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Issues in the Bill

Schedule 1 – Native title benefits

2.1 This Schedule has a clearly defined, narrow purpose. It seeks to clarify that payments and other benefits made under native title agreements are not subject to income tax, and that certain transfers of native title to trusts do not attract capital gains tax. This is broadly how the Australian Taxation Office (ATO) has implemented the tax law to date, but the position has been unclear and in a small number of cases Indigenous communities have paid tax because of their particular circumstances. The Schedule is intended to do no more than clarify this uncertainty and facilitate a small number of refunds.

2.2 However, the overwhelming response of witnesses at the hearing was to expand the debate and make wider policy changes to native title. As Native Title Services Victoria observed at the hearing, the policy debate around native title has progressed over the last 20 years.[1] It is only natural that groups involved with and affected by native title would want to improve the way it operates and to help Indigenous communities further benefit from it.

2.3 But these are big questions. A Schedule that clarifies the tax treatment of some native title transactions is not the place in which to consider major policy. These matters can only be addressed through broader consultation, both in terms of who is involved, and the issues that are on the table. Therefore, this report focusses on the Bill.

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

Should the Schedule proceed?

Background

2.4 The main issue debated at the hearing was whether the Schedule should proceed in its current form. Opinions during the inquiry fell into three categories.[2] Indigenous organisations generally supported the Schedule because it would clarify the relevant income tax and capital gains tax issues. However, they wanted to increase its scope in a range of ways including through the addition of a tax-exempt vehicle, such as an Indigenous Community Development Corporation, broadening scope by amending some definitions, or making investment income generated from native title payments tax exempt.

2.5 The second category was mining groups. These also wanted the inclusion of a tax-exempt vehicle, but thought that the Schedule should not proceed if was not amended. They were especially concerned that the Bill could encourage substantial up front payments to individuals at the expense of longer term, inter-generational goals.

2.6 The final group comprised the Government of Western Australia. It stated that a tax exemption specific to native title was not warranted, outside the normal provisions for charitable trusts. In its view, the Bill should not proceed in any form. The committee does not regard this view as tenable and discusses it further below.

2.7 The idea that investment income using money that has attracted the tax exemption should also be tax exempt was commonly made in submissions.[3] The argument is that, if native title is meant to assist Indigenous communities over generations, then the tax exemption should also apply over this time period:

> Following extinguishment and settlement, the 'asset' is a pool of funds and other non-monetary benefits which are notionally expected to be enjoyed by many future generations of native title holders. It is arguable that the value of native title rights and interests may increase over time. Moreover, the opportunity to invest native title payments will benefit future generations whose native title rights have been lost.
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> … there are strong policy arguments in favour of extending the income tax exemption to income derived from investing native title benefits. This will encourage native title holders to invest and build upon their asset. It also goes to the original intent of the

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2 Various witnesses and organisations, *Committee Hansard,* Canberra, 30 January 2013, pp. 24-25.

3 For example, Ms Fiona Martin, *Submission 1,* p. 5; NNTC, *Submission 12,* pp. 4-5.

> native title system which was to recognise native title as an intergenerational asset to be enjoyed by present and future generations of native title holders.[4]

2.8 Native Title Services Victoria (NTSV) suggested a variation on this. Its proposal was that investment income should be tax exempt up to the point that it has covered the effects of inflation and population growth among Indigenous people. For example, say the typical range of inflation is up to 3.5 per cent annually and Indigenous population growth is approximately 2.5 per cent annually. Then the first 6 per cent of investment income each year would also be NANE income, with the base being reduced if a distribution is made. NTSV argue that this approach is used in related areas, such as:

- fringe benefits tax, where some thresholds are adjusted for inflation;
- the mineral resources rent tax has an uplift factor to take inflation into account; and
- personal injury settlements, where an annuity will be tax exempt, even if it increases in line with inflation.[5]

2.9 The Minerals Council of Australia and the Chamber of Minerals and Energy of Western Australia argued in favour of establishing Indigenous community development corporations as the vehicle through which Indigenous communities receive a tax benefit for their agreements with mining companies and other project proponents.[6] These corporations were included in the Government's 2010 consultation paper, but are not included in the Schedule. The key points of the corporations would be:

- only the corporations would receive the tax exemption, and only when they applied the funds for community and economic development;
- payments to individuals would not be tax exempt, in line with native title's unique, communal nature;
- the corporations would overcome the weaknesses of charitable trusts, which cannot focus on Indigenous development and do not allow for the accumulation of wealth over generations; and
- the formal structure of the corporations would be an opportunity to apply good governance requirements.[7]

4 Law Council of Australia, *Submission 13,* pp. 5-6.
5 NTSV, *Submission 7,* pp. 3-5.
6 CME, *Submission 5,* p. 4; MCA, *Submission 9,* p. 7.
7 MCA, *Submission 9,* pp. 5-8.

2.10 The Council was especially concerned that individual payments can have a divisive effect on Indigenous communities and saw the corporations as a way of avoiding this. It stated:

> One of the lessons learnt over the last 20 years has been the divisive effect in Indigenous communities of native title benefits being paid directly to individuals. The best known example is the practice of mining companies operating in the Goldfields region of Western Australia during the 1990s of making substantial payments to registered applicants in order to secure grants of tenure, which resulted in multiple overlapping native title claims being made. Where a few individuals can secure control over benefits by virtue of a privileged position in the group, it has a divisive effect on the whole community.[8]

Analysis

2.11 The committee believes that a tax exemption for income and capital gains generated from native title is necessary and appropriate. Native title is derived from Indigenous peoples' cultural and religious relationship with the land that they have enjoyed since before European settlement. Although these rights are external in character to Australia's legal system, legislators none the less have a duty to reconcile the two sets of legal principles, if only because they interact from time to time. Providing a tax exemption under Australian law for income and capital gains closely connected with native title recognises its separate legal character. The committee is in no doubt that the proposals are consistent with native title.

2.12 Another important preliminary matter is whether the provisions will in fact clarify the income tax and capital gains tax implications of native title payments. The ATO commented that this was a complicated area and its experience to date had been in private binding rulings. However, it confirmed that the provisions would have the desired effect:

> My experience to date is that there have been circumstances where, because of the peculiar nature of the arrangement … some of these payments have been treated as being assessable income or generating a CGT liability. Based on the number of private rulings we have given, they are certainly the minority, but they certainly do arise. Those issues would almost certainly be clarified by this legislation such that they would not arise in the future.[9]

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8 MCA, *Submission 9*, pp. 7-8.

9 Mr Robert Puckridge, ATO, *Committee Hansard*, Canberra, 30 January 2013, pp. 20-21.

2.13 Arnold Block Leibler agreed, but from a different perspective. In their view, the ATO has occasionally taken an inconsistent approach to these matters, which would be rectified by the Bill:

> It is absolutely essential that there be new legislation. At present, confusion abounds on the ground. There is inconsistency in tax treatment of payments and of entities. We have some instances where entities are treated as being tax exempt but others that are, for all intents and purposes, exactly the same are treated as not tax exempt … So in fairness to the ATO as much as in fairness to all participating bodies, there needs to be consistency of treatment. That is what is behind the policy intent, as we understand it, of these laws.[10]

2.14 The committee therefore concludes that the Bill will at least achieve its stated goal of clarifying that native title payments will be exempt from income tax and capital gains tax.

