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HOUSE OF REPRESENTATIVES

TAX LAWS AMENDMENT (2006 MEASURES No. 1) BILL 2006

EXPLANATORY MEMORANDUM

(Circulated by authority of the
Treasurer, the Hon Peter Costello MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
AASB	Australian Accounting Standards Board
ATO	Australian Taxation Office
TAA 1953	<i>Taxation Administration Act 1953</i>
CGT	capital gains tax
Commissioner	Commissioner of Taxation
Federal Court of Australia	the Federal Court
GST	goods and services tax
GST Act	<i>A New Tax System (Goods and Services Tax) Act 1999</i>
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
MEC group	multiple entry consolidated group
MMS	multimedia messaging service
SIM	subscriber identity module
SMS	short message service
UCA	uniform capital allowances

General outline and financial impact

Foreign income exemption for temporary residents

Schedule 1 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to provide exemptions from Australian tax on non-Australian-source income for individuals who are temporary residents of Australia for tax purposes. This measure will:

- define who is considered to be a temporary resident;
- exempt foreign source income of temporary residents;
- tax only net capital gains made by temporary residents on which a foreign resident would be taxed;
- disregard net capital gains on employee shares and rights held by temporary residents to the extent that the relevant employment is not in Australia;
- remove interest withholding tax obligations of temporary residents; and
- exempt temporary residents from some record-keeping requirements associated with their interests in foreign companies and trusts.

Date of effect: The amendments will apply for income years that begin on or after the 1 July next following the date of Royal Assent, except for the interest withholding tax exemption which will apply from the date of Royal Assent.

Proposal announced: The reintroduction of this measure was announced in the 2005-06 Budget (Treasurer's Press Release No. 44 of 10 May 2005). This measure had previously been defeated twice in the Senate.

Financial impact: This measure will have revenue implications estimated to be a cost of \$75 million over the forward estimates period.

Compliance cost impact: Overall, the amendments will involve a net reduction in compliance costs.

Summary of regulation impact statement

Regulation impact on business

Impact: This measure provides an exemption for the foreign income of temporary residents. It is part of the Government's New *Business Tax System* reforms. It is based on the recommendations of the Review of Business Taxation that the Government established to consider reforms to Australia's business tax system.

- For businesses and intermediaries (eg, tax agents) affected by this measure there will be initially a small cost associated with the training of staff and the modification of internal systems that deal with remuneration to remove the need for normalisation payments (payments made to employees to compensate them for additional costs associated with working in Australia). Once any necessary training or changes have been implemented no ongoing compliance costs would be expected for these businesses.
- The intermediaries would have the usual requirement to keep up to date with a new area of the law and its interpretation. However, the new law would mean new business for them.

Main points:

- The foreign income exemption for temporary residents is designed to achieve two related objectives. The measure seeks to attract internationally mobile skilled labour to Australia. It also seeks to assist in the promotion of Australia as a business location, by reducing the costs to Australian business of bringing skilled expatriates to work in Australia.
- The New *Business Tax System* provides Australia with an internationally competitive business tax system that will create more jobs and improve savings. This measure will contribute to an environment for achieving higher economic growth by reducing the tax burden on people who are considered to be temporary residents of Australia for taxation purposes. It will also have the effect of reducing business costs (fewer or no normalisation payments) where foreigners are employed temporarily in Australia. Australia should then benefit from the dynamic effects of having business located here, as well as from the expenditure, profits and local employment that such businesses may generate. In addition, the bringing to Australia of foreign executives and skilled employees will facilitate the transfer of new management

techniques and information and skills to the Australian economy.

- Potential compliance, administrative and economic impacts of this measure were considered as part of the Review of Business Taxation. Specific compliance issues raised subsequent to the release of *A Tax System Redesigned* have been considered in implementing this measure.

Business-related costs

Schedule 2 to this Bill amends the *Income Tax Assessment Act 1997* to allow deductions for certain business capital expenses that are not otherwise recognised and are not denied a deduction elsewhere in the income tax law.

This Schedule also amends the cost base for capital gains tax (CGT) assets and cost rules for uniform capital allowances (UCA) assets.

This Schedule also allows deductions for certain lease and licence-related payments.

Date of effect: These amendments will apply to expenditures incurred on or after 1 July 2005. The amended CGT provisions will apply to CGT events that happen on or after 1 July 2005. The amendments to the UCA cost rules will also apply to expenditures incurred on or after 1 July 2005.

Proposal announced: This measure was announced in the Treasurer's Press Release No. 045 of 10 May 2005 and the *2005-06 Mid-Year Economic and Fiscal Outlook*.

Financial impact: This measure will have these revenue implications:

<i>2005-06</i>	<i>2006-07</i>	<i>2007-08</i>	<i>2008-09</i>
nil	-\$37m	-\$73m	-\$109m

Compliance cost impact: Expected to be low. The compliance cost impact is outlined in the regulation impact statement.

Summary of regulation impact statement

Regulation impact on business

Impact: The main impact of the measure will be on businesses and individuals that incur business capital expenditure.

Main points:

- These amendments will have an overall positive impact by providing a systematic treatment for business blackhole expenditures.
- There will be familiarisation costs for taxpayers.
- There will be implications for the Australian Taxation Office in terms of ensuring taxpayer compliance.

Deterring the promotion of tax exploitation schemes

Schedule 3 to this Bill amends the *Taxation Administration Act 1953* (TAA 1953) and *Income Tax Assessment Act 1997* (ITAA 1997) to introduce a new civil penalty regime to apply to an entity who:

- is a promoter of a tax exploitation scheme; or
- implements a scheme that has been promoted on the basis of a taxation product ruling, in a materially different way to that described in the product ruling.

Schedule 3 also amends the TAA 1953 and the ITAA 1997 to provide that:

- the Commissioner of Taxation (Commissioner) will be able to enforce a voluntary undertaking given by a promoter, or the person who implements a scheme covered by a product ruling; and
- the Commissioner will be able to apply to the courts for an injunction to stop the promotion of a tax avoidance or tax evasion scheme.

Date of effect: This measure will apply to conduct engaged in, on or after the date of Royal Assent.

Proposal announced: The proposal was announced by the then Minister for Revenue and Assistant Treasurer, Senator the Hon Helen Coonan, in Press Release No. C117/03 of 5 December 2003.

Financial impact: Low. This measure will have these revenue implications:

2007-08	2008-09	2009-10
+\$15m	+\$25m	+\$35m

Compliance cost impact: Low. The compliance cost impact is outlined in the regulation impact statement.

Summary of regulation impact statement

Regulation impact on business

Impact: Low.

Main points:

- The regime will not apply to businesses involved with legitimate tax effective schemes.
- Businesses involved in the marketing or implementation of high risk schemes can avoid the regime by seeking tax rulings from the Commissioner, involving minor costs for the preparation and lodgment of applications.
- The remedies of voluntary undertakings and injunctions provide timely low cost alternatives to civil penalty proceedings.

