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Tax Laws Amendment (2007 Measures No. 5) Bill 2007

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Tax Laws Amendment (2007 Measures No. 5) Bill 2007

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Commencement: Schedules 1 to 7, 9, parts 1,2 & 4 of Schedule 10 and Schedule 11 - Royal Assent. Schedule 8 the later of Royal Assent or the day on which the *Tax Laws Amendment (2007 Measures No. 4) Act 2007* receives Royal Assent. Part 3 of Schedule 10 – 1 July 2010. Schedule 12 a date fixed by Proclamation, or the day after a 6 month period on which this Act receives Royal Assent, whichever occurs sooner.

Links: The relevant links to the Bill, Explanatory Memorandum and second reading speech can be accessed via BillsNet, which is at http://www.aph.gov.au/bills/. When Bills have been passed they can be found at ComLaw, which is at http://www.comlaw.gov.au/.

This Bill contains 12 Schedules – each of which has a distinct purpose that is not necessarily related to any other schedule. Therefore, the following will separately deal with each of the schedules.

Schedule 1: Asset financing of tax preferred entities

Purpose

Proposed changes

The government has proposed to restrict the operation of **section 51AD** and **Division 16D** ITAA36 to arrangements entered into before 1 July 2003. In their place a proposed **Division 250** *Income Tax Assessment Act 1997* (ITAA97) would institute proposed arrangements for taxing the proceeds of leases or other arrangements for the use of assets by tax preferred entities.

Schedule 1 inserts proposed **Division 250** into the *Income Tax Assessment Act 1997* (ITAA97) and makes consequential amendments to this Act, as well as the:

- *Development Allowance Authority Act 1992*
- *Income Tax Assessment Act 1936* (ITAA36), and
- *Tax Administration Act 1953*.

The purpose of the proposed **Division 250** is to deny (or reduce) various capital allowance deductions that may be claimed by a taxpayer in circumstances where, broadly, a tax-preferred entity (i.e. one that is tax exempt) effectively controls the use of an asset and the taxpayer, who is the legal owner of the asset, does not have a predominate economic interest in that asset. Rather, these arrangements will be treated as a loan and taxed as a financial arrangement on a compounding accruals basis.[1]

Background

History of the proposed changes

These proposals arose from the recommendations of the 1999 Review of Business Taxation. That Review generally recommended that the current legislation (**section 51AD** ITAA36) be abolished and that leases using non-recourse finance not be treated differently to other leases. These recommendations were made in the context of the Review's overall recommendation that accelerated depreciation on capital equipment should also be abolished.[2]

The government signalled its intention to address this issue in the Assistant Treasurer's media release of 14 May 2002. It committed itself to further consultation on this matter over the course of 2002–2003.[3]

On 26 June 2003 an exposure draft of the 'Proposed Tax System (Tax Preferred Entities – Asset Financing Bill 2003' was released. Comment was invited on this draft Bill from interested parties. It was to have commenced operation from 1 July 2003. [4]

The various submissions were received by the government suggesting significant alterations to the draft Bill. In response to these submissions the government temporarily deferred the commencement of a proposed regime.[5]

The government again announced measures for the reform of tax exempt asset finance arrangements and forwarded a Draft in Confidence Tax Laws Amendment (2006

1. The Hon. Peter Dutton MP, Minister for Finance and Assistant Treasurer, 'Second reading speech: Tax Laws Amendment (2007 Measures No. 5) Bill 2007', House of Representatives, *Debates*, 16 August 2007, p 6.
2. J T Ralph (Chair), Review of Business Taxation, *A Tax System Redesigned - Overview Recommendations and Estimated Impacts*, July 1999, pp 59-60.
3. Senator the Hon. Helen Coonan, Minister for Revenue and Assistant Treasurer, 'Maintaining the momentum of business tax reform', *media release*, C57/02, 14 May 2002.
4. Senator the Hon. Helen Coonan, Minister for Revenue and Assistant Treasurer, 'Taxation of infrastructure financing bill released for comment', *media release*, C062/03, 26 June 2003.
5. Senator the Hon. Helen Coonan, Minister for Revenue and Assistant Treasurer, 'More time to finalise asset financing reforms', *media release*, C115/03, 4 December 2003.

Measures No. 7) Bill 2006 to selected industry participants on 1 November 2006.[6] This latter draft Bill, and the responses to it, appear to form the basis for the changes contained in **Schedule 1**. However, not every change in the draft legislation sought by concerned industry groups was accepted by the government.[7] The final *Tax Laws Amendment (2006 Measures No. 7) Act 2006* did not contain any amendments in relation to leasing of assets by tax exempt entities.

Proposed changes - Background

As noted above, these changes deal with undue tax advantages gained by the leasing of assets to a tax exempt body.

What tax exempt bodies are in view?

A tax-preferred entity may be a government department or a non-resident operating in a low, or no tax, jurisdiction that is not subject to Australian tax laws.[8]

What kind of transaction is in view?

For example, an Australian taxpayer will purchase an asset, say, a building, and leases it to a government department for a set period of time and sets the return to be paid over that time. The government department is responsible for all the costs associated with that building, such as the upkeep and utilities costs. At the end of the lease the ownership of the building reverts to the government department. Further, at the end of the lease, there may be a payment of a specified amount (i.e. a balloon payment) to the lessor.

The Australian taxpayer (i.e. the lessor) claims a deduction for the capital cost of the building. Often, the deduction is higher than the rental/lease payments received from the tax exempt entity. The excess deductions are used to reduce the taxpayer's assessable income from other sources. The tax exempt entity benefits through lower rent/lease charges than they might otherwise have paid.

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6. The Hon. Mal Brough MP, Minister for Revenue and Assistant Treasurer, 'Tax Exempt Asset Financing Reforms, *media release*, No. 081, Canberra, 13 September 2005, and Ernst & Young, Submission to Treasury on behalf of Infrastructure Partnerships Australia, Energy Supply Association of Australia, Minerals Council of Australia, Property Council of Australia, Australian Bankers Association, Australian Equipment Lessor's Association, Corporate Tax Association and Institute of Charted Accountants in Australia, 13 December 2006, p. 1.

7. *Explanatory Memorandum* to the Tax Laws Amendment (2007 Measures No. 5) Bill 2007, 16 August 2007, pp. 114-115; hereafter Explanatory Memorandum.

8. An example of such an entity may be a company operating in a special economic zone, such as the Subic Bay Freeport Zone in the Philippians.

The Australian taxpayer may be the legal owner of the asset (until the end of the lease) but it has little, if any, economic interest in the performance of the asset in question.

A general principal of income tax law is that, in order to claim deductions for expenditure relating to ownership of an asset (such as capital allowances), the owner must show that the asset is used for the purpose of producing assessable income, or in carrying in a business for that purpose. The government notes that the above arrangements have been used to circumvent this principle.[9]

Does the tax legislation already deal with these situations?

Section 51AD ITAA36 denies a taxpayer the capital deduction in these circumstances where the taxpayer financed the purchase of the asset using 'non-recourse' debt for at least 50 per cent of the purchase price.[10] The operation of this section has been avoided by arrangements not involving non-recourse debt.

Division 16D ITAA36 also acts to deny a taxpayer certain capital allowance deductions in these circumstances. Where this division applies **section 51AD** ITAA36 does not apply, and vice versa.

What's wrong with section 51AD and Division 16D?

Section 51D is thought to be overly harsh in its effect as:

- it creates a significant tax disadvantage by taxing gross income with no allowance for costs of the relevant asset and other costs in relation to the asset such as interest and repairs
- it denies tax deductions, while assessing related income for taxation purposes
- certain short term arrangements are inappropriately assessed under the above legislation, and
- the above legislation has been seen as a significant obstacle to the building of infrastructure through Public Private Partnerships (see below).

It has been suggested that **section 51AD** was easy to circumvent. Details on how this was achieved are not readily available; however it may be the case that this section was circumvented if:

9. *Explanatory Memorandum*, pp. 13–14.

10. Australian Tax Office, Taxation Ruling 96/22, *Income tax: section 51AD – deductions not allowable if an asset financed by non-recourse debt is used by a tax exempt or other entity*, 31 July 1996, p.4.

- the tax preferred entity used the asset under an agreement that was not a lease for accounting purposes, or
- if some other form of debt, rather than a non-recourse debt, was used to finance the asset.

Division 16D incorporates inappropriate risk test, such as the mere existence of responsibility for repairs and maintenance is considered as a criteria for the assessment of income under this division, not who actually carries out the repairs and maintenance.

Impact in Infrastructure Investment

A considerable number of Australian infrastructure projects are undertaken through Public Private Partnerships (PPPs). PPPs are basically partnerships between public authorities and private sector companies of the construction and operation of discreet infrastructure projects, such as tollways or port facilities. The most common form of PPP is the Build, Own Operate and Transfer (BOOT) model where a private company builds owns and operates an asset and at the end of a set period transfers the asset to public ownership.

As **section 51AD** and **Division 16D** ITAA36 disallow certain deductions for tax purposes because of the involvement of tax-exempt public authorities in the partnerships, these sections make it less attractive for the use of assets owned by public authorities in partnership with private sector companies. These provisions adversely impact on infrastructure development where assets owned by public authorities are involved.

The Ralph Review in its report A Proposed Tax System Redesigned at page 392, referred to below, in recommending the repeal of **section 51AD** emphasised the adverse impact on infrastructure providers as the main reason for this recommendation. It stated:

> **Section 51AD** has a severe impact where it applies because all deductions are denied to the taxpayer but the associated income is still assessable. It has been continually criticised by State Governments and infrastructure providers for its severe impact where it applies and the uncertainty it creates. Section 51AD has become even more problematical in recent years because of increased levels of privatisation and outsourcing of government services which were not contemplated when it was first conceived.

Tax exempt leasing

The basis for this view was set out in Discussion Paper 2 Volume 1 titled 'A Platform For Consultation' issued by the Review of Business Taxation in February 1999. Chapters 8, 9 and 10 dealt with taxation of leases and rights. Paragraphs 8.29 to 8.37, which summarise the impact of sections 51AD and Division 16D on tax exempt leasing, are set out below:

- 8.29 The ability of tax exempt entities to engage in leasing and similar arrangements is restricted by **section 51AD** and **Division 16D**, which operate to deny tax benefits to those who provide property to tax exempt entities, such as public utilities
- 8.33 **Section 51AD** is severe in its application, because it disallows completely deductions relating to the property, while all the income remains taxable. It applies to arrangements which have features of both operating and finance leases
- 8.34 While always criticised for its severe impact, existing **section 51AD** has become more problematic because of privatisation and outsourcing of government functions that were not contemplated when it was first conceived
- 8.36 **Division 16D** denies capital allowances to the owner of the property and treats lease payments as repayments of principal and payments of interest. **Division 16D** does not apply to other tax exempt entities, such as certain clubs or businesses operated by charities. A **Division 16D** qualifying arrangement is broadly similar to a finance lease
- 8.37 Both **section 51AD** and **Division 16D** are complex in their application, in that the operation of the 'effective control' test necessarily requires a degree of judgment on the part of the tax authorities, especially in relation to arrangements where the tax exempt remains involved to a greater or lesser extent in decisions relating to the arrangement. However, **section 51AD** is more controversial because the complexity is exacerbated by the severity of its application.[11]

It is interesting to note that industry groups have previously called for the repeal of **section 51AD**. However, in relation to **Schedule 1** industry simply requested that **section 51AD** cease to have effect to arrangements entered into on or after 1 July 2003.

The changes included in **Schedule 1** have been welcomed by industry groups as facilitating increased investment in infrastructure via PPPs.[12] The question is how do the proposed changes in **Schedule 1** meet some or all of the above concerns? The following points illustrate some of the advantages of the proposed **Division 250** ITAA97:

- firstly, existing **section 51AD** will not apply to arrangements entered into on or after 1 July 2003. While this restricts the continued application of this section the qualities of

11. Bernard Pulle and Richard Webb, 'Public Private Partnerships – an Introduction', *Research Paper*, No. 1 2002-2003. Parliamentary Library, Canberra, pp. 21–23.

12. Property Council of Australia, CPA Australia, Infrastructure Partnerships Australia and Australian Chamber of Commerce and Industry, *Submissions to Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures no. 5.) Bill 2007*, August 2007 at http://www.aph.gov.au/Senate/committee/economics_ctte/tlab_5_2007/submissions/sublist.htm (accessed 4 September 2007).

the proposed **Division 250** ITAA97 have to be considered to see whether they promote investment in infrastructure by PPPs

- where a proportion of the asset (say an office building) is not used by a tax preferred entity a proportion of the relevant tax deductions for capital allowances will be allowed under proposed **section 250-150** and related proposed sections
- where **Division 250** applies and the financial arrangement is assessed as a deemed loan, any losses accruing to the taxpayer from this arrangement are tax deductible under proposed **section 250-205**
- where a payment is made by the tax preferred entity to the taxpayer at the end of the agreement for the use of the asset results in a loss to the taxpayer – this loss is also tax deductible
- amounts expended by the taxpayer to modify the asset for use by a tax preferred entity are deducted from the amount of accrued financial benefits received by the taxpayer (proposed **paragraph 250-155(8)(b)**)
- while existing **section 51AD** ITAA36 denied a taxpayer deductions for their interest expenses in relation to the financing of an asset used by a tax preferred end user, proposed **Division 250** ITAA97 allows a deduction for the taxpayer's interest expenses, and
- under proposed **section 250-160** the taxpayer's costs of providing services to the asset used by the tax preferred entity (i.e. repairs and maintenance and any other service)will not be included in the deemed loan assessment under Division 250. These costs may be tax deductible to the taxpayer under other parts of the income tax legislation.

In short, proposed **Division 250** ITAA97 allows many more expenses as tax deductions than existing **section 51AD** and **Division 16D** ITAA36.

