept, in this regard, an asymmetrical approach adopted by both parties to this issue, so long as the apportionment adopted by the respective taxpayer remains "reasonable" in the circumstances.[67]
- In the above circumstances, professional valuations of assets may become critical both for the vendor and purchaser to substantiate that any apportionment of the sale or purchase price to those assets are reasonable in the circumstances by reference to the indicative market value of those assets.

The above general principles should be borne in mind when advising on the sale or disposal of depreciating assets and land with capital improvements subject to any capital allowance measures.

One issue that advisers should bear in mind in the context of depreciating assets that have been fully expensed under the temporary full expensing measures is circumstances in which parties may agree to dispose of depreciating assets at their "tax written down value". This can occur in circumstances where the parties wish to simplify the purchase price allocation issues, focusing instead on the allocation of value among other assets that might be regarded as more materially significant. If depreciating assets have nil adjustable values owing to the temporary full expensing measures, the parties would in these circumstances be in principle agreeing to "gift" these assets under the transaction, despite the market value of these assets being far in excess of their agreed value of nil.

In this regard, item 6 of the table in s 40-300(2) provides that where a taxpayer stops holding a depreciating asset under a "non-arm's length dealing" and the consideration the taxpayer receives is less than its market value, the termination value is deemed to be the asset's market value. Agreeing to effectively "gift" a depreciating asset where its market value is far in excess of its nil adjustable value might therefore expose the transaction on review or audit. This could be on the basis that the Commissioner might consider that the agreed value is not "reasonable" in the circumstances, or that the parties were not dealing at arm's length on the basis that the value reached is not as a result of a matter of "real bargaining", or that one party has submitted to the other to promote the other's interests such that the transaction is not a genuine arm's length transaction (eg a nil agreed value is a convenient position for the vendor who will not realise a balancing adjustment assessment on the disposal).[68]

Great care is therefore required when dealing with purchase price apportionment issues in the context of these "nil" adjustable value depreciating assets so as to not expose the vendor or purchaser on review or audit.

The author is not aware of the Commissioner taking issue with the above treatment of fully expensed depreciating assets as yet; however, advisers should nonetheless bear this point in mind and seek to risk manage against these issues where necessary.

Mischaracterisation of depreciating assets as capital works

A trap that can arise when dealing with transactions involving depreciating assets is the incorrect characterisation of assets as capital works where they are in fact depreciating assets.

The implications of this can mean that the tax treatment on the decline in value of the asset and its subsequent recognition on disposal may be incorrect, leading to a potential adverse income tax outcome on review or audit.

This issue commonly arises in the context of the carve-out for capital expenditure that falls within the definition of "plant".

Regarding this definition, s 43-70 broadly provides that capital expenditure on "plant" is not eligible to be deducted pursuant to the capital works Div 43 measures. In such circumstances, the capital expenditure may instead qualify as a depreciating asset eligible for deductions under Subdiv 40-B or 328-D.

The definition of "plant" for the purposes of the above provisions includes both its ordinary meaning and an extended statutory meaning.

In relation to the ordinary meaning of "plant", *Yarmouth v France* provides the following:[69]

> "Plant, in its ordinary sense … includes whatever apparatus is used by a business man for carrying on his business – not his stock-in-trade which he buys or makes for sale; but all goods and chattels, fixed or moveable, live or dead, which he keeps for permanent employment in his business."

The Commissioner provides some further guidance on this point in TR 2004/16, whereby the Commissioner states:[70]

> "That which is merely the 'setting' for the particular taxpayer's income earning activities is not within the ordinary meaning of plant. Whether 'buildings, structures or the like, or parts of them' that are more than merely 'setting' come within the ordinary meaning of plant depends upon 'whether the function performed by the thing [the building, structure, or part of it] is so related to the taxpayer's operations or special that it warrants it being held to be plant."