Goods and services tax and vouchers — prepaid phone products

Schedule 4 to this Bill amends Division 100 of the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act) to ensure that certain prepaid phone products are treated as 'eligible vouchers' for the purposes of the GST Act. Amendments will also be made to clarify that the goods and services tax (GST) is required to be remitted on the stated monetary value of a Division 100 voucher. A further amendment will also be made to Division 100 to include a rule which simplifies accounting for GST on

commissions and similar payments on a supply of a voucher through a distribution chain.

The GST attribution rules will also be amended to provide another circumstance where the Commissioner of Taxation can determine that GST, input tax credits and adjustments can be attributed to a particular tax period.

Date of effect: The amendments to the definition of ‘voucher’ will operate from 1 July 2000, the commencement date for GST. The amendment which clarifies that GST be remitted on the stated monetary value of a voucher will operate from 11 May 2005. The rule to simplify accounting for GST on vouchers provided through a distribution chain and the change to the attribution rules will take effect from the date of Royal Assent.

Proposal announced: The amendments to the definition of ‘voucher’ and that GST be remitted on the stated monetary value of a voucher were announced as part of the 2005-06 Budget. The rule providing for a simplified accounting for GST on Division 100 vouchers provided through a distribution chain and the change to the attribution rules have not previously been announced.

Financial impact: These amendments are expected to lead to a gain in GST revenue of approximately \$10 million per annum from 2005-06.

Compliance cost impact: When the GST was introduced, it was intended that prepaid phone products would be treated as vouchers under Division 100. However, some prepaid phone vouchers do not qualify as Division 100 vouchers. The amendments which are retrospective will reduce compliance costs and ensure consistency of treatment of prepaid phone cards.

The amendments to simplify accounting for GST on commissions and similar payments paid by suppliers of Division 100 vouchers to their distributors/retailers will reduce the cost of compliance where vouchers are provided through a distribution chain.

Chapter 1

Foreign income exemption for temporary residents

Outline of chapter

- 1.1 Schedule 1 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to provide exemptions from Australian tax on non-Australian-source income for individuals who are considered to be temporary residents of Australia for tax purposes.
- 1.2 This chapter explains who the exemptions will apply to and what income or gains will be exempt.
- 1.3 All legislative references are to the ITAA 1997 unless otherwise indicated.

Context of amendments

- 1.4 Given the increasing international mobility of labour — especially skilled labour — countries are adopting a more graduated approach to individuals entering and leaving the residence tax system. For instance, the UK, Singapore and Japan have all introduced an intermediate class of taxpayers who are treated differently from residents and non-residents. Others (eg, Thailand) operate on a remittance basis so that temporary residents are exempt from tax on their foreign source income unless they choose to remit it into the country.
- 1.5 *A Tax System Redesigned* noted that the current taxation treatment of foreign expatriates who become temporarily resident in Australia could discourage some multinational enterprises, particularly skill intensive businesses, from locating in Australia.
- 1.6 Persons working temporarily in Australia are often treated as Australian residents for Australian tax law purposes. Consequently they are taxed on their world-wide income including income from overseas investments, in addition to their Australian salary and other Australian income. That foreign investment income will generally be taxed in another country and so, as well as additional Australian tax to pay, there are increased compliance costs.

1.7 The additional tax expense (on their foreign or non-Australian investment income) is often borne by Australian businesses (those which indemnify employees for additional tax paid), increasing the cost of doing business in Australia. This tax treatment makes Australia a less attractive destination than many other countries for skilled foreigners to work.

1.8 As part of its Stage 2 response to *A Tax System Redesigned* the Government announced changes designed to reduce the tax burden on temporary residents. These would have the effect of assisting those Australian businesses seeking to attract key personnel to Australia.

1.9 Legislation to implement the measure was twice introduced into Parliament, in the *Taxation Laws Amendment Bill (No. 4) 2002* and the *Taxation Laws Amendment Bill (No. 7) 2002*. On both occasions it failed to pass the Senate. The Government announced in the 2005-06 Budget that it planned to reintroduce this measure in largely the same form as previously introduced.

1.10 However, re-examination of the measure, in part due to developments since 2002, identified a number of refinements reflected in this Bill.

- Revision of provisions dealing with employment income and gains was required following the recently implemented cross-border employee shares or rights measure. The clarification provided by those changes created potential for characterising income as capital gain rather than employment income, making it possible for temporary residents to gain access to the capital gains tax (CGT) exemption for what was essentially employment income.
- A number of rules that essentially applied to the same individuals as the announced temporary residents measure have been consolidated and streamlined.
- Modifications were also necessary to remove elements that unnecessarily distorted taxpayer decisions. For example, taxpayer reactions to time limits (for instance the four year limit on the exempt visitor exemption from the foreign investment fund rules, and the five year limit on the short-term resident CGT exemption for resident individuals leaving Australia) suggest that an arbitrary time constraint on a tax concession can significantly distort taxpayer decisions.

1.11 Table 1.1 summarises the changes between the existing law, the measure as previously introduced into Parliament and as announced in the 2005-06 Budget and as now implemented in this Bill.

Table 1.1

<i>Existing law</i>	<i>Previously introduced plus Budget-announced temporary residents rules</i>	<i>This Bill</i>
<p>Exempt visitors <i>Who:</i> Temporary visa holders (who have not applied for permanent visas). <i>Time limit:</i> Four years. <i>Exemption:</i> Foreign investment fund rules do not apply.</p> <p>Short-term residents (capital gains tax) <i>Who:</i> Resident individuals leaving Australia. <i>Time limit:</i> Resident for less than five of the past 10 years. <i>Exemption:</i> Capital gains tax deemed disposal rules do not apply for pre-residence assets, and assets acquired because of someone's death.</p>	<p>Exempt visitors <i>Who:</i> Temporary visa holders (who have not applied for permanent visas). <i>Time limit:</i> None. <i>Exemption:</i> Foreign investment fund rules do not apply.</p> <p>Short-term residents (capital gains tax) <i>Who:</i> Resident individuals leaving Australia. <i>Time limit:</i> Resident for less than five of the past 10 years <i>Exemption:</i> Capital gains tax deemed disposal rules do not apply for pre-residence assets, and assets acquired because of someone's death.</p> <p>Temporary residents (foreign income rules) <i>Who:</i> Resident temporary visa holders (who have not applied for permanent visas) <i>Time limit:</i> Four years, must not have been resident within the past 10 years. <i>Exemptions:</i></p> <ul style="list-style-type: none"> • foreign source income (other than employment income) including income attributed from foreign companies and foreign trusts; • capital gains (other 	<p>Temporary residents (foreign income rules) <i>Who:</i> Temporary visa holders (other than holders of visas who are able to access benefits similar to Australian citizens or permanent visa holders) unless they have been permanent residents after the rules commence. <i>Time limit:</i> None. <i>Exemptions:</i></p> <ul style="list-style-type: none"> • foreign source income (other than employment income) including income attributed from foreign companies and foreign trusts; • capital gains (other than gains taxable for non-residents and gains on some employee shares or rights to the extent the discount is taxable in Australia)*; and • no interest withholding tax obligations. <p><i>* Replaces 'short-term resident' exemption from the deemed disposal rule and applies to all assets.</i></p>