2.15 The mining sector was strongly of the view that the Schedule should not proceed because it would have the unintended consequence of encouraging large payments to individuals, which would be contrary to long term development goals:

> I think that the question comes back to the behaviour that you are trying to drive by these tax amendments … If you enacted the legislation or the bill as it is currently, there is no incentive … to have today and tomorrow money. There is a positive incentive to distribute everything immediately. Rio Tinto publicly stated in 2011 that the value of these native title benefits paid out under our agreements in the Pilbara alone was $100 million. That is distributed among five, six or seven agreements, but that is a lot of money to be distributed every year as a straight distribution.[11]

2.16 In order to prevent this outcome, the mining sector has changed the structure of its agreements with Indigenous communities. These days they tend to allow for a small amount of money to be distributed up front, with the majority set aside for longer term goals. BHP Billiton stated in evidence:

> We started off with very simple agreements that created some problems, and one of those problems resulted in the immediate distribution of all of the benefits that were paid. As result of that, the industry in the Pilbara moved to a different regime whereby structures were set up to guarantee the intergenerational

10 Mr Peter Seidel, ABL, *Committee Hansard*, Canberra, 30 January 2013, p. 24.

11 Miss Catherine Crompton, Rio Tinto, *Committee Hansard*, Canberra, 30 January 2013, p. 21.

> improvement that is the government policy and is something that industry is supporting. But we are now in the third era, because there is a recognition within industry that Aboriginal people want the ability to make decisions, and those decisions include the ability to set aside a proportion of funds for the intergenerational benefits but also to set aside a proportion of funds for immediate needs, and the tax regime at the moment is set up in such a way that there is full tax exemption for charitable trusts but you do not always get the full tax exemption where there is a discretionary trust.[12]

2.17 The Yamatji Marlpa Aboriginal Corporation gave the perspective of the other side of negotiating table and confirmed that mining companies have been driving these outcomes in native title negotiations:

> … mining companies have a lot to say in the Pilbara about how they want benefits to be spent and preserved and looked after. Part of the negotiation process is for those things to be reflected in agreements, which the traditional owners have accepted and taken on board. So those sorts of arrangements already exist to ensure that benefits will last into the future.[13]

2.18 Other witnesses confirmed that the general approach in agreements is that payments to individuals are small and usually only made when the recipient needs them.[14]

2.19 On the basis of this evidence, the committee is of the view that the negative outcome from the Bill envisaged by the mining sector is unlikely to eventuate. This is because native title agreements are now structured to prevent it occurring, and this feature of the contracts has been largely driven by the mining companies themselves, and because the schedule seeks to broadly put into law the current tax treatment of native title, not change it.

2.20 Since the Schedule is dealing with the income tax and capital gains tax implications of native title payments, the committee believed it would be appropriate to raise the associated issue of whether investment income derived from them should also receive concessional tax treatment. Treasury stated in evidence that this would not be appropriate because the concessional tax treatment would continue in perpetuity. What is proposed does not apply in other areas of the tax law:

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12 Mr Mark Donovan, BHP Billiton, *Committee Hansard,* Canberra, 30 January 2013, p. 22.

13 Mr Michael Meegan, YMAC, *Committee Hansard,* Canberra, 30 January 2013, p. 24.

14 Ms Fiona Martin, UNSW, *Committee Hansard,* Canberra, 30 January 2013, p. 27; Ms Melanie Stutsel, MCA, *Committee Hansard,* Canberra, 30 January 2013, p. 27.

> I think the issue here is that if anybody receives a payment and it is tax free, when they go and invest that payment they earn income from that payment. So the fact that the lump sum you got to begin with was tax free is pretty well irrelevant to the income that is actually earned from the investment of that payment because there is further income earned there … Otherwise you could keep extending that on and say that no-one ever pays tax in relation to income that has been earned from a native title payment that originally was non-assessable, exempt income …
>
> … it is similar to when you get a compensation payment and go away. If the reason you got that compensation payment was, say, for personal injury and you invest it then that earns income. The fact that it was a compensation payment for personal injury does not keep tagging along on the income that is earned from the actual payment.[15]

2.21 The committee acknowledges that the proposal for an Indigenous Community Development Corporation had support at the hearing. However, this proposal is outside the scope of the Bill and the committee leaves it for future debate.

2.22 The Committee's brief is to enquire into the legislation before it. Native title is relatively new – just 20 years old – and much of the last twenty years has been spent in proving title. Communities are moving to a phase of trying to unlock its economic potential and many of the issues raised relate to larger policy issues. These include the nature of native title once transferred to another economic form, and the mechanisms that should be available to indigenous communities to unlock the economic potential for the benefit of future generations. The larger issues of native title including the pathways for indigenous communities to grow in strength, confidence and skill in the management of their native title rights are complex ones. They are a matter of policy and should be the subject of extensive consultation with indigenous communities.

2.23 Therefore the committee declines to comment extensively on the submissions requesting an expansion of the Bill's range. However, the committee will say that the evidence given indicates that there is work to be done in finding agreement on what is an appropriate legal framework that recognises native title once transferred through a compensation payment to a monetary form. There is also work to be done on the range of mechanisms that indigenous communities seek to use to unlock its

15 Mr Paul McMahon, Treasury, *Committee Hansard,* Canberra, 30 January 2013, p. 26.

economic potential for the benefit of their community now and in the future.

Conclusion

2.24 The purpose of Schedule 1 is to amend the tax law so that it largely reflects the way that the ATO has been applying the law in relation to native title. It brings certainty to a group of native title holders who would most likely have been assessed as tax exempt by the ATO. Others will have to continue to negotiatate with the ATO on a case by case basis as they do now.

2.25 The Schedule should proceed because the provisions will give Indigenous communities the clarity they need over the tax treatment of payments under native title agreements. The beneficial tax treatment is an appropriate recognition of native title and the committee does not support the position of the Government of Western Australia to 'normalise' taxes in this area.

2.26 The mining sector did express concerns that the Schedule will result in short term payments to individuals to the detriment of long term goals. However, this is unlikely to occur because the mining companies themselves have been driving longer term results in the agreements and the negotiations. Extending the proposal in the Schedule, through making investment income tax exempt, is not warranted. This is because it would create an open ended tax concession that would soon lose connection with the native title interests that initially generated it.

Definition of native title benefits

Background

2.27 Another theme in submissions, particularly from Indigenous groups, was a recommendation that the definition of native title benefits should be broadened. Arnold Bloch Leibler and Yamatji Marlpa Aboriginal Corporation gave the most in-depth coverage of this. They argued that the definition should be broadened to apply to all payments under a native title agreement because:

- the Schedule applies conditions to the definition of a native title benefit, such as requiring the amount or benefit to be connected to extinguishment or impairment of native title, but the Government's press release in June 2012 simply states that the tax exemption applies to 'payments from a native title agreement';

- example 1.8 in the Explanatory Memorandum, which covers the definition of native title benefits, makes no reference to the requirement of an extinguishment or impairment of native title;
- current practice is that native title agreements do not state that payments are being made in return for their effect on native title;
- there is a risk that the ATO will query payments made under ILUAs, well after they are made, as to whether they related to an act affecting native title: 'At best, confusion will abound, and at worst the ATO may assess the payments or amounts as subject to tax (and potentially penalties and interest), with litigation the likely result;'[16] and
- when a court has determined there is no native title, the ATO will investigate in some cases whether an agreement affects native title, which is effectively a 'Kafkaesque inquiry.'[17]

2.28 Fiona Martin from the University of New South Wales made a similar argument, which in essence was that there can be a great deal of uncertainty over native title. ILUAs are typically made so that parties can avoid the protracted process of determining whether native title exists. The Schedule may require Indigenous communities and corporations to obtain additional, costly legal advice on the native title status of a piece of land.[18]

2.29 The hearing discussed the related question of what happens if native title is found not to exist on a piece of land, and whether the legislation should be broadened to cater for this possibility.[19] Ms Martin noted that situations do arise where native title is found to be extinguished after an agreement.[20]

2.30 Ms Martin also commented that many agreements have a commercial dimension and are not necessarily made under the *Native Title Act 1993* or other legislation. This means they would not meet the definition of a native title benefit. Ms Martin recommended that the tax exemption 'should apply to ordinary commercial arrangements.'[21]

2.31 The Minerals Council of Australia and the Chamber of Minerals and Energy of Western Australia also recommended that commercial agreements should be eligible for the tax exemption. Although they did so in the context of other changes to the Schedule, they noted that there is

16 ABL and YMAC, *Submission 4,* pp. 2-5.

17 Mr Peter Seidel, ABL, *Committee Hansard,* Canberra, 30 January 2013, p. 20.

18 Ms Fiona Martin, *Submission 1,* pp. 3-4.

19 Mr Matthew Storey, NTSV, *Committee Hansard,* Canberra, 30 January 2013, p. 31.

20 Ms Fiona Martin, UNSW, *Committee Hansard,* Canberra, 30 January 2013, p. 16.

21 Ms Fiona Martin, *Submission 1,* p. 4.

often ongoing uncertainty around native title in some locations, which means that some agreements would be unnecessarily excluded.[22] Agreements with Indigenous people in regional Australia often take native title into account, even when it is apparently extinguished.[23]

2.32 Connected to this is the position of the Chamber and the Council that the tax exemption should not be compensation for an effect on native title, a view which is shared by the Government of Western Australia.[24] They argue that negotiated benefits cover a range of issues in addition to native title, including land access, community and business development, and employment. Having a tax exemption linked to native title effects could also adversely affect mining access negotiations:

> Importantly, negotiations are greatly assisted by avoiding disputation over the percentage of benefits that are to be attributable as compensation, given the complexity of the issues in assessing how native title has been affected or will be affected and the lack of case law as a guide on quantifying compensation …
>
> … the Government's proposals potentially encourage a narrow legalistic focus on native title compensation in agreement negotiations rather than an approach that prioritises addressing the long term relationship between proponents and Indigenous groups.[25]

Analysis

2.33 At the hearing, Treasury responded to the suggestion that the definition of a native title benefit should be expanded by stating that this would affect the integrity of the measure. Potentially, any agreement where an Indigenous community receives payments from an external party could be tax free:

> … if you start trying to expand beyond payments that are, strictly speaking, for native title to include other sorts of payments, there are integrity concerns around that when you consider: what if there is a payment for services provided which is more like remuneration or contracting or something like that so that the payment goes to the Indigenous community for services provided?

