Taxation Laws Amendment Bill (No. 4) 2002
Taxation Laws Amendment Bill (No. 4) 2002

Chris Field
Law and Bills Digest Group
26 June 2002
## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purpose</td>
<td>1</td>
</tr>
<tr>
<td>Background</td>
<td>1</td>
</tr>
<tr>
<td>Main Provisions</td>
<td>1</td>
</tr>
<tr>
<td>Thin Capitalisation</td>
<td>1</td>
</tr>
<tr>
<td>Depreciation</td>
<td>2</td>
</tr>
<tr>
<td>Temporary Residents</td>
<td>3</td>
</tr>
<tr>
<td>Roll-over Relief</td>
<td>4</td>
</tr>
<tr>
<td>Endnotes</td>
<td>5</td>
</tr>
</tbody>
</table>
Warning:
This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.

Warning:
This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.

Taxation Laws Amendment Bill (No. 4) 2002

Date Introduced: 30 May 2002
House: House of Representatives
Portfolio: Treasury
Commencement: The majority of the Bill commences on Royal Assent, however the various measures have differing application dates which are detailed below.

Purpose
To:
• make largely technical amendments to the thin capitalisation regime
• introduce a statutory maximum life for certain assets for depreciation purposes
• provide tax exemptions for temporary residents for certain earnings not related to their Australian employment, and
• provide roll-over relief from capital gains tax for certain transfers from fixed trusts to companies.

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

Main Provisions
Thin Capitalisation
Thin capitalisation refers to the rules relating to the allowance of interest deductions on borrowings and acts to disallow deductions to the extent that borrowings exceed the allowable ratio to capital. The rules aim not only to discourage excessive borrowings but
also to prevent artificial arrangements where principally foreign corporations arrange their affairs so that their Australian operations have high debt levels to take advantage of the available deductions.

From 1 July 2001 a new thin capitalisation regime was introduced which extended the regime to domestic Australian companies and extended the definition of which debt is covered by the rules. The basic rule for general (other than financial companies) is that they may claim a deduction only for the interest on borrowings which is less, or equal to, a 3:1 ratio of debt to capital.\(^1\)

The measures contained in the **Schedule 1** of the Bill are of a technical nature and reflect the first years experience of the operation of the new regime and do not implement new policy. In particular, **Schedule 1** inserts definitions of controlled foreign entity debt and equity which are to be used when calculating the overall position of the entity claiming the deduction. According to the explanatory memorandum to the Bill the measures will prevent revenue loss of $50 million in 2002-03 and $30 million annually from 2003-04 onwards.\(^2\)

The explanatory memorandum to the Bill provides a description of the technical amendments contained in **Schedule 1** of the Bill.

**Depreciation**

Owners of capital plant and equipment are able to claim a deduction for the cost of the item based on the value of the item and its effective life. There are also special provisions which allow for accelerated depreciation allowing a greater deduction than would otherwise be available.

The effective life of an asset is based on either the taxpayer’s claim or the Commissioner’s ruling as to the effective life of an asset. In either case the determination is to be based on the period for which the asset could be used having regard to wear and tear, assuming normal maintenance. The Income Tax (Effective Life of Depreciating Assets) Amendment Determination 2002 (No. 2) proposes to increase the effective life for a number of assets acquired after 1 July 2002. The assets include cars; aeroplanes and helicopters; gas distribution and transmission; gas, oil, condensate, LNG, LPG manufacturing; and assets used in gas and oil production. The determination substantially increases the effective life of such assets, reducing the amount of depreciation which may be claimed each year.

On 14 May 2002 the Minister for Revenue and Assistant Treasurer announced that statutory caps would be placed on the effective life of the assets mentioned above to ‘ensure depreciation deductions….remain appropriate following reviews of the effective life of these assets by the Commissioner of Taxation.’\(^3\) It was also stated:

---

**Warning:**

This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.

This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
The new statutory life caps will provide certainty for the industries concerned, and provide an appropriate balance between meeting the needs of those industries as well as maintaining the integrity of the effective life depreciation system. The statutory caps range from substantial increases compared to the current effective life for some goods, eg aeroplanes, marginal increases for others and others which are the same as the current life. According to the explanatory memorandum to the Bill the statutory life amendments will increase revenue by approximately $825 million between 2002 and 2012 compared to current effective lives but result in a cost to revenue of approximately $2.2 billion over the same period when compared to the ATO proposals.

Division 40 of the *Income Tax Assessment Act 1997* (ITAA97) deals with capital allowances and provides for an entity to choose to depreciate an asset either by the life determined by the Commissioner or that determined by the taxpayer (section 40-95). Part 1 of Schedule 4 of the Bill will amend section 40-95 and related sections to provide that:

- where an asset has been depreciated by an owner according to the Commissioner’s effective life determinations
- the ownership changes after 1 July 2002, and
- the depreciation would, but for these measures, become subject to the new ATO ruling

the new owner is required to use the new effective life calculations contained in proposed section 40-102.