<i>Existing law</i>	<i>Previously introduced plus Budget-announced temporary residents rules</i>	<i>This Bill</i>
	<p>than gains taxable for non-residents, gains on portfolio interests in Australian companies and unit trusts, gains related to employment in Australia); and</p> <ul style="list-style-type: none"> • no interest withholding tax obligations. 	
<p>Result: Temporary residents taxed on most foreign source income and capital gains.</p>	<p>Result: Temporary residents exempt on most foreign source income and capital gains. Period of exemption depends on type of income.</p>	<p>Result: Temporary residents exempt on most foreign source income and capital gains for the period they hold a temporary visa. No explicit time limits.</p>

1.12 These modifications will have almost entirely positive implications for Australian businesses, making the prospect of working in Australia considerably more attractive. They will on balance also make the measure considerably simpler to administer and comply with.

1.13 Temporary residents will be treated more like non-residents than residents for tax purposes. Income related to their Australian employment — including foreign sourced employment income — continues to be taxed by Australia. By continuing to tax employment-related income, Australian labour will not be disadvantaged relative to foreign labour. Australian source investment income (eg, interest and dividends) will still be taxable in Australia.

Summary of new law

1.14 This measure is directed at people who are temporary residents. Temporary residents will generally be individuals who are in Australia on temporary visas, without any time limits. However, a person who is, or whose spouse is, an Australian resident for social security purposes will not be entitled to the temporary residents exemptions. Similarly, anyone who is an Australian resident for tax purposes but not a temporary resident after these new rules commence will not be entitled to the exemptions if they ever hold a temporary visa at a later time.

1.15 This Bill provides a tax exemption to temporary residents for all ordinary and statutory income from a foreign source, net capital gains from assets that do not have the necessary connection to Australia and for interest withholding tax obligations associated with amounts owing to foreign lenders. The exemption will not, however, apply to remuneration received for or associated with employment, or for services performed, while a temporary resident. This extends to benefits obtained under employee share schemes.

1.16 This measure also removes the existing four year limitation on the exemption from the foreign investment fund rules for all temporary residents and exempts them from attribution under the controlled foreign company rules and transferor trust rules. It also effectively removes the time limits from the short-term resident CGT exemption from the deemed disposal rule that applies when a person ceases to be an Australian resident.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Temporary residents will not be subject to Australian tax on foreign source income other than employment income, including amounts otherwise attributed from controlled foreign companies, foreign investment funds and foreign trusts.	Individuals who are residents of Australia are generally subject to tax on all income, including foreign source income. Under the foreign investment fund rules there is a limited exemption for 'exempt visitors' for four years provided they are the holders of a temporary visa.
Temporary residents are partly relieved of record-keeping obligations in relation to controlled foreign companies and foreign investment funds.	Temporary residents have to keep records in relation to controlled foreign companies and foreign investment funds if they meet the requisite conditions.
Temporary residents will be able to ignore capital gains other than gains taxable for non-residents (ie, assets with the necessary connection with Australia) and gains on some employee shares or rights.	Residents of Australia are subject to the CGT provisions in relation to all assets.

<i>New law</i>	<i>Current law</i>
Temporary residents are exempt from the CGT deemed disposal rule that applies when they cease to be residents.	Short-term residents (ie, persons who have been Australian residents for less than five of the past 10 years) are exempt from the CGT deemed disposal rule that applies when they cease to be residents, for pre-residence assets and assets acquired because of someone's death.
A gain or loss made on some employee shares or rights by temporary residents (or those who held them as temporary residents) will be recognised to the extent that it relates to employment in Australia. There is no change where the discount is taxed at the cessation time nor where the shares, have the necessary connection with Australia.	The normal CGT rules apply to employee shares or rights once the discount has been taxed. All gains and losses would be recognised for residents but only those on shares or rights that have the necessary connection with Australia would be recognised for non-residents.
Temporary residents will be exempt from Australian interest withholding tax obligations.	Residents of Australia are generally required to withhold tax from interest payments associated with foreign liabilities.

Detailed explanation of new law

1.17 This measure provides a tax exemption to temporary residents for all ordinary and statutory income from a foreign source (generally income that does not have an Australian source) and net capital gains from assets that do not have the necessary connection to Australia. It also relieves them of interest withholding tax obligations associated with amounts owing to foreign lenders. The exemption will not, however, apply to remuneration received for or associated with employment, or for services performed while a temporary resident. This extends to benefits obtained under employee share schemes. *[Schedule 1, item 1, section 768-905]*

Who are temporary residents?

1.18 The exemptions will apply to individuals who are temporary residents for the purposes of Australian tax law.

1.19 The first requirement to be a temporary resident for Australian tax purposes is that the individual holds a temporary visa granted under the *Migration Act 1958*. However, an individual who is, or whose spouse is, an 'Australian resident' as defined in the *Social Security Act 1991*, will

not be entitled to the temporary residents exemptions. In that Act, an 'Australian resident' is defined as a person who resides in Australia and is an Australian citizen, the holder of a permanent visa or a protected special category visa holder. Leaving aside the limitation on the person's spouse, this restriction will only exclude those who are in Australia on a protected special category visa (ie, some New Zealanders). They are excluded from its benefits because they are treated more like Australian citizens than temporary visa holders. In this legislation there is no time limit on how long the tax concessions are available, to simplify the rules and reduce the impact of these rules on taxpayer decisions. Nor does it matter if the person has been a temporary resident before. *[Schedule 1, item 2, definition of 'temporary resident' in subsection 995-1(1)]*

1.20 The policy underlying the definition of 'temporary resident' is that a temporary resident's connection with Australia is more tenuous than for other residents (referred to in this explanatory memorandum as permanent residents) and so a temporary resident should be treated more like a non-resident than a resident for tax purposes. Further, since temporary residents cannot benefit from Australian public spending to the same extent as permanent residents (for instance temporary visa holders are less often entitled to social security payments, Medicare and free public education) they should not have to support that spending to the same extent.

