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Tax Laws Amendment (2008 Measures No. 5) Bill 2008

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Glossary

Abbreviation	***Definition***
ADIs	authorised deposit-taking institutions
AEST	Australian Eastern Standard Time
AIFRS	*Australian equivalents to International Financial Reporting Standards*
Commissioner	Commissioner of Taxation
Corporations Act	*Corporations Act 2001*
FBT	fringe benefits tax
FBTAA 1986	*Fringe Benefits Tax Assessment Act 1986*
GST	goods and services tax
GST Act	*A New Tax System (Goods and Services Tax) Act 1999*
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
IWT	interest withholding tax
NAB case	*National Australia Bank Ltd v FC of T* 93 ATC 4914

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Tax Laws Amendment (2008 Measures No. 5) Bill 2008

Date introduced: 25 September 2008

House: House of Representatives

Portfolio: Treasury

Commencement: The Act commences on Royal Assent. The commencement of the measures in each Schedule is given in the Application sections of this Bills Digest.

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/.

Purpose

The Bill has five Schedules and the purpose of the amendments in each Schedule is briefly set out below:

- Schedule 1 seeks to amend the *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act) to overcome tax minimisation involving the use of the margin scheme and the sale of real property. This is a tax integrity measure, Schedule 1 also seeks to align the anti-avoidance provisions in the GST Act with the anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936).
- Schedule 2 seeks to effect changes to the thin capitalisation regime in Australian tax law to recognise changes in Australian Accounting Standards on the adoption in 2005 of the *Australian equivalents to International Financial Reporting Standards.*
- Schedule 3 seeks to extend the Interest Withholding Tax (IWT) exemption to State and Territory Government bonds to bring about a better functioning State and Territory bond market.
- Schedule 4 seeks to ensure that the full value of a benefit that has been provided to an employee and an associate in relation to a jointly held asset will be subject to fringe benefits tax (FBT) under the *Fringe Benefits Tax Assessment Act 1986* (FBTAA 1986). This is a tax integrity measure.
- Schedule 5 seeks to change the eligible investment business rules in Division 6C of the ITAA 1936 to remove impediments to commercial practice in respect of public unit trusts that focus on real estate investments.

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Committee consideration

The Bill was referred to the Senate Standing Committee on Economics on 25 September 2008. The Committee has been given an extended reporting date of 10 November. Details of the committee can be found at http://www.aph.gov.au/senate/committee/economics_ctte/tlab_5_08/index.htm.

Background

As there is no central theme to the Bill, the background to the various measures will be discussed in the commentary on each Schedule.

Schedule 1—Goods and services tax and real property

Background

One of the integrity measures proposed in Budget Paper No. 2, 2008-09 was that relating to the goods and services tax (GST) and the sale of real property. The integrity measure was directed at ensuring that the interactions between a number of provisions in GST law do not allow real property transactions to be structured to reduce the GST liability using the margin scheme. Basically, a tax integrity measure is one to prevent tax avoidance.

Budget Paper No. 2 gave the scope of the proposed changes as follows:

> The GST provisions dealing with real property are intended to ensure that GST is payable on the value added to land once it enters the GST system. The margin scheme achieves this outcome by applying GST to the 'margin', that is, the difference between the purchase price paid by the seller and the price paid by the buyer. This measure provides that, where the margin scheme is used after a GST free or non-taxable supply, the value added by the registered entity which made that supply is included in determining the GST subsequently payable under the margin scheme. The measure will also strengthen the GST anti-avoidance provisions to ensure that they can apply to contrived arrangements entered into to avoid GST.

Main provisions

An overview of the margin scheme

Division 75 of the *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act) allows an entity to use a margin scheme to bring within the GST system the entity's supply of freehold interests in land, of stratum units and of long-term leases (referred to as 'real property'). Subsection 75-5(1) provides that the margin scheme can only apply if the supplier and the recipient of the supply have agreed in writing that the margin scheme is to apply.

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The basic margin scheme rule is in subsection 75-10(2) of the GST Act. The margin scheme allows the seller to pay the GST equal to 1/11 of the 'margin' rather than 1/11 of the sale price. The 'margin' can be generally defined as the difference between the amount the seller paid for the property and the amount the property is sold for.

This contrasts with GST payable under the basic GST rule, which is 1/11 of GST inclusive price of the taxable supply under sections 9-70 and 9-75(1) of the GST Act.

Section 75-11 of the GST Act provides for working out the margins for supplies of real property in particular circumstances.

Thus:

- subsections 75-11(1) and (2) provide for working out the margin for supply of real property acquired from a fellow member of GST group,
- subsections 75-11(2A) and (2B) provide for working out the margin for supply of real property acquired from joint venture operator of a GST joint venture,
- subsections 75-11(3) and (4) provide for working out the margin for supply of real property acquired from a deceased estate, and
- subsections 75-11(7) and (8) provide for working out margin for supply of real property acquired from an associate.

The reader is referred to the Australian Taxation Office (ATO) publication GST and the margin scheme which provides basic information about the margin scheme and contains references to additional sources of related information (NAT 15145).

