EAST TIMOR REVENUE SERVICE

SERVIÇOS DE RECEITAS DE TIMOR LOROSA'E

ETRS/SRTL
Public Ruling 2001/7

Public Ruling: Depreciation

Relying on this Ruling

This is a public ruling within the meaning of Section 66 of Regulation 2000/18. Information in this ruling may be relied upon by taxpayers as the basis for determining their tax liability.

Introduction

1. As a result of Regulation 1999/1 and Regulation 2000/18 taxpayers deriving non-wage income in East Timor are subject to the provisions of the *Law on Income Tax*, as detailed in Directive 2001/2. That Directive outlines the depreciation and amortisation rules in the *Law on Income Tax* that allow taxpayers to recognise the cost of acquiring long-life assets over a period of years.

2. There are three systems used to recognise the cost of acquiring long-life assets:

- the cost of acquiring or constructing a business building or of improving, renewing and reconstructing a business building is depreciated on a straight-line basis pursuant to section 10.3 of Directive 2001/2, using the depreciation schedule set out in Part A of Schedule 1 to that Directive.
- at the choice of the taxpayer, the cost of depreciable assets is depreciated under section 10.4 of Directive 2001/2. Two alternative methods of depreciation are set out in that section.
- the cost of acquiring or creating intangible assets or of improving or renewing such assets is amortised on a straight-line basis pursuant to section 11 of Directive 2001/2, using the amortisation schedule set out in Part C of Schedule 1 to that Directive.

3. This Public Ruling examines the two depreciation systems for depreciable assets. The first system allows for depreciation of individual assets on a straight-line basis using the depreciation schedule set out in section 3 of Part B of Schedule 1 of Directive 2001/2. The second system is a pooling system under which the cost of assets is added to a pool and the pool is depreciated over time. The depreciation schedule applies on a declining balance using the depreciation schedule set out in sections 1 and 2 of Part B of Schedule 1 of Directive 2001/2.

What is a depreciable asset?

4. A depreciable asset is defined in section 10.12 of Directive 2001/2 as follows:

> "depreciable asset" means any tangible movable property of a taxpayer that:
>
> (a) has a useful life exceeding one year;
>
> (b) is likely to lose value as a result of wear and tear, or obsolescence; and
>
> (c) is used wholly or partly in the conduct of taxable business activities.

5. A key element of the definition is that the property be used "in the conduct of taxable business activities". The term "taxable business activities" is defined in section 1 of Directive 2001/2 as "business activities giving rise to income". This means that a depreciable asset must be used in an income-earning activity. An asset that is used solely for personal or recreational reasons, for example, will not be a depreciable asset.

6. In most cases, the person who is allowed a depreciation deduction will be the person who owns a depreciable asset or business building unless the asset is subject to a finance lease. In these circumstances, the lessee is deemed to have purchased the asset (section 15.1 of Directive 2001/2). If the owner is not allowed depreciation deductions but another person uses and controls the asset or building, the person who uses and controls the property is entitled to depreciation deductions for the cost of the asset or building. The cost of an asset or building would not include rental payments. Accordingly, a person who rents an asset or building could not claim any depreciation deductions even though that person may "use and control" the asset or building.

> Example 1:
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> Samuel Harada claims to have title to a commercial building in Dili. There is a dispute over title, however, as the Gomez family, which had a shop on the property prior to 1975, also claims title in the property. Samuel has invested $10,000 to repair the badly damaged building and now operates a grocery store in the building. While the Gomez family is seeking compensation or title through a legal action in the East Timor courts, Samuel has the use and control over the building he has repaired. Samuel would be allowed depreciation deductions for the cost of rebuilding the building.

Determining the "useful life" of assets

7. Whether depreciable assets are depreciated on an individual asset basis or using the pooling system, the period over which they are depreciated will depend on their useful life. The useful life of an asset is determined by the Commissioner (section 4 of Part B of Schedule 1 of Directive 2001/2). A schedule of the Commissioner's determinations of useful lives for depreciable assets are set out in ETRS/SRTL Public Ruling 2001/8.

Depreciating individual assets

8. As noted earlier, taxpayers may elect to depreciate assets on an asset-by-asset basis or by using a "pooling" system. If assets are depreciated on an individual basis, the annual depreciation rate is determined under the schedule in section 3 of Part B of Schedule 1 of Directive 2001/2. Individual assets must be depreciated on a "straight-line" basis, meaning that generally equal depreciation deductions are taken each year over the depreciation period.