22 CME, *Submission 5,* p. 3.

23 MCA, *Submission 9,* p. 4.

24 CME, *Submission 5,* p. 3; MCA, *Submission 9,* pp. 4-5; Government of Western Australia, *Submission 15,* pp. 4-5.

25 MCA, *Submission 9,* p. 5.

> The treatment should not apply to those types of payments. So you cannot sort of just broadly switch off the notion and say, 'Everything that falls underneath the heads of this agreement is treated as a native title payment.'[26]

2.34 The committee agrees that any commercial payment to an Indigenous community, without a clear link to native title, does not necessarily warrant becoming non-assessable, non-exempt income, particularly without reference to the larger debate on native title. The potential for abusing such a provision is too broad and if it were enacted, the committee would expect that amending legislation would soon be introduced to narrow its scope.

2.35 Government witnesses also responded to the concerns expressed that the tax benefits would not flow to Indigenous communities where it had been found that native title did not exist, contrary to the policy intent. The Department of Families, Housing, Community Services and Indigenous Affairs stated that the provisions were drafted on the basis that an inquiry into the precise effect on native title would not be required for the tax benefit to apply. The Department expressed this as, 'there is a nexus to an act that affects native title, but … there is no requirement for inquiry as to the essential nature of the payments.'[27]

2.36 Treasury made similar comments. It stated that the Office of Parliamentary Counsel has given its formal advice that the provisions will implement the policy intent of allowing the tax benefit to apply, even if native title is subsequently found not to exist. This policy intent is expressed in the Explanatory Memorandum and Treasury expects that the ATO will adopt this approach as well:

> Our clear intention was, as the explanatory memorandum said, to give effect to the government's decision that it should apply in such cases. That would be consistent with the way we understand Indigenous land use agreements are treated under the Native Title Act. We gave those instructions to Parliamentary Counsel. These are the words they came up with. Their advice is that it does give effect to that intention. I accept that it is possible to interpret it in a different way, but where you are confronted with two interpretations that are potentially at odds, the Acts Interpretation Act would require you to prefer the interpretation that gives effect to the legislative intent. I would expect the Taxation Office to take

26 Mr Paul McMahon, Treasury, *Committee Hansard,* Canberra, 30 January 2013, p. 32.

27 Ms Libby Bunyan, FAHCSIA, *Committee Hansard,* Canberra, 30 January 2013, p. 31.

> that view. The legislative intent is clearly stated in the explanatory memorandum.[28]

2.37 The committee is satisfied by this explanation. The Office of Parliametary Counsel are the technical experts in this matter and it is ATO practice to implement the policy intent of the law, which is clearly expressed in the Explanatory Memorandum.

2.38 In relation to the comments of Arnold Bloch Leibler, the committee understands that it may be artificial to determine whether there is a native title effect in an agreement where native title is later found not to exist. However, the committee notes that this broadly correlates with current practice by mining companies. They are prepared to negotiate with Indigenous communities as long as they assume traditional responsibilities, even if native title is later found not to exist:

> What we see right across the Pilbara and the Murchison is native title parties that get a seat at the table by virtue of their status as registered native title claimants—or in some cases even if they are not registered—and mining companies are prepared to negotiate an agreement with them … In many case mining companies are content for those payments to continue even if at some stage in the future—whether it is five or ten years—that a registered native title claimant is unable, because of the vagaries of proof in the Federal Court, to secure its native title, so long as it maintains a claim on traditional responsibilities. Mining companies well understand that, so long as there is a group that claims responsibility for that country, it is sufficient.[29]

2.39 The alternative under a high integrity system is more problematic. If a greater connection to native title was required, then the risk is that, in order for the ATO to assess whether income should be tax free, it will need to formally determine the native title status of land. In other words, the tax system would drive native title litigation. This is clearly undesirable, and hence the approach in the Bill will make the system more workable.

Conclusion

2.40 The proposals to broaden the definition of native title benefit are too broad and would serious affect the integrity of the measure. If the tax exemption applied to any commercial arrangement, the integrity problems would be readily apparent and the provisions would be soon amended. The committee would prefer that the Schedule proceed as proposed. The ATO

28 Mr Gregory Pinder, Treasury, *Committee Hansard,* Canberra, 30 January 2013, p. 32.

29 Mr Michael Meegan, YMAC, *Committee Hansard,* Canberra, 30 January 2013, p. 32.

has stated that the Schedule will give the required clarification in cases where Indigenous communities have paid tax. Future agreements can be structured to take into account the new law.

2.41 Stakeholders were concerned about how the law would operate if native title was found not to exist in particular communities. The Office of Parliamentary Counsel has confirmed that the tax exemption will still apply in these cases, and the ATO will implement this policy intent because it is expressed in the Explanatory Memorandum. Although the legislation has some artificiality in that there must be a native title connection when it may not formally exist, this is useful because it prevents the tax law driving native title litigation.

Definition of an Indigenous holding entity

Background

2.42 Another issue raised in submissions was that the definition of an Indigenous holding entity should be broadened, as should the definition of a distributing body, which comprises part of the definition of an Indigenous holding entity. Unpacking these definitions gives this composite definition of an Indigenous holding entity:

- a trust where the beneficiaries are either distributing bodies or Indigenous persons;
- an Aboriginal Land Council established under the land rights legislation;
- a corporation registered under the Corporations (Aboriginal and Torres Strait Islander) Act 2006 (CATSI);
- any other incorporated body that:
  - ⇒ is established by or under provisions of a law of the Commonwealth or of a State or Territory that relate to Aboriginals; and
  - ⇒ is empowered or required (whether under that law or otherwise) to pay moneys received by the body to Aboriginals or to apply such moneys for the benefit of Aboriginals, either directly or indirectly.

2.43 The policy intent behind the Schedule appears to be to confine the tax benefits to Indigenous persons. However, the comments in submissions are to the effect that it is unnecessary and would lead to impractical results.[30] Specific comments were:

30 LCA, *Submission 13,* p. 5.

- CATSI bodies have members, rather than shareholders, so cannot raise capital and are not well suited to business enterprises, compared with bodies created under the corporations law;[31]
- long standing Indigenous corporations incorporated under prior legislation will not be included, such as companies limited by guarantee, or trusts with a charitable unincorporated association or trust as a beneficiary;[32]
- many Indigenous organisations do not want to incorporate under laws that specifically relate to Indigenous persons, such as the CATSI Act;[33]
- a trust that has a general power to appoint additional beneficiaries will not be included, so all trusts would need to review and possibly amend their trust deeds, or new entities might be required;[34] and
- some Indigenous bodies provide community infrastructure that also services a small proportion of non-Indigenous clients, such as remote area health services, and these would be excluded under the Schedule.[35]

2.44 The committee received two specific suggestions. The Law Council of Australia recommended that bodies established under the corporations law could be included if they were subject to the same limitation as applies to trusts in paragraph 59-50(6)(b), that is 'if the beneficiaries of the trust can only be Indigenous persons or distributing bodies.'[36]

2.45 Ms Fiona Martin from the University of New South Wales recommended that the definition of a distributing body be expanded to include:

> - an association, society or body incorporated under Part IV of the *Aboriginal Councils and Associations Act 1976;* and
> - any other incorporated body that is empowered or required (whether under that law or otherwise) to pay moneys received by the body to Aboriginals or to apply such moneys for the benefit of Aboriginals, either directly or indirectly.[37]

Analysis

2.46 The committee put these arguments to the Government witnesses at the hearing. The ATO commented that the provisions were drafted so as to protect the integrity of the exemption, or in other words, to ensure that