By reference to the above, it would appear that "plant" requires an asset be beyond merely the setting or location in which the taxpayer undertakes its income-earning activities, but is an asset whose function is so closely related to the taxpayer's income-earning activities that they constitute plant.

The Commissioner has also provided some further principles in his guidance regarding the interpretation of the ordinary meaning of "plant". In this regard, the Commissioner considers that:

- items are not plant within the ordinary meaning if they form part of the premises of a business;
- items that are not part of the premises might be plant if they are closely related to the taxpayer's income-earning activities; and
- items that are merely the "setting" for the taxpayer's income-earning activities are not plant.[71]

The statutory meaning of "plant" has been extended to include certain items that do form part of a premises to deem them as plant. In this regard, "plant" is extended to expressly include the following items:

- articles, machinery, tools and rolling stock;
- animals used as beasts of burden or working beasts in a business other than a primary production business;
- fences, dams and other structural improvements, other than those used for domestic or residential purposes, on land that is used for agricultural or pastoral operations;
- structural improvements that are used for domestic or residential purposes if they are provided for the accommodation of employees, tenants or sharefarmers who are engaged in, or in connection with, activities on land used for agricultural or pastoral operations;
- structural improvements on land that is used in a number of other specific business activities relating to certain forestry activities; and
- structural improvements that are used wholly for operations carried out in the course of a business relating directly to certain limited commercial aquacultural activities (see s 45-40 for further details).[72]

In light of the above concepts, advisers should take care in correctly characterising what might appear to be capital expenditure as being subject to the capital works measures.

In considering a number of structural improvements falling within the concept of "plant", the author has set out below a series of examples that have, in the past, been regarded by the courts and the Commissioner as depreciating assets that are in the nature of plant and thus not subject to the capital works regime.

In *Wangaratta Woollen Mills Ltd v FCT,*[73] the High Court considered that a specifically designed dye house built to cope with problems relating to the dye manufacturing process (eg vapour evacuation, ventilation, condensation of steam from hot dyes, maintenance of constant temperature and corrosion caused by dyes) was considered "plant" on the basis that it was in the nature of a tool of the taxpayer's trade, playing a part itself in the manufacturing processes carried on by the taxpayer. In this regard, the dye house was considered to be not only a convenient setting for the taxpayer's operation, but also a "complex whole" in which every piece was essential for the efficient operation of the business such that it should be regarded as a single item of plant for the purposes of depreciation.

In *Port of Portland Pty Ltd and FCT*,[74] a breakwater (being a structural improvement constructed to protect against tides, currents, waves and storm surges) was considered plant in the context of the taxpayer's business activities as the owner and operator of Portland Harbour in Victoria. In this regard, part of the taxpayer's business was found to include the holding of vessels in a firm and stable position for certain operations to take place relating to the unloading, servicing and repairing of vessels. The breakwater played a role in this regard in keeping vessels in place and was much more than mere housing for an activity, it was part of the activity relating to the business itself.

ATO Private Binding Ruling (PBR) authorisation no. 1012152514077 concerned whether a house situated on land used in a primary production business was "plant" and therefore a depreciating asset. The house that was used for accommodation by an employee of the business also contained a control room used to monitor the activities of the business. Although the house, being a structural improvement, was used for domestic or residential purposes, it was used in connection with agricultural operations and was provided for as accommodation for an employee who was engaged in agriculture. The Commissioner therefore considered that the house constituted plant and was a depreciating asset.[75]

Similarly, in PBR 1052086970432, lodgings proposed to be constructed on land used for primary production activities

were intended to be occupied by tenants responsible for the management of primary production activities to be carried out on the land. The Commissioner considered that the lodgings constituted plant under the extended statutory meaning in the circumstances and thus could be depreciated under Subdiv 40-B. Importantly, the Commissioner highlighted that the lodgings and their construction purpose having a connection to the farming operations were essential for the lodging to qualify as plant.

