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Tax Laws Amendment (2006 Measures No. 7) Bill 2006

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Contents

Tax Laws Amendment (2006 Measures No. 7) Bill 2006

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Purpose

The Tax Laws Amendment (2006 Measures No. 7) Bill 2006 is an omnibus bill which proposes amendments to facilitate changes to:

- the small-business capital gains tax concessions
- the exemptions from interest withholding tax
- the fund and integrity arrangements for deductible gift recipients
- deductible gift recipient status of certain organisations
- depreciation rules applicable to the life of tractors and harvesters
- non-primary production income threshold and the total deposit limit for farm management deposits, and
- the capital protected borrowings rules.

Background

The Bill contains seven different measures. As the measures are very diverse, each measure will be dealt with separately under the heading *Individual Measures* below.

To increase the readability of this Digest in tandem with the Explanatory Memorandum, the discussion of the Main Provisions to each measure will follow the structure chosen for the Explanatory Memorandum.

Financial implications

The financial implications as specified in the Explanatory Memorandum to the Bill, will be dealt with as part of the discussion of the individual measures under the heading *Individual Measures*.

Individual Measures

Schedule 1—small-business relief for capital gains tax events

Background

Division 152 – the small business capital gains tax concessions

The measure proposes changes to the small business capital gains tax (CGT) concessions. These concessions can be found in Division 152 of the *Income Tax Assessment Act 1997* (ITAA 1997).[1] In its Report *Post-implementation review of the quality and effectiveness of the small business capital gains tax concessions*, released in October 2005, the Board of Taxation (Board) stated:

> Division 152 provides significant CGT concessions for eligible small business entities. […] The basic eligibility criteria that must be met to access the concessions are:
>
> - a limit of $5 million on the net value of assets that the business and related entities own;
> - the CGT asset must be an active asset;
> - if the asset is a share in a company or an interest in a trust, there must be a controlling individual just before the CGT event and the entity claiming the concession must be a CGT concession stakeholder in the company or trust.
>
> Some of the concessions have additional, specific conditions that also must be satisfied.[2]

The concessions for small businesses set forth in Division 152 have been summarised by the Board to include:

- a 15 year exemption which treats a capital gain as totally tax-free, provided the asset was held continuously for 15 years and the relevant person is over 55 and retiring (or permanently incapacitated) at the time of the CGT event happening;
- a 50 per cent reduction in the taxable amount of the gain;
- the ability to use up to a life time limit of $500,000 towards the retirement funding of the relevant individual; and
- the ability to defer paying tax on the gain where it is used to acquire replacement business assets. In this case, the gain is not recognised until the replacement business asset ceases to be an active business asset in its own right.[3]

A complicated regime

There is general agreement that the rules relating to the CGT concessions available to small business were complicated and difficult to apply. The senior tax counsel of the Australian Taxation Institute, Michael Dirkis, has been cited saying that:

> one of the difficulties with the law... Was the rules surrounding access to the concessions were fairly clunky... The major area of difficulty has been the entrance requirement into the concession. If you look at areas people were getting wrong, this was one of them.[4]

And the Sunday Canberra Times commented that:

> one of the most complex pieces of legislation pertains to the CGT small-business concessions that apply when a business is sold. Originally enacted in 1999, that legislation has attracted criticism for its complicated matrix of rules that require a very clear head to decipher. This was nonsense because the Government wanted small-business to be eligible to the concessions.
>
> The CGT small-business concessions cause a capital gain made on a sale of a business to be tax-free. But because of the many tests that must be satisfied, many small-business proprietors tripped at the last hurdle and failed to enjoy the concession.[5]

Addressing on this complexity, the Board commenced conducting a post-implementation review of Division 152 of the ITAA 1997 in 2004.

The Board of Taxation's Post-implementation review of the quality and effectiveness of the small business capital gains tax concessions

In October 2005, the Board released its post-implementation review report titled *Post-implementation review of the quality and effectiveness of the small business capital gains tax concessions* (Report). The Board concluded that the Division would require some:

> - fine-tuning [of] a small number of the provisions relating to the application of the eligibility criteria to improve the current outcomes of the legislation; and
> - minor legislative changes to address unintended consequences and administrative changes to assist understanding of the law.[6]

With these changes, the Board considered, the tax environment in which small-business operates could be improved, providing:

> incentives to small business generally to invest their capital to maximise employment, investment returns, and innovation.[7]

The Board's List of Recommendations can be found in the Report at pages 11 to 21.

