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Introduction

Referral of the Bill

1.1 On 29 November 2012 the Selection Committee referred the Tax Laws Amendment (2012 Measures No. 6) Bill 2012 to the committee for inquiry and report.

1.2 The Bill has eight schedules. Broadly, they:

- clarify that native title benefits are not subject to income tax, including capital gains tax (Schedule 1);
- update the list of deductible gift recipients (Schedule 2);
- extend the immediate deductibility of exploration expenditure, already provided to mining and petroleum explorers, to geothermal energy explorers (Schedule 3);
- extend the interim streaming provisions for managed investment trusts (MITs), in line with the Government's announcement to defer the commencement of the new regime for MITs (Schedule 4);
- apply an income-based means test to the rebate for medical expenses (Schedule 5);
- reverse capital allowance deductions that, at the time the debt is terminated, are excessive having regard to the amount of the debt repaid. This is to ensure that the relevant tax laws operate as intended responds to the High Court case in 2011 between the Tax Office and BHP[1] (Schedule 6);

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1 *Federal Commissioner of Taxation v BHP Billiton* [2011] HCA 17.

- remove concessional fringe benefit tax treatment for in-house fringe benefits accessed through salary sacrificing. In-house fringe benefits are those where the employer provides the same or similar goods or services as part of their business (Schedule 7); and
- make miscellaneous amendments (Schedule 8).

Schedule 1 – Native title benefits

Introduction

1.3 The native title system, initiated with the *Mabo* decision in 1992, has given Indigenous communities significant opportunities and increased security in enjoying the cultural and economic benefits of their relationship with the land. However, the focus in resolving native title uncertainties to date has been on issues such as rights of access and decision-making about land use.[2]

1.4 An important issue from the perspective of Indigenous people is the relationship between the native title system and the tax system. After all, one of the aims of native title is that Indigenous people should be able to obtain some financial benefit from it, if they wish to do so. At the hearing, Native Title Services Victoria spoke positively about the fact that these issues are now being addressed. For them it represents an indication that the native title legislation has been successful:

> In this 20 years, in fact, since the parliament passed the Native Title Act, we have now moved to the stage where the big issue in native title is how it can best deliver economic development for Indigenous Australians. The fact that we are having this discussion is an indication of the very positive results that have been achieved by the Native Title Act over that time.[3]

1.5 The *Native Title Act 1993* and the tax legislation are silent on the tax treatment of native title and there is very little case law. Current estimates are that mining companies are paying $200 million annually to Indigenous

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2 Dr Lisa Strelein, *Taxation of Native Title Agreements,* May 2008, Native Title Research Monograph, No. 1/2008, AIATSIS, p. 4.

3 Mr Matthew Storey, NTSV, *Committee Hansard,* Canberra, 30 January 2013, p. 33.

communities in the Pilbara alone, and that these sums will continue for decades.[4] An AIATSIS research paper states:

> Some of the agreements being reached involve payments and benefit packages that are complex and in almost all circumstances raise significant conceptual and practical questions as to their treatment for taxation purposes. Little analysis has been done to determine how native title fits with the tax system and resolution of this issue has eluded a generation of policy makers.[5]

1.6 Native title sits separately to the legal traditions that Australia inherited from the United Kingdom. The AIATSIS research paper describes native title and its impact as:

> Native title is a unique legal concept that seeks to bridge the rights held by Indigenous peoples under their own law, and an accommodation and protection of those rights within Australian law. Its recognition required an immediate rethinking of Australia property law and the way in which governments, in particular, dealt with land.[6]

1.7 This rethinking process is continuing, as reflected by the proposals in the Bill to clarify the tax treatment of native title benefits.

1.8 Prior to *Mabo*, the Commonwealth Government introduced land reforms in the Northern Territory for Indigenous people through the *Aboriginal Land Rights (Northern Territory) Act 1976*. This created a system equivalent to mining royalties, paid to land councils and Indigenous communities through the Aboriginals Benefit Account. In 1979, a Mining Withholding Tax was established on distributions made by the Account. The current tax rate is 4 per cent and total receipts to date are estimated at up to $60 million. The Mining Withholding Tax is outside the scope of this report, although the Committee notes there have been calls for its abolition.[7]

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4 CME, *Submission 5,* p. 2.

5 Dr Lisa Strelein, *Taxation of Native Title Agreements,* May 2008, Native Title Research Monograph, No. 1/2008, AIATSIS, p. 5.

6 Dr Lisa Strelein, *Taxation of Native Title Agreements,* May 2008, Native Title Research Monograph, No. 1/2008, AIATSIS, p. 4.

7 Professor Jon Altman, *Submission 2,* pp. 1-4; House of Representatives Standing Committee on Aboriginal and Torres Strait Islander Affairs, *Unlocking the Future: The Report of the Inquiry into the Reeves Review of the Aboriginal Land Rights (Northern Territory) Act 1976,* August 1999, p. 69.

Policy development and consultations

Initial attempts in 1998

1.9 The previous Government announced reforms to clarify the tax implications of native title as part of its native title reforms, the latter culminating in the *Native Title Amendment Act 1998.* The then Treasurer stated that he wished to apply existing tax law wherever possible, and make amendments where this would significantly reduce administrative and compliance costs or 'provide a more equitable treatment for certain transactions.'[8] The Government's views of the existing tax treatment at that time and its proposals are in the table below.