In IT 2392, the Commissioner considered that construction costs relating to the construction of a floating marina berth (floating pontoons attached to piles) were in the nature of "plant". Although now withdrawn, IT 2392 has been superseded by a number of subsequent reiterations of the ruling, which now is published in its present form in TR 2022/1 and sets out various "safe harbour" effective lives for assets. The Commissioner appears to implicitly still accept this reasoning on the basis that the Commissioner provides an effective life of 20 years for "marina-wet berths" (being piling, decking and floating pontoons) that are used in a marina operation.

The Commissioner appears to have followed the above reasoning in PBR 1011494523793 where the Commissioner regarded construction costs for a floating marina berth by a taxpayer that operated a marina business to be in the nature of a depreciating asset.

It can be seen from the above examples that when constructing capital improvements to land that is used for income-producing activities, consideration should be given to the purpose of those improvements and whether the improvements go beyond merely providing a "setting" for the income-producing activities.

Double-shuffle dilemmas for pooled assets

As mentioned earlier, there is equivalent "double-shuffle" style roll-over relief that is available to small business entities that depreciate assets pursuant to the general small business pool under Subdiv 328-D.

The roll-over relief is contained in s 328-243(1) and is broadly the same as the s 40-340(3) roll-over relief, save for some important differences.

For ease of reference, the roll-over relief under s 328-243(1) provides that a taxpayer can choose to apply the roll-over if:

- balancing adjustment events occur for depreciating assets because of s 40-295(2) (about a change in the holding of, or interest in, the assets);
- deductions for the assets are calculated under Subdiv 328-D;
- the entity or entities that had an interest in the assets just before the balancing adjustment events occurred (the transferor) and the entity or entities that have an interest in the assets just after the events occurred (the transferee) jointly choose the roll-over relief; and
- all of the depreciating assets that, just before the balancing adjustment events occurred, were held by the transferor and allocated to the transferor's general small business pool are held by the transferee just after those events.

Where the above conditions are satisfied, the roll-over provides the following effects:

- the transferor is not required to subtract anything from their general small business pool for the balancing adjustment events (and hence the assessable income from the negative pool balance does not arise);
- a choice made by the transferor to deduct primary production assets under either of Subdiv 40-F or 40-G applies to the transferee as if it had been made by the transferee; and
- the transferor and the transferee equally split the deduction for the pool for the income year in which the balancing adjustment event occurs.[76]

Although on its face, it may appear that the roll-over relief under s 328-243(1) provides equivalent roll-over relief to assets subject to the roll-over relief under s 40-340(3) for assets depreciated under Subdiv 40-B, there are two important differences:

- the roll-over relief for pooled depreciating assets requires that *all* assets subject to the pool are transferred. Unlike the roll-over relief under s 40-340(3), it is not possible to select only specific depreciating assets to be transferred subject to roll-over relief; and
- the roll-over relief for pooled assets cannot be used to separate or split the depreciating assets between two or more parties, even if those parties formerly had an ownership interest in the assets together.

The effects of these differences are illustrated in Diagram 2.