The Government's Response

The Government responded to the recommendations made by the Board, announcing changes to the CGT regime applicable to small business in the budget 2006/07. The Treasurer's press release *Capital Gains Tax (CGT): Government Response To The Board Of Taxation's Report On The Post-Implementation Review Of The Small Business CGT Concessions And Other Improvements*, released on 9 May 2006, stated that of the 39 recommendations, the Government:

> accepted all but one of the legislative amendment recommendations, 3 with minor amendments favouring the taxpayer […]. The Australian Taxation Office (ATO) has accepted all recommendations relating to administrative matters.[8]

This Bill is the legislative response by the Government to the Board's Report.

Main provisions

For ease of readability, the discussion of the main provisions of this measure follows the structure for the Explanatory Memorandum.

Significant individual test

Schedule 1, **item 39** of the Bill proposes to change the current controlling individual 50% test with the new significant individual 20% test. It will also change the calculation of the small business participation percentage, that is, under the new regime the 20% participation percentage can be made up of direct and indirect percentages. In the past, the 50% of the controlling individual 50% has had to be made up of direct participation percentages (proposed **sections 152-50** to **152-55** ITAA 1997). The Explanatory Memorandum contains a number of examples of how to calculate whether a person fulfils the significant individual test.[9] The implementation of this measure will also require a number of consequential amendments.[10] The Treasury prepared a Regulatory Impact Statement (RIS) for the significant individual test. The RIS sets out the policy objective, the options considered by the Department and their expected costs; it is included in the Explanatory Memorandum at pp. 40 – 44.

CGT concession stakeholder

Proposed **section 152–60** will introduce a test to ascertain whether a person is a *CGT concession stakeholder* of a company or trust. The test is based on the definition of a *significant individual* contained in proposed **section 152-55**.

Maximum net asset value taste

The *maximum net asset value test* will be prescribed by **item 22**, proposed **section 152-15**. This provision prescribes that a person will justify the *maximum net asset value test* if the sum of the net value of all CGT assets of:

- the taxpayer
- any entity connected with that taxpayer, or
- any small-business CGT affiliate of that taxpayer or entities connected with that person's small-business CGT affiliates

does not exceed a prescribed amount. The prescribed amount remains set at $5 million, it has not yet been increased to $6 million as announced in the 2006/07 Budget[11] and the amount is not indexed.

The key term of the maximum net asset value test is *net value of the CGT assets*. The meaning of this term is defined in proposed **subsection 152-20(1)**.

Items 24 to **29** contain special rules concerning the calculations of the *net value of the CGT assets*, including specific rules in relation to:

- a taxpayer's dwelling (proposed **subsection 152-20(2A))**
- the net value of the CGT assets of others (proposed **subsection 152-20(3)** and **(4)**, and
- so-called *small-business CGT affiliates*.

The Explanatory Memorandum contains examples in relation to the *maximum net value test* and a variety of calculations to which the reader may refer.[12]

Active asset test

Items 31 to **37** proposes changes to the *active asset test*, stipulated in proposed **section 152-35.** This section will stipulate that a CGT asset will satisfy the *active asset test*:

- if it was owned for 15 years or *less*—if it was an active asset for periods totalling half of the period to specified in proposed **subsection 152-35(2)** (proposed **paragraph 152-35(1)(a)**).
- if the asset was owned to *more* than 15 years—if the asset was active for a total of at least 7.5 years during that period (proposed **paragraph 152-35(1)(b)**).

There will be *no* requirement any more that the asset is to be active immediately before the CGT event.

The term *active asset* is defined in **item 32**, proposed **subsection 152-40(1)** to include tangible or intangible CGT assets owned by the taxpayer and which are used, or held ready for use:

- in the course of carrying on a business, or
- in the course of carrying on a business by the taxpayer's small-business CGT affiliates or another entity connected with the taxpayer (proposed **subparagraphs 152-40(1)(a)(i)** and **(ii)**).

In relation to intangible assets, the asset is considered to be active if it is:

- owned by the taxpayer, and
- inherently connected with the business that the taxpayer, a small-business CGT affiliate or another entity, that is connected with the taxpayer, carries on (proposed **paragraph 152-40(1)(b)**).

Item 33 will substitute existing subparagraph 152-40(3)(b)(ii) with proposed **subparagraph 152-40(3)(b)(ii)**. This will allow seeing through a corporate entity to establish the level of active assets in a company or trust.