31 Ms Fiona Martin, *Submission 1,* p. 4.

32 Ms Fiona Martin, *Submission 1,* p. 4; ABL and YMAC, *Submission 4,* p. 6; NNTC, *Submission 12,* p. 4.

33 ABL and YMAC, *Submission 4,* p. 6

34 ABL and YMAC, *Submission 4,* pp. 5-6.

35 NNTC, *Submission 12,* p. 3.

36 LCA, *Submission 13,* p. 5.

37 Ms Fiona Martin, *Submission 1,* p. 5.

only Indigenous people could claim NANE status from native title payments. The broader the definition of Indigenous holding entity, the greater the risk that non-Indigenous people could enjoy the concessional tax treatment:

> … as a general statement, the broader it is and the more difficult it is to relate it back to a particular native title claim or, in some cases, simply to an application or an agreement, the more difficult it will be for us to ensure that there is any integrity in the system. This happens all the time. Just to make a general comment: when you have an exempt system, the broader the definition of the exemption the more likely it is to lead to unforeseen consequences … We would say that our preference is to have a targeted exemption …[38]

2.47 The committee supports this approach. It would generally prefer that a tight regime be introduced, rather than a regime that is too loose that then needs to be tightened. The exception to this approach is where any specific unintended consequences are apparent.

2.48 One such possible adverse consequence was the comment by the National Native Title Council relating to community infrastructure, such as regional health services. These facilities also service a small proportion of non-Indigenous people and the Council queried whether this meant that they would be excluded under the Bill. The committee put this to Treasury, who responded that incidental benefits to non-Indigenous people would not be caught by the provisions:

> … I do not think it would stop the payment that was being spent in this way from being a native title benefit. It would be impractical to try and eliminate all cases where there was some incidental benefit to non-Indigenous people. If a sporting facility, a park or anything of that nature were built out of those funds, I do not think the legislation would exclude that from being a native title payment; and, therefore, it should still get the non-assessable non-exempt treatment. It might be different if someone started paying somebody's bills directly.[39]

2.49 Treasury also responded to the concern that trusts that have a power to appoint additional beneficiaries would have to amend their trust deeds to ensure that they are within the definition of an Indigenous holding entity. Treasury acknowledged that the deeds may have to be amended, but suggested the best way of doing this would be to remove the power of

38 Mr Robert Puckridge, ATO, *Committee Hansard,* Canberra, 30 January 2013, p. 26.

39 Mr Paul McMahon, Treasury, *Committee Hansard,* Canberra, 30 January 2013, p. 27.

appointment. Instead, trusts could provide for future generations to automatically become beneficiaries of the trust from the day they are born.[40]

Conclusion

2.50 The committee is satisfied with the approach of having a targeted exemption through the proposed definition of an Indigenous holding entity. This will protect the integrity of exemption and ensure it is confined to Indigenous people. Some Indigenous organisations may have to change the formalities of their arrangements, but these compliance costs are reasonable, given the long run benefits these groups will receive from having their native title income classified as NANE.

2.51 The committee was able to obtain clarification at the hearing about Indigenous organisations that provide community infrastructure, such as health services, and where non-Indigenous people are able to gain an incidental benefit from them. The Schedule will not exclude those organisations from being an Indigenous holding entity, as long as the benefit to non-Indigenous persons remains incidental.

Retrospectivity

Background

2.52 The Bill backdates the exemption to 1 July 2008 and makes consequential amendments to allow taxpayers to have their assessments amended for this purpose. The Law Council of Australia recommended that the exemption instead be backdated to the commencement of the *Native Title Act 1993.* Its argument is as follows:

> The Law Council acknowledges that this may result in some challenges associated with retrospective tax refunds over a significant period of time. However, the Bill represents a clear acknowledgment that taxing native title benefits may be inimical to the purpose for which the payments have been made. It is also acknowledged in the draft Explanatory Materials that 'benefits provided in respect of native title do not result in a net gain to the recipient'.[41]

2.53 The opposite view was put by the Government of Western Australia, in that it would now have to incur additional costs because of

40 Mr Paul McMahon, Treasury, *Committee Hansard,* Canberra, 30 January 2013, p. 33.

41 LCA, *Submission 13,* p. 7.

retrospectivity.[42] However, it did not elaborate why these costs would be incurred, or how much they were.

2.54 The Minerals Council of Australia provided a different perspective again on retrospectivity. It thought that this would impose additional obligations on the Government, including:

- substantial tax refunds to individuals and organisations that received native title payments;
- establishing a clear and transparent process for making claims and calculating refunds; and
- allocating resources to the ATO and the courts to resolve any disputes that may arise.[43]

Analysis

2.55 At the hearing the committee asked Treasury why 1 July 2008 was chosen as the date for retrospectivity. Treasury responded that it was unlikely that anyone had paid tax relevant to the Schedule before that date.[44] Therefore, although a retrospectivity date back to 1993 may be attractive in theory, in practice a retrospectivity date of 2008 is all that is required.

2.56 The committee also questioned whether the ATO would be involved in additional compliance activity following the legislation. The ATO stated that it was 'very unlikely' that it would revisit previous agreements with a view to obtaining more revenue, unless important new information came to light.[45]

2.57 On the basis of this evidence, the committee does not believe that the retrospectivity provisions will lead to the ATO incurring substantial implementation costs, as suggested by the Minerals Council of Australia. The committee's sense of the issue is that the ATO and Treasury have a reasonable idea who is entitled to a refund, commencing with those taxpayers that sought private binding rulings. The ATO also stated that the provisions will greatly clarify the tax liabilities in these matters, and so the committee expects any disputes to be at a minimum.[46]

Conclusion

2.58 The committee supports the retrospectivity of the provisions because it is to the benefit of taxpayers. It has also been calculated with reference to the

42 Government of Western Australia, *Submission 15,* p. 4.

43 MCA, *Submission 9,* p. 9.

44 Mr Paul McMahon, Treasury, *Committee Hansard,* Canberra, 30 January 2013, p. 30.

45 Mr Robert Puckridge, ATO, *Committee Hansard,* Canberra, 30 January 2013, p. 30.

46 Mr Robert Puckridge, ATO, *Committee Hansard,* Canberra, 30 January 2013, p. 21.

most likely point when income tax or capital gains tax has been paid in relation to a native title payment. Given that the ATO already has some knowledge about the taxpayers whom the provisions are likely to benefit, the committee expects that implementation should not be problematic.

Schedule 5 – Rebate for medical expenses

Background[47]

2.59 The committee received one submission on the Schedule. The Australian Medical Association (AMA) expressed concern about the provisions and recommended that the Schedule be removed from the Bill. The AMA's reasoning was that the incidence of illness does not depend on income, and therefore neither should government safety nets:

> Illness does not discriminate between the rich, the poor, the young, the aged or the frail. Previous Governments have designed safety nets to ensure that every Australian who experiences high out-of-pocket medical expenses because of high, and often unexpected, medical needs in a given period, is supported financially through these difficult periods. Safety nets ensure that patients can continue to have affordable access to the care they need to recover and restore their normal, productive lives.
>
> All Australians, regardless of their income, are eligible for the Medicare Benefits Schedule (MBS) and Pharmaceutical Benefits Scheme (PBS) safety nets. The net medical expenses tax offset (NMETO) provides the final safety net for patients, after the MBS and PBS safety nets have been applied. In the policy context, it is incongruous to apply an income test to the NMETO.[48]

2.60 The AMA also sought to differentiate means testing for health insurance and means testing of safety nets for medical expenses. It noted that high income earners already 'make a higher contribution to health care' through the tax system. It also argued that the financial savings to the Government would be modest, and hence not worth pursuing.[49]

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47 Submission evidence only; representatives of the AMA were unavailable to attend the hearing.

48 AMA, *Submission 11*, p. 1.

49 AMA, *Submission 11*, pp. 1-2.

Analysis

2.61 The Government's position is that the Bill is part of an overall drive to improve the sustainability of the health system. Better targeting health expenditure, such as an income test on the offset, is part of this strategy.[50]

2.62 The Government has also argued that the Bill does not infringe any human rights in relation to health in the International Covenant on Economic Social and Cultural Rights. This is because the Bill does not reduce the availability of health care. Instead, it requires those who have a greater capacity to pay to take more responsibility in supporting the health system.[51]

2.63 The committee agrees that the sustainability of the health system should be a high priority and the Schedule should be viewed from that perspective. Reducing government support for medical services for high income earners, who have a greater capacity to pay, is consistent with that goal. There are many instances in Australia where means tests are applied to government benefits and they enjoy broad support.

