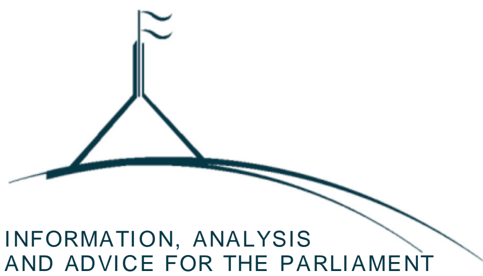

INFORMATION AND RESEARCH SERVICES

Bills Digest
No. 42 2002–03

Taxation Laws Amendment Bill (No. 5) 2002

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ISSN 1328-8091

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No. 42 2002–03

Taxation Laws Amendment Bill (No. 5) 2002

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2 October 2002

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Taxation Laws Amendment Bill (No. 5) 2002

Date Introduced: 27 June 2002

House: House of Representatives

Portfolio: Treasury

Commencement: Various dates as indicated in the section on Main Provisions.

The following abbreviations and acronyms are used throughout this Bills Digest:

Abbreviation	***Definition***
ATO	Australian Taxation Office
Commissioner	Commissioner of Taxation
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
IT(TP) Act 1997	*Income Tax (Transitional Provisions) Act 1997*
PAYG	pay as you go

Purpose

There are four Schedules to this Bill with measures for the following purposes:

- **Schedule 1** provides special transitional arrangements for oyster farmers capturing oyster spat by the traditional stick farming method. Oyster farmers using the traditional stick farming method will be able to value certain stock at the start of the 2001-2002 income year based on an amount per stick used to capture the spat

- **Schedule 2** prevents the possibility of double taxation where an amount is paid in respect of work in progress (partially completed work for which a recoverable debt has not yet arisen)

- **Schedule 3** makes a number of technical corrections and amendments to the capital allowances system, and

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- **Schedule 4** enables the Commissioner to recover all outstanding PAYG withholding amounts by making an estimate of the debt. The taxpayer is allowed to have the estimate reduced or revoked by giving the Commissioner a statutory declaration.

Background

In view of the diverse nature of the measures dealt with in this Bill, the background to the various measures is considered under the Main Provisions.

Main Provisions

Schedule 1—Relief for certain oyster farmers

Oyster farmers using the traditional stick farming method have not included in trading stock the oysters they hold and which are growing in the water. There would be a large one-off excess in the value of their closing stock over their opening stock (zero) if oyster farmers included the growing oysters in stock in the 2001-2002 income year. The inclusion of this excess in assessable income could cause severe financial hardship for some farmers in the industry.

The amendments in **Schedule 1** insert **proposed section 70-41** into the IT(TP) Act 1997 and have the effect of giving growing oysters a special value at the start of the 2000-2001 income year by a method proposed in **proposed subsection 70-41(6)** which would relieve the hardship which oyster farmers using the traditional stick method would otherwise experience.

Reference is invited to paragraphs 1.27 to 1.33 of the Explanatory Memorandum[1] which sets out succinctly the proposed method of valuation of opening stock.

Schedule 2—Avoidance of double taxation of work in progress payments

As a result of various court decisions, the taxation treatment of amounts paid or received in respect of work in progress has given rise to the potential for the taxation of the same amount twice, albeit in the hands of different taxpayers.

The amendments in **Schedule 2** clarify the taxation treatment of payments and receipts in respect of work in progress. **Proposed section 25-95** to the ITAA 1997 provides a deduction for work in progress amounts paid and **proposed section 15-50** to the ITAA 1997 includes in assessable income work in progress amounts received.

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Proposed subsection 25-95(3) gives a definition of work in progress amount. For an amount to be work in progress amount it must satisfy the criteria in **proposed paragraphs 25-95(3)(a)** and **(b)**. These criteria are that an entity agrees to pay the amount to another entity, and that the amount can be identified as being in respect of work (but not goods) that has been partially performed by the recipient for a third entity, but not yet completed to the stage where a recoverable debt has arisen in respect of the work.

These amendments will remove any potential for double taxation.

The amendments do not cover partly completed goods (e.g. of manufacturers) which are normally brought to account as trading stock.

These amendments apply to amounts paid on or after 23 September 1998.

Paragraphs 2.2 to 2.7 of the Explanatory Memorandum cover the cases that have led to the anomaly which these amendments seek to rectify.

Schedule 3—Technical amendments to the Capital Allowances System

Background

The introduction of the uniform capital allowance system for depreciating assets and its general application, giving deductions for some previously non-deductible capital expenditure (referred to as 'black hole expenditure') were key components of the New Business Tax System announced in Attachment B of the Treasurer's Press Release of 21 September 1999.[2]

The *New Business Tax System (Capital Allowances) Act 2001* introduced a new capital allowances system to allow deductions for the cost of a depreciating asset over a period that reflects the effective life of the asset. The capital allowances rules are in Division 40 of the ITAA 1997.

