Attachment B

REFORMING THE CAPITAL ALLOWANCES SYSTEM

The Government will fundamentally reform the capital allowances system that enables certain expenditures to be written off over time for income tax purposes.

The measures announced today will implement key elements of the Review of Business Taxation's recommendations to reform the way in which depreciating assets are taxed.

Key Features

- From 11:45 am AEST 21 September 1999 (the 'time of effect'):
  - ending of accelerated depreciation for plant and equipment commenced to be constructed, or acquired under contract entered into after this time, except for small business taxpayers;
  - elective reassessment of effective lives of plant and equipment acquired after this time;
  - removal of balancing charge offset except for small business taxpayers and involuntary disposals; and
  - removal of plant and equipment assets from the capital gains tax system.
- From 1 July 2000:
  - removal of immediate deductions for plant items costing $300 or less and introduction of a low-value pool for assets costing less than $1,000, except for small business taxpayers who will retain access to accelerated depreciation and the balancing charge offset until 1 July 2001.
- From 1 July 2001 (subject to further consideration by the Government):
  - a new tax law for all depreciating assets (not just plant and equipment), including special pooling arrangements for small business taxpayers.

Changes to plant and equipment depreciation provisions applicable from time of effect

The following changes apply only to plant and equipment assets covered by Division 42 of the *Income Tax Assessment Act 1997*.

Replacement of accelerated depreciation

Accelerated depreciation for plant and equipment will be replaced from the time of effect with a system under which depreciation rates will be determined only by the effective life of the investment asset. Assets acquired or commenced to be constructed before the time of effect will retain access to accelerated depreciation.

The removal of accelerated depreciation will:

- contribute in a significant way to funding a lower and more competitive company tax rate; and

- increase economic efficiency by broadening the tax base, reducing distortions and reducing tax law complexity and, therefore, compliance costs.

Replacement of accelerated depreciation with a system determined by the effective life of the asset only will not apply to small business taxpayers with 3 year average turnovers of less than $1 million — Attachment I provides details of how the special arrangements for small business are to apply.

Taxpayers who use depreciable assets for income producing purposes, but are not small businesses, will no longer qualify for accelerated depreciation — for example, an office worker who acquires a personal computer for use in connection with their employment.

Moreover, to qualify for accelerated depreciation tax benefits, the plant and equipment may not be used predominantly for leasing or for related activities (other than short-term hire). This means that plant and equipment used in rental properties would not be eligible for accelerated depreciation.

Effective lives can be reassessed

The Government recognises that the effective lives of assets can change because of technological or market developments.

Accordingly, consistent with the Ralph Review recommendation, taxpayers now will be able to reassess the effective lives of their assets acquired after the time of effect.

- This means that, if an asset is expected to have a shorter effective life than originally anticipated, the rate of depreciation will be able to be increased from the time of the reassessment.

Further details on reassessing effective lives are provided in the appendix below.

Removing the balancing charge offset

The Government will remove the current balancing charge offset for disposals of plant and equipment after the time of effect. The balancing charge offset is only available for plant and equipment subject to Division 42 of the *Income Tax Assessment Act 1997*. This measure will not apply to:

- small businesses taxpayers — see Attachment I for details of small business eligibility; and

- involuntary disposals of plant and equipment — the offset will mirror the current capital gains tax rollover relief for involuntary disposals.

Further details on the offset for involuntary disposals are provided in the appendix below.

Removing plant and equipment from the capital gains tax system

The Government will remove plant and equipment from the capital gains tax regime for disposals occurring after the time of effect. Under this measure:

- the capital gains tax indexed cost bases of relevant assets will be frozen at their 30 September 1999 value; and
- the excess of disposal proceeds over the frozen indexed cost base will be taxed as balancing adjustments.

Introducing a low-value pool for assets costing less than $1,000.

The expensing of plant items costing $300 or less will continue until 1 July 2000 at which time non-small business taxpayers will be able to elect to write off all items costing less than $1,000 through a low-value pool.

The low-value pool will be depreciated at a declining balance rate of 37½ per cent.

The $300 limit will continue to apply for small business taxpayers until 1 July 2001, after which time the simplified depreciation system will apply (see Attachment I). Further details on the low-value asset pooling arrangements are provided in the appendix below.

Implementing a new tax law for depreciable assets

The Government has indicated a disposition to accept the broad thrust of the reforms contained in Section 8 of *A Tax System Redesigned.*

Draft legislation prepared by the Ralph Review covering the recommended reforms has been released. The Government will be consulting further on the detail of this draft legislation.

These reforms would simplify the law relating to depreciating assets and remove anomalies that exist in the current law and take effect from 1 July 2001. For example, under the cashflow/tax value method of determining taxable income and the new code for the taxation of depreciable assets as recommended by the Ralph Review:

- blackhole expenditures would be accorded appropriate taxation treatment:
  - expenses that do not create an asset or improve an asset from its original condition would be able to be written off in the year in which they are incurred, for example
    - some blackhole expenses on export market development, defending native title claims and closing mines do not create or improve an asset; and
  - expenses that create a depreciating asset would be able to be written off on the basis of the asset's effective life.
- capital investments that currently receive statutory rates of write off, such as patents and buildings, would be written off on the basis of their effective lives.

However, the Government has decided that current special rates for primary producer assets, such as horticultural plants, water and landcare assets, and the current treatment of expenditure on research and development and on Australian films will remain unchanged.

Current arrangements

Accelerated depreciation

Accelerated depreciation applies only to a number of asset classes, most notably plant and equipment. As well, balancing charge offsets apply only to plant and equipment.