Basis of policy commitment

This measure was announced in the then Minister for Revenue and Assistant Treasurer's press release of 13 September 2005.[13]

Position of significant interest groups/press commentary

The following comments are drawn from industry responses to the draft in confidence Tax Laws Amendment (2006 Measures No. 7) Bill 2006, as well as submissions to the Senate Economics Committee's inquiry into the provisions of the Bill.

13. The Hon. Mal Brough MP, Minister for Revenue and Assistant Treasurer, 'Tax Exempt Asset Financing Reforms, *media release*, No. 081, Canberra, 13 September 2005.

As a general response a number of industry bodies appear to be concerned that the proposed **Division 250** ITAA97 significantly extends the reach of existing tax law (i.e. existing **section 51AB** and **Division 16D** ITAA36) as it applies to the leasing of assets by tax exempt entities.[14]

Deloittes Ltd, a large accountancy firm, generally support the introduction of **Division 250** into the ITAA97, but also express reservations about the extended reach of these provisions compared to current legislation and seeks consideration of various technical issues arising from the draft legislation.[15]

The Minerals Council of Australia is seeking an exemption from the provisions of this Schedule for the supply of minerals to tax exempt bodies, such as the supply of coal to State government owned power stations, on the basis that these arrangements are undertaken on an arms length commercial basis.[16] However, it acknowledges that the examples given in Explanatory Memorandum indicates that this will be the case under the proposed legislation.

The Property Council of Australia supports the general direction of the proposed provisions. However, it is concerned that the proposed provisions discriminate against the use of non-recourse debt for assets used by non residents. Further it is concerned that the definition of having a 'predominate economic interest' in an asset is different for residents and non residents and recommends that the definitions be the same (see following discussion).[17]

While recognising that the provisions of this Schedule, and the proposed **Division 250** in particular, contain many compromises, Infrastructure Partnerships of Australia support these provisions and urge that they be quickly passed by Parliament.[18]

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14. Ernst & Young op. cit., p. 2.

15. Deloitte Touche Tohmatsu Ltd, *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007 – Re Division 250 draft legislation*, 23 August 2007, p. 1.

16. Minerals Council of Australia, *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007*, 24 August 2007. p. 1.

17. Property Council of Australia, *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007*, 27 August 2007. p. 2.

18. Infrastructure Partnerships Australia, *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007*, 24 August 2007, p. 1.

The Australian Chamber of Commerce and Industry (ACCI) recognise that the provisions of this Schedule are complicated, but these complications arise from the exemptions requested during the consultation process. The group also urges that the legislation be quickly passed by Parliament.[19]

Responding to a confidential discussion paper on these proposals circulated in early 2005 the Urban Local Government Association of Queensland Inc. noted that some local government contracts, such as garbage collection contracts may be assessed under the proposed provisions and increase in cost.[20] It is not clear whether this is a valid concern in relation to the specific proposals in this Bill.

Pros and cons

The Explanatory Memorandum notes that the proposed changes will streamline the law by limiting the application of existing **section 51AD** and **Division 16D** ITAA36 to arrangements that commenced before 1 July 2007 (or before 1 July 2003 in certain circumstances), so that the relevant law will be in one location.

Further, the proposed arrangements will:

- remove the harsh impact of existing **section 51AD**
- certain relatively short term and lower value arrangements will be excluded from the proposed **Division 250** ITAA97, and
- all arrangements that come within the scope of the proposed regime will be taxed the same way, i.e. as financial arrangements on a compounding accruals basis (see below).[21]

As noted above, various industry bodies are concerned that the proposed measures may extend the reach of the current tax legislation in this area.

Financial implications

The Explanatory Memorandum notes that these proposals have no financial impact.[22] However, if arrangements that were not previously subject to tax are caught by the

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19. Australian Chamber of Commerce and Industry, *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007*, August 2007, p. 3.
20. Urban Local Government Association of Queensland Inc, Letter to the Hon. Peter Costello MP, Treasurer, 4 July 2005, p. 2.
21. *Explanatory Memorandum*, p. 15.
22. ibid, p. 5.

proposed provisions then it is reasonable to expect that there may be an increase in revenue.

Key issues

These proposals rewrite the relevant tax law on the tax treatment of leases of assets by tax exempt entities into simpler more modern language and consolidate these provisions into one location in the ITAA97. However, the older legislation will not disappear; rather, it will be limited to agreements entered into before 1 July 2007.

These provisions may also extend the reach of current tax law in this area.

Main provisions

Item 1 of **Part 1** inserts proposed **Division 250** into the ITAA97. The following summarises the main sections in the proposed Division.

Application

Proposed **section 250-15** ITAA97 applies the provision of this Division where:

- the asset is put to a tax preferred use for a period that is greater than 12 months
- the benefits are provided to the taxpayer by a tax preferred entity or end user or any entity connected to these groups or by a non-Australian resident for tax purposes
- except for this Division the taxpayer would have been entitled to claim a capital allowance, and
- the taxpayer does not have a 'predominate economic interest' in the asset.

Exclusions

Proposed **sections 250-20** to **250-45** specifically exclude arrangements made in the following circumstances from assessment under proposed **Division 250**:

- a small business that chooses to deduct amounts from their assessable income under **subdivision 328-D** ITAA97 (which specifically deals with capital allowances for small business). A small business for these purposes is one whose turnover is less than $2 million in the previous income year[23]

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23. Section 328-110 ITAA97.

- the total nominal value of the arrangement is less that $5m (this amount is indexed annually)
- if the assessable income from the arrangement, at the start of that arrangement is less than the alternative assessable amount. Proposed **subsection 250-40(3)** gives the method for working out the alternative assessable amount of income for proposed **Division 250** ITAA97 purposes, and
- if the Commissioner for Taxation determines that it is unreasonable for proposed **Division 250** to apply to a particular arrangement.

Further under proposed **section 250-30** this Division does not apply:

- if the arrangement is not longer than 5 years in duration and less than $40 million in value in relation to real property where the arrangement is a lease
- if the arrangement is less than 3 years in duration and worth less than $20 million.

If at the end of the arrangement the tax preferred entity may:

- purchase the asset, may acquire an interest in the asset or may required the asset to be transfer the asset to another party, and
- the consideration for these rights is not fixed as the market price of the asset at the time these actions are taken, or
- the arrangement is a debt interest

and the arrangement would otherwise meet the exclusion provisions of proposed **section 250-30**, then the arrangement will no longer be exempt despite otherwise meeting the provisions of this proposed section proposed **section 250-35**).

Predominate economic interest

As noted above, if the taxpayer lacks a predominate economic interest in the asset used by the tax preferred entity, then the provisions of proposed **Division 250** apply. Proposed **sections 250-115** to **250-135** define when a taxpayer does not have a predominate economic interest in an asset being used by a tax preferred entity. Briefly, a taxpayer does not have a predominate economic interest in the asset if any of these circumstances are met:

- more than 80 per cent of the asset's price has been financed by limited recourse debt, if it is used by an Australian tax preferred entity,
- more than 55 per cent of the assets price has been financed by limited recourse debt if the asset is used by a non resident for tax purposes

- if at the end of the arrangement the asset is to be transferred to a tax preferred entity and the consideration for this transfer is not fixed at the market price at the time of transfer
- if the arrangement cannot be cancelled without the taxpayer's permission and the period of the arrangement is greater than 30 years, or if it is less than 30 years in duration, 75 per cent or more of the assets effective life exists when the arrangements starts
- if the asset has a guaranteed residual value at the end of the arrangement
- the arrangement is a debt interest
- the sum of the present value of the benefits provided (or reasonably expected to be provided) to the taxpayer exceeds 70 per cent of:
  - the declining value of the asset (see proposed **subparagraph 250-15(d)(i)**), or
  - the market value of the expenditure in relation to the asset (see proposed **subparagraph 250-15(d)(ii)**).

For these purposes limited recourse debt is defined in existing **section 243-20** ITAA97. Briefly it means that the rights of the creditor, in the event of a default in the repayment of the financial obligations, are limited to the rights over the asset in question – and do not include rights over the debtor's other assets.

Comment

Section 51AD ITAA36 deals with situations where non-recourse debt is used. **Item 27** of the Bill limits the application of this section to arrangements that commenced before 1 July 2007 (but see also **sub-item 71(11)**). It is not clear that the proposed **Division 250** will apply to arrangements where non-recourse debt is used to fund these arrangements, as opposed to limited-recourse debt as defined above. However, the definitions of limited recourse debt and non-recourse debt are very similar.

Denial of capital allowance deductions

Proposed **section 250-145** denies capital allowances deductions from assessable income where the proposed **Division 250** ITAA97 applies.

Comment

It is important to note that this proposed section does not deny the taxpayer the ability to claim tax deductions in respect of their interest expense. So, if a taxpayer borrowed the finance to build the assets used by the tax preferred entity, the interest expense on that borrowing may be claimed as a tax deduction under tother sections of the ITAA97. This is a significant difference to the provisions in **section 51AD** ITAA36.

Apportionment of capital allowance deductions

Proposed **section 250-150** allows the taxpayer to choose to have a proportion of the capital allowance deductions from assessable income allowed. The proportion allowed is the present value of the financial benefits that are subject to treatment as a 'deemed loan' (see below) to the market value of the asset. If this method is not appropriate, then the Commissioner for Taxation may approve another method.

For example the sum of the present values of the financial benefits arising from a deemed loan under proposed **Division 250** are $10 million. The market value of the asset is $100 million. The percentage of capital expenditure that cannot be claimed as a capital allowance deduction is 10 per cent.

The example in the Explanatory Memoranda indicates that this option will be chosen where the asset is used partly by a tax preferred entity and some of the benefits will flow from a taxable entity.[24] An example of such a situation may be where an office building is leased to both a government department and a commercial organisation. The financial benefits flowing from the government department are treated as a deemed loan. The proportion of the capital expenditure on the building related to its use by the government department cannot be claimed as a tax deduction. However, the capital expenditure related to the use of the building by a taxable organisation can be claimed as a tax deduction. Proposed **section 250-150** allows this to occur in these circumstances.

Comment

Again, the ability to claim part of the capital allowances, arising form the use of an asset by a taxable entity, is a significant difference from the provisions of **section 51AD** ITAA36. Under the current legislation a taxpayer could not claim these capital deductions in these circumstances.

Deemed Loans

Proposed **sections 250-155** and **250-160** deal with when a financial arrangement is deemed to be a loan for the purpose of the proposed **Division 250**. The definition of a 'deemed loan' is quite broad in proposed **section 250-160** so that almost any financial arrangement to which **Division 250** applies will be treated as a deemed loan.

However, classification as a deemed loan applies to a return on an investment. It does not apply to other cash flows such as consideration for services rendered or for the recovery of production costs.[25] As noted above, this may allow the taxpayer to claim repairs and

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24. *Explanatory Memorandum*, p. 53.

25. ibid, p. 58.

maintenance costs as a deduction from the assessed income flowing from this arrangement. Again, this is a significant difference to the provisions of **section 51AD** ITAA36.

Comment

The classification of financial arrangements as a 'deemed loan is at the heart of the tax regime in **Division 250**. For a major intent of these changes is to tax all such arrangements as a deemed loan where this Division applies.

Definition of financial arrangement

Proposed **sections 250-165** and **250-170** broadly define what a financial arrangement may be. The definition does not mention the term lease by name, but clearly a lease would be included in this definition.

Comment

The broad definition of financial arrangement may covers agreements under which tax preferred entities used assets that were not previously caught under the provisions of **Division 16D** or section **51AB** of ITAA36. Thus the reach of proposed **Division 250** ITAA97 may be far wider than the older legislation.

End value of an asset

Proposed **section 250-180** defines what the end value of an asset may be. An end value is the value of the asset after the end of the arrangement under which that asset was provided to the tax exempt entity. The end value of an asset is used in taxing these arrangements as a deemed loan and in other circumstances, such as when **Division 250** ceases to apply to the asset.

Subdivision 250-E

Proposed **Subdivision 250-E** implements the proposed taxation arrangements for deemed loans.

Proposed **section 250-205** restates the basic rule that gains are assessable income and losses are a deduction from assessable income. Proposed **section 250-210** notes that gains or losses are only to be taken into account once under this Act. This rule prevents these gains and losses from being recognised in other areas, for example in relation to the thin capitalisation rules.

Proposed **section 250-215** allows for two methods to be used for taking these gains or losses into account:

- the compounding accruals method, and/or
- the balancing adjustment method (for use at the end of the arrangement if appropriate).

Proposed **section 250-245** allows for a different method to be used, providing that the alternative method can be shown to produce results that are approximately the same as those produced by the compounding accruals method.

Proposed **section 250-220** requires that a taxpayer use one or the other method (either the set compounding accruals method or the alternative method approved by the Commissioner under proposed **section 250-245**) for the entire life of a particular financial arrangement.

Compounding accruals method

Proposed **sections 250-230** to **250-255** implement the compounding accruals method for determining the gains or losses arising from a deemed loan. Generally the compounding accruals method will be used in circumstances where the gain or the loss over the entire life of the arrangement is sufficiently certain at the time the arrangement commences.

The Explanatory Memorandum notes that to apply the compounding accruals method a taxpayer:

- estimates the rate of return (discount rate) that brings the net present value of all cash flows (financial benefits) to zero
- applies that rate of return to the initial investment to provide an estimate f the year by year gains
- these gains (or losses) form the basis for the annual taxation of the arrangement.

However, the amounts brought to account for taxation purposes are nominal gains only.[26] Detailed examples of the application of this method are included in the Explanatory Memorandum at pages 82 though to page 90.

Comment

Proposed **section 250-190** notes that the distinction between income and capital recepts is ignored when **Division 250** applies. Rather, all the gains or losses are income gains or losses.