Table 1.1 Tax treatment and reform proposals for native title transactions in 1998

Transaction	Existing tax treatment	Proposed tax treatment
Obtaining a native title determination and vesting native title in a registered body corporate as agent or trust.	The vesting in the body corporate may represent an asset transfer for capital gains tax (CGT).	Native title will not lose its pre-CGT status upon acquisition by the body corporate.
Transferring native title with-in a group of native title hol-ders and succession from one group of holders to another.	Would trigger a CGT liability, but would be difficult and costly to administer due to it being a communal asset.	Exempt from CGT.
Compensation payments received for the extinguishment or voluntary surrender of native title rights, including pastoral leases.	Generally regarded as compensation for the loss of a capital asset and exempt from tax. But the form of the payment may attract income tax.	Exempt from CGT and income tax, irrespective of the form of the payment.
Payments for the temporary impairment or suspension of native title, i.e. all receipts where it is not extinguished.	Individual taxpayers would pay tax at their marginal rate. Identifying the taxpayers would be difficult.	All receipts taxable through a withholding tax of 4 per cent.
Payments by non-native title holders, e.g. for: (i) extinguishment (ii) temporary impairment (iii) other expenses.	Expenses for ongoing operations deductible. Payments to protect assets not deductible, but may increase an asset's cost base (CGT).	(i) not deductible but may increase an asset's cost base (ii) deductible (iii) existing tax law will apply.

Source The Hon. Peter Costello MP, Treasurer, and the Hon. Daryl Williams AM QC MP, Attorney-General, 'Taxation Implications of the Native Title Act and Legal Aid for Native Title Matters,' Media Release, 13 February 1998, p. 4.

1.10 The proposals were to exempt dealings in native title from Capital Gains Tax for Indigenous people, recognising its 'pre-1985' status. Payments where native title was not extinguished, but applied over time for a productive purpose, would be taxed at 4 per cent, which would be

8 The Hon. Peter Costello MP, Treasurer, and the Hon. Daryl Williams AM QC MP, Attorney-General, 'Taxation Implications of the Native Title Act and Legal Aid for Native Title Matters,' *Media Release,* 13 February 1998, p. 1.

consistent with the approach under the Mining Withholding Tax. The Government also made proposals to clarify the tax treatment of native title dealings for the mining, tourism and other industries that seek access to land, but this is not attempted in the Bill.

1.11 The then Government did not proceed with its proposals. The committee is not aware of any formal explanation for this, although one commentator has suggested that the proposals lost priority when the then Government announced its program of tax reform, including the goods and services tax.[9]

The AIATSIS research paper

1.12 From 2007, researchers started publishing conference papers on the interaction between native title and the tax system.[10] AIATSIS published a major paper in 2008, which put forward four policy proposals, each of which would provide some tax benefit contingent on a 'social security means testing exemption:'

- sovereign immunity from taxation, which implies Indigenous people form a separate sovereign nation alongside or within Australia;
- a zero per cent withholding tax for a class of native title agreements, including any agreement relating to a process under the *Native Title Act 1993;*
- payments for loss or impairment of native title and the exercise of those interests and rights, as well as interest income from those funds, could be excluded from various tax regimes; and
- a new tax vehicle could be created, which supports Indigenous economic development and financial accumulation and distribution.[11]

The Government's consultation paper

1.13 In October 2010, the Government released a consultation paper where it canvassed views on proposals similar to the last three of those in the AIATSIS paper (that is, excluding the sovereign immunity proposal). The Government's proposals were different in some respects. For example,

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9 Mr Warren Black, 'Tax Implications to Native Title Holders of Compensation Payments,' 1999, *Journal of Australian Taxation,* vol. 2(5), p. 344.

10 Ms Miranda Stewart, 'Native Title and Tax: Understanding the Issues,' 2010, *Indigenous Law Bulletin,* vol. 7(21), pp. 7-11, fn. 1.

11 Dr Lisa Strelein, *Taxation of Native Title Agreements,* May 2008, Native Title Research Monograph, No. 1/2008, AIATSIS, p. 64.

they did not envisage that interest income from investing native title payments should be tax exempt. There was also no mention of a social security means testing exemption.[12]

1.14 The paper gave an overview of some of the issues. For example, it noted that native title agreements can provide for both monetary and non-monetary benefits, which can then be used for investment, the use of goods and services, payments to providers of goods and services, and payments to individuals. Benefits can be provided through the extinguishment or suspension of native title, or they can be provided for other reasons. Often, native title agreements do not explain why a benefit is being provided, such as whether it relates to a change in native title status or some other reason.

1.15 In some cases, the tax treatment is relatively clear. A direct link between extinguishment of native title and a benefit would mean that the benefit would not be subject to income tax because it was obtained through disposing of an asset. As a pre-CGT capital asset, no capital gains tax would be involved, either. However, the treatment becomes less certain where the benefit is linked to the suspension of native title or other reasons. Uncertainty increases where the benefit and its reason cannot be linked. Treasury summarised the difficulties as follows:

> The current income tax system treats native title as a capital asset capable of being exploited to generate income, rather than as an inalienable, intergenerational and communal right with particular cultural significance. Further, the tax system assumes that benefits under a native title agreement can be clearly apportioned between extinguishment of native title, suspension of native title and any other matters dealt with in the agreement, which may not accord with the agreement making process as experienced by native title groups.[13]

1.16 Under current tax law, the returns from funds invested to generate a profit are taxable. The main vehicle through which this tax outcome is avoided in pursuit of a community purpose is the charitable trust. The requirements for a trust to obtain this status from the ATO are:

- it exists for the public benefit or relief of poverty;
- its purposes meet the legal definition of 'charitable';

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12 Discussion overall drawn from: Australian Government, *Native Title, Indigenous Economic Development and Tax,* Consultation Paper, October 2010.

13 Australian Government, *Native Title, Indigenous Economic Development and Tax,* Consultation Paper, October 2010, p. 5.

- it is not for profit; and
- its sole purpose is charitable.