Items ineligible for the margin scheme

The Explanatory Memorandum to the Bill in paragraphs 1.1 and 1.2 gives an outline of the purpose of the amendments in **Schedule 1**. Basically, they are intended to ensure that the margin scheme provisions and the going concern, farmland and associates provisions are not used in a manner to allow property sales to be so structured that GST does not apply to value added to real property on or after 1 July 2000.

It must be noted that the supply of a going concern is GST-free under Subdivision 38-J of the GST Act. Also Subdivision 38-O provides that the supply of subdivided farm land and farm land supplied for farming are GST-free. 'Supply' as defined in sections 9-10 of the GST Act means any form of supply, including a supply of goods, services, a grant, assignment, or surrender of real property.

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Supply ineligible for the margin scheme on real property acquired as a going concern under certain conditions

Item 2 of **Schedule 1** inserts **proposed paragraph 75-5(3)(e)** to subsection 75-5(3) to make a supply of real property ineligible for the margin scheme if:

- the real property was acquired by the supplier from an entity as or part of a supply of a going concern that was GST-free under Subdivision 38-J, and
- the supplier was registered or required to be registered at the time of the acquisition, and
- the supplier had acquired the real property through a taxable supply on which GST was worked out without applying the margin scheme.

This last condition ensures that a supply of real property that was ineligible for the margin scheme previously because it was acquired as a going concern which was GST-free does not become eligible to the margin scheme subsequently.

Supply ineligible for the margin scheme on real property acquired as farm land under certain conditions

Item 2 of **Schedule 1** inserts **proposed paragraph 75-5(3)(f)** to subsection 75-5(3) to make a supply of real property ineligible for the margin scheme if:

- the real property was acquired by the supplier from an entity as or part of a supply of a going concern that was GST-free under Subdivision 38-O,and
- the supplier was registered or required to be registered at the time of the acquisition, and
- the supplier had acquired the real property through a taxable supply on which GST was worked out without applying the margin scheme.

Here again, this last condition ensures that a supply of real property that was ineligible for the margin scheme previously because it was acquired as farmland which was GST-free does not become eligible to the margin scheme subsequently.

Supply ineligible for the margin scheme on real property acquired from an associate under certain conditions

Item 2 of **Schedule 1** inserts **proposed paragraph 75-5(3)(g)** to subsection 75-5(3) to make a supply of real property ineligible for the margin scheme if:

- the real property was acquired by the supplier from an associate who was registered or required to be registered at the time of the acquisition, and
- the acquisition from the associate was without consideration, and
- the supply from the associate was not a taxable supply, and

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- the associate made the supply in furtherance of an enterprise carried on by the associate, and
- the associate had acquired the real property through a taxable supply on which GST was worked out without applying the margin scheme.

Here again, this last condition ensures that a supply of real property that was ineligible for the margin scheme previously because it was acquired from an associate for no consideration does not become eligible to the margin scheme subsequently.

Item 3 of **Schedule 1** inserts **proposed subsection 75-5(3A)** which provides that the last two conditions in **proposed paragraph 75-5(3)(g)** do not apply if the acquisition from the associate was not by means of a supply by the associate.

At present, Division 75 does not apply to transactions between associates for no consideration. **Item 1** of **Schedule 1** inserts **proposed subsection 75-5(1B)** so that a supply to an associate is taken for the purposes of subsection 75-5(1) to be a sale whether or not the supply is for a consideration. **Item 8** of **Schedule 1** makes a consequential amendment to section 75-13 to enable the margin to be worked out for supplies between associates, whether or not the supply was for consideration.

Margins for supplies of real property acquired through several acquisitions

Under current law an entity that acquires real property and subsequently sells it under the margin scheme, it only pays GST on the valued added by itself. The value added by the entity from which that real property was acquired is not subject to GST.

Item 4 and **item 9** of **Schedule 1** make provisions to ensure that an entity which sells real property under the margin scheme will pay GST on both the value added by itself and the entity from whom it was acquired, in situations where no GST had been paid on the value added by that entity.

The reader is referred to paragraphs 1.41 to 1.51 on pages 20 to 26 of the Explanatory Memorandum to the Bill for details of these provisions with examples of their operation.

Strengthening the GST general anti avoidance provision

Division 165 of the GST Act contains the general anti-avoidance provisions in the GST Act. This Division is aimed at artificial or contrived schemes to give entities benefits by reducing GST, increasing refunds or altering the timing of payment of GST or refunds. Section 165-40 provides that the Commissioner may negate the avoider’s GST benefits from such schemes.

Division 165 is not intended to apply where parties merely take advantage of concessions such as the margin schemes. Currently, paragraph 165-5(1)(b) provides that the GST benefit which could be negated by the Commissioner should not be attributable to the

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making by an entity of a choice, election, application or agreement that is expressly provided by GST law.

Item 11 of **Schedule 1** inserts **proposed subsection 165-5(3)** to provide that a GST benefit which an avoider gets from a scheme is not taken to be attributable to a choice, election or application or agreement referred to in paragraph 165-5(1)(b) if:

(a) the scheme, or part of the scheme was entered into or carried out for the sole or dominant purpose of creating a circumstance or state of affairs; and

(b) the existence of the circumstance or state of affairs is necessary to enable the choice, election, application or agreement to be made.