Balancing adjustment method

The balancing adjustment is covered by part of proposed **section 250-255** and by proposed **sections 250-265** through to **250-275**. It is used when there is a significant changes in the arrangement. For example the taxpayer may sell the asset to another investor or a subsidiary member might leave a consolidated group that has provided the asset to a tax

26. *Explanatory Memorandum*, p. 69.

exempt entity. A balancing adjustment is also made at the end of the arrangement if additional financial benefits are provided to the taxpayer at this time.

Comment

Subdivision 250-E clearly assumes that the main method for assessing gains and losses arising from a deemed loan will be the compounding accruals method. The balancing adjustment method is to be used in conjunction with the compounding accruals method and deals with gains or losses arising from changes in circumstances during the life of the arrangement or with financial flows when the arrangement ends.

Proposed **section 250-280** covers the receipt of benefits or the payment of consideration in circumstances where money was not received. Such circumstances may include the right to use an asset that does not actually involve either the payment or recept of money as consideration for that right.

Proposed **Subdivision 250-F** covers the treatment of the financial benefits flowing to the taxpayer if **Division 250** ceases to apply to the arrangement. Such circumstances may include where the arrangement between the taxpayer and the tax exempt entity ends but the taxpayer retains ownership of the asset in question. The taxpayer then may dispose of the asset.

Proposed **Subdivision 250-F** covers the implications for assessment under **Division 40** ITAA 97 (dealing with capital allowances in other circumstances) and values for Capital Gains Tax (CGT) purposes.

Old legislation

Item 27 amends existing **section 51AD** and **Division 16** ITAA36 so that they do not apply to an arrangement entered into on or after 1 July 2007. However, in certain circumstances **section 51AD** ceases to apply from 1 July 2003 (see below).

Sub-item 71(11) of **Part 3** of **Schedule 1** prevents **section 51AD** ITAA36 from applying where:

- the asset is used by a tax preferred entity, and
- the arrangement was entered into before 1 July 2007 and
- the tax preferred use of the asset starts on or after 1 July 2003.

That is, existing **section 51AD** ITAA36 is ‘turned off’ from 1 July 2003. This latter provision was one sought by industry in comments on the draft legislation.[27]

27. *Explanatory Memorandum*, p. 115.

Schedule 2: Thin capitalisation: Definition of excluded equity interests

Purpose

Schedule 2 amends the definition of the excluded equity interests in **subsection 820-946(2A)** ITAA97 so that securities that remain on issue for more than 180 days are not included in this definition.

Background

What is thin capitalisation?

Thin capitalisation occurs when a multinational entity allocates an excessive amount of debt to an Australian subsidiary. The thin capitalisation rules in ITAA97 disallow a proportion of otherwise deductible finance expenses (i.e. interest on the debt) where that debt funds Australian operations and exceeds certain thresholds.

What is an excluded equity?

An excluded equity is one that is excluded from the assets used to determine whether the Australian subsidiaries' debt exceeds the above mentioned thresholds for thin capitalisation purposes.

What is the problem with the current definition?

The current definition of an excluded equity interest includes securities that have been on issue for less than 180 days as at the date the thin capitalisation calculations are undertaken. That is, short term securities. However, these securities may remain on issue for more than 180 days and are thus longer term securities that should be included in the thin capitalisation calculations.

Apparently, an entity can decrease the amount of its debt for thin capitalisation calculations purposes by issuing securities that have been in existence for less than 180 days as at the calculation date (thus qualifying as an excluded security) but which have a duration of longer than 180 days.

What is the proposed measure?

The proposed amendment would ensure that securities that were on issue for less than 180 days at the time the thin capitalisation calculations were made, but which had a longer duration, were not included in the definition of an excluded security for these purposes.

Basis of policy commitment

This measure was part of the 2007–08 Budget announcements.[28]

Pros and cons

The proposed measure strengthens the integrity of the thin capitalisation rules by preventing one method of manipulating the value of an entities' debt.

Financial implications

The Explanatory Memorandum did not identify any financial impact of the proposed measure.

Key issues

The integrity of the thin capitalisation rules is the major issue behind this particular measure.

Recently there has been some concern about the impact of private equity deals on the revenue arising from the corporate tax regime. Briefly, private equity deals involve taking over a company using very large amounts of debt, sometimes in excess of 70 per cent of the value of a company. Concerns have been raised that the interest on that debt would significantly reduce the revenue from the corporate tax.[29]

The thin capitalisation rules are the first line of defence against any developments of this kind. Thus their integrity is an important issue.

Main provisions

Item 1 of **Schedule 2** adds text to existing **subsection 820-946(2A)** to ensure that securities that have been issued for less than 180 days as at the date of the thin capitalisation calculations, but which have a duration of more than 180 days are not included in the definition of excluded securities for these purposes.

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28. The Hon. Peter Costello MP, Treasurer and Senator the Hon. Nick Minchin, Minister for Finance and Administration, *Budget Measures 2007–08* (Budget Paper No. 2), 8 May 2007, p. 25.

29. For example see Scott Murdoch, 'PE funds in Treasurer's sights' *Australian*, 2 July 2007, p. 29.

Item 2 applies this amendment to income years starting on or after 1 July 2002.

Comment

On the face of it this change is retrospective, applying to transactions that took place on or after 1 July 2002.

However, on that date the group consolidation taxation regime came into effect. This regime allows wholly-owned groups of companies (together with eligible trusts and partnerships) to consolidate for tax purposes. By consolidating, a group is treated as a single entity for tax purposes. On 1 July 2002 the thin capitalisation rules were also modified to treat a consolidated group as a single entity and to remove the grouping provisions. The definition of excluded equity in the thin capitalisation rules also took effect on this date.

Thus the changes in the schedular seek to apply a consistent treatment to transactions from the start of the current thin capitalisation regime.

Schedule 3: Thin capitalisation–application to certain authorised deposit-taking institutions

Purpose

The proposed amendments will allow a particular type of authorised deposit taking institution (ADI), known as a specialist credit card institution (SCCI), to be treated as if it were not an ADI but as if it were a financial entity as defined by the relevant legislation. The proposed amendments alter the ITAA97 only.

Background

What is an ADI?

Section 5 of the *Banking Act 1959* (Banking Act) contains the following definition:

> ***"authorised deposit-taking institution"*** means a body corporate in relation to which an authority under subsection 9(3) is in force.

In turn, an authority under this subsection of the Banking Act allows the ADI to operate a banking business in Australia. Such businesses are heavily regulated by the Australian Prudential Regulation Authority (APRA) and generally are required to maintain significant capital reserves. An ADI may be either a Bank or other financial institution that meets the above definition.

What is a SCCI?

SCCIs are a special class of authorised deposit-taking institutions (ADIs) that are authorised to perform a limited range of banking activities. SCCIs may only perform credit card issuing and/or acquiring business and any other services related to credit card issuing and/or acquiring. SCCIs are not permitted to accept or maintain deposits (other than incidental credit balances on credit card accounts). As ADIs, SCCIs are subject to the requirements of the Banking Act and any other Acts applicable to ADIs. An authority to act as an SCCI does not entitle the SCCI to call itself a 'bank'.[30]

Technically, these institutions are participants in the Australian banking payments system as defined in the *Payments Systems (Regulations) Act 1998* as a credit card scheme under **section 11** of that Act and is either (or both) a credit card acquiring and/or a credit card issuing entity for the purposes of the regulations supporting the *Banking Act 1959*.

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30. APRA, Guidelines on the Authorisation of Specialist Credit Card Institutions, p. 1, at http://www.apra.gov.au/ADI/upload/Guidelines-on-Authorisation-of-Specialist-Credit-Card-Institutions.pdf (accessed 21 August 2007).

Why are SCCIs different to other ADI?

The important point to note is that SCCIs are not deposit taking institutions in the normally accepted sense of that term – in that they do not take, or maintain, deposits from their customers. Thus, APRA supervises their operation on a different basis to other institutions. The Explanatory Memorandum notes that SCCIs, where they are a part of a consolidated group that does not contain any other type of ADI, are assessed for capital adequacy purposes on the basis of their own operations, and not those of the consolidated group of which they are a part.[31] In contrast the capital adequacy treatment of other ADIs is done in reference to the capital adequacy of the consolidated group of which they are a part, on a world wide basis if necessary.

What is a financial entity?

A financial entity is extensively defined in **section 955-1** ITAA97. The key component of this definition is that it is not an ADI, and therefore not subject to the prudential regulation regime that apply to ADIs.

What difference does it made for thin capitalisation purposes?

The calculation of the various thresholds for the application of the thin capitalisation rules depend, in part, on the type of entity to which these rules are applied. Different methods apply depending on whether the entity is:

- an ADI
- a financial entity that is not an ADI, or
- a general entity.

Allowing SCCIs to be subject to thin capitalisation rules applying to a financial entity, rather than the rules applying to an ADI, may make a significant difference to the application of these rules to both the SCCI and a parent organisation of these entities.

If the entity, or consolidated group was classed as an ADI for thin capitalisation purposes it would be assessed under the provisions of existing **Subdivision 820-D** ITAA97. If it was not an ADI then the thin capitalisation rules would be worked out under either existing **Subdivisions 820-B** for outward investing entities or **820-C** for inward investing entities, as appropriate.

Very briefly, an outward investing entity is an Australian business or Australian entity that operates overseas through either a permanent overseas establishment or an Australian

31. *Explanatory Memorandum*, p. 120.

controlled foreign entity.[32] An inward investing entity is one that is either a foreign controlled Australian entity or a foreign entity operating in Australia.[33]

Briefly, these subdivisions work in different ways:

- **Subdivision 820-D** works on the basis of disallowing various interest deductions on the dept of the entity if a certain level of minimum capital asset has not been reached during the assessment period, but
- in contrast **Subdivisions 820-B** and **820-C** work on the basis that an entity may accumulate a maximum amount of allowable debt and allows the calculation of the interest deductions from assessable income to be disallowed if the entities debt exceeds these levels.

The underlying assumption behind the proposed amendments is that existing **Subdivisions 820-B** and **820-C** ITAA97 are the most appropriate methods for assessing non-ADI financial institutions for thin capitalisation purposes.

Basis of policy commitment

These proposed changes were announced in the Mid Year Economic and Fiscal Outlook for 2006–06 financial year.[34]

Pros and cons

The proposed changes will allow the treatment of SCCIs, for thin capitalisation purposes, to be based on the actual merits of these organisations, and not on their legal classification as an ADI.

Financial implications

The Explanatory Memorandum does not identify any financial implications arising from this proposed measure.[35]

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32. Section 820-85 ITAA97 for definition of non-ADI outward investing entities.
33. Section 820-185 for definition of non-ADI inward investing entities.
34. The Hon. Peter Costello MP, Treasurer, Senator the Hon Nick Minchin, Minister for Finance and Administration, *Mid Year Economic and Fiscal Outlook 2006–07*, December 2006, pp. 83-84.
35. *Explanatory Memorandum*, p. 5.

Key issues

The key issue behind this proposed measure is the appropriate treatment, for thin capitalisation purposes, of a particular kind of ADI – the SCCI. The proposed changes seek to treat this type of entity on the basis of its operations. That is, the SCCI does not seek or maintain permanent deposits on behalf of its customers and hence should not be treated for thin capitalisation purposes as if it does.

Main provisions

Item 2 of **Schedule 3** inserts proposed **section 820-588** into the ITAA97. The proposed section allows a consolidated group to choose whether to be treated as an ADI or a financial entity for thin capitalisation purposes, where all the members of that group are SCCIs.

Item 5 inserts proposed **section 820-610** into the ITAA97. This proposed section allows a consolidated group to choose to be treated as either:

- an outward investing entity (non-ADI) or outward investor (financial),as the case requires, or
- an inward investing entity (non-ADI) or an inward investing vehicle (financial) again as the case requires

If at all times during the relevant period all the members of the consolidated group are SCCIs. The important point is that these are not ADIs for thin capitalisation purposes.

Item 11 requires that the amendments in **Schedule 3** apply to income years starting on or after 1 January 2004.

Schedule 4: Extending the CGT small superannuation funds roll-over on marriage breakdown

Purpose

These proposed amendments to the ITAA97 will allow:

- the in specie (i.e. 'in kind') transfers from a small superannuation fund to another complying superannuation fund in satisfaction of a Family Court order not to be subject to the Goods and Services Tax (GST)
- the transfer of a spouse's separate superannuation interest in a small superannuation fund, where the spouses are separated but no payment splitting order has been issued, to another superannuation fund (either large or small), to be GST free
- GST not to apply to transfers of non-superannuation assets between former members of a de-facto couple under the provisions of a written agreement, and
- GST also not to apply to transfers from a small superannuation fund by ex members of a de facto couple to another complying superannuation fund under the provisions of a written agreement.

Theses proposals will only apply to circumstances where the relationship between the couple has ended beyond any reasonable prospect of it recommencing.

Background

What is a small superannuation fund?

A small superannuation fund is a complying superannuation fund with less than 4 members. A complying superannuation fund within the meaning of **section 45** of the *Superannuation Industry (Supervision) Act 1993*.[36] That is, one that complies with the requirement of this Act.

By far the most common form of a small superannuation find is the Self Managed Superannuation Fund (SMSF). The number of SMSFs in Australia has risen significantly over the past year from around 320,000 at the end of June 2006 to almost 360,000 at the end of June 2007.

To put this growth in context, the monthly average of SMSF registrations in the 2006-07 financial year was over 3800, compared with around 2000 per month between June 2004 and June 2006.

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36. Section 955-1 ITAA97.

Almost 690,000 people are now members of an SMSF and on average, each fund holds around $800,000. This figure will continue to grow over time with most self-managed funds currently in an accumulation phase (i.e. the phase where the assets are growing before retirement).