2.64 The AMA argued that there is a difference between means testing for health insurance and means testing of safety nets for medical expenses incurred. However, the AMA did not elaborate why this was the case and the committee is not aware of any compelling arguments to support this claim.

2.65 Finally, the AMA's argument that the improvement to revenue of the measure is too small to be worth pursuing ignores the practicalities of managing a government budget. Budgets comprise a large number of small programs, as well as a small number of large programs. Budget savings and budget responsibility require the proper management of both the smaller and larger programs. If all smaller programs escape review, then the total cost to the budget can be substantial. A saving of $100 million in one program, potentially replicated across the large number of programs the Government supports, can make a real difference to the budget outcome.

Conclusion

2.66 In the Schedule, the Government is taking a proportionate approach to deliver a budget saving and support the sustainability of the health system. The measure will not affect the availability of health care in Australia, but better target government assistance through means testing, which is widely used across many policy areas. The AMA made a number

50 *Explanatory Memorandum,* p. 58.

51 *Explanatory Memorandum,* p. 69.

of arguments against the Schedule, but they either were not substantiated, or did not withstand scrutiny.

Schedule 6 – Limited recourse debt

2.67 At the hearing, Ashurst Australia supported the Schedule in the sense that it was appropriate to respond to the BHP Billiton case.[52] In other words, Ashurst supported the policy intent. However, it raised a number of other issues, and these are dealt with below.

Breadth of the provisions

Background[53]

2.68 The Property Council of Australia, Ashurst Australia, and the Institute of Chartered Accountants in Australia were all concerned that the provisions potentially had a wider scope than the policy intent. For example, they were concerned that the Bill does not specifically refer to special purpose vehicles and can cover other entities.[54] Ashurst stated in evidence:

> … the tax office's concern is with related party situations. The situation … just outlined is not a related party situation, and it seems to us that a sensible way of resolving this is to confine the scope of these proposed changes to related party situations, which would protect the revenue without introducing this level of uncertainty into the general business community.[55]

2.69 The Institute argued that including an exemption for small business would be consistent with the Government's policy of simplifying the tax system for this sector. It recommended that 'a debt arrangement of $1 million or less be excluded from the definition of "limited recourse debt".'[56]

Analysis

2.70 In the light of the facts in the BHP Billiton case, the stakeholders' proposed that the amendments should be limited to related party transactions. The committee put this proposal to the ATO and Treasury. However, these

52 Mr Paul O'Donnell, Ashurst Australia, *Committee Hansard,* Canberra, 30 January 2013, p. 1.

53 Neither the ICAA nor the PCA attended the hearing. Both organisations stated that their submissions fully represented their views.

54 ICAA, *Submission 8,* p. 3; PCA, *Submission 10,* p. 2.

55 Mr Ian Fullerton, Ashurst Australia, *Committee Hansard,* Canberra, 30 January 2013, p. 6.

56 ICAA, *Submission 8,* p. 3.

witnesses responded that the limited recourse debt provisions in Division 243 have an important role within the tax framework. Further, the definition of 'related party' is complex and inserting such a term in the tax law would not necessarily provide certainty to taxpayers:

> In finance tax there is a great deal of argument about what is or what is not a related party, and there is a lot of detail that you have to go into sometimes in order to see what the real nature of a relationship is. In that particular vein, and particularly because it is a minor clarifying change, we do not really think that it is appropriate to further confine it. All taxpayers should be treated the same, shouldn't they?[57]

> From a policy perspective I want to clarify that Division 243 is not designed to deal with related parties. It is designed for when the equity risk is being shifted through a financing arrangement from the borrower to the lender so that the borrower cannot get the capital allowance deduction, but the lender can get a deduction for credit risk assumed.[58]

2.71 The committee finds these arguments compelling. Although the amendments have been triggered by the BHP Billiton case, the provisions' role in the tax system is more fundamental than dealing with complicated transactions between subsidiaries in a corporate group. Further, the concept of related parties is difficult to legally define and using this term would, of itself, increase uncertainty for taxpayers.

2.72 These arguments also respond to the proposal by the Institute that there should be a small business exemption from the provisions. The evidence from Treasury and the ATO is to the effect that Division 243 has an important role to play in preserving the integrity of the tax system with smaller enterprises as well, and so a small business exemption would not be appropriate.

Conclusion

2.73 The argument that the provisions should be limited to related party transactions appears attractive in the first instance, as did the idea that there should be a small business exemption. However, such limitations would increase complexity and are inappropriate given the role Division 243 has in protecting the integrity of the tax system.

57 Mr Michael Pols, ATO, *Committee Hansard,* Canberra, 30 January 2013, p. 7.

58 Ms Nan Wang, Treasury, *Committee Hansard,* Canberra, 30 January 2013, p. 7.

The meaning of 'predominantly'

Background

2.74 Ashurst Australia suggested that the word 'predominantly' in the new provisions was uncertain. In the examples in the Explanatory Memorandum, the borrowings to purchase the project asset are equal to or greater than 80 per cent of the asset's value. Ashurst queried whether the provision would still be satisfied at lower proportions of borrowing. It recommended that 'predominantly' be more clearly defined in the Bill and the Explanatory Memorandum.[59]

Analysis

2.75 At the hearing, the committee put this to the ATO. Its response was that the use of the word was 'a well-trodden path' and it was a known term.[60] Broadly, 'predominantly' could be described as any proportion above a half:

> The court's interpretation of the word 'predominantly' is largely—and probably more of a rule-of-thumb aspect—51 per cent or more. That is the sense we have within the ATO of the word 'predominantly'. It is not the sole purpose—it does not have to be to that extent—but it is something that is perhaps overwhelming or largely a majority …[61]
>
> The High Court has dealt with this at great length in relation to the general anti-avoidance provision: predominant and dominant being the same kinds of expressions and having the same kind of context.[62]

Conclusion

2.76 The committee is satisfied that 'predominantly' is well known and represents any proportion above a half.

Safe harbour

Background

2.77 Safe harbour was an issue for stakeholders. In the consultations for the Bill, and in the Explanatory Memorandum, the Government states that any risk of unintended consequences through more broadly defining

59 Ashurst Australia, *Submission 3,* p. 2.

60 Mr Peter Chocula, ATO, *Committee Hansard,* Canberra, 30 January 2013, p. 6.

61 Mr Peter Chocula, ATO, *Committee Hansard,* Canberra, 30 January 2013, p. 6.

62 Mr Michael Pols, ATO, *Committee Hansard,* Canberra, 30 January 2013, p. 6.

limited recourse debt will be covered by subsection 243-20(6).[63] This provides that an arrangement will not be considered as limited recourse debt if, 'having regard to all the relevant circumstances, it would be unreasonable for the obligation to be treated as limited recourse debt.'

2.78 The Property Council of Australia made a specific suggestion for a safe harbour. It recommended that a safe harbour apply where:

- the assets (of the entity) that lead to the creation of the capital allowance deductions represent less than 50 per cent of the entity's total assets; or
- loans are not limited recourse debt by the terms of the contract (and therefore escape subsection 230-20(1); and
  - ⇒ the entity's liabilities are less than 75 per cent of assets; or
  - ⇒ gearing is more than 75 per cent, but the lender has recourse to all the entity's assets and the loan is on arms' length terms.[64]

2.79 If this proposal is not accepted, then the Council recommended that the Bill be redrafted 'to clarify that the provisions will have no operation where the relevant debt is fully repaid.' The Council is concerned that the provisions may be triggered when the relevant debt has been repaid.[65]

2.80 If the above are not implemented, then the Council recommended that the Explanatory Memorandum be amended to provide further clarity about the operation of subsection 230-20(6). The Institute also took this view and it provided three specific examples in its submission that it believed would not be captured by the Bill. It recommended that these scenarios should be included in the Explanatory Memorandum, along with Treasury's analysis of them, to provide certainty to taxpayers.[66]

Analysis

2.81 The clearest indication for amending the existing protective provision in subsection 230-20(6) would be if it was not operating as intended or had been demonstrated to be problematic. However, the committee received no evidence to this effect. Therefore, the committee does not believe that amendments are necessary.

2.82 The committee is also of the view that it is not necessary to include the Institute's scenarios in the Explanatory Memorandum. This document is not meant to provide detailed advice about tax Bills. Rather, it is designed

63 *Explanatory Memorandum,* p. 76; The Treasury, *Limited recourse debt – Amended definition: Summary of consultation process,* November 2012, p. 2.