The Explanatory Memorandum to the Bill in paragraph 1.55 on page 27 cites a similar concept in the general anti-avoidance provisions of Part IVA of the ITAA 1936 in relation to income tax. It adds:

> 1.56 For the avoidance of doubt, new subsection 165-5(3) introduces into the GST Act a concept that is already found in subparagraph 177C(2)(a)(ii) of the ITAA 1936, so that if a GST benefit is attributable to the making of a choice, election, application or agreement, then consideration needs to be given to the purpose of creating any circumstance or state of affairs which enable such a choice, election, application or agreement.
>
> 1.57 This exception is not limited to schemes involving real property and the margin schemes and applies to other schemes to which GST general anti-avoidance provisions may apply.

The limits to the application of the **proposed subsection 165-5(3)** is that the scheme must be for the sole or dominant purpose of deriving a GST benefit.

Financial impact

According to the Explanatory Memorandum to the Bill the measures in Schedule 1 will have the following positive revenue implications.

2007-08	*2008-09*	*2009-10*	*2010-11*	*2011-12*
Nil	$43m	$135m	$160m	$185m

Application

Generally, the amendments made in Schedule 1 will apply to new supplies made on or after the date of commencement (Royal Assent).

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Schedule 2—Thin capitalisation and international financial reporting standards

Background

On 13 May 2008, the Treasurer and the Assistant Treasurer announced in a joint media release that the Government will amend the thin capitalisation regime in Australian tax law to recognise changes that were effected by the adoption in 2005 of *Australian equivalents to the International Financial Reporting Standards* (AIFRS).[1] The attachment to the joint media release stated:

> The Government will amend the thin capitalisation regime to accommodate certain impacts arising from the 2005 adoption of Australian equivalents to International Financial Reporting Standards. These amendments will allow entities subject to thin capitalisation to depart from the current accounting treatment in relation to certain intangible assets and to exclude both deferred tax assets and liabilities and surpluses and deficits in defined benefit superannuation funds from such calculations.

Main Provisions

Overview of thin capitalisation rules

Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997), which sets out the thin capitalisation rules, applies to foreign controlled Australian entities, Australian entities that operate internationally and foreign entities that operate in Australia. The object of Division 820 is to ensure that these entities do not reduce their Australian tax liabilities by using an excessive amount of debt capital to finance their Australian operations.

Financing expenses that an entity can otherwise deduct from assessable income, such as interest, may be disallowed under Division 820 under certain circumstances when the entity is thinly capitalised.

If an entity is not an authorised deposit-taking institution (ADI) for the purposes of the *Banking Act 1959* and the entity's debt exceeds the prescribed level, the entity is 'thinly capitalised'.

If an entity is an ADI and the entity's capital is less than the prescribed level, the entity is 'thinly capitalised'.

1. See item 24 of the Table and Attachment in: W. Swan & C. Bowen , *The way forward on tax measures announced, but not enacted, by the previous government,* joint media release, no. 53, 13 May 2008, http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/053.htm&pageID=003&min=wms&Year=&DocType=0, accessed 20 October 2008.

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Rules for the recognition and valuation of assets, liabilities and equity capital according to accounting standards

Subsections 820-680(1) and (1A) of the ITAA 1997 require compliance with accounting standards in relation to the recognition of assets and liabilities of an entity and in calculating:

- the value of an entity's assets (including revaluation of assets),
- the value of an entity's liabilities (including its debt capital), and
- the value of an entity's equity capital.

Deferred tax liabilities and assets not to be recognised

Item 5 of **Schedule 2** inserts **proposed section 820-682** to modify the application of accounting standards in the recognition of deferred tax assets and deferred tax liabilities.

Proposed subsection 820-682(1) provides that an entity must not recognise deferred tax liabilities and deferred tax assets for the purposes of Division 820 in working out the application of thin capitalisation rules. Australian accounting standard *AASB 112 Income Taxes* would have otherwise required the recognition of these deferred tax liabilities and deferred tax assets.

Proposed subsection 820-682(3) provides that **proposed section 820-682** does not apply to an outward investing entity ADI or an inward investing entity ADI.

According to subsection 820-300(2) of the ITAA 1997, an entity will be an outward investing ADI if:

- it controls one or more controlled foreign entities (whether an entity is controlled by a foreign interest is to be determined in accordance with the rules applying in relation to controlled foreign corporations - generally 50% control),
- it has a permanent establishment overseas,
- it is an Australian entity and an associate of another entity that is an outward investing entity(non-ADI) or an outward investing entity (ADI).

The expression 'inward investing ADI' is defined in subsection 820-395(2) of the ITAA 1997 and applies if the entity is a foreign bank that carries on its banking business in Australia at or through one or more of its Australian permanent establishments.

Defined benefit plan liabilities and assets not to be recognised

Proposed section 820-682(2) provides that an entity must not recognise an amount relating to a defined benefit plan as a liability or an asset for the purposes of Division 820 in working out the application of thin capitalisation rules. Australian accounting standard

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AASB 119 Employee Benefits would have otherwise required the recognition of these amounts.

Recognition of internally generated intangible assets

Proposed subsection 820-683(2) provides that an entity may choose to recognise an internally generated asset referred to in **proposed subsection 820-683 (1)** notwithstanding that its recognition is precluded by Australian accounting standard *AASB 138 Intangible Assets*.