1.21 Where individuals have access to all or most of the benefits that Australian permanent visa holders or Australian citizens have despite being on a temporary visa, it is logical that they should bear the same responsibility as other Australian residents to fund Australian public spending. That greater access to benefits can be obtained by protected special category visa holders and by someone whose spouse is an Australian resident for social security purposes. A person who is an Australian citizen, or whose spouse is one, does not need the inducement of tax concessions to come to, or return to, Australia for short periods. Likewise, those who at some time have the degree of connection with Australia to warrant full residence taxation will not be excused from that obligation in the future (ie, they will be treated as permanent residents) if they again become Australian tax residents. That is, they will not ever be a temporary resident after that time. This approach also removes the need for additional provisions (including deemed disposal rules for CGT purposes) when such persons cease to be permanent residents. If the person who holds the temporary visa does not have a spouse, the condition concerning the person's spouse is irrelevant. *[Schedule 1, item 2, definition of 'temporary resident' in subsection 995-1(1)]*

1.22 Since there is no requirement in the definition of a 'temporary resident' to be an Australian resident for tax purposes, the provisions can theoretically apply also to non-residents who are in Australia on temporary visas. However, since non-residents are not taxed on their

foreign income or on net capital gains from assets that do not have the necessary connection with Australia, the provisions will make little difference to them (there is an exception for capital gains on some employee shares and rights that relate to employment in Australia). In particular, the provision that states that employment income and like amounts are not non-assessable non-exempt income does not of itself make these amounts assessable income for non-residents [*Schedule 1, item 1, note to subsection 768-910(3)*]. ‘Temporary resident’ is defined not to exclude non-residents, simply to make it easier to determine if a person is a temporary resident. Further, the taxation of non-residents from countries with which Australia has tax treaties, will continue to be governed by the treaties.

To what does the temporary residents exemption apply?

Foreign source income of temporary residents

1.23 This Bill makes ordinary income derived from a foreign source during the period the taxpayer is a temporary resident non-assessable non-exempt income. This measure also applies to all statutory income that has a source other than Australia, including amounts otherwise attributable from a foreign company or a foreign trust, on which the taxpayer would otherwise be taxed. This extends to amounts derived through partnerships and trusts but not to amounts derived by other taxable entities (eg, not where a trustee is taxable under section 99 or 99A of the *Income Tax Assessment Act 1936* (ITAA 1936)). There is no exemption for Australian source income. It follows from this that expenses or losses incurred in earning this income are not deductible and that these amounts will not reduce tax losses. Net capital gains are dealt with separately (see paragraphs 1.31 to 1.34). Further, it also follows that temporary residents who are also Australian residents for tax purposes, will not be able to claim foreign tax credits for tax paid on foreign income that is no longer assessable. [*Schedule 1, item 1, subsection 768-910(1)*]

1.24 This measure, however, does not exempt any income or remuneration that in any way relates to employment or services performed by the taxpayer while the taxpayer is a temporary resident of Australia. That includes income derived by the individual from the performance of contracts. Such income will continue to be taxed in Australia. Any discount on employee shares or rights will continue to be assessable according to Division 13A of Part III of the ITAA 1936 (or section 26AAC of the same Act). These exceptions to the general rule for temporary residents are to prevent the exemptions from making the employment remuneration for temporary residents less costly than for other Australian residents. Another objective is not to allow the foreign employment income to be totally tax-free since foreign tax will usually

not be payable on that income. Where the person is a resident and is employed overseas for a minimum of 91 days, the exemptions available under sections 23AF and 23AG of the ITAA 1936 may be available. These new provisions will not have any effect on the operation of those sections. *[Schedule 1, item 1, subsections 768-910(3) to (6)]*

1.25 Because of the need to make a timing connection between the amounts that would otherwise be assessable and the person's residence status, the provision dealing with statutory income refers to the person being a temporary resident when the amount is derived by the taxpayer. For the purpose of this provision, the person is said to derive the amount of statutory income when all of the conditions for it to be statutory income have been satisfied. For example, an amount might otherwise be attributed from a controlled foreign company if the person is an attributable taxpayer at the end of a statutory accounting period of the foreign company. That is when the otherwise attributed amount would be said to be derived by the taxpayer and so the question then becomes whether the person is a temporary resident at that time. *[Schedule 1, item 1, paragraph 768-910(1)(b) and subsection 768-910(2)]*

1.26 Specifically excluded from the temporary residents measure is income included in assessable income under Division 86, that is alienated personal services income. Alienated personal services income may be earned through an entity, however since it actually relates to income from personal services it is appropriate to ensure that this income is excluded from the exemptions under this measure. *[Schedule 1, item 1, paragraph 768-910(3)(c)]*

1.27 Since ordinary and statutory income from a foreign source of an eligible temporary resident is essentially exempt from Australian taxation, it is also necessary to exclude temporary residents from attribution percentage calculations that may be required under the rules that attribute income from controlled foreign companies. The effect of this is to relieve temporary residents of the compliance burden associated with these calculations and the associated record-keeping requirements. *[Schedule 1, item 1, section 768-960]*

1.28 The existing 'exempt visitor' exemption from taxation under the foreign investment fund rules is replaced by an exemption for temporary residents. Again, there is no limit on how long that exemption may be used. This was a part of rationalising the various exemptions available to persons temporarily in Australia. They are also relieved from the record-keeping requirements of these rules for the notional accounting period of the foreign company, foreign trust or foreign life policy for which nothing will be attributed to the temporary resident. *[Schedule 1, item 1, section 768-965]*

1.29 A temporary resident who is an attributable taxpayer in relation to a foreign trust will not be attributed with any income of the trust under

the transferor trust provisions while a temporary resident. This is achieved by saying that the person is not a resident for the purpose of section 102AAZD of the ITAA 1936 at any time the person is a temporary resident. However, the person will still be required to keep certain records (under section 102AAZG of the ITAA 1936) that would be relevant to any period when the person is not a temporary resident. *[Schedule 1, item 1, section 768-970]*

1.30 Any interest in a foreign trust held by a temporary resident may be ignored if subsection 96C(6) of the ITAA 1936 has to be applied. As a result of the general exemption provided by this Bill, the temporary resident would not be taxed under section 96B on any foreign source income of the trust. *[Schedule 1, item 1, section 768-975]*

Capital gains of temporary residents

1.31 Temporary residents will be exempt from Australian tax on many capital gains. Conversely, many capital losses they make will be ignored for Australian tax purposes. They will however still be liable for Australian tax on net capital gains for which non-residents are taxable, and on net capital gains arising from some employee shares or rights to the same extent the discount is taxed under Division 13A of Part III of the ITAA 1936. The general treatment of their capital gains and losses mirrors the treatment of non-residents and the treatment of gains or losses from some employee shares and rights is discussed in paragraphs 1.36 to 1.50. Temporary residents are treated the same as non-residents for CGT purposes because that matches the treatment of their investment income and reduces compliance costs. *[Schedule 1, item 1, section 768-915]*

1.32 Section 136-40 would normally apply when a non-resident becomes an Australian resident to fix a cost base for the person's assets that do not have the necessary connection with Australia. That rule will not apply when a non-resident person becomes a temporary resident *[Schedule 1, item 1, section 768-950]*. Clearly, if the person does not become an Australian resident for tax purposes the rule does not apply in any case. Non-application of this rule reflects the policy of treating the person as a non-resident for CGT purposes. Instead, a cost base for these assets will need to be determined only if and when that person becomes a permanent resident (see paragraph 1.20). That is when the person ceases to be a temporary resident but remains, or becomes, an Australian resident for tax purposes. There is an exception to these rules for some employee shares and rights (see paragraphs 1.37 to 1.39) *[Schedule 1, item 1, section 768-955]*.