64 PCA, *Submission 10,* p. 2.

65 PCA, *Submission 10,* p. 2.

66 ICAA, *Submission 8,* p. 3; PCA, *Submission 10,* p. 2.

to demonstrate the policy intent and give Parliament and the wider community an explanation of the proposals at a more general level.

2.83 If an individual taxpayer wants certainty about interpreting a tax law, then they have the option of applying for a private binding ruling from the ATO. The committee understands that the transactions in this area are very complicated and that the tax outcome can depend on a range of factors. In these circumstances, a private binding ruling is the forum for this detailed analysis. The more general approach in Explanatory Memorandums is designed to explain how a Bill implements the policy intent.

Conclusion

2.84 The committee appreciates that taxpayers may wish to increase certainty in relation to new tax measures. However, the proponents of safe harbour provisions did not explain how the current protections for taxpayers are deficient. The proposal that the Explanatory Memorandum should have specific, detailed examples of how the provisions would work confused the role of the Explanatory Memorandum with private binding rulings. The latter are the proper process for considering the detailed operation of the tax law as it relates to specific and often complex fact scenarios.

Retrospectivity

Background

2.85 The legislation will apply to debts that terminate on or after 7.30 pm on 8 May 2012. Ashurst and the Council expressed the concern that debts that were created before this time, on the basis that they were not limited recourse debts, may now become so. This creates uncertainty for business.[67] Ashurst stated in evidence:

> … I think that the courts have suggested that you actually have to go back to the time when the loan is made in order to characterise whether or not it is limited recourse debt … So it is probably not technically true to suggest, at least in our view, that, if a termination occurs after the announcement last year, it only has effect—basically you are asking the taxpayer to effectively recharacterise something that he had no knowledge of at the time the loan was made, which admittedly gives rise to tax consequences after the announcement but which involves a recharacterisation of legal relationships that were in place before

67 Ashurst Australia, *Submission 3*, p. 3; PCA, *Submission 10*, p. 7.

> the announcement was made. That was the sense in which we thought it was retrospective.[68]

2.86 Ashurst also noted that taxpayers with similar circumstances could have very different tax outcomes. For example, assume two different companies that borrow in 2005 and their arrangements meet the new definition of limited recourse debt, but not the old definition. One loan goes bad on 7 May 2012 and the other goes bad on 9 May 2012. The company with the second loan may have its assessable income increased under the legislation, without the opportunity to restructure its affairs, whereas the other company does not face the same risk.[69]

2.87 The Council recommended that the new definition of limited recourse debt should not apply to arrangements that commenced before 8 May 2012. If this is not implemented, then the Council recommends that entities with arrangements that will now be classified as limited recourse debt be given the opportunity to restructure their affairs in a tax effective manner.[70]

Analysis

2.88 The committee received two opposing views on retrospectivity at the hearing and what effect this had on taxpayers. The ATO stated that the policy intent and the expectation among taxpayers was always that Division 243 applied to special purpose entities:

> … it was discussed when the provision was enacted whether it did apply to single purpose entities. There was a general expectation that it did apply to single purpose entities, and that is evidenced by some of the statements that were made by externals on their own websites. There are examples that the ATO retains in relation to an explanation by one law firm that they expected that the provision when enacted would apply to single purpose entities. There were some submissions provided and there was no change made to the legislation to carve out single purpose entities. On that basis, we had a sense always and until the High Court provided its decision that it did apply to single purpose entities.[71]

2.89 However, Ashurst Australia argued that the courts' interpretation has technically applied since Division 243 was first enacted. Therefore, the Schedule is changing the law:

68 Mr Ian Fullerton, Ashurst Australia, *Committee Hansard,* Canberra, 30 January 2013, p. 3.

69 Ashurst Australia, *Submission 3,* p. 3.

70 PCA, *Submission 10,* p. 7.

71 Mr Peter Chocula, ATO, *Committee Hansard,* Canberra, 30 January 2013, p. 8.

> … I agree that we can actually have our own views, but it is really what the High Court thought and, to put it mildly, opened, when you read the legislation. With all due respect to the High Court, it is obvious that they make the law. Regardless of what people other than parliament might have said at the time the legislation was enacted, it looks as though this is a change of law, and it does seem to have consequences if you are making a lending decision in a project finance context.[72]

2.90 The committee appreciates Ashurst's argument, but it does not reflect the practicalities of administering the tax system. If the Government of the day announces that a law will have a particular effect and there is some level of consensus that it will do so, then the committee would expect the ATO to administer the law on this basis. Individual taxpayers can interpret tax law differently and pursue this in the courts, but if the consensus is in line with the policy intent, then the great majority of investment decisions will be consistent with this and legislative correction will have a minimal effect.

2.91 The committee does not find persuasive Ashurst's example about taxpayers being treated differently, depending on the date when a debt went bad. The taxpayer whose debt goes bad between the decision of the High Court in the BHP Billiton case and the Budget announcement is in fact receiving a windfall gain. In other words, the inconsistency in treatment is beneficial for a small group of taxpayers.

Conclusion

2.92 The committee considers that the Bill is prospective from the date of announcement. It is true that it applies from before the Royal Assent, however this is common for integrity changes.

Schedule 7 – In-house fringe benefits

Reasons for the reforms

Background

2.93 Ernst & Young recommended that Schedule 7 should not proceed because it does not have sound underlying reasons. In particular, it stated that the ultimate revenue gain of $190 million annually is small in terms of total tax receipts. It also suggested that the policy objectives of the reform are

72 Mr Paul O'Donnell, Ashurst Australia, *Committee Hansard,* Canberra, 30 January 2013, p. 8.

not clear.[73] Ernst & Young argued that there is nothing in the original legislation that suggests that there is meant to be a limit to salary sacrificing. They also argued that there are other options available in limiting salary sacrificing that would protect more revenue:

> … in reviewing the [Act] and the supporting Explanatory Memorandum ('EM'), there is nothing to indicate that the intention of the legislation is anything other than how it is worded, which is to allow employers to provide the same products or services to their employees that they ordinarily provide to the public, at a concessional valuation …
>
> There is nothing in the Act or the EM that indicates the intent of the legislation is not to allow employees to access these benefits by way of a salary sacrifice arrangement. Additionally it is noted that the proposed measures in the Bill are not intended to stop salary sacrifice benefits generally, nor does there appear to be any public policy to do so, as salary sacrifice arrangements are still widely available for a range of other benefits where the potential revenue gain would be significantly greater than that which is proposed under these measures.[74]

2.94 Ernst & Young also raised equity concerns about the Schedule, in that the effects of the Schedule would be felt more by lower income workers:

> I think it is fair to say that the group of people that this is likely to impact is significantly different from recent budget changes. If we go back to the budgets last year and in recent history, there have been a number of changes designed to isolate what are considered to be executive perks, if you like … But this measure will have a very different impact because it will largely impact a blue-collar work base. Even though it might only be $1,000 worth of tax concessions, it is a concession that is considered a very important one to those people who will be affected.[75]

2.95 Ernst & Young extended this argument to low income employees in other industries, such as retail.[76]

2.96 If the provisions nevertheless proceed, Ernst & Young recommended that limits be placed on salary sacrificing in-house fringe benefits that will not affect low to middle income earners. Examples are a cap on the amount of in-house fringe benefits that are concessionally taxed, and an income limit

73 Ernst & Young, *Submission 14,* pp. 3-4.

74 Ernst & Young, *Submission 14,* p. 3.

75 Mr Paul Ellis, Ernst & Young, *Committee Hansard,* Canberra, 30 January 2013, p. 10.

76 Mr Paul Ellis, Ernst & Young, *Committee Hansard,* Canberra, 30 January 2013, p. 11.

so that the concession is only available to individuals whose annual earnings are below a certain amount. Ernst & Young state that both approaches are used for employee share schemes:

- there is a $5,000 limit on salary sacrificing shares offered under a tax deferral scheme; and
- a $1,000 reduction is available for taxed up front schemes for individuals who earn less than $180,000 annually.[77]

Analysis

2.97 At the hearing, Treasury responded to these claims by stating that the reduced rates of tax for in-house fringe benefits was initially designed to benefit employers, on whom fringe benefits tax is levied, rather than employees. However, as time has progressed, the tax advantages of in-house benefits has meant that more employees are taking advantage of them, and they are now seen as a benefit for employees, contrary to their original purpose:

> The policy behind this change was to ensure that the tax concession that is provided in the fringe benefits tax law actually benefits the employer. It just so happens over time employees have moved into more and more salary sacrifice arrangements and through the interaction between the income tax system and the fringe benefits tax system employees are now getting an income tax advantage by salary sacrificing which is different to what the intention of the original provisions was, that the concessional treatment there was for the benefit of the employer in terms of recognising what the costs of providing those benefits were. So it becomes a matter of should the concessional treatment be available for the employer or should the tax system be subsidising some employees who have the ability to salary sacrifice in-house benefits?[78]

2.98 In this comment, Treasury has also touched on one of the less attractive features of salary sacrificing, namely that the ability to take advantage of it varies widely across employees. Higher income earners have higher marginal rates of tax and so make greater savings for each dollar they can salary sacrifice. Further, an employee is only able to salary sacrifice if their employer offers it. At the hearing, Ernst & Young suggested that salary sacrificing had become an important feature of remuneration packages in

77 Ernst & Young, *Submission 14,* p. 4.

78 Ms Raylee O'Neill, Treasury, *Committee Hansard,* Canberra, 30 January 2013, p. 14.

the electricity sector.[79] However, there is no reason why employees in particular parts of the private sector, such as retail, electricity, or private education, should have the additional advantage of concessionally taxed in-house fringe benefits, while other sectors do not.

2.99 Ernst & Young's argument that the amounts involved are small compared with the total Budget were dealt with in relation to Schedule 5, the medical expenses rebate. In short, the argument ignores the reality of public sector budgeting, where all programs must withstand scrutiny. If budget savings are not made because an individual program is small, then this argument could be applied to other small programs, which would mean that a substantial proportion of public expenditure would be exempt from review.

Conclusion

2.100 Concessionally taxing in-house fringe benefits was a theoretically-based refinement to the tax, introduced at its inception. It was designed to benefit employers, on whom the tax is levied, in recognition of the fact that it costs them less to provide in-house fringe benefits. Over time, the in-house provisions have had unintended consequences because they have evolved into a benefit for employees that has no policy basis. Therefore, there are good policy reasons for the amendments.

2.101 Although the argument was made that amending the in-house provisions would be inequitable because they adversely affect lower income earners in some specific sectors, overall, the beneficiaries of salary sacrificing tend to be higher income earners. Whether of benefit to higher or lower income earners, the in-house provisions are of themselves already inequitable because they are only available in certain industries and with certain employers, without a policy basis.

Transitional rules

Background

2.102 The Schedule introduces some transitional rules so that employees with a salary sacrificing arrangement in place on the announcement date will continue to receive the concessional tax treatment until 1 April 2014. An employee who commences salary sacrificing from the date of announcement, 22 October 2012, will be subject to the new rules. Material variations to an existing arrangement will trigger the new provisions. These include changing employer, the types of benefits covered, and changing the end date of an arrangement, when it is fixed.

79 Mr Paul Ellis, Ernst & Young, *Committee Hansard,* Canberra, 30 January 2013, p. 9.

2.103 In its submission, Ernst & Young recommended that, if the provisions become law, they should commence on 1 April 2014 with no transitional rules. Their reasons were:

- commencing the provisions on 22 October 2012 for new agreements has not given employers sufficient time to consider the impact of the changes on their business;
- the 22 October 2012 start date is part of the way through the FBT year, which may result in inequitable outcomes for some employees, in particular where they salary sacrifice from time to time ('deduct and pay'), rather than through an ongoing arrangement ('accrual');
- the loss in revenue will be marginal ($20 million in 2011-12 and $55 million in 2012-13); and
- compliance costs for business and the ATO will be reduced if they do not have to manage two systems simultaneously.[80]

2.104 Ernst & Young made some further recommendations if these are not adopted. The most important of these was that employee movements within a group of companies will be regarded as a material change of employer and thus trigger the new provisions, when there is no change of employer in substance. They recommended that an exemption apply to material changes when an employee remains within a corporate group.[81]

Analysis

2.105 In discussing the transitional rules, the committee recognises that their role is to facilitate the fair and orderly introduction of the new system, while balancing competing demands. Although stakeholders sought various changes to provisions to their advantage, the rules should be judged on their overall purpose of introducing the new arrangements. Treasury explained the role of transitional arrangements at the hearing:

> It is a trade-off between the certainty of one specific start date and allowing people time to change and to adapt to the new law by having a transitional period. The changes that have been made to the fringe benefits tax over the last few years have generally allowed transitional periods because people are locked into particular contracts and a hard-and-fast state can be quite draconian for a lot of employees if the law changes from a specific date without a transitional period. So by doing this there has been an attempt at a balance between the integrity of the reforms and allowing existing employees time to rearrange their affairs. It is a

80 Ernst & Young, *Submission 14,* pp. 5-6.

81 Ernst & Young, *Submission 14,* p. 7.

> balancing act, basically. The date that has been chosen is seen as sufficient time for existing employees to deal with the changing circumstances.[82]

2.106 Starting the new arrangements for all taxpayers from 1 April 2014 would have two negative effects. Firstly, implementation of the new rules would be delayed. Secondly, taxpayers would start adjusting their behaviour from now until that date to maximise the tax benefits they could generate, such as bringing forward as much salary sacrificing as possible under the current rules. Treasury confirmed the importance of integrity measures in tax law changes at the hearing:

> … if you allowed all employees to start from 1 April 2014, there would be a shift in behaviour from some employees knowing full well that the law would be changing. So it is an integrity measure, which is often a feature of the tax law, that these types of things are implemented from a specific date so that taxpayers know what the law is as of that date rather than allowing a shift in behaviour.[83]

2.107 Participants at the hearing also discussed whether the new laws would unfairly affect taxpayers who salary sacrifice on a 'deduct and pay' basis (ad hoc) compared with those who used an 'accrual' basis (an ongoing contract). For the former group, the new rules will commence when they next attempt to salary sacrifice, whereas for the latter group, the new rules will commence on 1 April 2014, or whenever a taxpayer makes a material variation, whichever occurs earlier. Treasury stated at the hearing that it consulted confidentially on the transitional rules and that it took into account industry concerns:

> There was a comment made about the different types of salary-sacrifice arrangements that are provided by employers, whether on a deduction in pay or an accruals basis, and the complexity that the transitional rules would add to that. We consulted confidentially on this measure specifically around the transitional rules and what the salary-sacrifice arrangements are that are undertaken in relation to in-house benefits. We have tried to reflect the concerns of the sector in what we have put into the legislation.[84]

2.108 The two electricity companies who presented at the hearing, Essential Energy and Endeavour Energy, noted that the former had moved to

82 Ms Raylee O'Neill, Treasury, *Committee Hansard,* Canberra, 30 January 2013, p. 13.
83 Ms Raylee O'Neill, Treasury, *Committee Hansard,* Canberra, 30 January 2013, p. 12.
84 Ms Raylee O'Neill, Treasury, *Committee Hansard,* Canberra, 30 January 2013, p. 13.

deduct and pay and would be implementing the new rules now. However, the latter was still on an accrual basis and its employees would be salary sacrificing their electricity at the concessional rate until 1 April 2014. At first glance, this result is inconsistent. But the purpose of the transitional rules is not to treat substantially similar taxpayers in the same way. The rules are designed to bring taxpayers into the new regime in an orderly manner. If a taxpayer is receiving a concessional benefit that has lost its policy basis, and they are about to enter into an new deduct and pay arrangement, then this is a suitable time for the new rules to commence.

2.109 A similar argument applies to the question where an individual transfers employer within a corporate group. In evidence, Treasury stated that this would be a material variation, including where a public servant transfers between agencies.[85] The purpose of the transitional rules is not to maximise the number of people who can use the current arrangements. Their purpose is to bring over taxpayers to the new system efficiently. If a taxpayer changes employer within a corporate group, then they will make new FBT arrangements, and this will be an appropriate time for the new rules to apply.

2.110 Taxpayers often use the corporate veil to reduce their tax liabilities. In this context, the committee sees no inherent unfairness in the corporate veil triggering the new in-house provisions for fringe benefits tax.

Conclusion

2.111 There were two main concerns expressed about the transitional provisions. The first was that running two systems until 1 April 2014 would impose significant compliance costs and that a single start date of 1 April 2014 would be simpler for all parties. However, taxpayers could accelerate salary sacrificing between the announcement and 1 April 2014, which would affect the integrity of the measure.

