Guide to Claiming Depreciation on Buildings, Machinery and Equipment

Guide No.9 in the Tax Guide Series

About This Guide

This Guide has been prepared to help you calculate your income tax deduction for wear and tear on buildings, machinery and equipment. The guide is based on the changes that will commence on the 1st April 2010 but is applicable to the year ended 31st March 2010 in all respects except the rates of depreciation (paragraph 11) and the method (paragraph (13).

1. Can I claim an income tax deduction for the cost of acquiring business assets?

The cost of acquiring business assets such as buildings, plant, machinery or equipment is not an outright income tax deduction but you will be able to claim the cost over several years. This is called a depreciation deduction. The depreciation deduction is an estimate of the amount by which your asset will reduce in value each year and you may need to make a final year adjustment when the assets are disposed of or written off.

2. Do all business assets qualify for a depreciation deduction?

No.

To qualify for a depreciation deduction, the business assets must:

(i) Have a useful life exceeding one year;

(ii) Lose value as a result of normal wear and tear; and

(iii) Be owned and used by the person who is carrying on the self employment or business activity.

3. Examples of business assets that qualify for a depreciation deduction.

(i) Motor vehicles;

(ii) Fishing boats and outboard motors;

(iii) Machinery and equipment used in your work;

(iv) Buildings used for work premises;

(v) Roads, driveways and car parks;

(vi) Furniture used in business premises;

(vii) Computers and electrical products used for work.

4. Examples of assets that do not qualify for a depreciation deduction.

(i) Land;

(ii) Machinery and equipment purchased for private use;

(iii) Buildings used for private purposes;

(iv) Intangible assets such as goodwill;

5. Why don't assets that have a useful life of less than 1 year qualify for a depreciation deduction?

Assets that have a life of less than one year are deductible under the renewal basis. The renewal basis allows a full deduction for the replacement cost of the item.

6. Why do assets that do not lose any value, not qualify for a deduction?

The depreciation deduction allows a self employed and business person to claim an amount that represents the loss in value of a business asset because of wear and tear caused by work use. If an asset does not lose any value, it simply does not qualify.

Land is the most common form of asset that does not lose any value. Another example would be a classic or antique motor car. If a classic car is maintained in good working order, its value would not be expected to reduce as it is a collector's item. Similarly, works of art in business premises would not be expected to reduce in value.

7. Why is it necessary to own a business asset in order to claim a depreciation deduction?

The purpose of the depreciation deduction is to allow a self employed or business person to claim an income tax deduction (over time) for their cost of acquiring a business asset. If a business asset is owned by someone else, such as a family member, it will not qualify for a deduction because the cost of acquisition has not been incurred by the self employed or business person.

8. What is meant by the use of a business asset?

Not every asset owned by a self employed or business person qualifies for an income tax deduction because the tax law says that it must be used in the business for the purpose of deriving taxable income. For example, a building owned by a person but left unoccupied is not a depreciable asset because it is not used by the business.

In addition the asset must be used for the purpose of deriving income from self employment or

business.

9. How is the depreciation deduction calculated?

The depreciation deduction is calculated by applying the annual rates of depreciation to the cost or written down value using the straight line method.

10. How is cost calculated?

Cost is the starting point for determining the depreciation deduction. This cost is the actual amount paid for the asset or the actual costs incurred in constructing the asset, plus all other costs associated with shipping it, or the components, to St Helena.

Cost is not an estimated market value and no depreciation deduction is allowed unless you have evidence of the actual cost. Items included in the cost of an asset are:

· The total purchase price;

· Construction costs;

· Cost of transporting and installing the asset (freight and freight insurance);

· Import duties.

As an example, the indicative cost of a depreciable asset purchased in the United Kingdom for £25,000 and transported to St Helena could be as follows.

Example 1

Cost Price	25,000
Freight Charge	3,000
Import Duty (5%)	1250
Wharfage (5%)	1250
Transport Charges, Jamestown	150
Total Cost	**30,650**

11. What are the annual rates of depreciation?

The rates used in calculating the depreciation deduction are set out in the Income Tax Ordinance as follows:

a) Buildings and other structural improvement - 5% per annum;

b) Other depreciable assets - 20% per annum;

c) Any asset having an effective life of three years or less - 33 1/3 % per annum.

An example of an asset to which paragraph

(c) applies is computer equipment. This would be so because even though the asset may be in working order after 3 years, technology advances may render some hardware obsolete and it would not be unreasonable for a person to replace all the hardware every three years.

12. What does written down value mean?

The term written down value refers to the cost of the depreciable asset less any depreciation deduction allowed. The term is important for the purpose of determining whether the depreciation allowance for wear and tear has been accurately estimated. Whether or not this is the case can only be determined by comparing a business asset's sale price at the time of disposal, with its written down value.

13. What does the straight line method mean?

There are two generally accepted accounting methods for calculating the depreciation allowance. These methods are the diminishing value method and the straight line method. Under the Ordinance, only the straight line method is acceptable.

The straight line method calculates the annual depreciation deduction in the first year of use and the same amount is allowed as a depreciation deduction in each subsequent tax year (if it is exclusively used for business) until the written down value is nil.

14. Calculation of depreciation

Using the cost shown in example 1, the following example illustrates the calculation of a depreciation deduction for a business asset that has a depreciation rate of 20% per annum.