1.17 Charitable trusts have several limitations that affect their suitability in supporting Indigenous communities. Firstly, they must be for the public benefit, which may not be consistent with focussing on Indigenous people. Secondly, they cannot support profitable projects, which would be inconsistent with supporting Indigenous businesses. Finally, they are subject to the rule against perpetuities, which prevents the accumulation of wealth across generations. The accumulation of wealth by future generations could well be an important requirement for native title holders who agree to extinguish their native title rights.

Refinement and announcement

1.18 In June 2012, the Attorney General and the Minister for Families, Community Services and Indigenous Affairs announced that the Government's approach would be to 'clarify that income tax and capital gains tax will not apply to payments from a native title agreement.' They also foreshadowed consultation on the legislation.[14]

1.19 In July 2012, the Government released exposure draft legislation for comment. Treasury noted there was support for the proposals, but that many submissions sought to widen the scope of the legislation. Treasury's response was that this 'would be contrary to the intent of the measure, which is to clarify the tax treatment of certain native title benefits by confirming that they are not subject to income tax, and as such were not adopted.'[15]

1.20 However, two detailed changes were still made to the Bill. Firstly, where native title is yet to be determined or may not be determined, the benefits provided under an agreement will still be tax exempt. Secondly, Treasury confirmed there are no capital gains tax implications from creating a trust that is an Indigenous holding entity over native title rights, or for related transactions.[16] This is similar to one of the 1998 proposals.[17]

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14 The Hon. Nicola Roxon MP, Attorney-General, and the Hon. Jenny Macklin MP, Minister for Families, Community Services and Indigenous Affairs, 'The Future of Native Title,' *Media Release,* 6 June 2012.

15 The Treasury, *Tax Treatment of Native Title Benefits - Summary of consultation process,* November 2012, p. 1.

16 The Treasury, *Tax Treatment of Native Title Benefits - Summary of consultation process,* November 2012, p. 2.

17 See row 1 of table 1.1.

Proposals in the Bill

Income tax

1.21 Simply put, the Bill states that an amount or benefit is non-assessable non-exempt (NANE) income (that is, exempt from income tax) where it arises from a native title benefit. For the exemption to apply, an Indigenous person or Indigenous holding entity must receive the benefit. The amount or benefit can arise indirectly from a native title benefit, that is, through a chain of transfers. However, the benefit must maintain its NANE status at each individual transfer. If it loses this status at one point, such as passing through a company that is not an Indigenous holding entity, then this status cannot be re-acquired.[18]

1.22 A key element in the regime is the definition of a native title benefit. This is an amount or non-cash benefit:

- that arises under an agreement (such as an Indigenous Land Use Agreement) made under Commonwealth, State or Territory legislation, to the extent that the amount or benefit relates to an act that would extinguish native title or would be inconsistent with the continuation of native title to some extent; or
- compensation for acts affecting native title under Division 5 of Part 2 of the *Native Title Act 1993*.[19]

1.23 An amount or benefit will still have tax exempt status if it is later found that native title does not exist or if no formal determination of native title is ever made.[20]

1.24 An Indigenous holding entity is defined as:

- a distributing body; or
- a trust whose beneficiaries can only be Indigenous persons or distributing bodies.[21]

1.25 A distributing body is defined in section 128U of the *Income Tax Assessment Act 1936,* within the Division that covers the Mining Withholding Tax. It includes Aboriginal Land Councils and corporations registered under the *Corporations (Aboriginal and Torres Strait Islander) Act 2006.* A distributing body is a body established under Australian law that

18 *Explanatory Memorandum,* pp. 14-15.

19 *Explanatory Memorandum,* p. 16.

20 *Explanatory Memorandum,* p. 17.

21 *Explanatory Memorandum,* p. 18.

distributes the money it receives to, or for the benefit of, Indigenous persons.[22]

1.26 When an amount or benefit starts to be applied to more commercial applications, then it loses its NANE status. For example, the income earned from investing an amount or benefit with NANE status will be subject to income tax. Further, using an amount or benefit to pay for administrative costs or goods and services will not be NANE income for the recipient. Conversely, an expense will not be deductible where it was used to gain NANE income because those revenues are tax free. Expenses can be apportioned where they were used to generate both NANE and taxable income.[23]

Capital Gains Tax

1.27 The Bill confirms that there are no Capital Gains Tax implications resulting from native title rights, or rights to a native title benefit, being transferred to an Indigenous holding entity or to an Indigenous person. This also applies where a trust is created that is an Indigenous holding entity over such rights. Further, no Capital Gains Tax implications arise from a native title right being ended.[24]

Transitional and consequential provisions

1.28 The amendments apply from 1 July 2008. This retrospectivity is to the benefit of taxpayers. Transitional provisions apply so that taxpayers can seek amended assessments back to this date.[25] Consequential amendments are made to the tax law so that mining withholding tax does not apply to NANE amounts or benefits under the Bill.

Human rights

1.29 The Bill promotes the right to self-determination under the International Covenant on Civil and Political Rights and the International Covenant on Economic, Social and Cultural Rights (ICESCR). The Explanatory Memorandum also discusses whether the Schedule contravenes the rights of equality and non-discrimination of the ICESCR and the International Convention on the Elimination of All Forms of Racial Discrimination (CERD). This is because the Schedule gives Indigenous people a tax

22 *Explanatory Memorandum*, p. 19.
23 *Explanatory Memorandum*, pp. 15-16.
24 *Explanatory Memorandum*, p. 19.
25 *Explanatory Memorandum*, p. 20.

exemption in relation to amounts and benefits they receive through their native title rights, which is not available to the wider community.[26]

1.30 The Explanatory Memorandum concludes that differences in treatment will be legitimate if there are reasonable causes for this and if there is a proper purpose behind the differences. These requirements apply here because the Schedule seeks to clarify the tax position relating to unique rights that only Indigenous people can hold. Further, NANE status only applies to income relating to the impairment or extinguishment of native title.