2.112 The second sought to show that the provisions would be unfair on some taxpayers. However, this argument was premised on the idea that the current rules should apply to as many taxpayers for as long as possible. The transitional rules are not designed for this purpose. Rather, they are designed to move taxpayers away from the current system, which has lost its policy basis, towards the new system in an orderly manner. If a taxpayer has a convenient opportunity to move to the new system, such as purchasing a new service under a deduct and pay arrangement, then it is appropriate for this to occur.

85 Ms Raylee O'Neill, Treasury, *Committee Hansard*, Canberra, 30 January 2013, p. 11.

Effect on independent schools

Background[86]

2.113 The fringe benefits tax regime provides significant benefits to independent schools in Australia. They are treated as non-profit organisations and so they can reduce their fringe benefits tax liability through a rebate equal to 48 per cent of gross fringe benefits tax payable, subject to a $30,000 cap per employee. This provides a significant tax concession where schools provide tuition for the children of staff. Further, they have up until now received a 25 per cent discount on the taxable value of this tuition through the in-house rules.

2.114 The Independent Schools Council of Australia (ISCA) stated during the inquiry that the Bill would significantly increase cost pressures in independent schools. It analysed the effect of the Bill on a teacher salary sacrificing $15,000 a year in school fees. This analysis is reproduced in the table below:

Table 2.1 Effect on FBT liability for a teacher salary sacrificing $15,000 in school fees ($)

Scenario	Current FBT rules	Proposed FBT rules	FBT difference
No rebate	8,908	13,038	4,130
Rebate applied	4,633	6,708	2,147

Source *ISCA, Submission 6, p. 7.*

2.115 The effect of the rebate for non-profit organisations is shown in the 'proposed FBT rules' column. If the rebate is not applied, or if a staff member has already fully utilised the $30,000 threshold, then the FBT payable is $13,038. Applying the rebate reduces this to $6,708. The current rules on in-house benefits further reduce these liabilities to $8,908 and $4,633 respectively. Exactly how these calculations would work out for individual staff would depend on their particular circumstances, such as how many children they have at the school and the fees involved.

2.116 The Association stated that increased cost pressures would 'greatly impact' the sector. It summarised these effects as follows:

> The independent schooling sector appreciates this capacity to access FBT concessions for its employees as a means of 'value adding' to their contribution to the NFP sector. Staff of non-government schools broadly access benefits across the areas of in-house benefits (school fees in particular), remote area housing benefits (extremely important for schools in rural and remote

86 ISCA declined to attend the hearing. It stated that its views were fully represented in its submission.

> areas) and salary packaging (a means of attracting, rewarding, and keeping highly competent staff in the sector). A phasing out of FBT concessions would lead to significant increased pressure on wage rates in the sector and to a substantially reduced capacity to attract good staff, particularly to more rural or remote areas.
>
> The impact of any change to the in-house fringe benefits rules will either see a real reduction in school revenue or a similar reduction in the value of employee remuneration in schools …
>
> Schools not only need to attract suitably qualified teaching staff, but also compete in an open market for staff in educational support areas such as finance, IT, maintenance, nursing, administration, catering etc. The provision of limited fringe benefits assists greatly in being able to attract and retain such staff.[87]

Analysis

2.117 The committee notes that the new in-house provisions will adversely affect independent schools, depending on the fees involved. The effect will be greater with higher school fees and higher teachers' salaries.

2.118 However, the Association did not demonstrate to the committee why the in-house provisions should apply to independent schools in the first place. As discussed above, the in-house provisions were designed to support employers, who are the taxing point for fringe benefits tax. In-house benefits would cost less for employers to provide their staff, and therefore a concessional rate was deemed appropriate. However, the in-house concessional rate has changed into being primarily for the benefit of employees at a significant cost to the budget. There is no underlying policy reason for this. Nor is there any underlying policy reason that the in-house concessional tax benefit should be more favourable to high income teachers or high fee schools. These are an unforeseen product of the interaction between income tax and fringe benefits tax.

2.119 The committee notes that independent schools already receive substantial concessional treatment for fringe benefits tax from the not-for-profit provisions. These have a sound policy basis and the Bill will leave them untouched.

Conclusion

2.120 Although independent schools gain a significant tax advantage when their staff send their children to the same school as students, the Association

87 ISCA, *Submission 6*, p. 7.

did not demonstrate why these schools should enjoy this in-house tax advantage, which is not available in many other sectors. As noted earlier, the in-house concessional tax treatment has evolved into a key aspect of employee remuneration, instead of recognising that in-house benefits cost less for employers to provide their employees.

2.121 Independent schools already enjoy substantial concessional treatment of fringe benefits tax through their not-for-profit status. The Schedule will not affect this.

Overall conclusion

2.122 The Bill makes a range of amendments to the tax law. Some of the Schedules did not attract submissions from stakeholders and the committee accepts this as support for them.

2.123 Schedule 2 updates the list of deductible gift recipients. The organisations that have been listed, or had their listing extended, include AE1 Incorporated, which seeks to locate and honour the crew of Australia's first submarine; Teach for Australia, which seeks to attract top graduates to teach in disadvantaged communities; and Australia for UNHCR, which raises funds to support the humanitarian programs of the United Nations High Commissioner for Refugees. These are important causes and the committee is pleased that they have been included in the Bill.

2.124 Schedule 3 extends the immediate deductibility of exploration expenditure, already provided to mining and petroleum explorers, to geothermal energy explorers. This will restore competitive neutrality in the sector and support a clean energy source.

2.125 Schedule 4 extends the interim streaming provisions for managed investment trusts from 2012 to 2014, in line with the Government's announcement to defer until 2014 the commencement of the new overall regime for managed investment trusts and the new general trust income rules. The committee expects that coordinating the commencement of these different systems will reduce compliance costs for taxpayers.

2.126 The committee received submissions in relation to the other four major Schedules in the Bill. Schedule 1 clarifies the tax law so that payments under native title agreements will be subject to neither income tax nor capital gains tax. These reforms have been on the policy agenda since 1998 and the committee is of the view that this tax treatment is fully consistent with the unique nature of native title.

2.127 At the hearing, there was considerable support for the view that the Schedule should also provide preferential tax treatment for Indigenous community development corporations. This is outside the scope of the Bill and the committee does not believe that a recommendation along these lines would be appropriate. However, the committee would like to stress that native title is only 20 years old. Parliament, Indigenous people and other stakeholders are still learning about what native title is, what it means, and how Indigenous people can benefit from it. The committee expects that further legislative innovations will be introduced in the coming years and so the Schedule should proceed in its current form.

2.128 Schedule 5 applies an income-based means test to the rebate for medical expenses. The AMA argued that a means test should not apply to a medical care safety net when illness does not discriminate on the basis of income. The committee nonetheless supports the Schedule because it will result in better targeted health expenditure and a more sustainable health system.

2.129 Schedule 6 amends the definition of limited recourse debt, following a High Court case in 2011 where BHP Billiton secured double deductions for its iron briquette plant in Western Australia. Although there was general support for the provisions, there were also concerns about retrospectivity and whether the Schedule should be limited to related party transactions, similar to the facts in the BHP Billiton case.

2.130 The committee was not unduly concerned about retrospectivity because the new law applied from the date of announcement and the policy intent of the provisions was unchanged. Further, there was only a short delay between the announcement and the introduction of the Bill. Although limiting the Schedule to related party transactions may be attractive, it overlooks the fact that the limited recourse debt rules play an important role in the integrity of the tax system.

2.131 Schedule 7 removes the 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. The in-house provisions were initially included in the fringe benefits tax because the tax is imposed on employers and in-house benefits cost less to employers to provide them.

2.132 However, since then the in-house rules have evolved into a key element of employee remuneration in some industries, contrary to the original goal. For example, the independent schools sector expressed concern that it would be affected because many teachers send their children to the same school. However, the independent schools did not establish why they should receive this concessional tax treatment in the first place, especially one that varies with the teacher's salary and the tuition fee. It should also be noted that independent schools already receive an FBT advantage through being not for profit organisations.

2.133 Overall, the Bill makes a range of amendments that protect the integrity of the tax system, closer aligns it to underlying policy, and achieves important social goals. The Bill should pass.

Recommendation 1

2.134 **The House of Representatives pass the Tax Laws Amendment (2012 Measures No. 6) Bill 2012 as proposed.**

Julie Owens MP
Chair
8 February 2013