All members of SMSFs are trustees of their fund and are ultimately responsible for the running of their fund.[37] Over 68 per cent of SMSFs have only two members, typically a husband and wife.[38]

What is an 'in specie' transfer?

A superannuation fund is able to hold a wide variety of assets, providing the fund's trustees invest within the prescribed prudential guidelines.[39] These assets may be financial assets (such as shares, bonds or cash) or real property. Art works may be used as an investment, as may other more exotic investment such as antique furniture, jewellery or cars.[40]

Normally, when superannuation fund assets are transferred to another fund, they are first sold and the resulting cash is sent to the proposed superannuation fund. An 'in specie' transfer occurs when the assets of one fund are not sold, but the title is transferred directly to the trustees of the proposed superannuation fund.

How are cash transfers between superannuation funds treated for GST purposes?

In situations where the assets of a superannuation fund are transferred to another fund they are subject to the GST. This would apply even where one spouse's interest in a small superannuation fund was transferred into another fund under normal circumstances

37. Australian Taxation Office, *A look at self managed superannuation funds*, Fact Sheet, 13 August 2007 at http://www.ato.gov.au/corporate/content.asp?doc=/content/00105431.htm (accessed 23 August 2007).

38. Australian Tax Office, Self managed fund statistical report – SMSF membership size tables, at http://www.ato.gov.au/super/content.asp?doc=/content/00100435.htm&page=3&H3 (accessed 23 August 2007). This figure is the latest available for 2003–04. As noted above the simplified superannuation changes have increased the number of such funds. It is likely that the percentage of all SMSFs that are two member funds has also increased.

39. See APRA website at http://www.apra.gov.au/Superannuation/Superannuation-Circulars-and-Guidance-Notes.cfm for full list of Superannuation Prudential Regulation standards

40. The most exotic investment by a superannuation fund the author has heard of was the leasing of offshore lobster pots off the southern beaches of the Sydney region!

However, where this transfer occurs in response to an order of the Family Court following the breakdown of a marriage GST is not applied, if the transfer is between two small superannuation funds only.[41]

What is a 'payment splitting' order?

A payment splitting order is an order issued by the Family Court requiring the trustees of a superannuation fund to split a single superannuation interest between the ex members of a married couple.[42]

What are the problems arising from the current law?

Under the current law, the only option for ex-spouses to transfer their assets from a small superannuation fund, without incurring GST, would be to set up their own small superannuation fund. This may be impractical as the ex-spouses superannuation assets may be too small to economically justify this action. Further, if such a course was taken the ex-spouse would have to pay the sometimes significant costs of setting such a fund up. This meant that an ex-spouse may be forced to retain their superannuation assets in a small fund when it was personally very difficult to do so (see below for further discussion).

In addition, the current rules fail to accommodate a spouse's preference to transfer their assets from a small superannuation fund, in circumstances where a couple has separated and the relationship is not likely to recommence and no payment splitting order has been issued, to any other complying superannuation fund. Nor do they cover the transfer of a spouse's superannuation assets in specie to another superannuation fund. Further, they do not accommodate the split of non-superannuation assets between former members of a de-facto couple. Under current law, all of the above transfers would be subject to GST.

Basis of policy commitment

This measure was announced in the Minister for Revenue and Assistant Treasurer's media release of 8 May 2007.[43]

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41. Section 126-140 ITAA97.

42. Sections 90MS and 90MT *Family Law Amendment Act 1975.*

43. The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, 'Extending small superannuation fund capital gains tax (CGT) roll-over on marriage breakdown', *media release*, No. 46, 8 May 2007.

Position of significant interest groups/press commentary

Press commentary has generally supported the proposed measures.[44] Further, the Certified Practicing Accountants Australia (CPA Australia) have also supported this measure.[45]

Pros and cons

The proposed changes in this schedule can be seen as equity measures. That is, a favourable GST treatment is to be extended to transfers of assets by both ex-spouses and spouses from small superannuation funds in a wider range of similar circumstances. This treatment is also extended to the division of both superannuation and non superannuation assets of ex members of de-facto couples where that relationship has broken down.

In so far as a potential GST bill prevented a spouse or ex-spouse from transferring their superannuation assets from a small superannuation fund to another fund the current law prevented a clean break after the effective ending of a relationship. As noted above, all members of the most common type of small fund, the SMSF, must be trustees of that fund. The current law thus kept separated spouses and ex spouses in contact with one another due to their continuing roles as trustees of an SMSF. No doubt, in many cases this continued contact was unwanted. The proposed changes would allow the transfer of a spouse's or ex-spouse's interest in a small superannuation fund to another fund, without GST consequences thereby encouraging a clean break in these circumstances.

The ability to transfer assets 'in specie' allows arrangements to be made where the assets are 'lumpy', that is not easily divisible. Such lumpy assets could include a property or another significant physical asset (say a valuable artwork). Such assets may make up a disproportionate amount of the value of the assets of a small fund. Further, they may be difficult to sell in an orderly manner or may have significant emotional value for one of the members of the fund. The ability to transfer in specie allows such assets to be transferred, without first being sold in a potential fire sale.

These measures can also be seen as promoting the financial and emotional independence and financial security of a separated spouse. One of the proposed measures allows a separated spouse to transfer their superannuation assets from a small superannuation fund to any other complying superannuation fund without a GST consequence. This allows a

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44. See Mike Bannon, 'Simpler take on tax rules', *Herald Sun*, 9 May 2007, p. 6; John Wasiliev, 'Splitting assets in break-up will be easier from July', *Australian Financial Review*, 12 May 2007, p. 41; Tim Blue, 'Split the difference in assets', *Weekend Australian*, 12 May 2007, p. 38.

45. CPA Australia, *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007*, 24 August 2007. p. 1.

separated spouse to transfer these assets away from the control of the other member(s) of a small fund. As noted above, if the fund is an SMSF the other trustee may be the other spouse. As a trustee of such a fund they may exercise undue influence on the use of the separated spouse's superannuation assets or on the separated spouse themselves. The ability of the separated spouse to transfer assets away from such influences potentially enhances the security of those assets and supports the separated spouse's financial and emotional independence in retirement.

The only possible point against this proposal is it expected cost to revenue. However, as discussed below, this effect if likely to be relatively small.

Some Members and Senators may object that these provisions do not deal with the division of superannuation and non-superannuation assets between separating and ex members of a same sex couple.

ALP/Australian Democrat/Greens/Family First policy position/commitments

The ALP has welcomed this particular measure.[46]

Financial implications

The Explanatory Memorandum notes that this measure will cause a minor drop in revenue, as illustrated in the following table:

Table 1: Effect on Revenue of extending CGT exemption

2007–08	2008–09	2009–10	2010–11
-$1m	-$1m	-$1m	-$1m

Source: Explanatory Memorandum[47]

Key issues

The major issue behind this particular measurer is the extension of concessional GST treatment to transfers of assets in situations similar to the situation that already has this

46. Senator, the Hon. Nick Sherry, 'Superannuation measures welcome', *media release*, 10 May 2007.

47. *Explanatory Memorandum*, p. 6.

concessional treatment. That is, should transfers of assets in situations that are similar to the transfer of assets between small superannuation funds in satisfaction of a family court order also receive concessional GST treatment?

According to the Explanatory Memorandum the proposed amendments in this Schedule means that a CGT roll-over will be available if the division of the assets is made under a written agreement in Western Australia, Tasmania, Queensland or the Northern Territory. Under the relevant state law correctly drawn up agreements in these states have the status of binding financial agreement under the Commonwealth's Family law Legislation.[48]

There is no explanation for the non-inclusion of similar agreements drawn up in New South Wales, Victoria, South Australia or the Australian Capital Territory, as binding financial agreements for the purposes of Commonwealth Family Law. This may be a major deficiency in the proposed amendments in this Schedule.

Main provisions

Item 1 amends the table in **section 112-150** ITA97 so that GST does not apply in situations where assets are transferred from a small superannuation fund to any other complying superannuation fund because of a marriage breakdown. **Items 4** and **5** also have the same effect.

Items 2 and **3** amend **sections 126-5** and **126-15** so that the split of assets between former members of a de-facto couple, done under a written agreement, is not subject to GST.

Item 6 inserts proposed **subsections 126-140(2A)** through to **(2D)** into the ITAA97. These proposed subsections also allow the transfer of assets from a small superannuation fund to another complying superannuation fund without GST consequences in the event of a marriage breakdown. But these changes also allow the GST free transfer of assets from a small fund to another fund for ex members of a de-facto couple. Proposed **subsection 126-140(2B)** specifies that these transfers must occur in response to a family court order or award or a written agreements under state legislation in respect of the ending of a de-facto marriage.

To qualify for the GST roll-over all these assets must be transferred. However, this can be completed in several separate transfers. Further, the language in the amendments made by **Item 6** uses the terms 'transfer of assets' that appears to include 'in specie' transfers of assets, as well as the transfer of assets undertaken by more normal methods.

Item 7 provides that these measures commence from 1 July 2007 regardless of when an award, Family Court order or agreement was made.

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48. *Explanatory Memorandum*, p. 131.

Schedule 5: Income tax treatment of the Prime Minister's Prizes

Purpose

Schedule 5 of the Bill amends the ITAA97 so that the portions of the Prime Minister's Prizes for Australian History and Science (respectively) that are assessable for income tax purposes become tax exempt.

Background

History Prize

The Australian Government awards a prize annually for excellence in Australian history for an outstanding recent publication or body of work that contributes significantly to an understanding of Australian history. The Prize for Australian History comprises an embossed gold medallion and a grant of $100 000 and may be awarded to an individual or a group, if the achievement is a collaborative or team effort. Eligibility for the Australian History Prize is limited to Australian citizens or those who hold permanent resident status in Australia. The cash grant which is part of the Prize is awarded in recognition of achievement and is provided on an unencumbered basis. Recipients are free to use the grant for whatever purpose they choose.[49] This History Prize was first awarded on 20 June 2007.

Science Prize

The Australian Government awards five prizes annually for outstanding achievements in science and science teaching; only one of which, the Prime Minister's Prize for Science, is the subject of this Schedule.

The Prime Minister's Prize for Science is awarded for an outstanding specific achievement or series of related achievements in any area of science advancing human welfare or benefiting society. In this context, science encompasses the physical, chemical, biological and technological sciences, mathematics and engineering.

This Prize comprises an embossed gold medallion and a grant of $300 000 and may be awarded to an individual or jointly to up to four individuals, if the achievement is a collaborative or team effort. Where such is the case, papers cited in support of the nomination must be co-authored by a majority of the group's members.

49. Department of Education, Science and Training, *The Prime Minister's Prize for Australian History – 2006 Nomination Guidelines*, 15 November 2006.

There are no restrictions as to when the achievement was accomplished, however the recipient (either single or collective) must be active in research at the time the award is given. Eligibility for the Science Prize is limited to Australian citizens or those who hold permanent resident status in Australia.[50]

Current Tax Treatment

On 13 December 2002 the Australian Taxation Office (ATO) published final ruling CR 2002/83, which stated that the cash grants awarded as part of the Prime Minister's Prizes for Science are not assessable as income under either **section 6-5** or **section 10-5** of the *Income Tax Assessment Act 1997*, or under **paragraph 26(e)** of the *Income Tax Assessment Act 1936*.[51]

However, the tax status of the Prime Minister's Prize for Australian History is less clear.

Basis of policy commitment

The Prime Minister announced that the Prize for Australian History will be tax free on 20 June 2007. Formally the Prime Minister's Prizes for Science were not included in this particular announcement.[52]

Position of significant interest groups/press commentary

The Australian Society of Authors (ASA) welcomed the announcement that the History Prize would be tax free.[53]

Pros and cons

The proposed amendments clarify that the Prime Minister's Prizes for Science and History are tax exempt. While the above mentioned ATO ruling exempting the Science Prize from income taxation it did not necessarily have the force of law.

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50. Department of Education, Science and Training, *Prime Ministers Prizes for Science, 2007 Nomination Guidelines*, 2007.

51. ibid.

52. The Hon John Howard MP, Prime Minister, 'Australian History Prize', *media release*, 20 June 2007.

53. Australian Society of Authors, 'ASA congratulates Prime Minister on tax free prizes' *media release*, 27 June 2007.

Financial implications

The Explanatory Memorandum does not identify any significant financial implications.

Key issues

The key issues behind these provisions is the clarification of the tax exempt status for the Prime Minister’s Science Prize and the encouragement of the study of Australian history by conferring tax free status on the History Prise.

Main provisions

Item 1 of **Schedule 5** amends existing **section 11-10** ITAA97 to ensure that the medallions that are part of the Prime Minister’s Prizes for Science and History are not subject to personal income tax.

Item 2 of this Schedule adds proposed **section 51-60** to the ITAA97. The effect of this proposed section is that the financial component of the Prime Minster’s Prizes for Science and History is not subject to personal income tax.

Item 3 provides that the above amendments apply to the 2006–07 income year, and later years.

Schedule 6: Removal of the same business test cap

Purpose

This schedule removes the provisions in the ITAA97 that limits the use of the 'same business test' (SBT) for the recoupment of losses by a company, or a consolidated group of companies, whose total income exceeds $100m in a particular income year.

Background

What is the same business test?

A company that satisfies the SBT may be entitled to claim a deduction for prior year losses even if it fails the alternative continuity of ownership test. The SBT (which is discussed at length in *Taxation Ruling* TR 1999/9) may also be applied in relation to a company's current year losses or deductions for bad debts).