1.31 Another argument in favour of the Schedule is the special measure provisions in the CERD. This states that measures taken to solely secure the advancement of certain groups shall not be racial discrimination where this gives these groups equal enjoyment or exercise of human rights and fundamental freedoms (demonstrated in this instance by the *Closing the Gap* agenda). There are also a number of conditions that must be met for special measures. The Explanatory Memorandum states that these are met because:

- only Indigenous people can hold native title;
- the amendments are proportional because NANE income status only applies to native title benefits to the extent that they are for the impairment or extinguishment of native title;
- the Schedule clarifies the treatment of native title rights, which are accepted and recognised by the international community as securing the existence and identity of Indigenous people in Australia; and
- the Schedule is functional and goal related because it is linked to the existence of native title, rather than instituting a permanent advantage for Indigenous people.[27]

Financial impact and compliance cost

1.32 The financial impact of the measure on the Government is close to zero from 2012-13 to 2015-16. The Explanatory Memorandum states that expected compliance costs are nil.[28]

26 Discussion drawn from *Explanatory Memorandum*, pp. 23-26.

27 If all Native Title is extinguished, then the amendments are non-permanent in that they will no longer effectively operate.

28 *Explanatory Memorandum*, p. 3.

Schedule 2 – Deductible gift recipients

1.33 A deductible gift recipient (DGR) is an entity or fund that can receive tax deductible gifts. A DGR can either be endorsed by the ATO or be listed in the tax law. The Schedule will change the DGR status of five entities:

- AE1 Incorporated, which seeks to locate and honour the crew of Australia's first submarine, will be a DGR between September 2011 and September 2014;
- Australia for UNHCR, which raises funds to support the humanitarian programs of the United Nations High Commissioner for Refugees, will have its listing extended;
- One Laptop per Child Australia, which seeks to enhance learning opportunities for over 500,000 primary school aged children by providing each one with a connected laptop, will have its listing extended to June 2016;
- Teach for Australia, which seeks to attract top graduates to teach in disadvantaged communities, will be listed in respect of gifts received from January 2013; and
- Yachad Accelerated Learning Project, which seeks to close educational gaps in remote, regional and rural locations of Australia through practices developed in Israel, will have its listing extended to June 2015.[29]

1.34 The Government's revenue projections from the measure are given in the table below:

Table 1.2 Financial impact of changing the DGR status of five entities ($m)

Organisation	2012-13	2013-14	2014-15	2015-16
AE1 Incorporated	-0.8	-0.8	-0.8	0
Australia for UNHCR	0	-6.3	-7.0	-7.8
One Laptop per Child Australia	0	-0.1	-0.1	-0.1
Teach for Australia	0	-0.2	-0.2	-0.3
Yachad Accelerated Learning Project	0	-0.1	-0.1	-0.1
Total	**-0.8**	**-7.5**	**-8.2**	**-8.3**

Source *Explanatory Memorandum, p. 4.*

29 *Explanatory Memorandum,* p. 4.

1.35 In the Explanatory Memorandum, the Government states that compliance costs from the provisions are nil and that no human rights issues are involved.[30]

Schedule 3 – Geothermal energy explorers

1.36 Geothermal energy is heat contained within rock or any other naturally occurring substance in the earth. It has the potential to be used to generate electricity with minimal emissions. Geothermal energy has been identified in every Australian State and the Northern Territory.[31]

1.37 The definition of 'exploration or prospecting' in the *Income Tax Assessment Act 1997* does not extend to geothermal energy. This, and other features of the tax law, means that explorers for geothermal energy cannot immediately deduct prospecting expenditure, a benefit which is available to explorers of minerals or petroleum.

1.38 This issue was raised by the Policy Transition Group, which consulted on the design of the Minerals Resource Rent Tax. Although outside its terms of reference, stakeholders raised the tax anomaly with the Group during its inquiries. The Group provided advice to Government that the tax law should be amended so that geothermal exploration is incorporated into the wider definition of exploration. This advice was consistent with the Government's policy of encouraging the development of geothermal energy.[32]

1.39 The Government accepted the Group's advice in March 2011, and stated that the new deductibility arrangements would commence from 1 July 2012.[33]

1.40 The Government's revenue projections from the measure are given in the table on the next page.

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30 *Explanatory Memorandum,* p. 5.

31 Discussion drawn from *Explanatory Memorandum,* pp. 31-34.

32 Policy Transition Group, *Report to the Australian Government: Minerals and Petroleum Exploration,* December 2010, pp. 7, 29.

33 The Hon. Martin Ferguson MP, 'Tax Deduction a Major Boost for Geothermal Energy in Australia,' *Media Release,* 24 March 2011.

Table 1.3 Revenue impacts of the geothermal energy exploration measure ($m)

2012-13	2013-14	2014-15	2015-16
0	0	-5	-5

Source *Explanatory Memorandum, p. 6.*

1.41 In the Explanatory Memorandum, the Government states that compliance costs from the provisions will be low and that no human rights issues are involved.[34]

Schedule 4 – Managed investment trusts

1.42 The amendments have been made in the context of major reforms of the taxation of managed investment trusts, as well as re-writing Division 6 of Part III of the *Income Tax Assessment Act 1936,* which deals with trust income. The former reforms were scheduled to commence on 1 July 2012, but were deferred by 12 months to permit further consultation. They were then deferred by another 12 months, to coincide with the trust income changes.[35]

1.43 In 2011, the tax law was amended to enable the 'streaming' of capital gains and franked dividends to beneficiaries. Managed investment trusts were exempt from these provisions for 2010-11 and 2011-12, recognising that these trusts generally do not 'stream' income to their beneficiaries. However, the trustee of a managed investment trust could elect to apply these rules on an irrevocable basis. The new regime for managed investment trusts was then expected to commence from 2012-13. Because the new regime has been deferred by two years, the irrevocable election arrangement has been extended by the same period.