Items 36 and **37** will amend existing subsection 152-40(4) and introduce proposed **subsection 152-40(5)**, establishing special rules for widely held companies as well as trusts that are listed on an approved stock exchange or have more than 50 members (with some exceptions applicable to trusts with less than 20 members (proposed **subparagraphs 152-40(5)(b)(i) to (iv)**). The reader may refer to the examples listed in the Explanatory Memorandum.[13]

Additional requirement for shares in companies and interests in trusts

Where the CGT event occurs in relation to shares in the company or interest in a trust (the so-called *object company or trust*), then the proposed **subsection 152-10(2)** will add two additional basic conditions which must be satisfied just for the CGT event occurs. Under **item 20**, to access the small business CGT concessions proposed in this measure, the *object company or trust* must be either a:

- CGT concession stakeholder (proposed **paragraph 152-10(2)(a)**), or
- CGT concession stakeholder with a *small business participation percentage* of at least 90% (proposed **paragraph 152-10(2)(b)**).

The Explanatory Memorandum contains examples which demonstrate how the two prerequisites operate.[14] The reader is also referred to the example added to proposed **subsection 152-10(2)**.

15-year exemption

The proposed new measure will introduce the requirement that for an *individual* to access the 15-year exemption on shares or interests in trusts, the company or trust must have had a *significant individual*, for periods totalling at least 15 years or more. The Explanatory Memorandum emphasises, that it is not necessary that the *significant individual* is the same person at all times.[15] This is also clear from the proposed provision.

For a *company or trust* to access the 15 year exemption, the respective entity must have had a *significant individual* for a total of at least 15 years during which it owned the CGT asset (proposed **paragraph 152-110(1)(c)**). **Item 45**, proposed **section 152-120**, will make specific arrangements for discretionary trusts. Such trusts will require a *significant individual* in a loss year or nil income year. Proposed **section 152-125** will stipulate that payments made to a CGT concession stakeholder are to be disregarded as an exempted amount.

Retirement exemption

Subdivision 152-D implements the small business retirement exemption. Section 152-300 explains that a taxpayer can choose to disregard a capital gain from a CGT event happening to a CGT asset of his or her small business if the capital proceeds from the event are used in connection with the taxpayer's retirement. **Item 55**, proposed **subsection 152-325(7)**, will deem a payment made in view of the retirement of an employee or another CGT concession stakeholder to be a termination payment. However, as this provision is a deeming provision,[16] actual termination of the employment is not a prerequisite.

Currently, taxpayers who receive payments that can trigger the retirement exemption, but are under the age of 55, are required to roll-over the exempted amounts into a superannuation fund. **Item 47**, proposed **paragraph 152-305(1)(b)**, will be amended to allow a person *under* the age of 55 to receive such payments, as long as the choice to use the retirement exemption (according to the Explanatory Memorandum usually with the lodgement of an income tax return) occurs *after* the taxpayer turns 55.

Further changes made to the retirement exemption include rules in relation to receiving capital proceeds in instalments; **items 49** and **55**, **subsections 152-310(2)**, **(3)** and **section 152-325** respectively, and the gifting of active assets.

Small-business roll-over

Subdivision 152-E regulates the small business roll-over. According to section 152-400, a small-business roll-over allows a taxpayer to 'defer the making of a capital gain from a CGT event happening in relation to one or more small business assets if you acquire replacement assets'.

Item 57, proposed **section 152-410**, will abolish some of the current prerequisites for the roll-over, including that a taxpayer may choose to obtain a roll-over if:

- within the period starting one year before, and ending 2 years after, the last CGT event during the year for which the taxpayer chooses a small business roll-over, the taxpayer chooses one or more CGT assets as replacements (the so-called *replacement asset*), and
- this *replacement asset* satisfies certain further conditions.

After the amendment, the small-business rollover may be chosen merely on the basis that the basic conditions as stipulated in subdivision 152-A are satisfied in relation to the gain. According to proposed **section 152-415,** choosing to roll-over will allow the taxpayer to choose to disregard all or part of the capital gain.

Further, the amendments will include CGT events J5, J6 and J2 for the purposes of the small business roll-over. **Items 12** and **13**, proposed **sections 104-185**, **104-190**, **104-197** and **104-198**, will facilitate the inclusion of these CGT events. The Explanatory Memorandum contains detailed examples in relation to the proposed rules applicable to the respective event.[17]

Deceased estates

Item 39, proposed **section 152-80**, will make rules for the treatment of the CGT assets that are part of the estate of a deceased person. Proposed **subsection 152-80(1)** sets out the requirements which must be fulfilled cumulatively for this section to apply. Proposed **subsection 152-80(2)** will allow a legal personal representative or the beneficiary to access the same concessions available to the deceased.