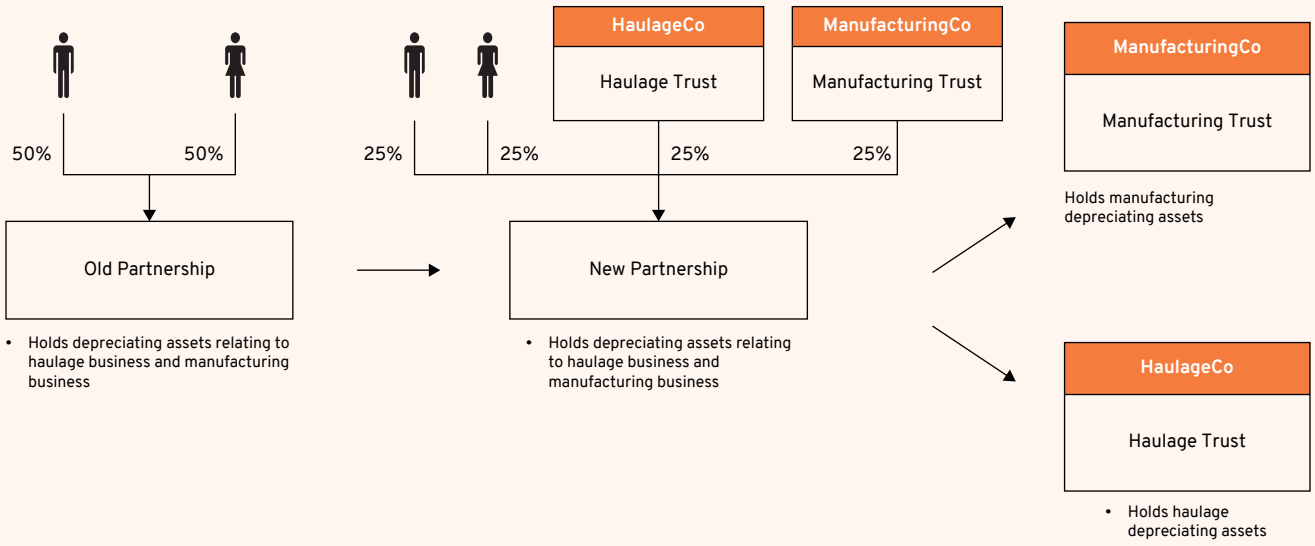
In the above diagram, a two-step double-shuffle roll-over has been applied to transfer depreciating assets from the old partnership to two new entities, namely the Manufacturing Trust and the Haulage Trust.

If the depreciating assets were subject to Subdiv 40-B, this could be facilitated by way of the application of s 40-340(1), since the roll-over can be applied on an *asset-by-asset* basis such that each asset can, as part of the second stage of transfers, effectively be split between the Manufacturing Trust and the Haulage Trust.

In comparison, a roll-over of this nature would fail the requirements of s 328-243(1) as *each and every* pooled depreciating asset that was held by the New Partnership would not be held by the same transferee (or transferees) after the transfer.

As to this last point, the Commissioner's reasoning in ATO ID 2011/99 confirms this position. In ID 2011/99, a partnership comprising two partners conducted a business in which all the depreciating assets were allocated to its general small business pool. The partnership was subsequently dissolved, with the partners splitting the assets between them and

Diagram 2. Double shuffle dilemmas with depreciating asset roll-overs



carrying on business activities as sole traders from thereon. The Commissioner has taken the view in this situation that the roll-over relief under s 328-243(1) would not be available because, just after the disposals, neither former partner had an interest in *each* of the assets that were allocated to the general small business pool.

It can therefore be seen that if the requirements for the roll-over relief under s 328-243(1) are not properly observed, this can create disastrously adverse balancing adjustment event consequences for the taxpayers involved.

Transactional issues for leased assets

Other issues that are often overlooked when dealing with depreciating assets are those that arise when dealing with leased depreciating assets.

This article is limited to addressing some of the broader issues and planning points that arise for the leasing of plant and equipment. Issues relating to depreciating assets that are affixed to land give rise to their own issues, which are not dealt with in this article.

As a starting point, some of the relevant issues when considering leased depreciating assets are as follows:

- who is regarded as the "holder" of the asset, and thus, entitled to claim deductions for the decline in value of the asset?;
- if the "holder" of the asset changes from the lessor to the lessee, what are the income tax implications of this change?; and
- how does the operation of the hire purchase agreement provisions in Div 240 overlap with Div 40 and the general capital allowance treatment of leased depreciating asset?

As mentioned above, the rules for determining who is the holder of a depreciating asset are set out in the table in s 40-40. Section 40-40 lists 10 different ways in which to identify the holder of a depreciating asset. Some assets may have holders under more than one item in the table, and other items such as 1, 5, 6 and 7 exclude certain parties from being holders of a depreciating asset.