1.44 The general effect of the Schedule is that, if a trustee elected or elects to apply the interim streaming provisions for any of the years between 2010-11 and 2013-14, then those rules will be applied for that and all later years until 2013-14. Elections must be made within two months after the end of the relevant income year.

1.45 The Explanatory Memorandum states that the measure is, 'expected to have an unquantifiable but not significant impact on revenue.' The

34 *Explanatory Memorandum,* p. 7.

35 Discussion drawn from *Explanatory Memorandum,* pp. 51-52.

Government states that compliance costs from the provisions will be low and that they do not raise any human rights issues.[36]

Schedule 5 – Rebate for medical expenses

1.46 Under section 159P of the *Income Tax Assessment Act 1936,* taxpayers can claim a rebate for medical expenses, which is often referred to as the net medical expenses tax offset. This section was first introduced in 1975, which was the same year as the Medicare reforms. Parliament has regularly amended the offset since then. The offset for 2012-13 is 20 per cent of out-of pocket expenses above a threshold of $2,120. Legislation in 2010 increased the threshold from $1,500 to $2,000, which was also then indexed to the CPI.[37]

1.47 The offset has a major effect on revenue at about $500 million annually. The *Tax Expenditures Statement 2011* was released in January 2012 and provides estimates for the offset's effect between 2007-08 and 2014-15, presented in the table below. The dip in 2011-12 is presumably due to the $500 increase in the threshold.

Table 1.4 Estimated revenue effect of the medical expenses offset ($m)

2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
-390	-435	-465	-525	-475	-510	-520	-555

Source *Tax Expenditures Statement 2011.*[38] *Figures for 2010-11 are preliminary. Estimate reliability is 'medium'.*

1.48 The Schedule imposes an income test on the offset that will have two effects: it will increase the threshold for that individual or family, and it will decrease the offset they receive if the offset applies to them. The new system is summarised in the table on the next page.

36 *Explanatory Memorandum,* p. 7.

37 Discussion drawn from *Explanatory Memorandum,* pp. 57-59.

38 <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2012/Tax-Expenditures-Statement-2011/TES> viewed 25 January 2013.

Table 1.5 Operation of the proposed medical expenses offset

Taxpayer status	Adjusted taxable income for rebates	Out-of-pocket medical expenses	Rate of offset available (%)
Single	$84,000 or less	$2,120 or less	0
		Greater than $2,120	20
	Greater than $84,000	$5,000 or less	0
		Greater than $5,000	10
Family	$168,000 or less	$2,120 or less	0
		Greater than $2,120	20
	Greater than $168,000	$5,000 or less	0
		Greater than $5,000	10

Source *Explanatory Memorandum, p. 59. The family threshold is increased by $1,500 for each dependent child after the first. The family threshold applies if a taxpayer is married on the last day of the year or has dependants on any day of the year.*

1.49 The income thresholds are broadly in line with those for the Medicare levy surcharge. They are indexed annually by average weekly ordinary time earnings.

1.50 The revenue savings from the measure are expected to exceed $100 million annually:

Table 1.6 Revenue impacts of the medical expense rebate measure ($m)

2012-13	2013-14	2014-15	2015-16
0	115	125	130

Source *Explanatory Memorandum, p. 8.*

1.51 In the Explanatory Memorandum, the Government states that compliance costs from the provisions will be nil.[39]

1.52 The International Covenant on Economic Social and Cultural Rights recognises the right to the enjoyment of the highest attainable standard of physical and mental health. The Government argues that the Schedule is consistent with this agreement because it is not reducing the availability or access to medical services. Rather, it is reducing a Government rebate for higher income earners who have a greater capacity to pay and thus the Schedule promotes the health system's sustainability. Therefore, any limitations for certain individuals in accessing the health system are, 'reasonable, necessary and proportionate.'[40]

39 *Explanatory Memorandum,* p. 7.

40 *Explanatory Memorandum,* p. 69.

Schedule 6 – Limited recourse debt

Preventing double deductions

1.53 Limited recourse debt arises where a lender can only seek recourse against a borrower for a limited range of assets or interests. This can occur through the terms of a contract, where the lender expressly limits themselves to what action they can take to seek repayment of a loan. It can also happen as a matter of practicality. An example is where a company is established as a special purpose entity for a project and it is lent money for this purpose. If the project fails before the loan is repaid, the lenders only have recourse to the project's assets, which by then may have little or no value. Either way, limited recourse debt will have higher risk and lenders can charge higher interest rates.

1.54 The limited recourse debt provisions have a number of roles, one of which is to prevent taxpayers obtaining double deductions for projects in certain circumstances. Currently, major companies can create special purpose entities within their group, which receive loans from another wholly owned subsidiary, the 'internal banker'. This company enters international capital markets and borrows funds for it to lend to special purpose entities within the group.[41]

1.55 But if the project fails, then the internal loan is written off because the special purpose entity's only major asset was the project, which by now has little value. Because the practical effect of the arrangement is that the internal banker has limited recourse on the loan, the failure of the project means that the internal banker can now claim the loss as a deduction for a bad debt. However, the special purpose entity has also received deductions for depreciating the project asset.