1.33 In the reverse scenario, when an Australian resident ceases to be a resident for tax purposes and becomes a foreign resident, the person is effectively deemed to have disposed of all assets that do not have the necessary connection with Australia. This rule is called CGT Event I1 (section 104-160). The purpose of this rule is to capture the gain or loss

on those assets that accrued while the person was a resident. That rule will not apply to residents who are temporary residents and who become non-residents. That is the purpose of the words 'or immediately before the CGT event'. Again, this reflects the policy that a temporary resident is treated as a non-resident for CGT purposes and so there is effectively no change in residence status as far as the CGT rules are concerned. Of course, the rule cannot apply to a temporary resident who never became an Australian resident. [*Schedule 1, item 1, section 768-915*]

1.34 The law currently contains some exceptions to the above deemed disposal rule. One of those concerns individuals who have been Australian residents for less than five of the preceding 10 years (subsection 104-165(1)). The deemed disposal rule does not apply to some of their assets that do not have the necessary connection with Australia. That exception is being replaced with the exemption for temporary residents [*Schedule 1, item 1, section 768-915 and item 20*]. However, Australian residents who are in Australia at the time of Royal Assent of this Bill will still be able to take advantage of it for up to five years, but only on one occasion [*Schedule 1, item 21*]. The other existing exceptions to the deemed disposal rule remain unchanged.

Employee shares and rights

1.35 Where an employee is granted shares or rights under an employee share scheme, before or after coming to Australia, the taxation treatment of the discount at which they were granted is governed by Division 13A of Part III of the ITAA 1936. Where part of the relevant employment is performed outside Australia, only part of the discount is taxed in Australia. This is the case whether the discount is taxed upfront (at the time of acquiring the shares or rights or when the person becomes employed in Australia) or at a later cessation time. There is no change to this for those who are or were temporary residents at any time in the period of relevant employment or when the discount is to be taxed. To avoid doubt this is explicitly stipulated. [*Schedule 1, item 1, paragraph 768-910(3)(d)*]

What is the CGT treatment of these shares and rights?

1.36 The overriding policy consideration when it comes to the treatment of gains or losses on employee shares or rights held by temporary residents is to make sure that their employment remuneration while in Australia is subject to Australian tax despite the concessions being provided to them. Net gains on employee shares and rights are not totally ignored which would otherwise often be the case under the general CGT treatment of temporary residents. To do so would invite too much restructuring of employment remuneration to obtain tax benefits, to the disadvantage of other Australian resident employees. Their treatment will depend on whether the shares or rights are assets that have the necessary connection with Australia and on when the discount is taxed. The following paragraphs discuss the various possibilities in turn.

What if the shares or rights have the necessary connection with Australia?

1.37 Where employee shares or rights do have the necessary connection with Australia (eg, shares in an Australian private company) there is no change to their treatment for CGT purposes. Their cost base is determined by Subdivision 130-D and depends on when the initial discount is taxed. Because part of the relevant employment to which the shares or rights relate may be performed outside Australia, only part of that initial discount may be taxable in Australia. However, because gains or losses on them would be counted for CGT purposes whether the person is a non-resident or a resident the whole gain or loss is counted.

What if the shares or rights do not have the necessary connection with Australia and taxation of the original discount is deferred?

1.38 Where the employee share or right does not have the necessary connection with Australia (eg, shares in a foreign company or a portfolio interest in an Australian public company) the CGT treatment depends on when the initial discount is taxed. There are no changes to the CGT treatment where the discount is taxed at a cessation time. If that time occurs before the temporary resident becomes a permanent resident (see paragraph 1.32), the cost base of the shares or rights is set by subsection 130-83(3), but any gain or loss that arises from a CGT event happening before becoming a permanent resident is disregarded [*Schedule 1, item 1, section 768-915 and item 30*]. The cost base is re-determined at the time the person becomes a permanent resident and replaces the cost base determined under section 130-83 [*Schedule 1, item 1, subsection 768-955(2)*]. In addition, the shares or rights are treated as being acquired at that time [*Schedule 1, item 1, subsection 768-955(3)*]. If a CGT event then occurs the normal CGT rules apply and there are no further CGT concessions. Any gain or loss that accrues between the cessation time and

when the person becomes a permanent resident is ignored. If the cessation time occurs after the person has become a permanent resident, section 130-83 operates normally [*Schedule 1, item 1, subsection 768-955(4)*]. Again, there is no further CGT concession.

What if the shares or rights do not have the necessary connection with Australia and taxation of the original discount is not deferred?

1.39 There are changes to the CGT treatment where the original discount on shares or rights that do not have the necessary connection with Australia is taxed upfront [*Schedule 1, item 1, paragraphs 768-920(1)(c) and (d) and (2)(d) and (e)*]. This taxing point may be in the income year in which the person becomes an employee in Australia for Division 13A purposes or at the time the shares or rights were granted to the employee. The cost base of the shares or rights will be their market value at the time they were granted, under section 130-80 or 130-85.

1.40 In either case, some or all of any gain or loss is to be recognised (it normally wouldn't be counted by someone who is being treated as a non-resident) because of the connection with the person's employment in Australia. Accordingly, only the portion that has that connection is to be recognised. The rest of the gain or loss will be disregarded. The proportion is the same as that used for determining how much of the original discount is assessable income. These modifications to the CGT rules for employee shares or rights will apply to both residents and non-residents who are or have been temporary residents.

1.41 Only shares or rights acquired under an employee share scheme, or shares obtained as the result of exercising a right acquired under an employee share scheme, are covered by these new rules [*Schedule 1, item 1, paragraphs 768-920(1)(a) and (2)(a) and (c)*]. The latter shares are called 'derived shares' in this Bill and the rights that were exercised to obtain them are called the 'original rights' [*Schedule 1, item 1, subsection 768-920(2)*]. This Bill deals separately, but in similar fashion, with each of these cases. Because of the operation of section 139DQ of the ITAA 1936 and an amendment to that section so that it also applies for the purposes of these new provisions dealing with temporary residents, the rules will also apply to matching shares or rights acquired in connection with the 100 per cent takeover or restructure of a company [*Schedule 1, item 1, notes to subsections 768-920(1) and (2) and items 8 to 10*].