Consequential amendments

The measure requires a number of consequential amendments. These further amendments are set out and briefly discussed in the Explanatory Memorandum.[18]

Application

The measures proposed in this Schedule will apply from the income year 2006-07 onwards.[19] However, the Explanatory Memorandum points out that the proposed tests will have implications for CGT events that happened before the income year 2006-07.[20]

Revenue implications

The financial impact of this measure is estimated to be $303 million for the financial years 2007-08 to 2009-10. However, the Explanatory Memorandum refers to additional measures, the costs of which are difficult to quantify but which are expected to be minimal.

Comment

The Australian Law Review cited the Senior Tax Counsel of the Taxation Institute of Australia, Michael Dirkis, who remarked that:

> the five amendments to the CGT small-business concessions meant the requirements were clearer and the hurdle to qualify for the concessions were lower.[21]

However, the measures have also attracted some criticism. First, it has been noted that the measure does not raise the net assets threshold from $5 million to $6 million.[22] Second, the Business of Small Business Organisations of Australia noted that it would be preferable if the thresholds would be permanently indexed.[23] Finally, it must be borne in mind that, further changes to the small business concession rules as part of the announced standardisation of the eligibility criteria for the new small business concessions will be made in the near future,. These changes will come into force in 1 July 2007. This new framework will harmonise eligibility tests for GST, the simplified tax system, CGT, Fringe Benefits Tax and the Pay-as-You-go concessions.[24] Experts have commented that business should be cautious and delay major decisions until the whole package has been introduced and passed.[25]

Schedule 2 – Interest withholding tax

Schedule 2 of the Bill proposes changes to the *Income Tax Assessment Act 1936* (ITAA 1936), modifying some of the sections concerned with interest withholding tax.

Background

Interest payments to non-residents are, subject to a number of exemptions, taxed with withholding tax. As the *Australian Master Tax Guide* explains:

> this means that an amount representing the tax payable is withheld from the payment [of interest] and is remitted by the payer direct to the ATO.[26]

Sections 128F and 128FA ITAA 1936 stipulate the exemption that applies where debentures meet the so-called public offer test. The proposed amendments will modify these two sections to tighten the eligibility requirements for this withholding tax exemption. The tightening is necessary because, according to the Explanatory Memorandum:

> on a strict legal form assessment of the term debenture, it is possible that certain financial instruments that have not traditionally been regarded as debentures could be interpreted as such.

Thus, the tightening of the eligibility requirements counteracts a potential broadening of the scope of the term *debenture* to the point where the availability of the exemption ceases to correlate with the policy intent of the Government. In addition, to future proof the exemption against further broadening, the amendment will introduce a regulation making power, giving the Treasurer the flexibility to react to future developments in this area.

Main provisions

The Bill proposes changes to provisions of Division 11A of the ITAA 1936, dealing with dividends, interest and royalties paid to non-residents and to certain other persons. Specifically, amendments are proposed to:

- section 128F—this section stipulates that this Division will not apply to interest on certain publicly offered *company* debentures or debt interests, and
- section 128AF—this section stipulates that the Division does not apply to interest on certain publicly offered *unit trust* debentures or debt interests.

Schedule 2, **item 1** to **item 3** will amend section 128F to narrow the range of company debentures or debit interests eligible for interest withholding tax exemptions. Specifically, the amendments will stipulate eligibility for interest on a non-debenture debt interest that is:

- also a non-equity share, or
- prescribed by regulation.

Item 4, proposed **subsection 128 F(1C)** will introduce the regulation making power under which other, future forms of debentures and debit interests can be described as non-eligible for the purposes of section 128F. This will enable the Treasurer to counteract any judicial expansion of the term *debenture*.

The proposed amendments to **section 128AF**, **items 5** and **6**, will prescribe the same scope for *unit trust* debentures or debt interests. Item 7 will introduce the regulation power for the purposes of this section.

Application

The majority of provisions in this measure will apply in respect to debt interests issued from the day this Bill was introduced into Parliament, namely 7 December 2006. The regulation making power will apply from the bill receiving Royal Assent.