Prior to the introduction of the new capital allowances system in Division 40 of the ITAA 1997 there were over 37 separate capital allowance regimes in the income tax law that were not consistent. The uniform capital allowance system is based on the following principles:

- a set of general rules to calculate the deduction for the notional decline in the value of most depreciating assets
- a pooling mechanism under which some expenditures are pooled and given deductions for the decline in the pool, and
- deductions, immediate or over a period of time, for certain capital expenditure used in the primary production and the mining industries.

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Some of the key concepts that underline the capital allowances system in Division 40 are set out below as they would assist in appreciating the technical amendments. These are as stated in the Explanatory Memorandum to the New Business Tax System (Capital Allowances) Bill 2001[3]

What the Division does	Division 40 provides a set of general rules (in Subdivision 40-B) to calculate the deduction to taxpayers for the notional decline in value of most depreciating assets they hold. It also provides pooling mechanisms, under which some expenditures are pooled and taxpayers are given deductions for the decline of the pool. Further, it allows immediate deductions for certain other capital expenditure.
What is a depreciating asset?	A ***depreciating asset*** is an asset with a limited effective life that loses value over that life because it is effectively used up.
What is not a depreciating asset?	Land, trading stock and most intangible assets are not 'depreciating assets'.
Who is the holder of a depreciating asset?	Generally, this will be its legal owner. In specific circumstances, entities other than legal owners will hold an asset.
When does the decline in value start?	Usually, once you first use the depreciating asset or install it ready for use for any purpose. The deduction for the decline will be adjusted if the asset is not used for a taxable purpose (e.g. if the asset is for private use).
How is the decline in value calculated?	You choose between one of 2 formulas. Both rely on the effective life of the asset, and generate a decline writing the asset off regardless of changes to the actual market value of the asset. Both produce an adjustable value, that is, the amount remaining after the decline.

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What is the asset's effective life?	It is the period that the asset can be used by you or anybody else for income producing purposes, assuming it will be subject to wear and tear at a reasonable rate and that it will be maintained in reasonably good order and condition. You choose between your reasonable assessment of the effective life and any applicable 'safe harbour' determination of effective life by the Commissioner.
What is the asset's cost?	Generally, it is the amount you paid for it. Special rules adjust this cost in certain cases, for example, non-arm's length transactions. The cost rules are detailed in Subdivision 40-C.
What happens when you cease to hold the asset? The balancing adjustment	You calculate a balancing adjustment. This results in a further amount being included in assessable income (if adjustable value is lower than termination value) or allowed as a further deduction (if adjustable value is higher than termination value). This calculation is set out in Subdivision 40-D.
Pooling for certain assets	A pooling mechanism can be used as an alternative to calculating the decline in value using the general formula. There is a pool for in-house software development expenditure as well as for assets costing less than $1,000 or that have declined in value below $1,000. This mechanism is set out in Subdivision 40-E.
Primary producers	The decline in value for certain primary production assets and deductions for certain expenditure are calculated separately. These separate rules are set out in Subdivisions 40-F and 40-G.
Immediately deductible capital expenditure	You can calculate the decline in value of certain capital expenditure that is immediately deductible. These types of expenditure are set out in Subdivision 40-H.
Other capital expenditure deductible over a period of time	You can calculate the deduction for the decline in value of certain other deductible capital expenditure. The rules for this calculation are set out in Subdivision 40-I.

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Choice of two methods for working out decline in value

A taxpayer has a choice of two methods to work out the decline in value of a depreciating asset. The choice is between the 'diminishing value method' and the 'prime cost method'.

Diminishing value method

The decline in value using the diminishing value method for an income year is worked out using the following formula set out in section 40-70 of the ITAA 1997.

$$\text{Base value} \times \frac{\text{Days held}}{365} \times \frac{150\%}{\text{Asset's } {}^{*}\text{effective life}}$$

The base value is generally the cost of the asset for the income year when the asset is acquired or in a subsequent year the cost less the decline in value accounted for that asset in previous income years.

Prime cost method

The decline in value using the prime cost method for an income year is worked out using the following formula set out in section 40-75:

$$\text{Asset's } {}^{*}\text{cost} \times \frac{\text{Days held}}{365} \times \frac{100\%}{\text{Asset's } {}^{*}\text{effective life}}$$

It will thus be seen that the effective life of an asset is a key determinant in ascertaining the decline in value or depreciation in an income year.

