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Bills Digest

No. 137 2001–02

Taxation Laws Amendment Bill (No. 3) 2002

ISSN 1328-8091

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Published by the Department of the Parliamentary Library, 2002

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Taxation Laws Amendment Bill (No. 3) 2002

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20 May 2002

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Taxation Laws Amendment Bill (No. 3) 2002

Date Introduced: 21 March 2002

House: House of Representatives

Portfolio: Treasury

Commencement: The provisions containing the amendments described in this Digest commence on Royal Assent. However, the measures themselves have various application dates which are described below.

Purpose

To:

- clarify the GST treatment of certain transactions involving a government body during land development
- allow special GST credits for car rental companies in respect of certain vehicles, and
- clarify the amount of deduction allowed by general insurance companies in respect of future claims.

Background

As there is no central theme to the Bill the background to the various measures will be discussed below.

Main Provisions

Land Development and GST

The amendments deal with the treatment for GST purposes of situations where, as part of development approval, a developer provides infrastructure or other works to a landowner. Such situations may arise where, for example, a developer provides roads and sewage for an estate and these are transferred to public ownership. As the GST rules stand, it is likely that for GST purposes that the supply of the right to develop the land and the subsequent return of infrastructure would both be considered to be a taxable supply and so subject to GST.

While government involvement in the development of land usually involves State or Territory governments, the Commonwealth is involved in joint development projects in both Melbourne and Sydney former Australian Defence Industries (ADI Limited) sites. The Commonwealth is represented in the joint developments by ComLand Limited. While the Melbourne developments at Maribyrnong and Footscray are proceeding smoothly and with little controversy, that at St Marys in Sydney has had a more controversial history.

The St Marys site covers approximately 1 545 hectares (ha) and was rezoned for urban and other uses by the NSW government in January 2001. It was envisaged that approximately 8 000 homes would be constructed on the 867 ha available for urban development, 630 ha would be set aside for a regional park to preserve flora and fauna and approximately 42 ha will be used for regional open space. Not included in the regional park area was approximately 178 ha of Cumberland Plain woodland which was listed on the Register of the National Estate (the majority of the listed area was already contained in the regional park). The initial rezoning decision was opposed by a number of groups, including local resident groups, whose arguments ranged from the need to preserve the entire area to those that the remaining area of Cumberland Plain woodland should be preserved.[1] The Commonwealth, as landowner, remained undecided about the inclusion of additional land in preservation areas. The Annual Report for ComLand states:

> If these additional areas are preserved, this will mean a significant reassessment of the development activities on the site, including potentially reopening the NSW rezoning process, at a significant cost and lengthy delays in commencing the St Marys project.[2]

On 25 October 2001, during the campaign for the 2001 election, the Minister for the Environment and Heritage announced that an additional 250 ha, including the remaining listed Cumberland Plain woodland would be preserved. The Minister's announcement also included statements from the Member for Lindsay that the decision 'protects one of the largest stands of Cumberland Plain Woodland in Western Sydney'.[3] Local resident groups remained committed to the idea that the entire area should not be developed. While the cost of the additional preservation area to the joint development has not been reported, the Minister for Finance was reported as stating that the preservation of the additional 178 ha of Cumberland Plain Woodland would result in an estimated revenue loss of between $80 and $150 million.[4]

The amendments to the GST treatment of land development, which are not directly related to the operations of ComLand, are contained in **Schedule 1** of the Bill. **Item 4** will insert a **new Division 82** into the *A New Tax System (Goods and Services Tax) Act 1999*. **Proposed section 82-5** provides that the supply of a right for development by an Australian government agency is not to be treated as consideration, and therefore giving rise to a GST liability, for another supply if the other supply is made under an Australian law. It will not matter if the other supply is made to the government authority or another entity.

Similarly, **proposed section 82-10** provides that the supply of a good or service to an Australian government agency in exchange for a development right will not be treated as having been made for consideration.

Application: From 1 July 2000 (**item 6**).

Rental Cars

The introduction of the GST and abolition of the wholesale tax regime from 1 July 2000 caused a number of problems for car rental companies. The main problem is that while rental companies pay the 10% GST when purchasing vehicles (or the 22% wholesale tax if purchased prior to 1 July 2000) they, like other businesses, could claim no input tax credits until 1 July 2001 and only 50% from 1 July 2001 to 1 July 2002. (The restriction on claiming input tax credits was introduced as a transitional measure to prevent a 'buyers strike' by business prior to the introduction of the GST.) While most businesses could avoid the impact of the transitional input tax credit rules by simply not purchasing vehicles during this period, or minimising its impact by reducing purchases in the period, rental companies turn over vehicles every 9 to 12 months and so have been caught by the transitional rules in respect of a large number of vehicles.

An additional effect of the tax changes for rental companies is that the change from a 22% wholesale tax (approximately equivalent to a 17% retail tax) to a 10% retail GST resulted in downward pressure on the prices of both new and recently purchased used cars, which due to the short turnover time, included most stock of rental car companies. As well, rental companies are required to pay the GST on the sale of used cars while, as indicated above, not being able to claim input tax credits for their purchase. The executive director of the Motor Trades Association of Australia is reported as saying that rental companies traditionally made most of their profits in buying and selling vehicles, not in renting them.[5]

While rental car companies and some motor industry groups have been lobbying for some time for changes to reduce the impact of the GST and associated transitional provisions, these views were initially rejected. It has been reported that the Treasurer's office suggested to rental companies that they should increase rates or hold cars for longer to address the difficulties.[6]

The measures contained in the Bill were not announced prior to the introduction of the Bill and are estimated in the Explanatory Memorandum to the Bill to cost $36 million over 2 years.