1.56 The end result is that the parent company can write off the asset twice. Normally, the consolidation provisions in the tax law would mean that transactions between wholly owned subsidiaries would be cancelled out, and the above arrangements would not lead to any particular tax advantage. However, 600 corporate groups in Australia are not fully consolidated and double deductions could be available to them. Further, there is $6 billion to $7 billion of bad debts available annually to the large business market. One of the intentions of the limited recourse debt

41 Internal bankers can be established for legitimate business purposes; Mr Peter Chochula, ATO, *Committee Hansard,* Canberra, 30 January 2013, p. 7.

provisions is to prevent the creation of a bad debt deduction when an asset is already being depreciated.[42]

Current definition of a limited recourse loan

1.57 The issue that the Bill addresses is the definition of limited recourse debt. Section 243-20 defines a limited recourse debt in three main ways:

- where an obligation to pay an amount by law is limited to certain legal rights;
- where an obligation to pay an amount by law is 'capable of being limited' to certain legal rights;
- where there is no debt property, but the obligation to pay an amount is nevertheless 'capable of being limited' to certain legal rights.

The BHP Billiton case

1.58 The case covered BHP Billiton's iron briquette plant in Western Australia. A wholly owned subsidiary, BHP Billiton Direct Reduced Iron, was created for the project and it was funded by two wholly owned subsidiaries within the BHP Billiton Group: a loan from BHP Billiton Finance and equity from BHP Minerals Holdings. The BHP Billiton board approved the project in 1995, but it was subject to cost overruns and received additional equity and loans from Holdings and Finance. In 2000, the directors of Finance wrote off the balance of the loan, some $1.8 billion, out of original loan amounts of $2.7 billion on the basis of a report by Ernst & Young. The project continued until 2004 with share capital only.[43] It was then terminated after an explosion at the plant.

1.59 BHP Billiton sought both bad debt and capital allowance deductions in relation to the project. The ATO applied Division 243 to reduce the capital allowance deductions between 2001 and 2006 by over $1 billion. The ATO also sought to use the provisions to increase the assessable income of Reduced Iron for 2000 by $381 million.[44]

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42 Mr Peter Chochula, ATO, *Committee Hansard,* Canberra, 30 January 2013, p. 3.

43 French CJ, Heydon, Crennan and Bell JJ, *Federal Commissioner of Taxation v BHP Billiton,* [2011] HCA 17, pars 3-15.

44 Gummow J, *Federal Commissioner of Taxation v BHP Billiton,* [2011] HCA 17, par. 78; ATO, 'Decision Impact Statement: Commissioner of Taxation v BHP Billiton Finance Limited; Commissioner of Taxation v BHP Billiton Limited,' <http://law.ato.gov.au/atolaw/view.htm?DocID=LIT/ICD/M117-M125of2010/00001> viewed 10 December 2012.

1.60 The role of Finance was crucial in that it created the deduction for a bad debt. Edmonds J in the Federal Court found that it operated as a lending business and was not a sham. This was because the loans were made in the ordinary course of Finance's business. Comparisons with how a major bank would operate were not relevant. This was despite the fact that:

- Finance did not have its own staff, but paid management fees for the services of BHP Billiton;
- In July 1999, BHP Billiton provided a guarantee to Reduced Iron to pay its debts, excluding those owed to Finance;
- Finance decided to write off the bad debt on the basis of the Ernst & Young report without issuing a demand for payment to Reduced Iron.[45]

1.61 When the case reached the High Court, the main issue was the meaning of subsection 243-20(2) of the *Income Tax Assessment Act 1997*, in particular that the rights of the creditor 'are capable of being limited in the way mentioned in subsection (1).' The ATO argued that subsection (2) focussed on whether there is 'a practical capacity or ability to bring about legal limitations on legal rights irrespective of whether there is any arrangement to which the debtor is a party.' In other words, the words 'capable of' had the same meaning as 'susceptible to'. Although any contract could be varied in theory, the ATO argued that it was applying the stricter test of whether an arrangement was 'practically or commercially susceptible' to being varied.

1.62 In its decision in June 2011, the High Court did not accept this argument and placed a higher standard again for arrangements to be 'capable of being limited.' It stated that there must exist at the start of the loan some power by which the debtor could limit their liability, although that power need not exist in an enforceable arrangement. Although Finance and Reduced Iron were part of a corporate group, the High Court accepted that Finance was not a sham and it operated at arm's length from the other BHP Billiton companies to which it lent. Therefore, by the High Court's interpretation of Division 243-20, the amounts were not a limited recourse debt.[46]

1.63 The facts in this case occurred before the introduction of the current consolidation provisions, which would limit the scope to which creating a

45 ATO, 'Decision Impact Statement: Commissioner of Taxation v BHP Billiton Finance Limited; Commissioner of Taxation v BHP Billiton Limited,' <http://law.ato.gov.au/atolaw/view.htm?DocID=LIT/ICD/M117-M125of2010/00001> viewed 10 December 2012.

46 French CJ, Heydon, Crennan and Bell JJ, *Federal Commissioner of Taxation v BHP Billiton,* [2011] HCA 17, pars 41-65.

wholly owned, special purpose entity can be used to create additional deductions. However, where a corporate group has wholly owned subsidiaries overseas, then the consolidation rules may not apply and the device may be available. The decision has significant revenue implications, given the sums involved in this one case and the fact that this is a routine method for large companies to finance projects.

1.64 In its listing of decision impacts statements, the ATO categorised this decision as 'current,' rather than ,'resolved,' indicating that it was considering further action on the matter. A prominent law firm recognised this may be the case:

> The decision clearly places a significant limitation of the scope of the limited recourse debt rules and other taxation provisions that utilise this concept. It remains to be seen whether the ATO will seek to have the provision re-drafted to express the ATO's view of the scope of the provision.[47]

Developing the new provisions

1.65 In the 2012 Budget on 8 May, the Government announced that it would amend the definition of limited recourse debt and that the changes would apply from the date of announcement. The key points in the proposal were that deductions would not be available where, 'the taxpayer is not effectively at risk for the expenditure and does not make an economic loss.'[48]

1.66 Treasury issued a discussion paper in July 2012 and an exposure draft in October 2012. Treasury stated that it received two main sets of comments about the proposals, which were not accepted.[49] The first comment was that the provisions are retrospective because they apply to debt already in place on 8 May 2012. Treasury's response was that the announcement reflected the ongoing policy intent of the provisions.