In broad terms, the holder of a depreciating asset will be its economic owner.

The explanatory memorandum to the legislation that introduced s 40-40 states that the "economic owners" of depreciating assets are the entities that are able to access the asset's economic benefits while stopping other entities from doing the same.[77]

Broadly, item 10 of the table in s 40-40 applies in most cases to ensure that the holder, and economic owner of the asset, is recognised as the legal owner of the asset. This is because it is typically the legal owner of the asset who is in a position to use or exchange the asset, or deny others the same rights and privileges.

The above general principle is, however, complicated by arrangements that concern certain types of leases over depreciating assets.

Two types of lease arrangements that are the focus of this part of the article and are commonly encountered in practice are leases commercially known as:

- operating leases; and
- finance leases.

An operating lease typically comprises the following features:

- a contract whereby one party (the lessee) leases an asset from another party (the lessor) for a specific period;
- ownership of the asset and any risks associated with economic ownership are not transferred to the lessee;
- the lease payments typically comprise an amount to cover the running costs of the asset that are borne by the lessor; and

- at the end of the lease period, the asset is returned to the lessor and there is typically no right granted to the lessee to acquire the asset either before or at the end of the term of the lease.

A finance lease, on the other hand, typically has the following features:

- it is an agreement that permits the lessee to utilise the asset of the lessor in exchange for periodic lease payments;
- the lessor retains legal ownership of the asset during the entire leasing period;
- the amounts paid by the lessee to the lessor often comprise both a principal and interest component based on the estimated residual value of the asset, enabling the lessor to recover a large part, or all, of the cost of the asset;
- the lessee, although not the owner of the asset, takes control of the asset and contractually enjoys the benefits and assumes the risks involved in the economic ownership of the asset; and
- at the end of the leasing period, the lessee may (but does not necessarily have the right, obligation or contingent obligation to) purchase the asset often at its residual depreciated value; otherwise, the lessee may return the asset to the lessor, with the lessor disposing of the asset and with any shortfall in the sale value as against the residual value having to be paid by the lessee.

The treatment of depreciating assets under both of the above types of leases can vary dramatically. Therefore, correctly characterising a lease presents as a common trap for unaware advisers when correctly reporting the tax treatment of leased depreciating assets.

Operating leases

For operating leases, since the lessor retains legal ownership of the asset, item 10 of the table in s 40-40 should in most cases apply to treat the lessor as the "holder" of the asset and not the lessee.

As such, the tax treatment of the lease agreement can be summarised as follows:

- the lessee is entitled to deduct any lease payments made to the lessor[78] but is not entitled to deduct any decline in the value of the leased asset; and
- the lessor would recognise any lease payments as assessable income[79] and would be entitled to deduct amounts for the decline in value of the asset.

Further, the mere entering into of the operating lease should not attract any balancing adjustment event consequences for the lessor.

Finance leases

The position for finance leases differs significantly.

Who the "holder" of a depreciating asset is under a finance lease will largely depend on whether item 6 of the table in s 40-40 applies and, to an extent, whether the provisions under Div 240 apply.

As to item 6, it broadly provides that the lessee will be treated as the holder of the asset and not the lessor where:

- the lessee possesses the asset, or has a right against the lessor to possess the asset immediately;
- the lessee has a right as against the lessor, the exercise of which would make the economic owner of the asset the lessee under any item of the table in s 40-40 (eg item 10 as the legal owner); and
- it is reasonable to expect that the economic owner will become its holder by exercising the right, or that the asset will be disposed of at the direction, and for the benefit, of the economic owner.