Costs

The financial impact and compliance costs are estimated to be nil.[27]

Schedule 3—Streamline gift fund and integrity arrangements for deductible gift recipients

Background

For an overview of the background on Deductible Gift Recipients (DGRs), the reader is referred to the explanations contained in the Bills Digest to the Tax Laws Amendment (2006 Measures No. 6) Bill 2006.[28]

Main Provisions

Schedule 3 of the Bill proposes changes to the legislative framework applicable to DGRs. These changes are based on the announcement made by the Assistant Treasurer on 9 May 2006.

Under the current law, DGRs are required to maintain separate gift funds into which gifts and contributions to the recipient are to be recorded. For gift funds that are endorsed as a DGR, **items 1** and **2**, proposed **subsections 30-125(1)** and **(2)**, will change this requirement so that these entities need not to have separate gift funds in the future. Entities that are not endorsed as DGRs, but maintain gift funds that have been endorsed as deductible funds, will still be required to maintain a separate gift fund. However, where these entities maintain more than one endorsed gift fund, **item 7**, proposed **subsection 30-130(3)** will allow these entities to consolidate these gift funds into one.

Further, **Schedule 3** proposes changes to provisions in the *Tax Administration Act 1953* (TAA 1953), with a view to enhancing the DGR integrity arrangements. Under the current law, the Australian Commissioner of Taxation (Commissioner) has different powers to review DGRs depending upon whether the DGR was endorsed or listed. **Item 8** proposes changes to section 353-20 of the TAA 1953 to provide the Commissioner with the power to request information from both endorsed and listed DGRs, thus aligning the integrity arrangements applicable to both types of DGRs (proposed **subsection 353-20(1)**).[29] A failure to comply with this request will be an offence under the TAA 1953. Further, it is proposed to require the Commissioner to report to the Minister where the Commissioner is satisfied that a DGR:

- fails or ceases to use gifts, contributions or money received solidly for the principal purpose of the relevant fund, authority or institution
- changed its principal purpose, or

- fails or ceases to comply with any rules or conditions made by the Prime Minister or any other Minister relating to the recipient being or becoming a DGR (proposed **subsections 353-20(2) and (4)**).

Item 10 will introduce a proposed **Division 382-B** into the TAA 1953. This Subdivision will stipulate the record-keeping obligations of DGRs.

Application of the measure

The measure will commence with the legislation receiving Royal Assent.

Financial implication

The financial impact and compliance costs are estimated to be nil.[30]

Schedule 4—Deductible gift recipient extensions

Main provisions

Schedule 4 of the Bill will extend periods during which deductions will be permitted to certain DGRs (**items 1** to **4**). These DGRs are expressly listed in the ITAA 1997 (sections 30-80 and 30-105). The Explanatory Memorandum notes that this expansion is given to 'support the completion of work of the relevant organisation'.[31] More details in relation to the individual organisations can be found in the Explanatory Memorandum to which the reader is referred.[32]

Financial implications

The Explanatory Memorandum expects that there to be *cost* to revenue of

2007-08	2008-09	2009-10
$2 million	$2 million	$0.3 million

Application

Depending upon the DGR, the measure takes effect on different dates.[33]

Schedule 5—Effective life of tractors and harvesters

Background and main provisions

Schedule 5 of the Bill proposes an amendment to current subsection 40-102(5) of the ITAA 1997 to provide taxpayers in the primary production sector with the option to use a so-called *capped life* to work out the decline in value of their depreciating assets, i.e. their tractors and harvesters. Generally, *capped lives* may be chosen by a taxpayer where the effective life of the asset as determined by the Commissioner as a *safe harbour effective life* is longer than the capped life. The *capped life* introduced by this measure in relation to tractors and harvesters will be 6 2/3 years.

It should be noted that the *safe harbour effective life* used by the Commissioner for Taxation is currently also 6 2/3 years. This has not changed since 1956. However, as a result of the Review of Business Taxation – A Tax System Redesigned (The Ralph Review), the Commissioner may increase this *safe harbour effective life* in which case a taxpayer may choose the then shorter *capped life*.

Financial implications

The Explanatory Memorandum indicates financial and complying costs impacts are nil.

Application

The measure will become effective on 1 July 2007.