1.42 Next, the person holding the shares or rights must have been engaged in some of the employment to which the shares or rights relate in Australia as a temporary resident [*Schedule 1, item 1, paragraphs 768-920(1)(b) and (2)(b)*]. This latter condition is there to relate the relevant employee shares or rights, or the derived shares, to the person's status as a

temporary resident. If the person does not perform any of the relevant employment in Australia as a temporary resident, the new rules do not apply even if the person still holds the shares or rights during some of the time in which the person is a temporary resident. To avoid doubt, it is made clear that it does not matter whether the person is still a temporary resident, a permanent resident or a foreign resident when the relevant CGT event occurs [*Schedule 1, item 1, subsection 768-920(3)*].

1.43 The final pre-condition for application of the new rules concerns when they are applied. That time is when a CGT event happens to the shares or rights or the derived shares for the first time [*Schedule 1, item 1, paragraphs 768-920(1)(e) and (h) and (2)(f) and (i)*]. Two classes of CGT events are ruled out. The first is Event I1 (see paragraph 1.33) because ceasing to be an Australian resident is not to be relevant to temporary residents for all CGT assets including these employee shares or rights. However, that event could still be the trigger for application of these rules if the person had already become a permanent resident and then ceased to be an Australian resident [*Schedule 1, item 1, paragraphs 768-920(1)(f) and (2)(g)*]. The provision would not then be applied to any further CGT events happening to those shares or rights. The second type of CGT event that will not trigger application of these rules is where any capital gain or loss from the event is disregarded because of another provision in Part 3-1 or 3-3 [*Schedule 1, item 1, paragraphs 768-920(1)(g) and (2)(h)*]. A typical example of this would be where a roll-over is allowed. Explicitly stating that a capital gain or loss arises under this provision despite the new general CGT concession for temporary residents, indicates that this provision would be triggered by a CGT event that would otherwise result in a gain or loss that would be disregarded by that general CGT concession [*Schedule 1, item 1, subsection 768-920(5)*].

What if the person is a temporary resident or a foreign resident at the time of the CGT event?

1.44 If the person is a temporary resident or a foreign resident when the first possible trigger event occurs, the person makes a capital gain or loss that is not disregarded [*Schedule 1, item 1, subsections 768-920(4) and (5)*]. The amount of the gain or loss is a proportion of the amount of gain or loss that would otherwise be disregarded (because the person is a temporary resident) or not made (because the person is a foreign resident). The process for the calculation of the gain or loss is a two-step process [*Schedule 1, item 1, subsections 768-920(6) and (9)*].

1.45 The first step is to calculate the amount of the gain or loss that is to be adjusted. This is called the notional gain or loss and is the capital gain or loss that would have arisen for a permanent resident from the time of acquisition of the shares or rights, or the original right in the case of

derived shares, until the time of the CGT event. In the case of shares or rights acquired from an employee share trust, the time of acquisition is when the temporary resident first acquired a beneficial interest in the share or right [*Schedule 1, item 1, subsection 768-925(2)*]. Where the CGT event happens to a derived share the relevant starting time is when the taxpayer first acquired a beneficial interest in the original right [*Schedule 1, item 1, paragraph 768-925(2)(b)*]. Matching shares or rights to which subsection 139DQ(1) of the ITAA 1936 applies will be taken to be acquired when the employee shares or rights in the old company were acquired. The cost base to be used in this calculation is that which would be obtained by applying section 130-80 or 130-85 as the case requires, with any modification required by section 134-1 in the case of derived shares [*Schedule 1, item 1, subsections 768-925(1) to (3)*].

1.46 The second step is to apply two factors or fractions in turn [*Schedule 1, item 1, section 768-930*]. The first fraction seeks to determine the amount of the notional gain or loss that may be apportioned to the period ending at the cessation time. Even though the shares or rights may not be qualifying shares or rights, the cessation time is still defined in Division 13A of Part III of the ITAA 1936. In the case of derived shares, the relevant cessation time is that of the original rights that were exercised to obtain those shares [*Schedule 1, item 1, subsection 768-940(1)*]. The amount is determined using a simple comparison of days before the cessation time and days ending at the time of the CGT event [*Schedule 1, item 1, subsections 768-935(1) and 768-940(1)*]. If the CGT event occurs before the cessation time for the shares or rights or the original rights, the whole of the notional gain or loss is counted at this stage [*Schedule 1, item 1, paragraphs 768-935(3)(a) and 768-940(3)(a)*].

1.47 The second factor is based on how much of the relevant employment for which the shares or rights were granted was performed in Australia. This fraction is that which was implicitly used in calculating how much of the original discount was to be included in assessable income. It is the ratio of the amount included in assessable income under Division 13A (or the amount that would have been included but for subsection 139BA(2) of the ITAA 1936) and the amount of the discount calculated for the purposes of Division 13A. Application of this fraction results in the amount of the gain or loss that is not disregarded being an approximation of the amount that was remuneration for employment in Australia. That amount is then used in calculating the taxpayer's net capital gain or net capital loss for the year. The rest of the notional gain or loss is disregarded in that calculation. [*Schedule 1, item 1, subsections 768-935(4) and 768-940(4)*]

Example 1.1: Capital gain made while still a temporary resident

Emma from England is granted shares (with a total market value at the time of A\$100,000) under an employee share scheme on 1 February 2006 for the three years of employment beginning on 1 January 2006. She comes to Australia as a temporary resident on 1 January 2007 (at which time she also becomes an Australian resident for tax purposes) and completes the remaining two years of the employment to which the shares relate in Australia. Emma elects to have the discount assessed in that income year. Assume that the cessation time for the shares occurs on 1 June 2009. Emma who is still a temporary resident disposes of the shares on 1 July 2009 for A\$130,000.

Emma's notional capital gain is \$30,000. The first fraction is 1216/1246 and the fraction derived from the Division 13A calculation is 2/3. Therefore, the capital gain from this sale to be used in the calculation of her net capital gain for the income year ending 30 June 2010 is:

$$\$30,000 \times (1216/1246) \times (2/3) = \$19,518$$

The remaining \$10,482 of the notional gain is disregarded.

What if the person is a permanent resident at the time of the CGT event?

1.48 In this situation, a proportion of the gain or loss that has accrued up to the time the person became a permanent resident must be added to a capital gain or loss that would otherwise be recognised [*Schedule 1, item 1, subsections 768-920(7) and (9)*]. The two-step calculation is slightly different from that discussed in paragraphs 1.45 to 1.47. Again, the first-step is to calculate the amount of the gain or loss that is to be adjusted (ie, the notional gain or loss). This is the capital gain or loss that would have arisen from the time of acquisition of the shares or rights, or the original rights in the case of derived shares, until the time of becoming a permanent resident. The same special rules apply as were discussed in paragraph 1.45. This calculation may be done by reducing what would otherwise have been the notional gain or loss by the amount of the actual capital gain or loss that would be taken to be made apart from this set of rules [*Schedule 1, item 1, subsection 768-925(4)*]. The main reason for this modification is because at this point (of becoming a permanent resident), the individual must determine a new cost base for these shares or rights and the CGT provisions apply without concession from then on [*Schedule 1, item 1, section 768-955*]. It is the amount of the gain or loss that accrued up to that time that is then dealt with.