Critical to the above is the meaning of the words "reasonable to expect". The Commissioner considers that for item 6 to apply, it must be reasonable to conclude that the lessee will acquire the asset.[80] This requires an assessment as to the future and the likelihood that the lessee will acquire the goods (or have them disposed of at their direction or benefit). Factors to consider might therefore include:

- independent assessments of the expected market value of the goods at the end of the hire period as against the amount required to purchase the goods under the arrangement;
- the lessee's history in deciding to acquire goods under previous similar agreements; and
- any other relevant commercial considerations affecting the notional buyer's decision to acquire the goods.[81]

Finance leases that provide a right to the lessee to acquire the depreciating asset at the end of the lease, depending on the facts and circumstances, may therefore be captured by item 6 such that the lessee is treated as the "holder of the asset". Otherwise, without such a right, it would be expected that the finance lease would be treated the same as an operating lease.

Generally, the consequences of a depreciating asset being subject to a finance lease with the lessee being treated as the "holder" for the purposes of Div 40 should arguably be as follows:

- a balancing adjustment event should arise to the lessor, which may result in an amount of assessable income being derived by the lessor due to ceasing to hold the asset;[82]
- the lessee should apportion the lease payments between the capital component (which would be depreciable by the lessee based on the decline in value of the asset) and any finance charge component (which would be deductible); and[83]
- if the lessee does not exercise its right to acquire the asset at the end of the lease term, the lessee then ceases to be regarded as the holder of the asset at that time, and a balancing adjustment event arises to the lessee.

A final point to raise in relation to finance leases is the interaction of Div 40 with Div 240.

Division 240 applies to leases where they fall within the definition of a "hire purchase agreement". A hire purchase agreement is defined as either an agreement for the purchase of goods by instalments where title in the goods does not pass until the final instalment is paid or, alternatively, a contract for the hire of goods where:

- the hirer has a right, obligation or contingent obligation to buy the goods;
- the charge that is or may be made for the hire, together with any other amount payable under the contract (including an amount to buy the goods or to exercise an option to do so), exceeds the price of the goods; and
- title in the goods does not pass to the hirer until the option referred to above is exercised.

"Goods" in the above context would include items such as chattels but would exclude fixtures. Additionally, "a right, obligation or contingent obligation" would include a call or put option (or both).[84]

The "excess" in payments over the price of goods represents the interest component of the contract; however, the addition of a nominal amount is not sufficient to bring an agreement within the definition of a hire purchase agreement.[85]

Importantly, the notional buyer is only deemed to own the goods for the purposes of Div 240 if:

- the notional buyer would have been the owner (or quasi-owner) of the goods if the arrangement had been a sale of goods; and
- it is reasonably likely that the right, obligation or contingent obligation to acquire the goods will be exercised by, or in respect of, the notional buyer.[86]

In the above context, it can generally be expected that, in circumstances where a finance lease is in respect of goods (as opposed to, say, fixtures), and item 6 of the table in s 40-40 deems the lessee to be the holder of the depreciating asset, the terms of the finance lease will also qualify as a hire purchase lease and be subject to the implications of Div 240 (save for limited circumstances).[87]

Where Div 240 applies, the broad effect is that the lease is effectively recharacterised as a sale of property by a notional seller (the lessor) to a notional buyer (the lessee) for a notional sale price combined with a loan from the lessor to the lessee to finance the acquisition of the asset.[88]

Broadly, this therefore requires that the lessor return as assessable income notional "profit" on the notional disposal of the asset, being the amount equal to the difference between the consideration for the notional sale over the cost of acquisition of the asset by the lessor.[89] The consideration is either the price stated as the cost or value of the property under the arrangement or otherwise its arm's length value.[90] Practically, in an arm's length dealing, the consideration is generally calculated by reference to the "principal" charge component of the periodic lease payments.

The "interest charge" component calculated under Subdiv 240-E is also included as assessable income of the notional seller, with the notional buyer being entitled to a deduction for the same.[91]

The above effects thus broadly displace the tax consequences that would otherwise arise from the arrangement. For example, the actual payments to the notional seller arising periodically over the course of the arrangement are not included in assessable income and the notional buyer cannot deduct the actual payments to the notional seller as they are made.