- Many other classes of wasting assets such buildings and structures, allowable capital expenditures under the mining and quarrying provisions, intangible assets such as patents and copyright attract taxation write-off at statutory rates that may be unrelated to their effective lives.

- Other forms of capital expenditures (i.e. 'blackhole expenditures') either receive no taxation write-off or can only be written off as a capital loss when the asset ceases to be used or is disposed of.

Other features of the depreciation arrangements for plant and equipment are:

- Effective lives are broadbanded. There are seven broadbands. This means that an asset with an effective life at the top of a band receives the same rate of taxation depreciation as an asset at the bottom end of the band.

  - Using the 13 to 30-year band as an example, an asset with an effective life of 25 years currently receives the same rate of taxation depreciation as an asset with an effective life of 13 years.

- Taxpayers are allowed immediate deductions for items of plant that cost $300 or less, irrespective of the life of the items.

The balancing adjustment

The objective of taxation depreciation is to allow the cost of an asset to be written off over time.

A balancing adjustment operates to reconcile tax deductions allowed in respect of an asset with its net cost to the taxpayer at the time of disposal.

- Where an asset is sold for less than its tax written down value, a deduction is allowed for the difference.

- Conversely, where the disposal price is greater than the tax written down value, the difference is taxed to the extent of deductions allowed with any remaining excess potentially subject to capital gains tax.

The balancing charge offset allows taxpayers to set otherwise assessable balancing charges successively against the cost of replacement assets, the cost of other new assets or the depreciated value of other assets, thereby deferring their tax liability.

Why change is needed

The existing taxation treatment of wasting assets is complex and inconsistent across different classes of capital investment.

The balancing charge offset duplicates tax benefits because not only do some taxpayers get the benefit of accelerated depreciation, they also get an additional tax deferral when the asset is sold.

- A further benefit arises where assets eligible for accelerated depreciation increase (rather than decline) in value, because they also get capital gains tax indexation.

In practice most plant and equipment does not appreciate in value, but the tax law requires separate records to be kept for capital gains tax purposes.

- Removing depreciable assets from the capital gains tax system will both simplify the law and reduce compliance costs for taxpayers.

Section 8 of *A Tax System Redesigned* noted that the existing law contains 37 different amortisation regimes and that their rationalisation would offer significant simplification benefits. The new arrangements for depreciable assets will collapse most of those regimes into a single comprehensive regime that will also cover blackhole expenditures.

The appendix to this attachment provides details on how the following aspects of the reforms are to operate:

- reassessing the effective life of an asset;
- balancing charge offsetting for involuntary disposals; and
- replacement of $300 limit with a low-value pool for assets costing less than $1,000.

Other related measures

From 1 July 2001, a Simplified Taxation System, including a simplified depreciation regime, will apply to small business taxpayers — see Attachment I for details.

Reassessing the effective life rate of an asset

A taxpayer currently can choose to either:

- use the Commissioner of Taxation's effective life schedule;
  - the Commissioner of Taxation is working to publish a revised effective life schedule by 30 June 2000; or
- self-assess the effective life of their assets;
  - where self-assessing taxpayers now are required to indicate this on their income tax return.

Taxpayers will also be permitted to vary either up or down the effective life depreciation rates of plant and equipment acquired after the time of effect. This measure is designed to allow taxpayers to have regard to changing market or technological developments, or other factors connected with usage, that influence the rate at which an asset may lose economic value. The new rate of tax depreciation will be a function of the remaining reassessed effective life and the tax value at the time of reassessment.

- Guidelines will be provided to assist taxpayers to determine the conditions under which depreciation rates can be varied.
- Taxpayers will be required to indicate in their income tax return whether there has been a variation to the depreciation rates of their assets since their previous return.

Balancing charge offset for involuntary disposals

Recommendations 5.5 to 5.12 of *A Tax System Redesigned*, relating to a no-detriment approach to involuntary receipts, are subject to consideration by the Government. Under the no-detriment approach to involuntary receipts, taxpayers would not be disadvantaged if they are forced to dispose of an asset. Nevertheless, the Government has decided that balancing charge offsetting should remain for involuntary disposals of plant and equipment between the time of effect and the commencement of any general no-detriment approach for involuntary receipts.

The offset will be available in broadly the same circumstances covered by the current capital gains tax rollover provisions for involuntary disposals. Broadly, those provisions allow the rollover of capital gains against the cost of a replacement asset acquired either not more than one year before, or within one year of, the end the income year in which, the involuntary disposal occurred.

Replacing the $300 limit with a low-value pool for assets costing less than $1,000.

Items of plant and equipment costing $300 or less will continue be immediately deductible until 30 June 2000.

From 1 July 2000, taxpayers that are not eligible for depreciation allowances for small business taxpayers (see Attachment I) will be able to elect to write off all assets costing less than $1,000 each through a low-value pool. The key features of the pooling arrangement are:

- the low-value pool will be depreciated at a declining balance rate of 37½ per cent;
- in the year of acquisition, items will be written off at half the rate applicable to the pool — that is, 18¾ per cent;
- if a low-value pool asset is disposed of, the closing tax value of the pool in the year of disposal will be reduced by the amount of the proceeds; and
- if the pool has a negative value at the end of the income year (i.e. proceeds from disposals exceed the written down value of the pool), a corresponding amount will be included in taxable income.

The $300 limit will continue to apply for small businesses until 1 July 2001, at which time the Simplified Taxation System, including the simplified depreciation system, will apply.