9. There are two exceptions to the rule in the previous paragraph. First, where an asset is acquired part way through an income year (or disposed of part way through the year), that year's depreciation deduction is pro-rated to reflect the fact that the asset was used or held for the purpose of conducting taxable business activities during part of the year only (section 10.11(d) of Directive 2001/2) . Second, where an asset is used only partly in the conduct of taxable business activities during a tax year, the depreciation is again pro-rated to reflect the partial business use (section 10.11(c) of Directive 2001/2).

10. The key difference between the two pro-ration rules described in the previous paragraph is that the first pro-ration has the effect of deferring a deduction while the second pro-ration has the effect of denying it in the current year and in future years.

> Example 2:
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> On December 1, 2001, José Shopkeeper purchased a bicycle for $400 to use for delivery of goods from his shop. In 2002, his brother visited from Australia. Jose lent the bicycle to his brother for his brother's private use while he stayed in Dili for 40 days.
>
> The Commissioner has determined that a bicycle has a useful life of 1 to 4 years. Applying the depreciation schedule in section 3 of Part B of Schedule 1, ignoring the acquisition part way through a year and the partial private use in 2002, Jose would normally depreciate the bicycle as follows:

Year:	2001	2002	2003	2004
Depreciation deduction:	$100	$100	$100	$100

Applying the two pro-ratio formula, the depreciable deductions allowed to Jose would be as follows:

2001: 31/365 days x $100 = $8 ($8.49 rounded to nearest $)

2002: $100 – ($100 x 40/365 days) = $89 (rounded)

2002: $100

2004: $100

2005: $100 – $8 = $92 (that is, first year's depreciation not recognised because of the pro-ration for purchase part way though the year)

11. If a depreciable asset or business building is sold or otherwise alienated, the cost of the asset or building is reduced by the depreciation deductions allowed to the person selling the asset.

Example 3:

Anna owns a restaurant. She has a number of assets she uses in the restaurant. The assets were purchased in 2000 for a cost of $5,000 and in 2000 and 2001, Anna deducted $2,500 as depreciation of the assets. She replaced the assets in 2002, selling the original assets for $3,000.

Anna's cost of the assets is reduced from the original cost of $5,000 by the amount of depreciation deductions taken in respect of the assets (that is, $2,500), leaving her with a new cost of $2,500. If she sells the assets for $3,000, she will have a gain of $500 which will be included in her taxable income in 2002. She will not claim depreciation deductions for the assets in 2002, although she may claim depreciation deductions for the replacement assets she purchased.

Example 4:

This example uses the same facts as Example 3 except that Anna sells her original restaurant assets in 2002 for $2,000.

Once again, Anna's cost of the assets is reduced from the original cost of $5,000 by the amount of depreciation deductions taken in respect of the assets (that is, $2,500), leaving her with a new cost of $2,500. If she sells the assets for $2,000, she will have a loss of $500. This loss may be deducted as a business expense when calculating her taxable income for 2002.

12. The cost of an improvement, renewal or reconstruction of a depreciable asset that is depreciated on a straight-line basis or of a business building is treated as the cost of a new asset with a useful life equal to the useful life of the asset or building.

Example 5:

In late 2002 Daniel purchased a second-hand truck which he used in his business. In 2003 he fitted a new engine and transmission in the truck. Assuming the costs are in the nature of improvement or renewal rather than costs that would be regarded as repairs and maintenance able to be expensed, then Daniel can depreciate the costs of the replacement engine and transmission on a straight-line basis as if they had a useful life equal to the original useful life of a truck.

Depreciating assets using the pooling system

13. The alternative to depreciating assets individually is to use the pooling system for depreciation. Under this system, the cost of all assets (as well as expenses such as the cost of renewing, improving or reconstructing depreciable assets is added to a pool and the depreciated deduction is calculated by applying a depreciation rate to the "written down value" of the pool rather than applying the rate to each individual asset.

14. The first step to using the pooling system is to establish four pools for assets with different lives. These pools are set out in Part B of Schedule 1 to Directive 2001/2 as follows:

Pool	Useful life of assets in the pool
Pool 1	1 – 4 years
Pool 2	5 – 8 years
Pool 3	9 –16 years
Pool 4	more than 16 years

15. As assets are acquired, the cost of acquiring the assets is added to the pool for assets with that asset life. Similarly, as expenses are paid to renew, improve or reconstruct assets in a pool, the expenses

are added to that pool. The total value in a pool at any given time is the "written down value" of the pool.