There are a number of other aspects to Div 240 that go beyond the limited scope of this article.

Depreciating asset leases

Finally, the last planning point the author wishes to raise in this article concerns care being required when dealing with claiming deductions for the decline in value of depreciating assets claimed by the lessor where those assets are leased in circumstances where the lease constitutes a "depreciating asset lease".

Section 328-175(6) prevents a lessor that is a small business entity from claiming deductions under Subdiv 328-D for assets that are let, or might reasonably be expected to be let, pursuant to a depreciating asset lease.

A "depreciating asset lease" is defined as an agreement (including a renewal of an agreement) under which the entity that holds the depreciating asset grants a right to use the asset to another entity, but which is not a hire purchase agreement or a short-term hire agreement.[92]

A hire purchase agreement has been addressed above.

A "short-term hire agreement" is defined as an agreement for the intermittent hire of an asset on an hourly, daily, weekly or monthly basis.[93] However, to the extent an entity or their associates attempts to "chain" a series of short-term agreements together such that there is a substantial continuity of hiring for a longer than short-term basis, this will not constitute a short-term hire agreement.

The above restrictions effectively act as an anti-avoidance measure to only permit depreciating assets under short-term leases to gain the benefit of the concessional Subdiv 328-D capital allowance measures. This appears to target a mischief of preventing the same entity (or associates) from gaining the benefit of a majority of the economic use of an asset in circumstances where that entity does not itself qualify as a small business entity, and another entity that does qualify is simply being used as the "owner" of the asset to gain access to the small business capital allowance measures.

To comply with the above requirements, advisers may wish to abide by a general rule of thumb, as provided for by the Commissioner, that an asset hire of less than six months will generally constitute a short-term hire agreement, which is therefore not a depreciating asset lease.[94]

In the event that a depreciating asset is subject to a depreciating asset lease, any other available capital allowance measures such as Subdiv 40-B can be applied instead.

Concluding remarks

There are a number of ever-evolving tips and traps that advisers must take particular care of when advising clients on transactional issues concerning depreciating assets.

These issues, at least for the short to medium term, will be more prevalent than ever before given the risk of realising material balancing adjustment event assessable income amounts on the disposal of depreciating assets that were previously subject to the temporary full expensing and instant asset write-off measures.

It is hoped that this article has highlighted some of the contemporary transactional issues faced when dealing with depreciating assets and provided some helpful planning tips for advisers to consider.