Proposed subsection 820-683(1) applies to internally generated intangible assets, other than internally generated goodwill, that cannot be recognised under *AASB 138*. These include internally generated brands, mastheads, publishing titles, customer lists and items listed in paragraph 63 of *AASB 138 Intangible Assets*.

Proposed subsection 820-683(6) provides that the choice is not available to an entity that is an outward investing entity ADI or an inward investing entity ADI.

An entity may elect to revalue certain intangible assets

Proposed section 820-684 provides that notwithstanding the prohibition in Australian accounting standard *AASB 138 Intangible Assets* from revaluing certain intangible assets, an entity may choose to revalue such assets.

Proposed subsection 820-684(6) provides that the choice is not available to an entity that is an outward investing entity ADI or an inward investing entity ADI.

Financial implications

The Explanatory Memorandum to the Bill on page 8 states that the financial impact is ‘unquantifiable’.

Application

Item 9 of Schedule states that the amendments made by this Schedule, apply to assessments for each income year starting on or after the commencement of this Schedule. Under **clauses 2** and **3** of the Bill **Schedule 2** will commence on the day the Act receives Royal Assent.

Schedule 3—Interest withholding tax and state government bonds

Background

Interest withholding tax (IWT) is deductible under subsection 128B(2) of the ITAA 1936 where interest is payable by a resident to a non-resident unless an exemption applies. IWT

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is imposed under the *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* at a flat rate of 10 per cent of the gross amount of interest paid unless a different rate is specified under Australia's double tax agreements (DTAs). For payments made after 30 June 2000, sections 12-245, 12-250 and 12-255 of Subdivision 12-F, Schedule 1, of the *Taxation Administration Act1953* require a person to withhold amounts from payments of interest and pay such withheld amounts to the Commissioner of Taxation. Subsection 11-5(1) of the same Schedule deems an amount to have been paid when the paying entity applies or deals with the amount in any way on the other's behalf or as the other directs. Under current tax law there is no IWT exemption on interest paid on State and Territory Government bonds.

On 20 May 2008, the Treasurer, the Hon Wayne Swan in Press Release No 058 announced a package of measures to bolster Australia's financial markets. These measures included the proposal to provide interest withholding tax (IWT) exemption for State and Territory Government bond issuance:

> The final element of this package is to change the Interest Withholding Tax (IWT) arrangements for State Government bond issuance. Bonds issued by State Governments will be eligible for exemption from IWT.
>
> This change is expected to improve depth and liquidity in State Government bond markets and improve price discovery. A better functioning State bond market will add to the attractiveness of these bonds, and allow them to make a greater contribution to financial market stability, while resulting in only a small reduction in revenue received by the Australian Government.
>
> This suite of initiatives would be progressed quickly, with a view to legislation being introduced and passed in the current sitting of Parliament.
>
> This demonstrates the Government's determination to ensure the efficient operation of Australia's financial markets.[2]

The possible exemption of government securities from interest withholding tax was originally discussed in the 1999 Review of Business Taxation (the Ralph Review). However, the review recommended that the tax continue to apply to bonds.

> In the context of the revenue neutrality constraint applying to its recommendations, the Review does not consider extending the IWT exemption of sufficient priority to recommend the exemption.

2. W. Swan, *Increasing Commonwealth Government securities to bolster Australia's financial markets,* media release, no. 58, 20 May 2008, http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/058.htm&pageID=003&min=wms&Year=&DocType=0, accessed 27 October 2008.

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Main provisions

Division 11 of Part 111 of the *Income Tax Assessment Act 1936* (ITAA 1936) deals with dividends, interest and royalties paid to non-residents and to certain other persons.

IWT is payable on interest derived by a non-resident unless an exemption applies under subsection 128B(2) of Division 11 of the *Income Tax Assessment Act 1936* (ITAA 1936). IWT is imposed at a flat rate of 10% on the gross amount of interest, without deductions for expenses incurred in deriving that interest.

Section 128F provides that Division 11 does not apply to interest on certain publicly offered company debentures or debt interests.

Subsection 128F(5A) provides that section 128F does not apply in relation to a debenture or debt interest issued in Australia by a company that is covered by subsection (7) or is a central borrowing authority of a State or Territory.

Subsection 128F(5A) further provides that a central borrowing authority is a body established for the purpose of raising finance for the State or Territory. The following are examples of central borrowing authorities:

(a) the Tasmanian Public Finance Corporation;

(b) the Queensland Treasury Corporation;

(c) the South Australian Government Financing Authority;

(d) the Western Australian Treasury Corporation;

(e) the New South Wales Treasury Corporation;

(f) the Treasury Corporation of Victoria;

(g) the Northern Territory Treasury Corporation.

In consequence, IWT is at present payable on interest paid to non-residents by central borrowing authorities of State and Territory Governments.

Item 1 of **Schedule 3** inserts **proposed subsection 128F(5B)** into the ITAA 1936 to provide that subsection 128F(5A) does not apply to a bond issued in Australia by a central borrowing authority of a State or Territory. **Proposed subsection 128F(5B)** further provides that in this subsection ‘bond’ includes debenture stocks and notes.

Financial impact

The Explanatory Memorandum to the Bill at page 9 states that this measure will have the following revenue implications.