Schedule 6—Farm management deposits

Schedule 6 of the Bill proposes changes to Schedule 2G of the ITAA 1936, setting forth rules relating to farm management deposits (FMD). The *Australian Master Tax Guide* explains that:

> The farm management deposits (FMD) scheme is designed to allow primary producers to, in effect, shift income from good to bad years in order to deal with adverse economic events and seasonal fluctuations [...].
>
> The FMD scheme allows primary producers (with a limited amount of non-primary production income) to claim deductions for FMDs made in the year of deposit (and to reduce their PAYG instalment income accordingly. When an FMD is withdrawn, the amount of deduction previously allowed is included in both their PAYG instalment income and their assessable income in the repayment year.[34]

The current law specifies the number of eligibility rules, including, relevantly, that the:

- total of all deposits (deposit limit) cannot exceed $300,000, and
- owner of an FMP cannot claim a deduction equal to the market amount deposited if the owner and more than $50,000 in non-primary production income.

It is proposed to modify both these eligibility rules.

Main provisions

Item 1 proposes to increase the threshold of non-primary production income from currently $50 000 to $65 000 (proposed **paragraph 393-10(1)(b)**).

Item 3 proposes an increase of the deposit limit from $300 000-$400 000 (proposed **subsection 393-35(6)**)

Financial implications

The Explanatory Memorandum estimates the costs to revenue to be:

2006-07	2007-08	2008-09	2009-10	2010-11
Nil	$20m	$18m	$18m	$16m

It further states that there will be small transitional costs, however, there will be no increase in ongoing compliance costs.[35]

Application

The measure will be applicable from the income year in which the Bill receives Royal Assent.

Schedule 7—Capital protected borrowings

The amendments proposed in Schedule 7 will make changes to the ITAA 1997 and the *Income Tax (Transitional Provisions) Act 1997* to make changes to the law relating to capital protected borrowings (CPBs). These changes were announced in April 2003 in response to the Federal Court's decision in *Commissioner of Taxation v Firth* [2002] FCA 413.

Firth's case

In relation to the tax implications of capital protected loans or borrowings, the *Australian Master Tax Guide* explains:

> The ATO has previously taken the view that interest payable on capital protected loans used to purchase shares is not allowable to the extent that it exceeds the amount of interest calculated at the benchmark interest rates set out in the ATO website (*ATO Media Releases* NAT 99/26, 99/45). In effect, the ATO considered that the excess amount was not interest, and should be treated as non-deductible capital protection fee.[36]

This view was challenged in the matter *Commissioner of Taxation v Firth* [2002] FCA 413. In this matter, the question was whether:

> A portion of the interest expenses incurred by [a taxpayer] in respect of so-called protected equity investment loans (PEILs) should be regarded as having been incurred on capital account and as such not deductible by the taxpayer under the general deduction provisions of the *Income-Tax Assessment Act 1997* (Cth).[37]

The loans in question allowed the taxpayer to borrow funds to purchase shares. The loans were structured so that interest, set at a very high rate, was payable in advance, with the principal amount being repayable on maturity. Repayment of the principle was effected by returning the shares to the bank. Any profit made during the life span of the loan was kept by the taxpayer. If the shares were returned at a loss, the financial institution's right to take recourse against the taxpayer was contractually limited to the value of the shares – no personal liability of the taxpayer arose. The compensation for the risk taken by the financial institution was the high interest rate.

The taxpayer in the *Commissioner of Taxation v Firth* claimed a deduction for the full amount of the interest paid. The Commissioner of Taxation (Commissioner) argued that a proportion of this interest payment was:

> referrable to the limited recourse feature of the PEILs and, to that extent, was an outgoing of capital or of a capital nature.[38]

Thus, the deductibility of a proportion of the interest payment ought to be denied pursuant to section 8-1 of the ITAA 1997.

Justices Sackville and Finn of the Federal Court of Australia wrote the majority judgment in this decision. Their Honours found that the loan agreement entered into indicated that the funds were used to acquire shares, and, therefore, the taxpayer's expenses to service the interest were wholly revenue items. Thus, their Honours concluded there was no basis for requiring an apportionment of the interest liability incurred and discharged by the taxpayer.[39]

The Government's response

The Government reacted to the decision, announcing to make amendments to the ITAA to overcome the result of the Federal Court's decision in *Commissioner of Taxation v Firth*.[40]

The interim methodology, now proposed to legislated as Division 247 of the *Income Tax (Transitional Provisions) Act 1997* was announced by the then Minister for Revenue and Assistant Treasurer on 30 May 2003.[41]

Main provisions

Item 1 of **Part 1, Schedule 7** will introduce proposed **Division 247** into the ITAA 1997.

Proposed **section 247-5** will set out the object of proposed **Division 247** whilst proposed **section 247-10** will define the terms *capital protected borrowing* (CPB) and *capital protection*.