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6 S 40-30(1)(a).
7 S 40-30(3).
8 For example, items of intellectual property, in-house software, mining, quarrying and prospecting rights, to name a few.
9 Ss 40-35 and 40-40, items 2, 3, 4, 5, 6 and 10 of the table.
10 S 40-295.
11 S 40-285.
12 S 40-85.
13 S 40-285.
14 S 328-110.
15 Previously, this threshold was uncapped for the period 7:30 pm AEDT on 6 October 2020 to 30 June 2023, pursuant to the temporary full expensing measures—s 328-181 of the *Income Tax (Transitional Provisions) Act 1997*.
16 Similarly, this threshold was uncapped for the period 7:30 pm AEDT on 6 October 2020 to 30 June 2023, pursuant to the temporary full expensing measures—s 328-181(5) of the *Income Tax (Transitional Provisions) Act 1997*.
17 S 328-175(1).
18 Ss 328-185(7) and 328-220.
19 S 328-175(10).
20 Taxable purpose proportion broadly means the percentage of the asset used to earn assessable income—s 328-205.
21 S 328-215(4).
22 S 328-200.
23 Ss 328-200 and 328-215(2)–(3).
24 Ss 40-540, 40-548 and 40-551.
25 S 40-545(1).
26 S 40-545(2).
27 S 40-50(1).
28 S 328-175(3).
29 S 328-175(5).
30 Subdiv 108-D and s 110-25.
31 Ss 110-40 and 110-45.
32 S 328-175(3).
33 S 40-520(1).
34 S 40-525(1).
35 S 40-555(6)
36 S 40-520(3).
37 Explanatory memorandum to the Tax Laws Amendment (Small Business Measures No. 2) Bill 2015 (Cth).
38 Para 2.18 of the explanatory memorandum to the Tax Laws Amendment (Small Business Measures No. 2) Bill 2015 (Cth).
39 S 40-525(3).
40 S 40-530(2).
41 See ATO website guidance "Calculating the decline in value of horticultural plants" (QC 16962).
42 S 40-45(2) and 43-70(2).
43 S 43-20.
44 S 43-70(2)(f)(i).
45 S 43-70(2)(e).
46 Ss 40-300 and 40-305.
47 S 40-185(1).
48 S 40-75.
49 Assuming acquired on 1 July of the income year.
50 Assuming a top marginal tax rate.
51 S 97 ITAA36 and *Bamford v FCT* [2010] HCA 10 at [43]–[45].
52 *B&F Investments Pty Ltd (as trustee for the Illuka Park Trust) v FCT* [2023] FCAFC 114 (*Bblood*).
53 *Bblood* at [58]–[68]; and para 43 of PCG 2022/2.
54 S 328-215(2).
55 S 328-185(1).
56 S 328-180(1), as modified by s 328-181(2) of the *Income Tax (Transitional Provisions) Act 1997*.
57 Ss 328-180(1) and 328-185(1).
58 S 328-215(4).
59 See part C of Ch 2.6 of the explanatory memorandum to the Tax Law Improvement Bill (No. 1) 1998 (Cth).
60 S 108-70.
61 S 110-45.
62 *Kilgour v FCT* [2024] FCA 687 at [13]; *The Trustee for the Estate of the late AW Furse (No. 5) Will Trust v FCT* (1990) 21 ATR 1123 at 1132; *Granby Pty Ltd v FCT* (1995) 30 ATR 400 at 403.
63 *Granby Pty Ltd v FCT* (1995) 30 ATR 400 at 404.
64 Under Subdiv 115-C.
65 Under Div 152.
66 Para 3 of TD 98/24; and ATO ID 2002/818.
67 Para 5 of TD 98/24 (regarding CGT).
68 See, for example, Lee J's comments in *Granby Pty Ltd v FCT* (1995) 129 ALR 503 at 507.
69 (1887) 19 QBD 647 at 658.
70 At para 29 of TR 2004/16.
71 Para 29 of TR 2004/16; paras 8, 9, 33, 38 and 39 of TR 2007/9; and para 21 of TR 1999/2.
72 S 45-40.
73 [1969] HCA 39.
74 [2008] AATA 1162.
75 Pursuant to s 45-40(1)(f).
76 Ss 328-245 and 328-247.
77 Paras 1.25 to 1.27 of the explanatory memorandum to the New Business Tax System (Capital Allowances) Bill 2001 (Cth).
78 For example, under s 8-1.

79 Pursuant to s 6-5.

80 TR 2005/20.

81 Para 30 of TR 2005/20.

82 S 40-295(1)(a).

83 Consistent with the principles set out in *FCT v Ballarat & Western Victoria T.V. Limited* (1978) 78 ATC 4630 for the treatment of instalment payments made that comprise an income and capital component. See also, the Commissioner's comments in para 9 of the now withdrawn TD 94/20. Although withdrawn by reason of the pronouncement pre-dating the introduction of Div 40, the Commissioner's comments in para 9, in the author's opinion, have relevance to Div 40.

84 Para 32 of TR 2005/20.

85 TD 2003/17.

86 S 240-115.

87 Paras 29 to 35 of TR 2005/20.

88 Ss 240-20 and 240-25.

89 S 240-35.

90 S 240-3.

91 Ss 240-3 and 240-7.

92 S 995-1(1).

93 S 995-1(1).

94 See ATO ID 2011/72.