Broadly speaking, the SBT is satisfied where a company, at all times during the year in which it claims a deduction for a prior year loss:

- carried on the same business (meaning the business of the company as an entirety, or its 'overall business') that it carried on immediately before the change in the beneficial ownership of shares by reason of which it ceased to satisfy the continuing ownership and control requirements described in existing **section 165-12** ITAA97
- did not carry on any business (meaning a particular undertaking or enterprise) other than a business of a kind carried on before the disqualifying change as part of the overall business
- only derived income from transactions of a kind that it had entered into in the course of the overall business before the change of ownership, and
- the anti-avoidance provisions in existing **subsection 165-210(3)** do not apply to the company.[54]

A loss that cannot be recouped in a particular income year because the $100m ceiling is exceeded may nonetheless be recouped in a later year if the total income for that year is less than $100m. In this context, 'total income' includes exempt income and non-assessable non-exempt income, but excludes net capital gains and GST. To avoid double

54. Australian Taxation Office, *Taxation Ruling - Income tax: the operation of sections 165-13 and 165-210, paragraph 165-35(b), section 165-126 and section 165-132*, TR 1999/9, 29 November 2006, p. 1.

counting, non-assessable non-exempt income is also excluded to the extent that it represents an amount that is included in assessable income.[55]

Why limits on $100m in income?

In the Senate committee debate of the Bill that introduced the $100m limit on the application of the SBT the sponsoring Minister noted that the reasons for this limit were:

> it is a very difficult thing for large businesses because all the activities of a company have to be examined and, once the size of a company increases, it is a very difficult test to apply. That is why the scope of the test has been drawn so narrowly—deliberately so, and not only for administrative purposes. In order to apply this test appropriately and make it a fair test, the impact on large business was taken into account.[56]

History of the Measure

Before the legislation implementing this limit was considered in the upper house, the Senate Economics Committee unanimously recommended that it not be applied.[57] Soon after the legislation was passed by the Senate (7 December 2005) the then Minister for Revenue and Assistant Treasure announced that the operation of the SBT would be subject to further review. Submissions to this review were to be made by 31 January 2006.[58] Several organisations in a joint submission to this review supported the removal of the $100m limit.[59]

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55. CCH Australian Master Tax Guide 2007, - Topic 3-120.

56. The Hon. Helen Coonan, Minister for Communications, Information Technology and the Arts, second reading debate in committee stages: Tax Laws Amendment (Loss Recoupment and Other Measures) Bill 2005, Senate, *Debates*, 7 December 2005, p. 22.

57. Senate Economics Committee, *Provisions of the Tax Laws Amendment (Loss Recoupment and Other Measures Bill 2005*, 10 November 2005 at paragraph 2.52 and following.

58. The Hon. Mal Brough, Minister for Revenue and Assistant Treasurer, 'Loss Recoupment Rules, *media release*, No. 100, 7 December 2005.

59. Submission of the Australian Chamber of Commerce and Industry, Australian Council for Infrastructure Development Limited, Corporate Tax Association, Energy Supply Association of Australia, Ernst & Young Australia, Institute of Chartered Accountants in Australia and Minerals Council of Australia, on Loss Recoupment Rules for Companies, 31 January 2006, p. 2.

Basis of policy commitment

The removal of the $100m cap on the application of the same business test was announced in the 2007–08 budget.[60]

Position of significant interest groups/press commentary

The removal of the $100m limit on the application of the SBT has been widely support by business groups.[61] Press comment was very favourable at the time this measure was announced.[62] This support has been recently restated by the Minerals Council of Australia and other groups.[63]

Pros and cons

The removal of the $100m limit on the application of the SBT for claiming prior year losses etc may have the following benefits:

- encourage investment in infrastructure by large private companies
- enable the use of the SBT rules to claim early year losses arsing from a development project undertaken by a large company (such as a large mining company) to be claimed back in later years, and
- simplifies the tax legislation by removing the $100m cap.

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60. The Hon Peter Costello MP, Treasurer, and Senator, The Hon. Nick Minichin, Minister for Finance and Administration, Budget Measures 2007-08 (Budget Paper No. 2), 8 May 2007, p. 10.

61. Institute of Charted Accountants in Australia, 'Federal budget 2007–2008 – Another step in the right direction – but more required', *media release*, 8 may 2007, Taxation Institute of Australia, 'Budget 2007–08: Is everyone a winner?', *media release*, 8 May 2007, Certified Practicing Accountant Australia, 'Sound, but bland, election-year Budget', *media release*, 8 May 2007, Australian Chamber of Commerce and Industry, 'Business welcomes long-Awaited Tax Reforms for Infrastructure', *media release*, 16 August 2007.

62. Fleur Anderson and David Crowe, 'Budget delivers tax break to big business', *Australian Financial Review,* 8 May 2007, p. 1; Fiona Buffini, 'Big breaks for major projects', *Australian Financial Review*, 9 May 2007, p. 6 and 'Losses easier to access for profit offsets', *Australian Financial Review*, 9 May 2007, p. 6.

63. Minerals Council of Australia, *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007*, 24 August 2007. p. 1 and CPA Australia, *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007*, 24 August 2007. p. 1.

However, to the extent that the SBT is difficult to apply to large companies the removal of the $100m limit may further complicate their tax affairs.

ALP/Australian Democrat/Greens/Family First policy position/commitments

Both the ALP and the Democrats together sought to remove the $100m limit on the application of the SBT when the SBT was first introduced in 2005.[64] These amendments were not successful.

The ALP has recently supported the removal of the $100m limit on the application of the STB.[65]

Financial implications

The Explanatory Memorandum identified the following impact on revenue from this measure.

Table 2: Effect on Revenue of removing $100m cap on application of the SBT

2007–08	2008–09	2009–10	2010–11
-$15m	-$40m	-$50m	-$70m

Source: Explanatory Memorandum[66]

Key issues

The key issues behind this measure are whether the removal of the $100m limit on the application of the SBT will encourage investment in infrastructure and further investment in large mining and related development projects.

64. Senator Murray, second reading debate in committee stages: Tax Laws Amendment (Loss Recoupment and Other Measures) Bill 2005, Senate, *Debates*, 7 December 2005, p. 22.
65. Chris Bowen MP, Shadow Assistant Treasurer, 'Removal of Small Business Test Cap an Endorsement of Labour's Policy', *media release*, 9 May 2007.
66. Explanatory Memorandum, p. 7.

Main provisions

Items 1 and **2** of **Part 1**, **Schedule 6** repeal **sections 165-212A**, **165-212B**, **165-212C** and **section 716-805** ITAA97. The effect of the removal of these sections is to remove the $100m income limit on the application of the SBT.

Item 68 in **Part 3** of **Schedule 6** applies these amendments to any tax loss, net capital loss or bad debt that is incurred in an income year commencing on or after 1 July 2005.

After these amendments come into force a company, or consolidated group of companies will be able to deduct prior year losses that are incurred on or after 1 July 2005 in an income year if:

- the company satisfies the SBT test , or
- the continuity of ownership test.

Schedule 7: Partial capital gains tax roll-over for statutory licences

Purpose

This schedule amends the ITAA97, and the *Income Tax (Transitional Provisions) Act 1997*, so that the existing CGT exemption (or roll-over) for the granting of a proposed statutory licence on the ending of the previous licence extends to situations where one or more licences ends and consequently one or more licences are issued. Further, these amendments provide for a partial CGT roll-over in the above situations where 'non-licence capital proceeds' (such as money) are also received.

Background

What is a statutory licence?

Under existing **section 124-140** ITAA97 a statutory licence is an authority, licence, permit or quota (except a lease or a mining entitlement or prospecting entitlement) granted by:

- an Australian government agency under an Australian law, or
- a foreign government agency under a foreign law.

Examples include radio and television broadcasting licences, marine radio licences, taxi licences, import and export quotas, fishing permits or quotas, oyster farming licences, milk quotas, wool quotas and liquor licences. This list is by no means exhaustive.[67]

What is the basis of the current rollover provisions?

Under existing section **124-140** ITAA97 a CGT rollover occurs in if a statutory licence expires or is surrendered and a proposed licence by renewing or extending the original one. The conditions of the proposed licence have to be the same as the licences that has ended, or simply extend these conditions.

What are the problems with the current rollover provisions?

Obviously, the current CGT rollover provisions do not enable a CGT roll-over where the original licence ends and

- multiple licences take its place, and/or
- the proposed licence(s) have different conditions from the one they replaced.

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67. Australian Taxation Office, *Capital Gains: what is meant by the term "statutory licence in section 160ZZPE*, Taxation Determination 34, 29 December 2006, p. 1.

Basis of policy commitment

The measure was announced in the Minister for Revenue and Assistant Treasurer's press release of 8 June 2007.[68]

Pros and cons

The proposed amendments cover a wider range of circumstances where one licence ends and one or more licences take their place. Apparently, the proposed measures will have a particular application to the joint Commonwealth/NSW government 'Achieving Sustainable Groundwater Entitlements program'. Under this program licence holders may be offered a cash payment when they renew their licence to use groundwater, if they have achieved a reduction in usage.[69]

Given the growing scarcity of water in rural areas it is likely that different licences will be issued to land holders when current licences end. The proposed measure will prevent CGT applying where the successor licence(s) have different conditions or involve the recept of a cash payment.

Further the proposed provisions will prevent the imposition of CGT in circumstances where a proposed licence is issued for purposes that were not covered by the original licence, but are a similar activity. An example of these circumstances would be where a commercial fisherman was licensed to catch a particular species of fish. However, government authorities decided that the commercial fishing of this species was not sustainable and the fisherman was issued with a licence(s) to catch a different species of fish.

Financial implications

The Explanatory Memorandum did not identify any financial implications of this particular measure.

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68. The Hon. Peter Dutton MP, 'Capital Gains Tax (CGT) roll-over on ending of a statutory licence', *media release*, No. 69, 8 June 2007.

69. See the Hon. Peter Dutton, op. cit. and NSW Government – Department of Natural Resources, Achieving Sustainable Groundwater Entitlements Program, at http://www.naturalresources.nsw.gov.au/water/pdf/sgep_brochure_draft2c.pdf (accessed 27 August 2007).

Key issues

The key issue behind this measure is the granting of either a partial, or full, CGT exemption when one statutory licence ends and one or more licences, with different conditions or involving the recept of a payment, takes the first licence's place.

Main provisions

Part 1

Item 2 of **Schedule 7** repeals the current subsection **124-140(1)** ITAA97 and replaces it with three proposed subsections, **124-140(1)**, **(1A)** and **(1B)**. This amendment achieves several outcomes:

- where the acquisition of one or more proposed statutory licences replaces an expired licence, and CGT event C2 would otherwise occur, and the proposed licence(s) authorises substantially similar activity, a CGT roll-over occurs
- a foreign resident may benefit from this CGT rollover if the original licence is taxable Australian property and each proposed licence is taxable Australian property.

CGT Event C2

CGT event C2 happens if a taxpayer's ownership of an intangible CGT asset ends because it is redeemed, cancelled, released, discharged, satisfied, abandoned, surrendered, forfeited or expired.[70]

Taxable Australian property

A foreign resident's liability for CGT (for CGT events that happen on or after 12 December 2006) is based on whether the relevant asset is taxable Australian property. The following assets are taxable Australian property:

- taxable Australian real property
- an indirect interest in Australian real property
- a business asset of a permanent establishment in Australia
- an option or right to acquire any of the CGT assets in the above three points, or

70. Subsection 104-25(1) ITAA97.

- a CGT asset that is deemed to be Australian taxable property where a taxpayer, on ceasing to be an Australian resident, makes an election under **section 104-165** ITAA97.[71]

Item 3 inserts proposed **subsection 124-150** into the ITAA97. This proposed section allows a partial CGT roll-over in circumstances where the issue of a proposed licence is accompanied by a cash payment from the issuing authority. The change in the capital value of the licence, caused by the receipt of the cash payment, is an assessable gain (or loss) for CGT purposes.

Item 4 inserts proposed **Division 124** into the *Income Tax (Transitional Provisions) Act 1997*. This proposed Division covers the ending of water extraction licences in New South Wales (NSW) and their replacement with proposed licences under the Commonwealth/NSW 'Achieving Sustainable Groundwater Entitlements program'. This Division allows for the calculation of licence values for CGT purposes where proposed **section 124-140** ITAA97 also applies.

Part 3

Item 14 applies the amendments in **Schedule 7** to the 2006–07 income year and later income years. That is, these amendments take effect from 1 July 2006.

71. Section 885-15 ITAA97.

Schedule 8: Australian property trusts and stapled securities

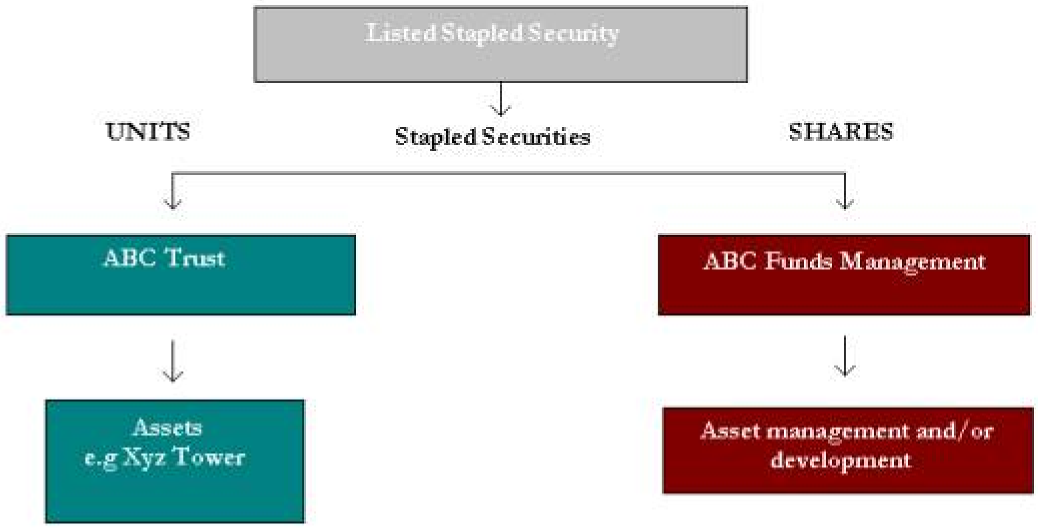
Purpose

Schedule 8 amends the ITAA97 and the *Income Tax Assessment Act 1936* (ITAA36) to provide a CGT roll-over when a public unit trust is interposed (i.e. put between) a stapled security and the holders of these securities.