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2007-08	*2008-09*	*2009-10*	*2010-11*	*2011-12*
Nil	–$7m	–$17m	–$19m	–$21m

Application

Item 2 of **Schedule 3** provides that this Schedule applies to interest paid after its commencement. Under **clauses 2** and **3** of the Bill **Schedule 3** will commence on the day the Act receives Royal Assent.

Schedule 4—Fringe benefits tax

There are two Parts to this schedule.

Part 1—Main amendments: Fringe benefits tax—jointly held assets

Background

In the Budget Paper No 2, 2008-09 on page 23 it was indicated that the Government intended to amend the fringe benefits tax (FBT) law to ensure that the full value of a benefit that has been provided to both an employee and an associate in relation to a jointly held asset will be subject to FBT.

Budget Paper No 2 added that this was an integrity measure and will re-establish the principle that income and deductions arising from jointly held assets should be allocated between joint owners according to their legal interests.

Main provisions

Currently, subsection 138(3) of the *Fringe Benefits Tax Assessment Act 1986* (FBTAA 1986) provides that for the purpose of the Act, where an employer provides a benefit jointly to an employee and one or more associates of the employee, the benefit shall be deemed to be provided to the employee only.

Section 24 of the FBTAA 1986 provides for the reduction of taxable value of a benefit granted to an employee for FBT purposes, where the employee concerned, had he or she incurred the expenditure, would have been entitled to claim a deduction from assessable income for income tax purposes. For this reason the rule in section 24 is referred to as the 'otherwise deductible' rule and this is acknowledged in the title to section 24 which is: **Reduction of taxable value —** ***Otherwise deductible rule***. Section 24 sets out the formula for working out the notional deduction (ND) to be allowed to the employer from the taxable value of the benefit for FBT purposes in such situations where the employee could have claimed a deduction for income tax had he or she incurred the expenditure instead of relying on a benefit granted by the employer.

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The anomaly caused by the Federal Court decision the *NAB* Case[3] on the interaction of subsection 138(3) and the otherwise deductible rule in which the amendments proposed in **Schedule 4** seek to remedy, is succinctly set out in the following paragraphs of the Explanatory Memorandum to the Bill.

> 4.4 The operation of subsection 138(3) and the otherwise deductible rule was considered by the Federal Court of Australia in National *Australia Bank Ltd v FC of T 93* ATC 4914 (*NAB* case). In the *NAB* case, an employer provided low interest loans jointly to the employee husband and his wife which were invested in a jointly held investment property (a loan fringe benefit).
>
> 4.5 The Federal Court held that as a result of subsection 138(3), the employee was the sole recipient of the loan fringe benefit. It further held that as sole recipient of the loan and sole investor of the proceeds, if the employee husband had incurred and paid unreimbursed interest on the loan, he would have been entitled to a deduction for the expense. Thus, under the otherwise deductible rule in section 19 of the FBTAA 1986, the taxable value of the loan fringe benefit is reduced to nil so that the employer had no FBT liability arising from the loan fringe benefit provided to both the employee and his spouse.
>
> 4.6 This outcome is inconsistent with the operation of the otherwise deductible rule as it would apply where a benefit is provided solely to an associate. In these cases, the otherwise deductible rule does not apply to reduce the employer's FBT liability for the fringe benefit, as the otherwise deductible rule does not apply where fringe benefits are provided to a spouse (associate).
>
> 4.7 This outcome is also in conflict with the income tax position as determined by the courts that income and deductions arising from jointly owned rental property should be allocated between joint owners in accordance with their interest in the property (eg, joint tenants in a rental property would include 50 per cent of the rental income in their assessable income and claim 50 per cent of the rental property expenses).
>
> 4.8 The anomaly has also led to arrangements involving expense payment fringe benefits where a spouse on a higher marginal tax rate salary sacrifices their income by an amount equivalent to the joint rental expenses. This allows the spouse on the higher marginal tax rate through a salary reduction to effectively claim a deduction for the entirety of the rental expenses despite owning only a share in the property.[4]

The amendments in **Schedule 4** to the otherwise deductible rule in the FBTAA 1986 to eliminate the above anomaly are proposed in relation to loan fringe benefits (**item 7** and

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3 National Australia Bank Ltd v FC of T 93 ATC 4914 (NAB case)

4. Parliament of the Commonwealth of Australia, *Tax Laws Amendment (2008 Measures No.5 Bill) 2008: Explanatory Memorandum*, House of Representatives, 2008, pp. 51–52.

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8), expense payment fringe benefits (**items 17** and **22**), property fringe benefits (**items 30** and **31**) and residual fringe benefits (**items 39** and **40**).

The notional deduction (ND) in respect of loan fringe benefits, expense payment fringe benefits, property fringe benefits and residual fringe benefits (referred to as the Unadjusted ND) is adjusted further by the 'employee's percentage of interest' in **proposed subsections 19(5)**, **24(9)**, **44(5)** and **52(5)** respectively. The effect of this further adjustment is to ensure that the taxable value of the benefit is only reduced by the employee's share of the benefit in each case.

Part 2 —Technical amendments

The Explanatory Memorandum to the Bill at paragraph 4.16 on page 55 states that the amendments in **items 42** to **75** will correct certain cross references and, in line with current drafting practice, improve the readability of the provisions that are amended.