1.49 Again, the first factor to be calculated is described separately but similarly for the case of shares or rights acquired under an employee share scheme and for derived shares [*Schedule 1, item 1, subsections 768-935(2) and 768-940(2)*]. In this case, the denominator of the fraction is the number of days up to the time of becoming a permanent resident because that is the period over which the notional gain or loss accrued. The numerator in the case where the cessation time occurs before the person became a permanent resident is the number of days up to that cessation time. Where the person became a permanent resident before the cessation time, the factor is one. The notional gain or loss is multiplied by this fraction [*Schedule 1, item 1, subsections 768-935(2) and 768-940(2) and paragraphs 768-935(3)(b) and 768-940(3)(b)*].

1.50 Finally, the same proportion as discussed in paragraph 1.47 is applied to the resulting amount [*Schedule 1, item 1, subsections 768-935(4) and 768-940(4)*]. The resulting adjusted notional gain or loss is then added to what would otherwise have been the capital gain or loss, to arrive at the actual capital gain or loss to be used by the taxpayer in determining the net capital gain or loss for the year [*Schedule 1, item 1, subsection 768-920(7)*]. For the purpose of determining whether the capital gain is a discount capital gain (see Division 115), the time-of-acquisition rules that would ordinarily apply when the person becomes a permanent resident do not apply. Instead, the shares or rights, or the derived shares, are taken to be acquired when the original shares or rights were granted [*Schedule 1, item 1, subsection 768-920(8)*].

How long does a person have to amend these calculations?

1.51 The standard amendment periods apply to most elements of this calculation. However, as with taxation of the original discount under Division 13A of Part III of the ITAA 1936 there could be some delay before the taxpayer is more certain of the extent to which the relevant employment is or will be performed in Australia. The same deadline for amendment applies to the determination under these provisions of the capital gain or loss made from a CGT event happening to the shares or rights to allow for amendment to the fraction implicitly used in Division 13A and discussed in paragraphs 1.47 and 1.50. [*Schedule 1, item 1, section 768-945*]

Interest paid to foreign lenders

1.52 Interest paid by a temporary resident to non-residents will be exempt from all interest withholding tax and withholding obligations. The interest income derived by the non-resident will also be non-assessable non-exempt income unless it is derived in carrying on business through a permanent establishment in Australia. The exemptions will apply to all non-resident lenders, including non-resident partners in

partnerships, non-resident beneficiaries of foreign trusts who are presently entitled to the income and non-resident trustees of foreign trusts. A resident trustee who would be taxed under section 99 or 99A of the ITAA 1936 (but not subsection 98(3) or (4)) would not be exempt from tax on the interest. *[Schedule 1, item 1, section 768-980]*

1.53 While withholding tax would otherwise be a liability of the overseas lender, it is generally the case that institutional lenders would require the Australian resident to compensate them for the additional tax incurred in lending money to an Australian resident. Therefore, this measure not only reduces compliance costs for the temporary resident, it also indirectly reduces their Australian taxation costs. It is primarily targeted at pre-existing loan arrangements and therefore does not extend to Australian resident lenders nor to Australian permanent establishments of foreign lenders.

Application and transitional provisions

1.54 Subject to paragraph 1.56, the amendments apply for income years that begin on or after the 1 July next following the date of Royal Assent for this Bill. In relation to CGT events, the amendments apply to events happening on or after that 1 July. The amendments to the cost base rules for CGT assets generally, and for employee shares or rights, apply to persons becoming Australian residents, whether temporary or permanent residents, after that 1 July. *[Schedule 1, subitems 40(1), (2), (4), (5), (8) and (9)]*

1.55 While the amendments affecting the application of the CGT rules to temporary residents apply from that 1 July, they can apply to matching shares or rights acquired on or after 1 July 2004 because of the amendments to section 139DQ of the ITAA 1936. *[Schedule 1, subitems 40(3) and (6)]*

1.56 The amendment to exclude temporary residents from withholding tax obligations applies to payments of interest made on or after the date of Royal Assent. *[Schedule 1, subitem 40(7)]*

Consequential amendments

1.57 A number of consequential amendments have been made because the existing exemption from the foreign investment fund rules (for exempt visitors for four years) is being replaced with an exemption for temporary residents. First, there is the repeal of the existing exemption contained in the foreign investment fund rules and the insertion of a reference to the new exemption for temporary residents in those rules *[Schedule 1, items 14 and 15]*. Next there is the insertion in the Dictionary of

a definition of a 'foreign life assurance policy' and the amendment of the existing definition of 'notional accounting period' to take account of foreign life policies [Schedule 1, items 38 and 39]. Finally, references to the term 'exempt visitor' in various tax laws needed to be changed [Schedule 1, items 3, 11 and 12].

1.58 In a similar fashion, a reference to the new exemption from the controlled foreign company rules for temporary residents is inserted into those provisions. [Schedule 1, item 13]

1.59 Two consequential amendments insert references to some of the new rules into the table of provisions which lists non-assessable non-exempt income. [Schedule 1, items 16 and 17]

1.60 Changes have been made to two tables in the CGT provisions dealing with the time of acquisition of CGT assets and the cost bases of those assets to reflect the modifications to those rules for temporary residents and for when they cease to be temporary residents. [Schedule 1, items 22 to 25]

1.61 Finally, notes have been amended or inserted into the ITAA 1936 (mainly in the provisions dealing with interest withholding tax) and the ITAA 1997 (in the CGT provisions) to act as signposts from other parts of the law to these provisions dealing with temporary residents. [Schedule 1, items 4 to 7, 18, 19, 27, 28, 31, 32 and 34 to 37]

REGULATION IMPACT STATEMENT

Policy objective

The objectives of the New *Business Tax System*

1.62 The New *Business Tax System* is designed to provide Australia with an internationally competitive business tax system that will create the environment for achieving higher economic growth, more jobs and improved savings, as well as providing a sustainable revenue base so the Government can continue to deliver services to the community.

1.63 The measure dealing with the taxation of temporary residents of Australia contained in this Bill is part of the New *Business Tax System*.

The objectives of the measure in this Bill

1.64 The exemptions for temporary residents are designed to achieve two related objectives. First, the measure seeks to attract internationally mobile skilled labour to Australia. Secondly, it will assist in the promotion of Australia as a business location, by reducing the costs to Australian business of bringing skilled persons to work in Australia.

Implementation options

1.65 The temporary residents measure arises directly from recommendations of the Review of Business Taxation. The genesis for the implementation options that are discussed here can be found at Recommendation 22.18 of *A Tax System Redesigned*.