When you stop holding a depreciating asset you may have to include an amount in your assessable income, or deduct an amount under a ***balancing adjustmen***t. The adjustment reconciles the decline with the actual change in value.

What is blackhole expenditure?

Blackhole expenditure refers to seven categories of business related expenditure which were not recognised in the income tax law prior to 1 July 2001 and which were allowed as a deduction thereafter following the acceptance of the recommendations in the Ralph Review. Deductions for such expenditure are now provided in section 40-880 of the ITAA 1997and are:

(a) expenditure to establish a business

(b) expenditure to convert the business structure to a different structure

(c) expenditure to raise equity for a business

(d) expenditure to defend a business against a takeover

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(e) costs to a business of unsuccessfully attempting a takeover

(f) costs incurred by a shareholder in liquidating a company that carried on a business, and

(g) costs to stop carrying on a business.

The amount that can be deducted is 20 percent of the expenditure for the income year in which it is incurred and for each of the next four income years.

Coverage of technical amendments

The technical amendments are intended to ensure that the capital allowances system operates in the manner envisaged. Some significant amendments are discussed below. The Explanatory Memorandum to the Bill gives a comprehensive coverage of the technical amendments and reference will be made to its paragraphs for further information.

Prime cost method

The concept of cost is only relevant for calculating the decline in value at the start or first year. Where any adjustment has been made under any paragraph of subsection 40-75(2), the 'cost' in the formula for calculating the decline in value needs to be replaced by the 'opening adjustable value'. The amendments proposed by **Items 17**, **18** and **19** clarify the application of the formula in the second and subsequent years in various situations.

(Paragraphs 3.4 to 3.5 of the Explanatory Memorandum)

Remaining effective life and roll-over relief

The amendments proposed by **item 22** will define the 'remaining effective life' for roll-over relief purposes as the period of an asset's effective life that is yet to elapse at the time the transferor transfers the asset to the transferee.

(Paragraphs 3.9 to 3.11 of the Explanatory Memorandum)

Opening adjustable value

Item 23 repeals the existing note to section 40-85(2) which defines 'opening adjustable value'. It also introduces a new note which directs the reader to other provisions which must be taken into account when working out the opening adjustable value of an asset.

(Paragraphs 3.12 of the Explanatory Memorandum)

Working out the cost of a depreciating asset

Subdivision 40-C indicates how the cost of a depreciating asset is worked out. The cost of a depreciating asset consists of two elements; the first and second elements. Section 40-180 deals with the first element and subsection 40-180(2) sets out a table as to how it is to

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be worked out in seven different situations listed as table items 1 to 7. It also provides that if more than one item in the table covers the asset, it is necessary to apply the last item that covers it. **Item 25** reverses table items 5 and 6 to ensure that where roll-over relief applies on the variation in the constitution of a partnership, the cost of a depreciating asset is determined by reference to the roll-over relief item.

(Paragraphs 3.13 to 3.19 of the Explanatory Memorandum)

Limits on luxury cars

The amendments in **item 29** are intended to ensure that where a luxury car is held by one or more entities, the car limit is applied to the cost of the car and not to each entity's interest in the car.

(Paragraphs 3.20 to 3.22 of the Explanatory Memorandum)

Balancing adjustments – partners and partnerships

A balancing adjustment occurs for a depreciating asset under paragraph 40-295(2)(b) when you stop 'holding' that asset. This adjustment occurs in the case of a partnership which undergoes a variation, as the variation has the effect of creating a new partnership with the effect that the old partnership stops 'holding' the relevant partnership assets.

The amendment proposed by **item 32** ensure that the adjustment occurs when you stop 'holding an interest' in the asset. Also the amendment proposed by **item 37** replaces the word 'held' in paragraph 40-340(3)(b) with the words 'had an interest in' [the asset]. '

This is intended to cover a situation where one or more partners have an interest in a partnership asset prior to a variation and continue to have an interest after the variation. In this case, the partners, and the partnership, are not affected by a balancing adjustment.

(Paragraphs 3.23 to 3.25 of the Explanatory Memorandum)

Termination value

The amendment in **Item 33** will ensure that the termination value can be worked out when an asset is allocated to a low-value pool and when a person who held that asset dies. In this case the termination value will be so much of the closing pool balance for the income year in which the person died as is reasonably attributable to that asset.

(Paragraphs 3.26 to 3.28 of the Explanatory Memorandum)

Blackhole expenditure

- Expenditure to establish a business structure

It was intended that only capital expenditure incurred in establishing a business structure should be allowed as a deduction under paragraph 40-880(a). **Item 40** amends this

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paragraph by substituting 'business structure' for business. **Item 41** inserts an example at the end of paragraph 40-880(1)(a) so as to clarify that it is the capital expenditure in incorporating a company, partnership or trust or some other structure that is the subject of the deduction under this paragraph.