Financial impact

According to the Explanatory Memorandum to the Bill on page 10, the measures in Schedule 4 will have the following revenue implications.

2007-08	***2008-09***	***2009-10***	***2010-11***	***2011-12***
Nil	$4m	$15m	$15m	$15m

Application

The amendments made by **Schedule 4** apply to benefits provided from 7:30 pm Australian Eastern Standard Time (AEST) on 13 May 2008 (the commencing time) (**items 9(1)**, **23(1)**, **32(1)** and **41(1)**).

Item 9(2) provides that the amendments do not apply to a loan benefit after the commencing time and before 1 April 2009, if the loan was entered into before the commencing time.

Items 23(2), **32(2)** and **41(2)** provide that that for expense payment benefits, property benefits and residual benefits, the current law will not apply to agreements in respect of these benefits entered into between the commencing time and 1 April 2009.

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Schedule 5—Eligible investment business rules

Background

On 22 February 2008, the Hon Chris Bowen MP, Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, announced in media release no. 010 that the Board of Taxation (the Board) would examine options for the introduction of a specific tax regime for managed investment trusts. The media release added that the review would include options to reform the trading trust rules in Division 6C of the *Income Tax Assessment Act 1936* (ITAA 1936) which particularly affect real estate investment trusts.

The Media Release further added that pending the release of the Board's report expected in mid 2009, the Hon Chris Bowen had released a consultation paper on the interim measures to remove the more burdensome features of Division 6C. This was a pre-election commitment of the Government.

The introduction in the consultation paper on page 1 gives a brief overview of Division 6C as well as the concerns of industry on the restrictive nature of its operations in relation to commercial practice.

> Division 6C was introduced in 1985 to ensure that any public unit trust carrying on active business activities would be taxed in the same way as a company. The intention was to ensure that trusts were not used to conduct trading businesses normally undertaken in a company and thus protect the corporate tax base. Provided widely held trusts limit their investments to certain traditional passive investments, they retain trust taxation under Division 6 and do not trigger company taxation. This is important because trusts often have certain taxation advantages over companies. In particular, they may have the ability to distribute tax preferred income and provide access to the capital gains tax discount to beneficiaries on trust assets, which is not available to equity holders of a company. Appendix 1 summarises the eligible investment rules in Division 6C.
>
> Industry is concerned that the existing Division 6C rules are overly restrictive and unduly impede commercial practice, especially in respect of public unit trusts that focus on real estate investments (that is, Australian listed property trusts). Australia does not have separate tax regimes for managed funds and REITs (Real Estate Investment Trusts). REITs are collective investment vehicles that invest in property for rent. Other countries have created specialised taxation regimes for these vehicles. REITs are so named because of the USA structure of that name, taxed there only as a company and benefiting from tax-deductible dividends in the context of the general USA system of taxing companies without giving credit to equity holders for that company tax.
>
> This consultation paper considers a number of potential changes to Division 6C that could be put in place relatively quickly. The reforms would modernise and clarify the definition of 'eligible investment business' within Division 6C by:

- providing rules clarifying the scope and meaning of the requirement that the investment in land be for the purpose of deriving rent;
- providing a safe harbour rule to permit up to 25 per cent for gross non-rental income from an individual investment in land, and from other investments directly related to such an investment in land without loss of trust status. This would replace the requirement that the investment in land be primarily for the purpose of deriving rent;
- expanding the range of financial instruments included in the definition of eligible investment business that the trustee can invest or trade in.

For ease of reference, the Appendix 1 of the consultation paper which summarises the eligible investment rules in Division 6C is included in the Attachment A to this Bills Digest.

The measures in the Bill seek to implement these reforms.

Main provisions

Section 102M of Division 6C of Part 111 of the ITAA 1936 contains the interpretation provisions and the definition of 'eligible investment business'.

Extending the definition of 'eligible investment business'

An 'eligible investment business' means either or both of:

(a) investing in land for the purpose, or primarily for the purpose, of deriving rent, or

(b) investing or trading in any or all of the financial instruments listed in paragraph of the definition of 'eligible investment business'

Item 4 of **Schedule 5** amends the definition of eligible investment business by adding paragraph (c) to include investing or trading in financial instruments (not covered by paragraph (b)) that arise under financial arrangements, other than arrangements excepted by **proposed section 102MA**.

Although there is no definition of financial instrument in section 102M, the Explanatory Memorandum to the Bill in paragraph 5.19 on page 63 states:

> This amendment is to include certain financial instruments not already included in the existing list of financial arrangements in the definition of 'eligible investment business'. The meaning of a financial instrument is discussed in the Australian Accounting Standards *AASB 132 Financial Instruments: Disclosure* and *Presentation* and *AASB 139 Financial Instruments: Recognition and Measurement.*

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Item 8 of **Schedule 5** inserts **proposed section 102MA** to exclude certain arrangements referred to in **proposed paragraph (c)** of the definition of 'eligible investment business'. Generally, the exclusions cover:

- leasing or property arrangements (**proposed subsection 102MA(2)**),
- interest in partnership or trust estate (**proposed subsection 102MA(3)**),
- general insurance policies (**proposed subsection 102MA(4)**),
- guarantees and indemnities (**proposed subsection 102MA(5)**),
- superannuation and pension income (**proposed subsection 102MA(6)**), and
- retirement village arrangements (**proposed subsection 102MA(7)**).