Background

What is a 'stapled security'?

A stapled security is where investors own two or more securities which are generally related and bound together through one vehicle. Typically, stapled securities consist of one trust unit and one share in the funds management company that cannot be traded separately. The trust holds the portfolio of assets while the related company carries out the funds management and or development opportunities. The following diagram, provided by the Australian Stock Exchange, illustrates the concept. [72]



Examples of stapled securities in Australia are the Babcock and Brown Capital, Westfield Group, the Stockland Trust Group or the Australian Pipeline Trust.

72. Australian Stock Exchange – Stapled Securities at http://www.asx.com.au/investor/lmi/how/LMIStapled.htm (accessed 28 August 2007).

Why make this change?

The Explanatory Memorandum notes that the proposed changes will enable trusts that are stapled entities to undertake expansion in overseas markets (principally the United States) through the exchange of equity interests with an overseas based company or trust, without adverse tax consequences.[73]

Basis of policy commitment

This measure was announced in the Minister for Revenue and Assistant Treasurer's media release of 4 April 2007.[74]

Position of significant interest groups/press commentary

Both CPA Australia and the Property Council of Australia have welcomed the proposed changes in **Schedule 8**.[75]

Pros and cons

The proposed changes will facilitate Australian property trusts acquisition of overseas property trusts or companies, by issuing equity in the Australian trust to overseas investors. The changes will also facilitate the expansion of the Australian Property Trust industry by retaining their current tax status of public unit trusts when these entities acquire interests in overseas based property investment trusts or companies.

Financial implications

The Explanatory Memorandum noted that the financial impact of this particular measure was unquantifiable.[76]

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73. *Explanatory Memorandum*, pp. 159–160.

74. The Hon. Peter Dutton MP. Minister for Revenue and Assistant Treasurer, 'Tax changes to enhance international competitiveness of Australian property trusts', *media release*, No. 31, 4 April 2007.

75. Certified Practicing Accounts Australia Ltd (CPA Australia), *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007*, 24 August 2007, p. 1; and Property Council of Australia, *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007*, August 2007, pp. 1 & 4.

76. *Explanatory Memorandum*, p. 8.

Key issues

The main issue behind these amendments is the facilitation of the expansion of the Australian property trust industry overseas.

Main provisions

Part 1

Items 1, **2**, **4** and **5** amend the ITAA36 so that any proposed interposed entity is not taxed as a company. This approach applies the same tax treatment that applied to the original stapled entity to the proposed interposed entity.

Item 3 allows a public unit trust to not be classed as a trading trust where that unit trust acquires a controlling interest in a foreign entity (such as an overseas resident property investment trust) where the business of the foreign entity is investing in land and buildings for the purposes of deriving rental returns.

This means that these public unit trusts are not taxed as companies, rather that the returns from the public unit trusts are distributed to the unit holder s and taxed in their hands.

Item 6 inserts proposed **Subdivision 124-Q** into the ITAA97. Proposed **section 145-1045** provides the individual investor with a GST roll-over where:

- a proposed entity (a proposed trust) is set up between the two existing entities that are stapled together (i.e. a trust and a company) and the investor, or
- where the two stapled entities are separated and an proposed entity (i.e. a trust) is set up to hold the equity of the two formally stapled entities.

Proposed **section 124-1050** requires that in both of the above cases the investor must receive an interest in the proposed interposed entity equal in value to their former interest in either the stapled entities or the now separated entities.

Proposed **section 124-1055** specifies that the capital gains or capital losses the investor (called the ‘exchanging member’ in the legislation) as a result of these transactions is disregarded for CGT purposes at this point in time.

Proposed **section 124-1065** does not allow the application of this CGT roll-over where the investor was a foreign holder within the meaning of existing **section 9** of the *Corporations Act 2001* and after the transactions the foreign holder disposes of their interests in the proposed interposed entity.

A foreign holder for the purposes of the above proposed section is a person holding securities whose address in the relevant securities register is outside Australia and its external territories.

Part 3

Item 13 applies the changes in **items 1** to **5** to the 2006–07 income year and later income years. Further, the amendments in **items 6** to **12** apply to CGT events happening on or after 1 July 2006.

Schedule 9: Deductible gift recipients

Purpose

Schedule 9 amends the ITAA97 to update the list of deductible gift recipients (DGRs). Nine proposed DGRs are added to the list in the Act while the time during which a particular organisation has this status is extended to 2009.

Background

What is a DGR?

A deductible gift recipient (DGR) is a fund or organisation that can receive tax deductible gifts.

To be a DGR an organisation has to be either:

- included in the list of such organisations in Division 30 of the ITAA97
- fall within a category of organisations listed in Division 30 ITAA97
- be a prescribed private funds listed by name in the Income Tax Assessment Regulations 1997, or
- endorsed as a DGR by the Commissioner for Taxation.

To be entitled to DGR endorsement by the Commissioner, an organisation must:

- fall within a general DGR category in it's own right, or operate a fund, authority or institution that falls into a general DGR category
- have an Australian business number
- maintain a gift fund, and
- be in Australia (with some exceptions).[77]

The general categories of DGRs are:

- environmental organisations
- harm prevention charities
- disaster relief organisations
- overseas aid funds

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77. ATO, Gift fund requirements for deductible gift recipients, *Fact Sheet*, at http://www.ato.gov.au/nonprofit/content.asp?doc=/content/13269.htm&pc=001/004/006/008/001&mnu=&mfp=&st=&cy=1 (accessed 29 August 2007).

- cultural organisations
- scholarship funds
- school building funds
- research organisations
- sports and recreation organisations
- industry, trade and design organisations
- defence organisations
- philanthropic trusts, and
- fire and emergency services organisations.[78]

The above list is not exhaustive.

Basis of policy commitment

The intention to add various organisations to the list of DGRs and to extend the time period during which tax deductible contributions can be made to a particular DGR was announced in a series of press releases by the Minister for Revenue and Assistant Treasurer during 2007.[79]

Pros and cons

These additions to the list of DGRs facilitate the support of several worthy causes.

However, there is a very slight cost to revenue associated with these additions.

Financial implications

The following table illustrates the very slight cost to revenue that may arise from the proposed additions to the list of DGRs.

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78. ATO: Deductible Gift Recipient Essentials, Fact Sheet, at http://www.ato.gov.au/nonprofit/pathway.asp?pc=001/004/006 (accessed 29 August 2007) and Subdivision 30-B ITAA97.

79. The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, 'Deductibility of gifts to state and Territory association of Kidsafe', *media release*, No. 095, 7 August 2007; 'Deductibility of gifts to the Bathurst War Memorial Carillon Public Fund Trust' *media release*, No. 094, 7 August 2007; and 'Extension of tax deductibility of gifts to the Shrine of Remembrance Restoration and Development Trust', *media release*, No 092, 25 July 2007.

Table 3: Effect on revenue of adding various organisations to the list of DGRs

2007–08	2008–09	2009–10
-	-$0.76m	-$0.76m

Source: Explanatory Memorandum[80]

Main provisions

Item 1 adds State and Territory Kidsafe organisations to the list of DGRs.

Item 2 extends the period during which tax deductible contributions may be made to the Shrine of Remembrance Restoration and Development Trust to before 1 July 2009. **Item 3** applies this particular amendment to gifts made to this trust on or after 1 July 2007.

Items 4 and **5** add the Bathurst War Memorial Carillon Public Fund Trust to the list of DGRs.

80. *Explanatory Memorandum*, p. 9.

Schedule 10: Film production offsets

Purpose

Schedule 10 amends both the ITAA97 and ITAA36 to:

- introduce a refundable tax offset for Australian expenditure in making Australian films (the producer offset)
- introduce a refundable film tax offset for post, digital and visual effects production in Australia (the PDV offset)
- enhance the existing refundable film tax offset for Australian production expenditure (the location offset), and
- phase out existing tax incentives provided to investors in Australian films.[81]

Background

What is a refundable tax offset?

The general rule is that the sum of personal tax offsets (including rebates) allowable to a taxpayer is limited to the amount of income tax (excluding Medicare levy) otherwise payable by the taxpayer. In other words, if the sum of the offsets exceeds the amount of income tax otherwise payable, the taxpayer is generally not entitled to a refund of the excess tax offset or to carry forward the excess tax offset to a future year.

One exception to this general rule are refundable tax offsets. These offsets are not limited to the amount of tax payable by the taxpayer. In certain situations if the amount of the tax offset is greater than the tax payable the taxpayer will receive a refund equal to the amount of the unused tax offset. Examples of refundable tax offsets include:

- the private health insurance offset
- the first child tax offset
- franking credits arsing from franked distributions for certain taxpayers (superannuation funds and the retired), and
- the Research & Development tax offset for small companies.[82]

What are the current tax concessions available to investors in Australian films?

The following tax concessions are granted to taxpayers who invest in Australian films:

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81. *Explanatory Memorandum*, p. 183.

82. CCH 2007 Australian Master Tax Guide, Topic - 15-380.

- a special tax deduction for capital expenditure incurred in acquiring an interest in the initial copyright of a proposed Australian film (ITAA36 **Pt 3 Division 10BA**)
- the two-year write-off concession that is available if the investor has elected that existing **Division 10BA** ITAA36 is not to apply
- an exemption for the net earnings from the film of up to a fixed percentage of the capital investment in cases where the deduction allowed was more than 100 per cent
- the refundable tax offset for film producers where the production expenditure is at least $15m (existing **Division 376** ITAA97), and
- a 100 per cent deduction for investors in companies licensed to invest in film and television production (film licensed investment companies).[83]

Why are these changes being proposed?

The Explanatory Memorandum notes that the current package of tax incentives has had limited effectiveness in recent years.[84] Further, there is some suggestion that the current measures have directed money to schemes that aim to reduce an investor's tax burden, rather than to produce successful films.[85] Further, in recent years fund raising for Australian films has declined, though this may be due to the uncertainty in the tax rules following the announcement of the review of existing **Divisions 10B** and **10BA** ITAA36 in 2005 (see below).[86] It is interesting to note that due to a combination of factors outside Australia the 2007-08 financial year is likely to see significantly increased levels of foreign and local film production in Australia.[87]

History of the proposed measures

Currently tax incentives for investment in Australian films are provided through existing **Divisions 10B** or **10BA** ITAA 36. A review of the key provisions of these Divisions was conducted in 2005.[88] A further, broader, review of film support measures was conducted

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83. CCH 2007 Australian Master Tax Guide, Topic 20-33.
84. Explanatory Memorandum, p. 184.
85. Elizabeth Kazi, '$283m film funding overhaul', *Australian Financial Review*, 9 May 2007, p. 23.
86. Michaela Boland, 'Rewriting script on film' *Australian Financial Review*, 13 November 2006, p. 4.
87. Michael Bodey, 'Hollywood hiccups a Sunshine bonanza', *The Australian*, 16 August 2007, p. 33.
88. Senator the Hon. Rod Kemp, Minister for the Arts and Sport, 'Call for submissions: Review of 10B and 10BA film tax incentives', *media release*, Melbourne, 22 September 2005.

during 2006–07.[89] A additional statutory review of the current refundable film tax offset scheme was also conducted during this period.[90] Current s**ection 376-110** ITAA97 required the Arts Minister to review the operation of this legislation by 4 September 2006. Industry and interested party submissions were sought to these reviews. The results of these reviews were announced as part of the 2007–08 Budget announcements. Further consultation with industry had led to the provisions announced in 2007–08 Budget undergoing further modification.[91]

Basis of policy commitment

These measures were announced in a joint media release by the Minister for Communications, Information Technology and the Arts and the Minister for the Arts and Sport on 8 May 2007.[92]

Position of significant interest groups/press commentary

These proposals have attracted substantial industry comment in submissions to the current Senate Economics Committee's Inquiry into the provisions of this Bill.

Generally, there has been broad support for the provisions in **Schedule 10** in the submissions to the above Inquiry; however the following issues were raised.

Role of Independent Production Companies

The provision of a 20 per cent refundable tax offset for productions that are not feature films has led to the belief that this will encourage TV broadcasters to undertake more in-house production. This is seen as undesirable because:

- TV broadcasters are given exclusive access to the broadcast spectrum. In exchange for this protection the broadcasters must meet public service licence conditions with include investment in Australian content. Allowing broadcasters access to the 20 per

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89. Senator the Hon. Rod Kemp, Minister for the Arts and Sport, 'Review of film support measures', *media release*, Canberra, 9 May 2006.

90. Senator the Hon. Rod Kemp, Minister for the Arts and Sport, 'Call for responses to film tax offset review', *media release,* Canberra, 24 May 2006.

91. Senator the Hon. George Brandis SC, Minister for the Arts and Sport, 'Further enhancements to proposed Australian film industry incentives, *media release,* No 82/07, 3 August 2007.