1.67 The second set of comments about the proposals was that they were too broad and could unintentionally capture other situations. Treasury's response was that the Explanatory Memorandum has been amended to clarify that existing carve-outs continue to operate. The Explanatory Memorandum refers to subsection 243-20(6), which states that an

47 Greenwoods & Freehills, *Tax Brief: Limited Recourse Debt,* 7 July 2011, p. 3.

48 The Hon. Wayne Swan MP, Deputy Prime Minister and Treasurer, *Budget Measures: Budget Paper No. 2, 2012-13,* May 2012, p. 32.

49 The Treasury, *Limited recourse debt – Amended definition: Summary of consultation process,* November 2012, pp. 1-2.

arrangement is not a limited recourse debt under subsection (1), (2) or (3) if, 'having regard to all relevant circumstances, it would be unreasonable for the obligation to be treated as limited recourse debt.' The Explanatory Memorandum notes that, where a debtor is fully at risk with respect to the loan, subsection (6) will override any liability that might technically arise under subsections (1), (2) or (3).[50]

1.68 The new operative provision in paragraph 243-20(2) retains the reference to rights that 'are capable of being limited.' However, it also includes a reference to debts that, 'are in substance or effect limited wholly or predominantly,' to certain rights.

1.69 In the Explanatory Memorandum, the Government states that the amendments protect a 'significant amount of revenue.' Compliance costs and human rights implications are negligible.[51]

Schedule 7 – In-house fringe benefits

Why in-house benefits are treated differently

1.70 The *Fringe Benefits Tax Assessment Act 1986* includes a number of provisions that refer specifically to in-house fringe benefits. These benefits are valued at reduced rates, typically 75 per cent of their retail value. The argument for the concessional treatment is that the value of in-house fringe benefits to the employer is less because it is part of their everyday business. In other words, they are more likely to access these products and services at wholesale rates, rather than retail, and the FBT system recognises this.[52]

1.71 The types of fringe benefits that are valued at reduced rates when they are provided in-house include non-remote housing, property (goods, animals, gas and electricity, land and buildings, and shares or bonds), expense payments (generally reimbursing an employee for an expense they incur), or residual benefits (not included in specific categories in the Act, but includes public transport from home to work).[53] These types of benefits

50 The Hon. Wayne Swan MP, Deputy Prime Minister and Treasurer, *Explanatory Memorandum to the Tax Laws Amendment (2012 Measures No. 6) Bill 2012,* November 2012, p. 76.

51 *Explanatory Memorandum,* pp. 8-9.

52 F. Gilders, J. Taylor, M. Walpole, M. Burton, T. Ciro, *Understanding Taxation Law 2012,* December 2011, LexisNexis, p. 367.

53 F. Gilders, J. Taylor, M. Walpole, M. Burton, T. Ciro, *Understanding Taxation Law 2012,* December 2011, LexisNexis, p. 367.

generally also attract a further $1,000 exemption on the taxable value, regardless of whether they are provided in-house. Therefore, there is usually a two-stage process in calculating the taxable value of these fringe benefits when they are provided in-house: multiplying the retail amount by 75 per cent, and then subtracting $1,000 from this product. Further calculations are then required to determine an individual's fringe benefits tax and these depend on other circumstances, for example whether the individual works in a non-profit organisation.

Incidence of salary sacrificing

1.72 The Explanatory Memorandum states that these exemptions are now subject to large-scale use through salary packaging, or salary sacrificing. This was not the original intent of the provisions:

> The concessions were not intended to allow employees to access goods and services by agreeing to reduce their salary and wages (through salary packaging arrangements) in order to buy goods and services out of pre-tax income.
>
> Since the in-house fringe benefits concessions were included in the FBT law, changes in technology have increased access to salary sacrifice arrangements.
>
> As a result of expansion in the availability of salary sacrifice arrangements, employees are increasingly accessing concessionally taxed fringe benefits under these arrangements and receiving tax-free non-cash remuneration benefits for goods and services.[54]

1.73 The use of salary sacrificing varies greatly across the economy. For November 2011, the ABS reported the following weekly figures for full time adults:

- salary sacrificing is higher in the public sector than the private sector ($105.90 compared with $36.30);
- across the public and private sectors, salary sacrificing is highest in the Australian Capital Territory at $96.90; and

54 *Explanatory Memorandum,* pp. 79-80.

- salary sacrificing is highest in the health care and social assistance industries at $183.[55]

1.74 Salary sacrificing is also concentrated in upper income ranges, in particular amongst managers, administrators, professionals, and associate professionals. ABS data from 2004 are in the table below.

Table 1.7 Salary sacrificing, by occupation group, May 2004

Occupation	**Employees with salary sacrifice (%)**	**Amount salary sacrificed as a % of average weekly earnings**	
		Employees with salary sacrifice	*All employees*
Managers and administrators	26.2	16.8	5.1
Professionals	23.2	18.1	4.6
Associate professionals	14.7	17.8	3.1
Tradespersons and related workers	8.5	9.6	1.0
Advanced clerical and service workers	12.4	13.8	1.9
Intermediate clerical, sales and service workers	8.1	16.8	1.7
Intermediate production and transport workers	7.5	9.4	1.1
Elementary clerical, sales and service workers.	1.8	14.7	0.4
Labourers and related workers	4.9	8.9	0.7
All occupations	**11.9**	**16.2**	**2.7**

Source ABS, Australian Labour Market Statistics, January 2007, Cat. No. 6105, p. 28.