The reader is referred to paragraphs 5.18 to 5.38 on pages 62 to 67 of the Explanatory Memorandum for a detailed explanation of the proposed law which are illustrated with examples.

Definition of 'investing in land' amended to include certain fixtures and movable property

Item 7 of **Schedule 5** adds 'and fixtures on land' at the end of the definition on 'land' in section 102M.

Item 8 of **Schedule 5** also inserts **proposed subsection 102MB(1)** to include moveable property that is:

(a) incidental and relevant to the renting of land; and
(b) customarily supplied or provided in connection with the renting of land; and
(c) ancillary to the ownership and use of land;

as being investments in land.

Safe harbour allowance of 25 percent for non-rental, non-trading income from investments in land

Item 8 of **Schedule 5** also inserts **proposed subsection 102MB(2)**to provide a safe harbour rule. Under this rule an entity's investments in land are taken to be for the purpose, or primarily for the purpose, of deriving rent during a year of income, if:

(a) each of those investments is for purposes that include a purpose of deriving rent, and

(b) at least 75% of the gross revenue from those investment for the year of income consists of rent (except excluded rent), and

(c) none of the remaining gross income from those investment for the year of income is:

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(i) excluded rent, or

(ii) from the carrying on of a business that is not incidental and relevant to the renting of the land.

Basically, **proposed subsection 102MB(2)** introduces a 25 per cent safe harbour allowance for non-rental income where that income is not derived from carrying on a business that is not excluded rent and not incidental to the renting of land.

Safe harbour allowance of 2 per cent for revenue from activities other than eligible investment business income

'Trading business' as defined in section 102M of Division 6C means a business that does not consist *wholly* of 'eligible investment business'. This definition does not allow a unit trust any margin to deviate from carrying on only 'eligible investment business' as at present there is no safe harbour provision to permit such a deviation.

Item 8 of **Schedule 5** inserts **proposed section 102MC** to provide that a trustee of a unit trust is taken not to carry on a 'trading business' if:

- not more than 2 per cent of the gross revenue of the trustee (as a trustee of a unit trust) was income from things other than 'eligible investment business', and
- that was incidental and relevant to carrying on the 'eligible investment business'.

Financial impact

The Explanatory Memorandum to the Bill on page 10 states that this measure has an unquantifiable revenue cost impact that is not expected to be significant.

Application

Item 9 of **Schedule 5** provides that the amendments made by this Schedule apply to assessments for the income year (the application year) in which this Act receives Royal Assent and later income years.

Item 10 of **Schedule 5** that the 25 per cent safe harbour provisions in **proposed subsections 102MB(2)**, **(3)** and **(4)** as well as the 2 per cent safe harbour provision in **proposed section 102MC** will not apply for the application year referred to in **item 9**, if the trustee chooses that those provisions are not to apply for that year.

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Concluding comments

Impact of GST integrity measures on housing affordability and tax minimisation

The integrity measures in relation to GST and the sale of real property (Schedule 1) have drawn adverse comments from the Urban Development Institute of Australia (UDIA) on their impact on housing affordability.[5] UDIA make the following comments on the consequences of the GST integrity measures:

> The proposed legislative change will have a significant impact on the future costs of housing developments, which is at odds with the Federal Government's stated policy and programs to improve housing affordability in Australia.
>
> It is, in effect, an increased tax on new housing developments, which will be passed onto homebuyers through increased prices.
>
> As the exemptions have not been applied to all land transactions, it is difficult to estimate that percentage of development projects will be impacted by this change. However a major developer has calculated the cost impact of the measure where it applies will be in the order of:
>
> - $11,000 additional per lot on a 60 lot infill development; and
> - $4,800 additional per lot on a 717 lot mixed townhouse & land development.

Since this submission was made by UDIA the Federal Government has announced a temporary increase in the First Home Owners Grant (FHOG) from $7 000 to $21 000 for new homes. While the announcement did not explicitly link the FHOG increase to the new GST integrity measures it would appear that new home buyers will be compensated for the projected increase in new housing development costs.

On the other hand, the Treasury in its submission to the Senate Standing Committee on Economics does not expect the GST integrity measures in relation to the sale of real property to have a significant impact on housing prices. Commenting on the impact on the housing sector in the current economic climate it states:

> The housing industry is currently experiencing difficult conditions. Approvals for new dwelling construction have fallen by 8.6 per cent over the year to August, and 16.7 per cent since their peak last November. Nonetheless, the downturn has so far been relatively moderate by past standards. Approvals remain around 20 per cent above the troughs reached in previous housing downturns.

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5 UDIA submission to the Senate Standing Committee on Economics on the Inquiry into Tax Laws Amendment (2008 Measures No. 5) Bill 2008, 3 October 2008.