Proposed **section 247-15** will stipulate the applicability of proposed **Division 247**. Proposed **subsection 247-15(1)** specifies that only particular types of CPB's will be subject to the operation of this Division, including borrowings for the acquisition of direct or indirect beneficial interests in shares, in units of unit trusts, or stapled securities. The Explanatory Memorandum contains detailed explanations in relation to CPBs, including:

- how to distinguish between CPBs to which this Division will apply and those which are not covered by the proposed measure,[42] and
- the most common forms of CPBs, for example, *instalment warrants* and *capital protected equity loans* and *dynamic hedging* (the latter was in issue in the matter of *Commissioner of Taxation v Firth*)[43]

to which the reader may refer.

Proposed **subsections 247-15(2)** and **(3)** will ensure that lenders and participants in employee share schemes will not be subject to the operation of the Division. **Subsections 247-15(4)** and **(5)** set out further limitations to the applicability of **proposed Division 247**, for example, to exclude some form of project finances which are based on the purchase of interests in certain unlisted companies by using funds obtained on a non-recourse basis (proposed **paragraphs 247-15(5)(a)** and **(b)**).

Proposed **section 247-20** provides that an amount which is reasonably attributable to capital protection is to be treated as a 'put option'. Proposed **subsection 247-20(1)** specifies the scope of this provision. If the CPB was obtained between 16 April 2003 and 1 July 2007, proposed **subsection 247-20(2)** will refer to proposed **Division 247** of the *Income Tax (Transitional Provisions) Act 1997* to work out the proportion of the borrowing that is capital protection and therewith a put option (see comments to **Item 2** of **Schedule 7**, below). For CPBs obtained after 1 July 2007, proposed **subsections 247-20(3)** to **(5)** will set out the method for how to calculate this proportion. The reader may refer to the Explanatory Memorandum which sets out detailed explanations to the individual steps and provides examples to the calculations.[44]

Proposed **section 247-25** stipulates that where capital protection can be invoked on several occasions during the life of a CPB, each occasion is deemed to be a separate 'put option'.[45]

Proposed **subsection 247-30(1)** provides that:

- invoking capital protection will be deemed to equate to an exercise of the put option (proposed **paragraph 247-30(1)(a)**), and
- with the deemed exercise of the 'put option' any interest in shares, unit in a unit trust or stapled security is taken to have been disposed of (proposed **paragraph 247-30(1)(b)**).

Proposed **subsection 247-30(2)** stipulates when a put option is deemed to have expired.

The **Note** to proposed **section 247-30** is a reminder that the expiry or exercise of a 'put option' can give rise to a capital gain and trigger a capital gains tax event.

Item 2 of **Part 1**, **Schedule 7** introduces proposed **Part 3-10** 'Financial transactions', **Division 247** 'Interim apportionment methodology for capital protected borrowings' into the *Income Tax (Transitional Provisions) Act 1997* (ITTPA).

The reader is again referred to the explanations and examples contained in the Explanatory Memorandum. They are of great assistance to enhance the understanding of this complex area of the Tax Law.

Proposed **Division 247** ITTPA stipulates the interim apportionment method, applicable to CPBs entered into between 16 April 2003 and 1 July 2007 (see referring provision in the ITAA 1997, proposed **subsection 247-20(2)** ITAA 1997 above).[46] The Division distinguishes between apportionment methods for different capital protected products, including instalment warrants (proposed **section 247-10** ITTPA) and other capital protected products (proposed **section 247-15** ITTPA).

Proposed **subsections 247-10(1) and (2)** ITTPA stipulate the apportionment method for instalment warrants purchased on the *primary market*, that is, 'directly from a lender…'.[47] Proposed **subsection 247-10(3)** ITTPA, together with the calculations set forth in proposed **subsections 247-10(4)** and **(5)** ITTPA, provides the method to ascertain the amount reasonably attributable to capital protection for instalment warrants purchased in the *secondary market*.

Capital protected products which do not fall within the scope of proposed **section 247-10** ITTPA will be caught by proposed **section 247-15 ITTPA**. According to this provision, the amount reasonably attributable to the capital protection will be the greater amount of two amounts worked out using the so-called 'indicator method' and the 'percentage method' (proposed **subsection 247-15(1)** ITTPA). The two methods are stipulated in proposed **sections 247-20** and **247-30** ITTPA.

Parts 2 and **3** of **Schedule 7** contain consequential amendments and application provisions.