Example 2

Year 1	Cost	30,650
	Depreciation Deduction	6,130
	Written Down Value	24,520
Year 2	Written Down Value	24,520
	Depreciation Deduction	6,130
	Written Down value	18,390
Year 3	Written Down Value	18,390
	Depreciation Deduction	6,130
	Written Down Value	12,260
Year 4	Written Down Value	12,260
	Depreciation Deduction	6,130
	Written Down value	6,130
Year 5	Written Down Value	6,130
	Depreciation Deduction	6,130
	Written Down Value	Nil

15. How do I calculate my deduction if I use assets part for business and part for private use?

A typical example of using an asset partly for business and partly for private use would be a motor car used for both work and family. Another example would be a building that is used as a residence and also as a place for business.

Where there is a combination of work and private use for any asset, a depreciation deduction will only be allowed for a percentage of the total depreciation. This percentage is calculated by comparing either the periods of work use or the proportion of work use, with a full tax year or full usage.

For example a building that is used as a residence and as a place of work would only partly qualify for a depreciation deduction. If 25% of the area of the building was used for work purposes, the depreciation deduction would be 25% of the full annual amount.

16. What happens if I start using an asset as a business asset part way through a tax year?

If an asset was acquired part way through the tax year or it started to be used as a business asset part way through the tax year, only a proportion of the total annual depreciation deduction will be allowed.

As an example, a business asset acquired on 1st July and used for work purposes would have been used for only 9 months during the tax year. The depreciation deduction would be 9/12 (75%) of the full year deduction.

17. What happens if I dispose of a business asset?

The depreciation deduction is only an estimate of the amount by which your business assets will reduce in value each year. When the asset is sold, disposed of or written off, its actual reduction in value is known by comparing the original cost price with the disposal price. In the majority of cases, the estimated depreciation deduction will be either more or less than the actual loss in value. In this case, it is necessary to make an adjustment to either increase or decrease the depreciation deduction.

This adjustment is calculated by denying a deduction in the year of disposal and calculating the difference between the consideration received for the asset and its written down value at the beginning of the year.

The consideration received will be either of the following amounts, depending on the circumstances of the disposal.

(i) The total amount received on disposal or the amount which the person disposing of the asset is entitled to receive. Actual receipt of money for a disposal is not necessary and a debt created as a result of the sale is regarded as consideration received.

(ii) If payment is made in kind, the fair market value of the payment in kind.

(iii) If the asset is lost or destroyed, the consideration will include any insurance amount received as a

result of the loss or destruction.

The Commissioner may also apportion a consideration based on fair market value where two or more assets are sold at the same time.

18. Calculation of adjustment - profit on disposal

The adjustment on disposal is referred to as either a profit or a loss.

A profit on disposal will arise where the consideration received exceeds the written down value of the asset at the beginning of the tax year. This profit is regarded as a business profit and included in the taxable income in the year of disposal.

As an example, consider the following illustration using the information shown in example 2 and assuming the asset was sold in year 3 for a consideration of £22,000.

Example 3

Year 1	Cost	30,650
	Depreciation Deduction	6,130
	Written Down Value	24,520
Year 2	Written Down Value	24,520
	Depreciation Deduction	6,130
	Written Down value	18,390
Year 3	Written Down Value	18,390
	Depreciation Deduction	Nil
	Consideration Received	22,000
	Profit on Disposal	3,610

The profit on disposal of £3,610 is a business profit and is included in taxable income for year 3.

This profit on disposal would have been different had the asset been partly used for earning taxable

income. Using the figures shown in example 2, the following illustrates the profit on disposal if the asset had been used 50% of the time for income earning activities and 50% for some other non business purpose.

Example 4

Cost	30,650
Consideration Received	22,000
Actual Decline in Value	8,650
Decline in Value Applicable to Business Use	4325
Depreciation Deduction Allowed Year 1	3,065
Depreciation Deduction Allowed Year 2	3,065
Total Deduction Allowed	6,130
Profit on Disposal (6,130 – 4,325)	1,805

19. Calculation of adjustment - loss on disposal

A loss on disposal will arise when the consideration received is less than the written down value of the asset at the beginning of the tax year. Where there is a loss, a deduction for the loss is allowed in the year of disposal.

As an example, consider the following illustration using example 3 but with a consideration on disposal of £15,000.

Example 5

Year 1	Cost	30,650
	Depreciation Deduction	6,130
	Written Down Value	24,520
Year 2	Written Down Value	24,520
	Depreciation Deduction	6,130
	Written Down value	18,390
Year 3	Written Down Value	18,390
	Depreciation Deduction	Nil
	Consideration Received	15,000
	Loss on Disposal	3,390

The loss on disposal of £3,390 is allowed as an additional depreciation deduction in year 3.

If the asset was only partly used for earning taxable income, only part of the loss will be allowed as an additional depreciation deduction. For example, if the asset in example 5 had only been used 50% of the time for income earning activities and 50% for some other non business purpose, the additional depreciation deduction will be reduced by 50% to £1,695 as shown below.

Example 6

Cost	30,650
Consideration Received	15,000
Actual Decline in Value	15,650
Decline in Value Applicable to	7,825
Depreciation Deduction Allowed	3,065
Depreciation Deduction Allowed	3,065
Total Deduction Allowed	6,130
Profit on Disposal (7,825 - 6,130)	1,695

Government of St Helena
Income Tax Office
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