- Expenditure to convert a business structure to a different structure

Item 42 inserts an example at the end of paragraph 40-880(1)(b) to clarify that the cost of conversion will include the costs of transferring the assets from the previous structure such as a partnership to a new structure such as a company.

- Expenditure to raise equity for the business

Item 43 inserts an example at the end of paragraph 40-880(1)(c) to clarify that the expenditure to raise equity for the business will also include expenditure such as preparing a prospectus to raise capital for business expansion.

- Expenditure to defend a business against a takeover

Item 44 inserts an example at the end of paragraph 40-880(1)(d) which illustrates that expenditure incurred in complying with subsection 633(1) or 635(1) of the *Corporations Act 2001* would be expenditure incurred to defend a business against a takeover.

Subsection 633(1) of the *Corporations Act 2001* sets out the steps to be taken in an off-market bid and subsection 635(1) sets out the steps in a market bid. In consequence the expenditure incurred in taking those steps will be covered by paragraph 40-880(1)(d).

- Costs of a business of unsuccessfully attempting a takeover

Item 45 inserts an example at the end of paragraph 40-880(1)(e) which illustrates that expenditure incurred in complying with subsection 633(1) or 635(1) of the *Corporations Act 2001* would be expenditure incurred in attempting a takeover albeit unsuccessfully.

- Costs to stop carrying on your business

Items 46 and **47** amend paragraph 40-880(1)(g) to make it clear that it is the costs to stop carrying on your business that comes within this paragraph. Further, an example is inserted at the end of that paragraph which shows that the legal costs in terminating the services of employees is covered by this paragraph.

(Paragraphs 3.37 to 3.71 of the Explanatory Memorandum).

Application

Generally the amendments take effect from 1 July 2001. The amendments that relate to provisions that were inserted as part of the capital allowances system will apply in accordance with the application provision to the capital allowances system (i.e. from 1 July 2001) **[Schedule 3, subitem 100(1), (2) and (3)].**

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Schedule 4—Recovery of PAYG Amounts

Proposed section 222AGA to the ITAA 1936 specifies the circumstances when the Commissioner may make an estimate for the recovery of amounts not paid to the Commissioner and the things that the Commissioner may have regard to in making the estimate.

The Commissioner may make an estimate under **proposed subsection 222AGA(2)** when a person has become liable under a provision to pay an amount to the Commissioner and the liability to pay that amount remains undischarged after the due date.

The factors to be taken into account when the Commissioner makes an estimate are:

(a) amounts deducted; or

(b) amounts withheld from payments; or

(c) payments received; or

(d) non-cash benefits provided;

during a period earlier than the period when the liability arose.

Proposed paragraph 222AGB(2)(e) provides that if the person or the person's trustee gives the Commissioner a statutory declaration substantiating the actual unpaid amount of the liability to which the estimate made by the Commissioner relates, the estimate will be reduced accordingly.

These amendments will apply to PAYG withholding amounts that are due and payable in the year ended 30 June 2002 and in subsequent years.

Concluding Comments

The tax system has undergone a massive change since 1 July 2000 and it is to be expected that there will be ongoing refinements to the legislation which gave effect to these changes. This Bill is an example of the technical amendments that have became necessary to give expression to the intent of the reform measures. Further, the need to contain aggressive tax planning to protect the community's revenue system makes it necessary for the Australian Taxation Office (ATO) to seek amending legislation of the type proposed in this Bill from time to time. There are compliance costs associated with such changes but that is a price that is inevitable in the interests of maintaining the integrity of the tax system. The Commissioner of Taxation has reiterated that every effort is being made by the ATO to assist the community to reduce compliance costs wherever possible:

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There are inevitably compliance costs associated with any tax system. Given the magnitude of the changes to our tax system, it is unrealistic to think that we could get everything operating at its most efficient from day one.

Our challenge – and a priority of equal importance to improving the integrity of the tax system – is to work with the community to reduce compliance costs wherever possible.

We have already taken a number of steps in this direction.[4]

Endnotes

1 Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 5) 2002.

22 The Hon. Peter Costello MP, 'Small Business and Primary Producers to Benefit from the New Business Tax System', *Press Release*, 21 September 1999.

3 Explanatory Memorandum to the New Business Tax System (Capital Allowances) Bill 2001.

4 Tax Reform implementation and the way forward – Address by the Commissioner of Taxation, Mr Michael Carmody (22 August 2001).

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