92. Senator the Hon. Helen Coonan, Minister for Communications, Information Technology and the Arts and Senator the Hon. George Brandis SC, Minister for the Arts and Sport, 'Backing Australian film industry, *joint media release,* Canberra, 8 May 2007.

cent refundable tax offset effectively subsidises their operations where they are a highly protected oligopoly to meet their already agreed public service obligations, and

- insofar as the proposed 20 per cent refundable tax offset encourages TV broadcasters to undertake additional 'in-house' production this will result in the decline of work commissioned by the TV broadcasters from independent production companies. [93]

This position has been vigorously rejected by various industry bodies on the following basis:

- it is more efficient if all producers have equal access to the available tax concessions
- the current business model for large broadcasters is to deliver the best and highest quality programs irrespective of their origan
- the proposed refundable tax offset will have a minor impact on the cost of producing programs 'in-house'. This advantage is not sufficient to suddenly cause TV broadcasters to switch from using independent production companies
- if the best idea for a production comes from an independent source, any broadcaster cannot develop that idea without the participation of that independent source, and
- there is currently a healthy balance between in-house and external productions.[94]

In support of the above position Free TV Australia made the following points:

- the origin of programming is not relevant to viewers
- in-house production makes a significant contribution to the overall health of the TV production sector
- independent producers are a very small part of the broader production community
- other incentives limited to independent producers already exist, and
- direct commissioning is not the only relationship between broadcasters and independent production organisations.[95]

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93. Australian Writers Guild, *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007*, 24 August 2007, p. 1; and Media, Entertainment & Arts Alliance. *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007*, August 2007, p. 2; and Australian Screen Council, *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007*, 24 August 2007, p. 1.

94. Free TV Australia, *Submission to the Senate Economics Committee Inquiry into the provisions of the Tax Laws Amendment (2007 Measures No. 5) Bill 2007*, 24 August 2007, p. 3. Support for this position was given by the Australian Subscription Television and Radio Association and ABC Television in their respective submissions, though not in as detailed terms as in Free TV Australia's submission.

Comment

The proposed 20 per cent refundable tax offset available to all producers significantly alters the economic incentives available to different groups to undertake non-film production. Some change in the current pattens of non-film production can be expected as a result of this change.

Further, the importance of the independent production sector in non-film production appears to be a matter of dispute. As noted above, one organisation claims that they have a comparatively small role in the broader production community. However, another industry organisation suggests that over 90 per cent of film drama production expenditure by the subscription television industry is provided to independently produced productions.[96] The two statements are not irreconcilable, but nonetheless they suggest that the current importance of the independent production sector is less than clear.

Lastly, the impression could easily be gained that TV broadcaster access to the proposed producer refundable tax offset is a proposed innovation. However, this not the case. Under the current provisions of **Division 10B** and **10BA** ITAA36, or under existing **Division 376** ITAA97, TV broadcasters have always had access to tax concessions should they choose to undertake production work. The particular issue arising from the proposed Producer tax offset is whether the tax benefits available under these proposed provisions will cause TV broadcasters to undertake more in-house production work at the expense of the independent production sector.

The inclusion of insurance and completion guarantees in eligible expenditure for the proposed offsets

It is common practice in the film production industry for producers to make arrangements to ensure the completion of a particular project, such as taking out insurance or providing financial guarantees. Currently, completion insurance is not classed as eligible expenditure for the purpose of some parts of the current legislation allowing tax offsets etc for film production. The Media, Entertainment & Arts Alliance believes that both completion insurance premiums and completion financial guarantee expenditure should be eligible expenditure for all of the proposed tax offsets.[97]

Use of the 40 per cent film refundable tax offset

Concerns have been raised that local large film production companies may simply 'repackage' overseas material and qualify for the 40 per cent refundable tax offset for film production. In these circumstances, little, if any Australian resources would be used in

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95. Free TV Australia, ibid, pp. 3 - 5.

96. Australian Subscription Television & Radio Association, op. cit., p. 3.

97. Media, Entertainment & Arts Alliance, op. cit., p. 3.

bringing such material to the public. It could be argued that gaining access to the 40 per cent film tax offset is inappropriate in these circumstances. [98] A representative from a large Australian production company has strongly denied that this outcome would occur under the proposed arrangements.[99]

Other press comment

General press comment, reporting the reaction of producers and directors to the proposed measures, has been overwhelmingly favourable.[100]

Pros and cons

The proposed measures may well lead to a general expansion of the Australian film and television industry. Further, additional overseas productions may be undertaken in Australian facilities using Australian production resources.

However, their may be some changes in the amount of production work undertaken by the independent production sector.

ALP/Australian Democrat/Greens/Family First policy position/commitments

The ALP has welcomed the proposed measures as being 'long overdue'.[101]

Financial implications

The following table illustrates the expected financial impact on revenue arising from the proposed measures.

Table 4: Effect on Revenue of introducing proposed tax offsets for film production

98. Michael Bodey, 'Tax break won't go to US scripts', *The Australian*, 16 August 2007, p. 33.

99. ibid.

100. Katrina Nicholas, 'Big movie deals were only logical', *Australian Financial Review*, 28 August 2007, p. 16; Michaela Boland, 'It's a wrap for the local movie industry', *Australian Financial Review*, 12 May 2007, p. 28; Michael Bodey, 'Tax rebate a boost, says big and small screen creatives', *The Australian*, 10 May 2007, p. 15; Michael Bodey, 'Film and television industry applaud production rebate', *The Australian*, 9 May 2007, p. 11.

101. Peter Garrett MP, Shadow Minister of the Arts, 'Howard government still playing catch-up', *media statement*, 9 May 2007.

2007–08	2008–09	2009–10	2010–11
-$67m	-$71m	-$69m	-$69m

Source: Explanatory Memorandum[102]

Key issues

There are a number of potential key issues connected with these proposed measures:

- given the apparent up-swing in both local film production and foreign film production in Australia are these measures needed?
- what is the value of the independent film production sector and should government policy underwrite its current role?

Main provisions

Part 1

Item 1 of **Schedule 10** repeals the current **Division 376** ITAA97 and replaces it with a proposed **Division 376**.

The current **Division 376** provided a refundable tax offset for Australian and foreign film production companies of 12.5 per cent of eligible qualifying expenditure if the cost of production is $15m or more.

Proposed **section 376-2** states that there are three refundable tax offsets and that a company is able only to claim one of the following:

- the producer offset of 40 per cent of the company's qualifying Australian production expenditure for a film production
  - 20 per cent for non-film (TV) production
- a location offset of 15 per cent of a companies' qualifying Australian production expenditure, or
- a post, digital and visual effects production (PDV) offset of 15 per cent of qualifying Australian production expenditure.

These offsets will be available if a certificate is issued that states the amount of Australian expenditure. The relevant offset is claimed by a company in its income tax return.

102. *Explanatory Memorandum*, p. 10.

Location offset

The purpose of the location offset is to encourage large scale film production to locate in Australia and is aimed at providing greater economic, employment and skill development opportunities.[103]

Proposed **section 376-10** sets out the qualifications for a company claiming the location offset, as follows:

- the production's qualifying Australian expenditure must have ceased being incurred in the income year
- the Arts Minister has granted a certificate to the applicant company
- the company claims the tax offset for the same income year in which the relevant expenditure ceased being incurred
- the company is either an Australian resident or a foreign resident with a permanent establishment and an Australian Business Number (ABN).

This section does not require that all production expenditure has ceased, rather only the Australian component of this expenditure. This allows any required post production work to be undertaken overseas if necessary.

Proposed **section 376-15** specifies that the amount of the offset is 15 per cent of the total qualifying Australian production expenditure on the film.

Under proposed **section 376-20** the Arts Minister must issue a certificate for a film to claim a location offset.

The location offset is available for the production of a feature film, a mini-series of television drama or other television series. But the location offset is not available for:

- documentaries
- advertising
- an exhibition or discussion program, a quiz program, a panel program, a variety program
- a film of a public event
- a training film, or
- a computer game.

The above restrictions do not appear to apply to the currently popular drama programs based on historical events (such as the recent ABC program on World War II Prime

103. *Explanatory Memorandum,* p. 216.

Minister John Curtin) or other documentary like drama programs. To qualify for a location offset television series must be completed within set time frames (not including pre production work or pilot programs).

PDV offset

The PDV offset is designed to attract post-production, digital and visual effects production to Australia as part of large budget productions, no matter where the film is shot.[104]

Proposed **section 376-35** entitles a company to a tax offset if:

- the qualifying Australian production expenditure related to PDV ceases being incurred in the income year
- the Arts Minister has issued the relevant certificate
- the company claims the offset for the same income year in which the expenditure ceases being incurred, and
- the company is an Australian resident or a foreign resident that has a permanent establishment in Australia and an ABN.

Proposed **section 376-40** states that the amount of the PDV offset is 15 per cent of the total qualifying Australian production expenditure on a film to the extent that it relates to PDV production.

Proposed **section 376-45** requires the Arts Minister to issue a certificate to a company in order to claim the PDV offset. This offset is available for work done on a feature film, mini-series of television drama or other television series where the value of the expenditure is at least $5 million. But it is not available for work done on the same types of productions that also are not eligible for the location offset (see proposed **section 376-20** above).

Producer offset

Proposed **section 376-55** specifies that a company is eligible for the producer offset if:

- the film is completed
- the ‘Film Authority’ (not the Arts Minister) has issued the relevant certificate
- the company claims the producer offset in its tax return for the income year in which the film was completed, and
- the company is an Australian resident or a foreign resident with a permanent establishment in Australia and an ABN.

104. *Explanatory Memorandum*, p. 227.

The 'Film Authority' is the Film Finance Corporation of Australia.

Proposed **section 376-60** states that the amount of the producer offset is:

- if the film is a feature film – 40 per cent, or
- if the film is not a feature film – 20 per cent

of the company's qualifying Australian production expenditure.

Proposed **section 376-66** requires the Film Authority to issue the relevant producer offset certificate. The relevant film must, amongst other things, have significant Australian content.

Feature films, single episode programs, a series or a season of a series or a short form animated drama are eligible to have a producer offset certificate issued for their production. Significantly, a documentary can qualify as an eligible film in respect of which a producer offset certificate can be issued.

However, the producer offset is not available in respect of same types of programs (i.e. game shows, panel discussions advertising) that also do not qualify for both the location and PDV offsets (except documentaries).

The producer offset certificate is also only issued if relevant expenditure thresholds are met. The producer's expenditure must be above these levels to qualify for the offset. These thresholds range from $250 000 to $1 million, depending on the type of film being produced.

Production expenditure

One of the key concepts in the operation of this Division is what is included (and excluded from) the term 'qualifying Australian production expenditure'. Proposed **subdivision 376-C** deals with this issue. These rules apply to all of the above offsets.

In order to be included in the term qualifying Australian production expenditure, a category of expenditure must first be classed as 'production expenditure'. Proposed **section 376-125** specifies that production expenditure is made up of amounts reasonable incurred in making the film, the use of equipment or in other activities necessary for making the film.

Proposed **section 376-135** specifically excludes certain classes of expenses from inclusion in the category of production expenditure – thus also from inclusion in the category of 'qualifying Australian production expenditure'. Amongst these exclusions is 'financing expenditure'. As noted above, some industry comment requested that these expenses be included in the expenditure that qualifies for the various tax offsets.

Qualifying Australian production expenditure

Proposed **section 376-145** specifies that generally qualifying Australian production expenditure is production expenditure that incurred in respect of goods and services provided in Australia or the use of Australian land.

Proposed **subdivision 376-C** contains additional specific rules on what is, and is not qualifying Australian production expenditure in relation to each of the above three tax offsets.

The Explanatory Memorandum contains additional detailed information on these proposed amendments.

Part 3

Part 3 of **Schedule 10** repeals current **Divisions 10B** and **10BA** ITAA36. This is achieved by **Item 41** of this Schedule. **Parts 2** and **3** also make consequential amendments to the tax legislation.

Part 4

Item 91 specifies different commencement dates for the proposed changes in this Schedule, as follows:

- the location offset applies to films that commenced principal photography or production of an animated image on of after 8 May 2007. That is, on or after the date of the 2007–08 Budget speech
- the PDV offset applies to work that commenced on or after 1 July 2007, and
- the producer offset applies to qualifying Australian production expenditure that incurred on or after 1 July 2007 and to such expenditure incurred before that date to the extent that it relates to goods or services provided after that date.

Schedule 11: Premium 175 per cent research and development tax concession for Australian research and development activities undertaken on behalf of a grouped foreign company

Purpose

Schedule 11 amends the ITAA36 and the *Industry Research and Development Act 1986* to allow a 175 per cent tax deduction for Research & Development (R&D) expenditure on foreign owned R&D activities. Currently, none of this expenditure is allowed as deduction from an entities' income.

Background

R&D Tax concessions

Companies that incur expenditure on R&D may claim a number of tax concessions, amongst which are:

- an accelerated rate of deduction (generally 125 per cent), subject to a $20 000 threshold, is allowed for wages, salaries, other labour costs and expenditure incurred directly on R&D activities and for certain payments to approved outside bodies, and
- an incremental concession 175 per cent rate of deduction applies where companies increase their level of R&D expenditure.

The R&D activities must:

- be undertaken by, or on behalf of a company
- not have guarantee financial returns to that company, and
- be exploited for Australian benefit.

These rules disqualify Australian companies who conduct R&D activities on behalf of a foreign company, from claiming these tax concessions.[105]

What is the 175 per cent R&D tax concession?

Companies that increase their level of R&D expenditure may claim a 175 per cent deduction rate for the amount of additional expenditure. In other words, the additional expenditure is eligible for a further deduction of 50 per cent, on top of the 125 per cent rate.

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105. *Explanatory Memorandum*, p. 237.

The amount of additional expenditure that is eligible for the 175 per cent rate is worked out by subtracting a company's average qualifying expenditure over the preceding three years from its current year qualifying expenditure.

To qualify for the additional 50 per cent deduction, companies are generally required to have a three-year history of being eligible to deduct an amount for qualifying expenditure.[106]

Why extend eligibility for the 175 percent R&D tax deduction?