Application: From 1 July 2002 (item 15).

**Temporary Residents**

A recommendation of the *Review of Business Taxation – A Tax System Redesigned* (Ralph Report) was that certain income of people who are working in Australia on temporary entry visas, of 4 years or less, be exempt from tax. The major recommendation was that income from foreign sourced assets owned prior to their residence in Australia be exempt.

The recommendation was designed to enhance the position of previous non-residents who had come to work in Australia, such as high level executives, and so improve the chances of such people taking up employment in Australia. The Ralph Report stated:

On taking up residence in Australia executives and other key personnel are likely to own overseas assets and housing that will produce income that will be taxable in Australia even if the executives are here for less than four years. Taxing the income from these pre-resident investments at Australia’s top rate of personal tax could increase the overall tax burden and deter executives from taking up opportunities in Australia.
A contrary argument is that if the overseas executive is to provide a benefit to an entity, principally companies, it is the responsibility of that entity to provide sufficient conditions to attract the desired person to match the benefit they would provide. Whether it should be the Commonwealth revenue which effectively pays to make the Australian position more attractive to the non-resident is open to debate.

After initially endorsing the recommendations contained in the Ralph Report, the Treasurer announced on 15 October 2001 that the exemption from tax would be extended to cover foreign sourced income of eligible temporary residents from assets regardless of when they were acquired (ie. the exemption would apply to income from foreign assets acquired while the person was working in Australia). The Treasurer also announced a number of related measures, including that no capital gain or loss would arise from the disposal of assets which did not have a sufficient connection to Australia. The measures were seen as assisting to attract skilled foreign workers and assisting in retaining and attracting corporate headquarters to Australia.7

The explanatory memorandum to the Bill estimates that the measures will cost between $40 and $50 million per year.8

**Item 9 of Schedule 3** will insert a **new section 51-52** into the ITAA97 to exempt the foreign sourced income of temporary residents from income tax. The exemption will not apply to foreign income earned as a result of employment undertaken or services provided while a temporary resident.

**Item 11** will insert a **new section 118-575** into the ITAA97 to exempt capital gains and losses for temporary residents derived from a source outside Australia. As well, the gain or loss must not have a ‘necessary connection with Australia’. This term is defined in section 136-25 of the ITAA97 and, in addition to things with a physical attachment to Australia, includes shares in resident public companies and units in resident unit trusts where the shares or units represent at least 10% of the value of the company or trust.

Application: From 1 July 2002 (**item 14**).

**Roll-over Relief**

Roll-over relief involves relief from capital gains tax (CGT) when assets are transferred from one ownership structure to another without there being a change in the underlying interests in the ownership of the assets or the income from the assets subject to the roll-over. The concept is not new and, for example, currently applies for the transfer of interests from an individual, trustee or partnership to a company where the company is wholly-owned by those who had interests in the former body and there is no change in the ratio of those interests (Division 122 of the ITAA97). The result of the roll-over relief is that a capital gains tax event does not arise on the disposal of the entity which transfers assets to a company and the cost base and indexed cost base are transferred to the new company to determine any future capital gains tax liability.
As part of the government’s response to the Ralph Report’s recommendation for the introduction of an entity taxation regime (the introduction of which appears to have been postponed indefinitely), it was announced that roll-over relief would be made available where assets are transferred from a fixed trust to a company, provided that all assets were transferred and the trust ceased to exist after the transfer was completed.9

The explanatory memorandum to the Bill estimates that the measure will have a small but unquantifiable impact on revenue.10

Schedule 2 of the Bill will insert a new Subdivision 124-N into the ITAA97 dealing with roll-overs from fixed trusts to companies. To be eligible for roll-over relief:

- the company to which the assets are transferred must not be tax exempt, must never have carried on commercial activities, have no CGT assets of its own other than small amounts of cash or debt and have no losses
- after the assets have been transferred, each entity which owned an interest in the trust must have an interest in the same proportion in the company and the market value of the interests held must be substantially similar, and
- the company must be an Australian resident (proposed section 124-860).

Both the trust and company must chose to have the roll-over relief apply (proposed section 124-865).

If roll-over relief is elected, capital gains and losses are to be ignored, the cost base of an asset transferred and pre-CGT assets will retain their CGT exemption (proposed section 124-875).

Application: The amendments will apply from 11 November 1999, the date of the original response to the Ralph Report (item 17).

Endnotes

1 For further information on the previous and current thin-capitalisation regimes, refer to the Bills Digest for the New Business Tax System (Thin Capitalisation) Bill 2001, No. 16, 2001–02.
2 Explanatory memorandum to the Bill, p. 3.
4 ibid.
5 Explanatory memorandum, p. 7.


8  Explanatory memorandum, p. 5.


10  Explanatory memorandum, p. 4.