Application

The interim apportionment methodologies will apply to CPBs entered into between 16 April 2003 and 1 July 2007. The main measure will apply to such CPBs entered into after 1 July 2007.

Financial implications

According to the Explanatory Memorandum, the financial impact will be minimal with lower compliance costs predicted for both, investors and lenders.

Endnotes

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1. Unless stated otherwise, references to a section as part of the discussion of Schedule 1 will be references to sections in the *Income Tax Assessment Act 1997*.
2. The Board of Taxation, *Post-implementation review of the quality and effectiveness of the small business capital gains tax concessions*, Report, p. 4–5.
3. Report, p. 5.
4. E Kazi, CGT breaks could encourage small business to sell, *The Australian Financial Review*, 12 December 2006, p. 4, citing M Dirkis, Senior Tax Counsel, Taxation Institute of Australia.
5. M Bannon, Streamlining Concessions, *Sunday Canberra Times*, 19 November 2006, p. 39.
6. Report, p. 10.
7. Report, p. 10.
8. The Hon P Costello, Treasurer, *Capital Gains Tax (CGT): Government Response To The Board Of Taxation's Report On The Post-Implementation Review Of The Small Business CGT Concessions And Other Improvements*, Press release, No. 38, 9 May 2006.
9. Explanatory Memorandum, pp. 15–19.
10. For a brief discussion of the consequential amendments, see paragraphs 1.21 and 1.22 of the Explanatory Memorandum, p. 19.
11. See Attachment A '2006-07 Budget Initiatives' to The Hon P Costello, Treasurer, Report of the Taskforce on reducing regulatory burdens on business – final Government response, Media release, No. 088, 15 August 2006.
12. Explanatory Memorandum, pp. 20–22.

13. ibid., p. 24.
14. ibid., pp. 26–27.
15. ibid., p. 28.
16. This is the effect of proposed **subsection 152-325(7)**.
17. ibid., pp. 32–38.
18. ibid., p. 39.
19. ibid., p. 3.
20. ibid., p. 39.
21. Kazi, op. cit.
22. This increase has been announced in The Hon P Costello, Treasurer, and the Hon F Bailey, Minister for Small Business and Tourism, *Making tax compliance easier for small business – the new small business framework*, Joint Press release, No. 123, 13 November 2006. Kazi, ibid., citing Paul Masters, Partner with Deloitte.
23. Kazi, ibid., citing Tony Steven, Business of Small Business Organisations of Australia.
24. The Hon P Costello, Treasurer, and the Hon F Bailey, Minister for Small Business and Tourism, *Making tax compliance easier for small business – the new small business framework*, Joint Press release, No. 123, 13 November 2006.
25. Kazi, op. cit., See also the comment by P Switzer, Confusion clouds new CGT regulation, *The Weekend Australian*, 30 December 2007, p. 26.
26. CCH, Australian Master Tax Guide, 38th edition, CCH Australia Limited, North Ryde, 2006, p. 1315.
27. Explanatory Memorandum, p. 5.
28. B Jaggers, Tax Laws Amendment (2006 Measures No. 6) Bill 2006, Bills Digest, No. 61, Department of Parliamentary Services, 2006-07, pp. 2–3.
29. Explanatory Memorandum, p. 57.
30. ibid., p. 5.
31. ibid., p. 62.
32. ibid., p. 62.
33. The application dates are listed in the Explanatory Memorandum, p. 6.
34. Australian Master Tax Guide, op. cit., p. 1175.
35. Explanatory Memorandum, p. 62.
36. Australian Master Tax Guide, op. cit., p. 1057.
37. *Commissioner of Taxation v Firth* (2002) 192 ALR 542, p. 550.
38. ibid.

39. ibid., p. 560.
40. The Hon P Costello, Treasurer, Taxation of Capital Protected Products, *Media release* No. 19, 2003.
41. The Hon. Senator H Coonan, Minister for Revenue and Assistant Treasurer, Taxation of Capital Protected Products, *Media release* C045/03, 30 May 2003.
42. Explanatory Memorandum, p. 75.
43. ibid., pp. 75–8.
44. ibid., pp. 81–6.
45. The Explanatory Memorandum contains detailed examples that explain the operation of this provision well. ibid., p. 86–7.
46. These interim measures were announced by Senator H Coonan, then Minister for Revenue and Assistant Treasurer, *Media release* C045/03, op. cit.
47. ibid., p. 91.

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