16. The depreciation rate for a pool is applied to the written down value of the pool at the end of the year and the resulting amount is allowed as a depreciation deduction in respect of that pool. The depreciation rates for the four pools are set out in Part B of Schedule 1 to Directive 2001/2:

Pool	Depreciation rate
Pool 1	50%
Pool 2	25%
Pool 3	12.5%
Pool 4	10%

17. As new assets are acquired during the year or the taxpayer pays depreciable expenses in relation to assets already in a pool, the costs of the new assets or depreciable expenses are added to the written down value of the pool. If there is a disposal of an asset in a pool during a year, the amount received for the disposal (for example, proceeds of a sale or insurance proceeds if an asset is destroyed or lost) is deducted from the written down value in the pool. The written down value at the opening of a year is the written down value at the close of the previous year less the depreciation deduction for that previous year.

Example 6:

In 2001, Mirko Seles purchased three assets for $200, $500 and $1,000 which all fell into Pool 2. In 2002, he spent $200 making an improvement to the third asset. In the same year, he sold the first asset for $100.

Depreciation deduction in 2001:

- The written down value at the end of the year is $200 + $500 + $1,000 = $1,700
- Depreciation is 25% x $1,700 = $425

Depreciation deduction in 2002:

- The opening written down value is $1,700 (previous year's closing written down value) – $425 (depreciation allowed in 2001 for the pool) = $1,275

- The closing written down value is $1,275 + $200 (improvement expense) – $100 (amount received for the sale of first asset) = $1,375.
- Depreciation is 25% x $1,375 = $344 (rounded)

18. The written down value of a pool can never be less than zero. If an asset is sold during the year, the written down value is reduced by the amount received for the asset. If the written down value is a negative number, it is treated as zero and the negative amount is included in income in that year (Directive 2001/2, section 10.6). The written down value of the pool at the start of the following year will be zero, even though assets remain in the pool.

Example 7:

Following the events in Example 6, in 2003 the opening written down value for pool 2 is $1,375 (the written down value at the end of 2002) – $344 (depreciation allowed in 2002 for the pool) = $1,031

In 2003, Mirko changed the nature of his business and sold the third asset in the pool for $1,200. He purchased another asset for a cost of $100. At the end of 2003, his written down value is $1,031 (previous year's written down value) + $100 (purchase during the year) – $1,200 (sale during the year)

= -$69

Mirko must include $69 in his taxable income for 2003. Since the written down value is zero, there is no depreciation deduction for the year (depreciation is calculated by multiplying the depreciation rate times the written down value at the end of the year). The following year, the opening written down value for pool 2 is zero. If Mirko sells the remaining asset in pool 2 in 2004, the entire proceeds will be included in his taxable income as he has already reduced the written down value of the pool to zero.

19. If the written down value of a pool is less than $100 at the end of the tax year, the entire value may be deducted as a depreciation deduction in that year (Directive 2001/2, section 10.7).

20. If an asset is acquired partly for use in a business and partly for another purpose, the cost is pro-rated depending on the intended use and only a proportion of the cost is added to the pool.

Example 8:

Alysha has bought a car which she intends to use in the mornings and afternoon to transport her children to school.

During the day it will be used to transport goods to and from her business. She estimates that two-thirds of the use will relate to her business and one-third will be personal use. Alysha may add two-thirds of the cost of the car to a depreciation pool.

Note that Alysha has an obligation to show her estimates were realistic. If her tax returns are audited by the ETRS, she can demonstrate the accuracy of her estimate by keeping a diary of use for a representative period of perhaps one or two weeks.

Date of effect

21. This Public Ruling has effect from 31 March 2001.

Thomas Story
Commissioner of East Timor Revenue Service
31 March 2001

Legislative references:

improvement, renewal of asset	Directive 2001/2, s 10.11(b)
partial year use of assets	Directive 2001/2, s 10.11(d); s 10.12, "capital cost" (a) and(b)
partial business use of assets	Directive 2001/2, s 10.9, s 10.11(c)
negative written down value	Directive 2001/2, s 10.6
deduction for value under $100	Directive 2001/2, s 10.7, s 10.11(a)
pools	Dir 2001/2, sch 1, Pt B, s 1
depreciation rates	Dir 2001/2, sch 1, Pt B, s 2