Item 7 of Schedule 1 of the Bill will insert a **new section 19B** into the *A New Tax System (Goods and Services Tax Transition) Act 1999* to allow a credit in respect of the sale, or other eligible supply, of cars held on 1 July 2000 for rental purposes. An entity which held the car for rental will be eligible for the credit if:

- the supply of the vehicle occurred between 1 July 2000 and 30 June 2002 (ie the vehicle was sold by the entity between these dates)
- the entity held the vehicle at the start of 1 July 2000
- it was the first sale of the car after 30 June 2000
- during the period between 1 July 2000 and the sale of the vehicle it was held for rental and it was covered by the required third party insurance for rental cars, and
- the car was subject to sales tax.

The amount of the special credit will be $1/11^{th}$ of the price of the sale of the vehicle, although special rules will apply where the vehicle was subject to an eligible short term lease.

Application: The special credits will be able to be claimed in a tax period ending on or after this Bill receives Royal Assent or 7 January 2003, or such later day as the Commissioner determines.

General Insurance Companies – Deductions

Where there is an insurance premium paid to a general insurance company (basically an insurance company other than a life insurance company) and a claim payment made in respect of that premium during the same income year, the taxation position is simple, the premium is included in assessable income and the payment is allowable as a deduction during the same income year. However, where the claim is made in respect of an insured risk, or an event insured against has occurred during the year but a claim has not been made, and payment is not to be made until later income years the tax position can become complex. This is particularly true where payment in respect of the insured event may be delayed for a number of years, such as may occur in some medical insurance cases.

Until a relatively recent court decision, the situation was covered by Taxation Ruling IT 2663 which is dated 20 October 1991. Under IT 2663, a deduction could be claimed in a year of income in respect of claims communicated to the insurer during the year but not paid in full and also those which have not been communicated to the insurer but for which the event giving rise to the liability occurred during the year. The amount of the deduction is based on the reasonable and proper estimate of the future liability, generally based on actuarial and accounting standards. Under IT 2663, this amount is then discounted to the present value of the funds needed to be set aside to pay the claims and potential claims (ie rather than the estimated amount of the claim being allowable as a deduction, the amount allowable is the amount that would need to be invested to pay the estimated amount at the estimated time it becomes due).[7] The present value is generally determined according to accounting standards. While this may appear to be a technical issue of little relevance, the amount of deduction which can be claimed can be very substantial, particularly in cases where claim payments are made over a substantial period, such as in workers compensation insurance.

The position as understood under IT 2663 was overturned by the Federal Court in *Commissioner of Taxation v Mercantile Mutual Insurance (Workers Compensation) Ltd* [1999] FCA 351.[8] The main matter at dispute in the case was whether only the present value of future claims could be claimed as a deduction or if the face value of future claims was allowable. The difference between the two amounts in the case was approximately $35 million, giving an indication of the considerable amounts that can be involved. As a lesser matter, the method of calculating the amount set aside for future claims (the prudential amount) was also disputed. A single judge of the Federal Court had ruled that the face value of the future claims could be deducted and that the method for calculating the prudential amount was reasonable. The Commissioner appealed to the Full Court against these decisions.

In relation to the amount of the deduction available, the Commissioner argued that a distinction should be drawn between the happening of the event that may give rise to a claim and the liability to pay the claim, which would arise in the future, and that the deduction for the contingency should be based on the present value of the future liability. It was also argued that in accordance with accounting standards the amount of the deduction should be that required to be set aside to meet the liability in the future.

The court rejected these arguments, with Hill J reasoning that there is no gap between when the insured for event occurred and the liability arising, even if the actual payment occurs in the future. It was stated:

> Contrary to the Commissioner's submission, there is no gap in time between the event insured against and the liability to pay. There is a presently existing liability to pay monies in the future, which liability, like the event which gives rise to it, occurs in the year of income.[9]

The Commissioner's arguments regarding accounting standards was also rejected, on the basis that while the accounting standards may recognise the concept of future value, Australian jurisprudence and case law does not.[10] Submissions relating to the method of calculating the prudential margin were also dismissed as not relevant once the decision relating to future value was taken into account.

Following the High Court's refusal to grant leave to appeal from the decision of the Federal Court, the Assistant Treasurer announced that the law would be amended to maintain the effect of IT 2663 and that the amendments would apply from the 1991-92 income year when IT 2663 first came into effect.[11]

Item 9 of Schedule 2 of the Bill will insert a **new Schedule 2J** into the *Income Tax Assessment Act 1936*, which will deal with the treatment of general insurance companies. The proposed Schedule will enact the treatment of income and deductions as envisaged in IT 2663, including that:

- where there is a greater amount allowed for outstanding claims in respect of a year than the actual payments for the year, the difference is to be included in assessable income for the year, and where the later claims exceed the claimed amount the balance is an allowable deduction, and
- the value of outstanding claims is to be calculated on the amount needed to be set aside and invested to meet outstanding claims (therefore requiring deductions to be based on the present value of future claims).

Application: For general insurance companies the amendments will apply for the 1991-92 and later years of income.

Endnotes

1 See *The Sydney Morning Herald*, 20 January 2001.

2 ComLand, Annual Report, 30 June 2001, p. 16.

3 Minister for Environment and Heritage, 25 October 2001.

4 *The Sydney Morning Herald*, 15 June 2001.

5 *The Australian Financial Review*, 24 April 2001.

6 *The Australian Financial Review*, 28 December 2000.

7 IT 2663, para. 104.

8 http://www.austlii.edu.au/au/cases/cth/federal_ct/1999/351.html

9 ibid., p.12.

10 ibid., p. 13.

11 Assistant Treasurer, Press Release, 18 February 2000.