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> The downturns in the housing sector has been caused primarily by the impact of cumulative interest rate rises over recent years due to tighter monetary policy and the effects of the turmoil in global financial markets. As such, the key constraint on the industry at present is lack of demand, which is highly sensitive to interest rates. On the positive side, past experience indicates that housing activity recovers reasonably quickly once mortgage interest rates begin to fall.
>
> The proposed integrity measure would have no effect on the cost or availability of finance, so it has no relevance to the problem of lack of demand. The measure could have an impact only to the extent that it contracts supply (independently of the contraction in demand). However, the supply of housing is highly inelastic in the short run. That is, supply does not change much in response to changes in the return to developers. Therefore, this measure is unlikely to impact on supply.
>
> One reason for this is that once the developer owns the land, there is a strong incentive to proceed with development because of the holding costs of capital locked up in the property. Selling the land for an alternative use is unlikely to be an option. The price of land zoned for housing on the urban fringe commands a substantial premium over the price of agricultural land, which is generally its only feasible alternative use. Of course, development will not proceed if there is not expected to be a buyer, but the level of demand is not affected by this proposal.[6]

With the full effect of the Reserve Bank's reduction in cash rates by 1 per cent on 7 October 2008 now having been passed on to borrowers by the commercial banks and forecasts of further reductions in interest rates in the near future, all other things being equal, home loan affordability can be expected to improve and the demand for housing increase as a consequence. This is in addition to the likely impact of the much higher FHOG on increasing demand for new housing. Further, with a continuing strong underlying requirement for new housing, due mainly to population growth, there are distinct prospects for an increase in housing construction activity.

It may reasonably be concluded that any disincentive to developers arising from the GST integrity measures will be outweighed by the expected strengthening in demand resulting from recent changes in monetary policy and other measures that have been implemented.

As mentioned earlier, the Treasury submission emphasises the need for the integrity measures to prevent further erosion of the GST base by tax minimisation practices in relation to the sale of real property and does so in its concluding comments:

> The current provisions in the GST law dealing with real property allow tax minimisation opportunities. These opportunities are inconsistent with the policy intent

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6. Treasury, *Submission to the Senate Standing Committee on Economics inquiry into the Tax Laws Amendment (2008 Measures No. 5) Bill 2008*, 8 October 2008, p. 4, http://www.aph.gov.au/senate/committee/economics_ctte/tlab_5_08/submissions/sub06.pdf, accessed 22 October 2008.

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that the GST should apply to the value added to real property by registered entities from 1 July 2000.

If these unintended tax minimisation opportunities are not addressed, there will continue to be distortions in the GST treatment between entities that structure their activities to take advantage of the deficiencies in the law and those entities that do not structure their activities in this way.

Further, if not addressed, these opportunities would be expected to be increasingly taken up by entities in the property development sector which would represent a significant and growing risk to the revenue. The GST and sale of real property integrity measure will ensure that the GST that was always intended to be collected is actually collected. It is not anticipated that the measure will have any significant effect on housing affordability.[7]

7. ibid. pp. 4–5.

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Attachment A

Appendix 1 to the consultation paper titled:

Potential changes to the eligible investment rules for managed funds, including property trusts

Industry consultation paper

Outline of Division 6C

Under Division 6C, a unit trust becomes a 'public trading trust' if, at any time during a year of income, it operates a trade or business and is also a 'public unit trust'. In general terms, a trust will be a public unit trust in relation to a year of income if it is widely held, listed or publicly offered for at least part of the year: that is, where its units are listed on a stock exchange, are held by 50 or more persons or are available for investment by the public. A unit trust will not be regarded as a public unit trust if 20 or fewer persons hold 75 per cent or more of the beneficial interests in the income or property of the trust.

Where one or more persons or bodies exempt from income tax (including governments and complying superannuation funds) hold units in a trust carrying entitlement to 20 per cent or more of the beneficial interest in the income or property of the trust, a unit trust will be taken to be a public unit trust, even though it would not otherwise be one, for example, because the number of unit holders is less than 50, because it is unlisted or because it is not publicly offered, or because it is held by 20 or fewer persons with 75 per cent or more of the beneficial interests.

The income of a unit trust which, in relation to a year of income, meets the tests to become a 'public trading trust' is subject to tax at the general company tax rate of 30 per cent. Distributions (referred to as 'unit trust dividends') made to unit holders out of income or other profits derived by the trustee during a year of income for which the trust has been or will be taxed as a company constitute assessable income in the hands of the unit holders as if they were dividends paid by a company and will be frankable accordingly.

To avoid becoming a 'public trading trust' in a year, a public unit trust must engage only in 'eligible investment business' for that year. 'Eligible investment business' is defined in section 102M (and needs to be read in conjunction with section 102N and the definition of trading business) and means either or both of:

(a) investing in land for the purpose, or primarily the purpose, of deriving rent; or

(b) investing or trading in any or all of the following:

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(i) secured or unsecured notes (including deposits with a bank or other financial institution);

(ii) bonds, debentures, stock or other securities;

(iii) shares in a company;

(iv) units in a unit trust;

(v) futures contracts;

(vi) forward contracts;

(vii) interest rate swap contracts;

(viii) currency swap contracts;

(ix) forward exchange rate contracts;

(x) forward interest rate contracts;

(xi) life assurance policies;

(xii) a right or option in respect of such a loan, security, share, unit, contract or policy;

(xiii) any similar financial instruments.

By the operation of section 102N, a public unit trust will become a public trading trust in relation to a year of income if, at any time of the year of income, the trustee either carried on a trading business, or controlled, or was able to control, directly or indirectly, the affairs or operations of another person in respect of the carrying on by that other person of a trading business.

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