In recent years the ownership of industrial resources had become increasingly concentrated. Multinational enterprises (MNEs) are now responsible for an increasing amount of industrial production and distribution. These following trends illustrate these developments:

- in pharmaceuticals, the top ten firms accounted for around one third of sales in the mid 1990's. Now this group of company's share of global sales has reached 50 per cent
- in the US aerospace sector, Boeing, Lockheed Martin, Northrop Grumman and Raytheon have emerged from 52 separate companies in the late 1980s, and
- in the auto sector, 40 firms in the 1980s have consolidated into 14 major global firms.[107]

Previously, MNEs had regionally based business strategies. While technologies were shared across the business group, production was often regional and plants were optimised around the size of the regional market. However, as trading regimes become more open and real transport costs fell regional strategies made less sense. Now production is more likely to be focused on fewer facilities which together provide global economies of scale.[108] This has led to the globalisation of manufacturing and supply of goods.

The increased importance of MNEs in industrial production and distribution has made the integration of Australian manufacturing and business into these global businesses of critical importance.

In this environment MNEs increasingly hold intellectual property in the jurisdiction of their corporate headquarters. There is a natural bias to perform any required R&D in these jurisdictions. Further, the lack of tax concessions for R&D work done in Australia on the behalf of a foreign owner of the intellectual property meant that this work did not come to Australia.

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106. CCH 2007 Master Australian Tax Guide, Topic 20-212.

107. Australian Government, *Industry Statement - Global Integration: Changing markets, Proposed opportunities*, 1 May 2007, p. 17.

108. ibid.

Making Australia an attractive place to undertake R&D will help Australian business to engage in the global business networks. Further, Australia would benefit from the skills developed, and the knowledge gained, form undertaking R&D work on behalf of MNEs.[109]

History of the measure

On 10 July 2006 the Minister for Industry, Tourism and Resources announced that the Government would prepare a proposed Industry Statement to set future policy directions for industrial development. A business roundtable on these maters was held on 26 July 2006 and submissions were invited from the public.[110] A large number of submissions was subsequently received from industry and other interested parties.[111] In March 2007 the Productivity Commission released its report entitled 'Public Support for Science and Innovation'. In that report the Commission recommended that any relaxation of the requirement that the intellectual capital be owned by an Australian entity be relaxed for the 175 per cent R&D tax concession only (see further discussion below).[112]

Basis of policy commitment

The package of measures, of which this particular measure was a part, was announced at a press conference held by the Prime Minister and the Minister for Industry, Tourism and Resources on 1 May 2007.[113]

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109. Department of Industry Tourism and Resources, 'Changes to the R&D Tax Concession', *Fact Sheet*, 1 May 2007.

110. The Hon. Ian Macfarlane MP, Minister for Industry, Tourism and Resources, 'Industry statement to set future directions', *media release*, 10 July 2006.

111. List of submissions to the 'Industry Statement' can be found at http://www.industry.gov.au/content/itrinternet/cmscontent.cfm?objectID=8BA97A5C-C4FD-29B0-B6FF8AF83C2F4B9B (accessed 31 August 2007).

112. Productivity Commission, *Public Support for Science and Innovation*, Research Report, Canberra. 9 March 2007, p. 395, at http://www.pc.gov.au/study/science/finalreport/science.pdf (accessed 31 August 2007).

113. The Hon, John Howard MP, Prime Minister and The Hon. Ian Macfarlane MP, Minister for Industry, Tourism and Resources, *Joint Press Conference*, Australian Government Industry Announcement, Zetland, Sydney 1 May 2007 and Department of Industry, Tourism and Resources, Industry Statement, *Fact Sheet*, 1 May 2007, at http://www.industry.gov.au/content/itrinternet/cmscontent.cfm?objectid=572C46BC-F5DC-42BA-7856D5B684345986 (accessed 31 August 2007).

Position of significant interest groups/press commentary

Generally, representatives of Australian industry welcomed the proposed extension of the 175 per cent R&D tax concession or generally supported the package of measures of which it was a part.[114] However, one group noted that it would be simpler and more effective to return to the 150 per cent arrangement that had applied up to 1996.[115]

However, a number of commentators have noted that the proposed change will not significantly increase the amount of R&D work undertaken in Australia.[116] There is support for this view from a recent report of the Productivity Commission. However, as noted above, the Commission argued that any relaxation of the requirement that the intellectual capital be in Australian hands be relaxed for the incremental 175 per cent R&D tax concession only.[117]

Pros and cons

Insofar as the extension of the 175 per cent R&D tax concession to work undertaken on behalf of foreign companies expands the R&D sector, and facilitates the development of skills and the accumulation of knowledge in Australia, it is a worthwhile proposal.

Further, it is clearly aimed at further integrating Australian business into global industrial production and distribution chains through the undertaking higher skilled activities (i.e. R&D). This will allow higher value production outputs (i.e. R&D) to occur. Such developments may be crucial for the continued development of Australian industry.

However, there is the possibility that a significant proportion of Australian R&D activity will end up being exploited by foreign companies. Further, it is less than clear that the proposed measure will significantly increase the amount of R&D work undertaken in Australia.

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114. Australian Industry Group, 'Proactive industry statement will be good for business' *media release*, 1 May 2007; Business Council of Australia, 'Industry statement a smart step in winning the innovation race', *media release*, 1 May 2007; Australian Nano Business Forum, 'Response to the Federal Government industry statement', *media release*, 2 May 2007.

115. Australian Chamber of Commerce and Industry, 'ACCI welcomes industry statement', *media release*, 1 May 2007.

116. Comments cited in Sophie Morris, 'Foreign owners must increase R&D to get tax break, *Australian Financial Review*, 2 May 2007, p. 5; David Crowe and Steven Scott, 'PM's $1bn blueprint targets key seats', *Australian Financial Review*, 2 May 2007, p. 5.

117. Productivity Commission, op. cit., pp-391–395.

ALP/Australian Democrat/Greens/Family First policy position/commitments

The ALP supports the proposed extension of the 175 per cent R&D tax concession, but believes that the proposed changes do not take account of the administrative complexities of administering the scheme identified by the Productivity Commission.[118]

Financial implications

The following table illustrates the estimated financial impact of the proposed extension of the 175 per cent R&D tax deduction.

Table 5: Effect on Revenue of extending the 175% R&D tax deduction

2007–08	2008–09	2009–10	2010–11
-$50m	-$50m	-$50m	-$50m

Source: Explanatory Memorandum[119]

Key issues

The key issue is whether the proposed extension of the 175 per cent R&D tax concession will sufficiently increase R&D activity in Australia in view of the projected costs to revenue.

Main provisions

Part 1

Item 4 inserts a definition of a 'foreign company' into existing **subsection 73B(1)** ITAA36. Generally, existing **section 73B** is the core section for the granting of R&D tax concessions. Thus, tax concessions available in respect of a foreign company's R&D activities will only be available to entities that meet this definition.

This definition requires that the entity is incorporated under the law of a foreign country and that it is a resident of a foreign country that has a double tax agreement with Australia.

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118. Senator Kim Carr, Shadow Minister for Industry, Innovation, Science and Research, 'Govt plays catch up on industry policy', *media release*, 18/07, 1 May 2007.

119. *Explanatory Memorandum*, p. 11.

The amendments to **subsection 73B(9)** in **items 6** and **7** allow a deduction to be given where an Australian entity undertakes research on behalf of a foreign company, as defined above.

Item 8 inserts proposed **subsection 73B(14C)**. This proposed subsection sets out the conditions that an Australian company, that is a subsidiary of a foreign entity, must meet in order to apply to claim the R&D tax deduction for research and development work undertaken on behalf of that parent. These conditions are:

- expenditure was for the purposes of carrying on Australian centred R&D activities wholly or primarily on the behalf of the foreign entity
- expenditure is undertaken under a written agreement
- that agreement must be between the foreign entity controlling the Australian company. The agreement must not be between an Australian subsidiary and another subsidiary of same group
- the eligible expenditure is greater than $20 000 p.a., and
- the Australian company undertaking the R&D work must be registered with the Industry Research and Development Board (IR&D Board)[120]
  - the Explanatory Memorandum notes that the activities of the Australian company must also be registered with the IR&D Board. However, the registration of activities does not seem to be a necessary requirement of this particular subsection. Rather that all activities meet particular conditions in this proposed subsection.[121]

This particular section allows only for the deduction of eligible expenditure on Australian centred R&D activity. That is, only 100 per cent of the expenditure, not 175 per cent, is an allowable tax deduction to the Australian company for R&D undertaken on behalf of a foreign entity.

Items 16 through to **23** deny a company access to a refundable tax offset for foreign owned R&D expenditure. Rather, only a deduction is available in respect of such expenditure. If the deduction exceeds the company's tax bill there is no refund of the difference.

Item 34 repeals the current **section 73Q** and inserts proposed **sections 73QA** and **73QB**. The first proposed section simply restates the current rules for calculating an Australian company's access to the additional 50 per cent tax deduction for expenditure on Australian owned R&D.

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120. The IR&D Board will be merged with the Venture Capital Board under the provisions of **Schedule 12** of this Bill. The proposed body will be called Innovation Australia.

121. Explanatory Memorandum, p. 243. The certificates issued by the IR&D Board deal in terms of activities, not companies, under amended **subsection 73B(34)** in **Item 10** of **Schedule 11**.

Proposed **section 73QB** sets out the method for calculation the additional 75 per cent tax deduction for R&D expenditure by an Australian company on behalf of a foreign company. The additional 75 per cent allowable tax deduction on this expenditure is only allowable if they could deduct 100 per cent of this expenditure for the past three years under the provisions of **items 6**, **7** and **8** above.

Proposed **section 73QB** also permits a newly established company, controlled by a foreign company, to claim the 175 per cent R&D tax deduction even if they do not have a 3 year history of tax deduction under the provisions of **items 6**,**7**, and **8** above (see proposed **sub-paragraph 73QB1(b)(iii)** and **subsection 73QB(2)**).

Part 2

This Part amends the *Industrial Research and Development Act 1986* (IR&D Act).

Item 51 repeals current **section 39D** of the IR&D Act. This section obliged the IR&D Board, when issuing certificates authorising particular R&D activities are eligible for the R&D tax deductions, to consider whether the activity would result in profits or gains to Australian residents. That is, can the results of the R&D work be exploited for the benefit of the Australian economy?

The proposed provision obliges the IR&D Board to consider whether the R&D activity will be of benefit to the Australian economy. This is a much easier standard to meet than the standard in the current law for the issue of such certificates.

Further, the IR&D Board may issue authorising certificates in respect of overseas research, undertaken by an Australian company, if it is considered to be of benefit to the Australian economy. This particular change would allow R&D activity to be undertaken anywhere in the world either by, or on the behalf of, an eligible Australian company, to qualify for the relevant R&D tax deduction.

Part 3

Item 78 applies the amendments made in **Schedule 11** to income years starting after 30 June 2007.

Schedule 12: Innovation Australia

Purpose

Schedule 12 of this Bill changes the current administrative arrangements of the *Industry Research and Development Act* 1986 (IR&D Act), the *Pooled Development Funds Act 1992* (PDF Act) and the *Venture Capital Act 2002* (VC Act).

The functions of the IR&D Board and the Venture Capital Registration Board (VCR Board) will be merged into a proposed board called 'Innovation Australia'.

Background

The existing boards

The IR&D Board administers a range of Australian Government programs that stimulate innovation through research and development (R&D) and commercialisation.[122] Beside the R&D tax deduction the IR&D Board also administers programs such as the Commercial Ready Program, the R&D START Program and the Renewable Energy Initiative.

The VCR Board regulates entities registered under both the Pooled Development Funds Act, and the Venture Capital Act. These include Pooled Development Funds, Venture Capital Limited Partnerships, Early Stage Venture Capital Limited Partnerships, Australian Venture Capital Fund of Funds, and Eligible Venture Capital Investors.[123]

Why change existing arrangements?

The Explanatory Memorandum states that the operation the existing Boards is effective.[124] However, according to the Minister, joining these Boards together will produce a consistent approach to program delivery and ensure that the Industry portfolio achieves maximum impact from its nearly $1bn annual support for business innovation.[125]

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122. Department of Industry, Tourism and Resources, *Industry Development & Research Board Annual Report 2005–06*, p. 14.

123. Industry, Tourism and Resources website, Venture Capital Registration Board, at http://www.ausindustry.gov.au/content/level3index.cfm?ObjectID=A98FC4FA-DD16-4B56-BB7259DB6DE6A0CF (accessed 3 September 2007).

124. *Explanatory Memorandum*, p. 269.

125. The Hon. Ian Macfarlane MP, Minister for Industry Tourism and Resources, 'Innovation Australia Board to be established, *media release*, 16 August 2007.

Pros and cons

The proposed merger of the two Boards will create a one stop shop for government support programs for industrial innovation in Australia.

Financial implications

The proposal is expected to lead to some moderate, one off, administrative costs to the Department of Industry, Tourism and Resources.[126]

Main provisions

Item 11 repeals **section 6** ID&R Act and replaces it with a proposed section of the same number. This proposed section establishes a new Board named 'Innovation Australia'.

The functions of this Board are contained in **section 7** and are the same as the existing IR&D Board. **Item 7** amends existing **section 7** to give Innovation Australia the additional function of advising the Minister about the operation of the IR&D Act and the VC and PDF Acts.

Item 23 amends existing **section 19** so that the Minister can, by a Ministerial Direction, direct Innovation Australia to take on additional functions related to either or both of the VC and PDF Acts.

Item 24 inserts proposed **section 19B** into the IR&D Act so that the Minister may require Innovation Australia to provide advice on a matter connected with the operation of the IR&D, VC or PDF Acts.

Items 34 to **36** amend existing **section 22** so that the Minister may appoint committees to advise Innovation Australia about the operation of the IR&D, VC or PDF Acts.

Items 48 to **64** retain the existing confidentiality and secrecy provisions of the IR&D, VC or PDF Acts and apply them to the operations of Innovation Australia.

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126. *Explanatory Memorandum*, p. 12.

Members, Senators and Parliamentary staff can obtain further information from the Parliamentary Library on (02) 6277 2495.