1.75 In 2004, people in these upper income groups salary sacrificed on average over 3 per cent of their average weekly earnings. The statistic for all other employees was less than 2 per cent. The proportion of employees from the elementary clerical, sales and service workers who salary sacrificed was less than 2 per cent, indicating that they have limited access to this tax minimisation strategy.

1.76 There is a number of reasons for this disparity:

- it requires the taxpayer either having knowledge about salary sacrificing or being well-advised about it;

55 ABS, '6302.0.55.002 – Information Paper: Changes to Average Weekly Earnings, Australia, April 2012, <http://www.abs.gov.au/AUSSTATS/abs@.nsf/ProductsbyCatalogue/DD23CEA658FF10D1CA2579DF0014A104?OpenDocument> viewed 13 December 2012.

- employers are not under any obligation to provide salary sacrificing;
- the saving per dollar sacrificed varies with the employee's marginal tax rate (and therefore income); and
- the employee must have discretionary income available to pursue the relevant purchases.[56]

The proposal in the Bill

1.77 Broadly, the Bill removes the concessional tax treatment of in-house fringe benefits accessed through salary packaging. A key provision is the definition of a 'salary packaging arrangement,' which is based on the food and drink provisions in section 41(2) of the *Fringe Benefits Tax Assessment Act 1986.* A salary packaging arrangement exists where the employee receives a benefit:

- in return for a reduction in salary or wages that would not have happened apart from the arrangement; or
- as part of an employee's remuneration package, and it is reasonable to conclude that the employee's salary or wages would be greater if the benefit were not provided.[57]

1.78 The Bill uses the concept of 'notional value' in determining the taxable value of in-house fringe benefits. This is already defined in subsection 136(1) of the Act and means 'the amount that the person could reasonably be expected to have been required to pay to obtain the property or other benefit from the provider under an arm's length transaction.' Amendments along these lines will be made to both in-house property fringe benefits and in-house residual fringe benefits. Expense payment fringe benefits are also covered by implication because they fit within either of the two previous categories.[58]

1.79 The Bill also removes the $1,000 reduction in aggregate taxable value of in-house benefits where they are obtained through a salary packaging arrangement.[59]

1.80 The new provisions apply to all salary packaging arrangements made on or after 22 October 2012. The treatment of pre-existing arrangements will

56 R. Gittins, 'Whopping tax break escapes taxman,' *Sydney Morning Herald,* 5 February 2007, p. 17.

57 *Explanatory Memorandum,* p. 82.

58 *Explanatory Memorandum,* pp. 83-86.

59 *Explanatory Memorandum,* p. 86.

continue as before, until 1 April 2014, unless they are materially altered or varied. All benefits provided on or after 1 April 2014 will be subject to the measure.[60] The FBT year commences on 1 April.

1.81 There are two key definitions for the transitional provisions. An existing salary packaging arrangement means those that were agreed and entered into before 22 October 2012. It is not necessary for the salary to have been reduced or for the benefit to have been provided to meet this criterion. A material alteration or variation of an existing salary packaging arrangement is not defined in the legislation, but will depend on the facts of the arrangement. Changes that are likely to be considered material include those relating to:

- the employer;
- the end date of the arrangement, when fixed; and
- the types of benefits covered.[61]

1.82 The Government's revenue projections from the measure are given in the table below:

Table 1.8 Revenue impacts of fringe benefits measure ($m)

2012-13	**2013-14**	**2014-15**	**2015-16**
15	45	145	155

Source *Explanatory Memorandum, p. 9.*

1.83 In the Explanatory Memorandum, the Government states that compliance costs from the provisions are low. The provisions raise a human rights issue in that they apply from the date of the policy announcement on 22 October 2012, rather than from the date they become law. However, this is not regarded as material because:

- no criminal offences are involved;
- this is a revenue measure and a gap between announcement and commencement of the measure would allow taxpayers to change their arrangements and affect the integrity of the tax system; and
- the legislation is being introduced within a reasonable time after the announcement.[62]

60 *Explanatory Memorandum,* pp. 87, 89.

61 *Explanatory Memorandum,* pp. 87, 89.

62 *Explanatory Memorandum,* pp. 9, 90.

Objectives and scope of the inquiry

1.84 The objective of the inquiry is to investigate the adequacy of the Bills in achieving their policy objectives and, where possible, identify any unintended consequences.

1.85 In its report, the Selection Committee gave the following reasons for referral and principal issues for consideration:

> Implication of policy decisions, in particular: interim streaming rules for managed investment trusts until the commencement of the new tax system for managed investment trusts; income test to the rebate for medical expenses from 1 July 2012; definition of 'limited recourse debt' includes arrangements where, in substance or effect, the debtor is not fully at risk in relation to the debt; removal of the concessional fringe benefits tax treatment for in-house fringe benefits accessed by way of salary packaging arrangements.[63]

Conduct of the inquiry

1.86 Details of the inquiry were placed on the committee's website. On 6 December 2012 the Chair issued a media release announcing the inquiry and seeking submissions.

1.87 17 submissions and a supplementary submission were received, which are listed in Appendix A.

1.88 A public hearing was held in Canberra on Wednesday, 30 January 2013. A list of the witnesses who appeared at the hearing is in Appendix B. The submission and transcript of evidence are available on the committee's website at www.aph.gov.au/economics.htm.

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63 House of Representatives Selection Committee, *Report No. 73: Private Members' business and referral of bills to committees,* 29 November 2012, p. 4.