1.66 The Government announced in the 2005-06 Budget that it planned to reintroduce legislation that would exempt temporary residents from income tax on most foreign source income and gains on foreign assets for four years (the original implementation option). The previous legislation was twice introduced into Parliament in 2002 but failed to pass the Senate. Subsequent re-examination of the measure, in part due to changes in the law since 2002 (eg, in the *New International Tax Arrangements (Foreign-owned Branches and Other Measures) Act 2005*), identified a number of refinements (reflected in the new implementation option) which simplify the measure and reduce compliance costs. As a result, the new implementation option for temporary residents being enacted in this Bill is broader than the original implementation option.

The original implementation option (the original option)

1.67 The original option provides an exemption for temporary residents for four years (provided they had not been resident in Australia in the preceding 10 years), which would apply to:

- all foreign source income of eligible temporary residents (other than employment income) including income of controlled foreign companies, other foreign companies and foreign trusts on which they would be otherwise taxed;
- net capital gains, other than net gains taxable for non-residents (ie, those with the necessary connection to Australia), and gains on portfolio interests in Australian publicly listed companies or Australian unit trusts; and
- interest withholding tax obligations in respect of liabilities regardless of when incurred.

1.68 In addition, the exemption from the foreign investment fund rules for exempt visitors would no longer be restricted to four years for taxpayers holding temporary visas, but would apply to exempt visitors for as long as a temporary visa was held.

1.69 A 'temporary resident' is essentially defined as someone who was an Australian resident for tax purposes for less than four years, who was on a temporary visa and had not applied for a permanent visa, and who had not been an Australian resident for tax purposes in the preceding 10 years.

The new implementation option

1.70 The new implementation option however now provides an exemption for temporary residents, which applies — for as long as the individual is a temporary resident — to:

- all foreign source income of temporary residents (other than employment income) including income of controlled foreign companies, other foreign companies and foreign trusts on which they would otherwise be taxed;
- net capital gains, other than net gains taxable for non-residents (ie, those with the necessary connection to Australia) or those on employee shares or rights to the extent the discount is taxable in Australia; and
- interest withholding tax obligations in respect of liabilities regardless of when incurred.

1.71 Apart from the removal of the four year limit the only change to this aspect is the extension of the exemption to net gains on portfolio interests in Australian companies and unit trusts.

1.72 The new option also partly relieves temporary residents of record-keeping obligations in relation to controlled foreign company and foreign investment fund rules.

1.73 As for the definition of a 'temporary resident', there is no requirement that the individual has not been an Australian resident in the preceding 10 years.

1.74 However, the definition does not include 'temporary visa holders' who hold temporary visas that allow them to receive benefits similar to those permanent visa holders receive. These people are identified as those individuals who are 'Australian residents' as defined in the *Social Security Act 1991*, which would include for example,

New Zealand citizens (resident in Australia for taxation purposes) who are classified as 'protected special category visa holders'. It also excludes an individual whose spouse is an 'Australian resident' for purposes of the *Social Security Act 1991*.

1.75 The exemptions will also be denied to anyone who has been a permanent resident after the rules commence. A permanent resident is someone who is a tax resident of Australia but who does not satisfy one or more of the above requirements to be a temporary resident.

1.76 The requirement that the individual be a tax resident has also been removed in this new option.

1.77 The term 'temporary resident' now determines eligibility for all aspects of the announced measure, including the exemption from the foreign investment fund rules. Therefore while the existing exemption for 'exempt visitors' from the foreign investment fund rules will (as under the original option) no longer be restricted to four years, it will now apply as long as the individual is a 'temporary resident' (not an 'exempt visitor').

1.78 Another significant change to the original option is a modification to an existing CGT exemption for short-term residents departing Australia (ie, those who are resident for less than five of the past 10 years) from the deemed disposal rule that would otherwise apply. This concession would be absorbed into the temporary residents measure, so that it is no longer restricted by time limits, and would apply as long as the individual is a temporary resident. However, the exemption will no longer apply to any individual who has been a resident for less than five of the past 10 years when they leave Australia, but will be limited to temporary residents. There will, however, be a transitional rule so that the concession will continue for a period of five years for other permanent residents who would otherwise be adversely affected.

1.79 The general principle that capital gains or losses will not be disregarded to the extent they relate to employment remains the same in the new option. However, clarification of the taxation of cross-border employee shares or rights since the original implementation option was introduced into Parliament has made it possible to be more specific about the instances where gains or losses related to employee shares or rights will not be disregarded.

1.80 Therefore the main differences between the original option and the new implementation option are:

- changes to the definition of a 'temporary resident';

- removal of various time limits;
- changes to CGT treatment — temporary residents are now only to be taxed on the same assets as non-residents, whereas previously they were treated more as a hybrid of residents and non-residents; and
- clarification of capital gains that are considered to be related to employment in Australia (and therefore to which the exemption does not apply), especially in the area of employee shares and rights.

Assessment of impact

Impact group identification

Temporary residents

1.81 This measure will impact on people holding temporary visas granted under the *Migration Act 1958* who are in receipt of income from foreign sources or who hold foreign assets, and who do not have access to benefits (whether directly or indirectly through their spouses) similar to those available to the holders of permanent visas.

1.82 A reference to temporary visa holders may include people who enter Australia under the economic, international and social/cultural visa streams and also people in Australia on student visas.

1.83 The main impact of the changes (to the original option) will be on temporary residents who remain in Australia for longer than four years. Currently, this is approximately 7 per cent of temporary visa holders. About 90,000 temporary visa holders are potentially impacted. Unlike the original implementation option, the new option will deny treatment as a temporary resident to those on temporary visas whose spouse is an Australian citizen or has a permanent visa. No data on the number of these were available.

Business

1.84 Businesses that employ, or are run by, people who qualify for this exemption may receive an indirect benefit as a result of this measure. This will occur in instances where businesses make normalisation payments to compensate their employees for the potential increase in their overall taxation costs that can occur as a result of their coming to Australia for a short period.

1.85 The measure will also impact on intermediaries, such as accounting firms, that act on behalf of taxpayers or businesses affected by this measure.

Australian Taxation Office

1.86 There will be administrative impacts on the ATO with the introduction of this measure.

Analysis of costs/benefits

The original option

Compliance costs

Temporary residents

1.87 The original option would be expected to significantly reduce compliance costs for individuals when preparing their tax returns, as temporary residents would generally only need to declare income (other than employment income) from Australian sources. Information in relation to foreign income and most capital gains would no longer be required for Australian tax purposes, provided that income or gain was not related to Australian employment. While these changes would mean a net benefit for temporary residents, there would have been some additional costs involved in determining whether some items of income or gains related to Australian employment.

1.88 Similarly, providing an exemption from interest withholding tax obligations will also, where applicable, result in reduced compliance costs for these taxpayers in relation to their Australian tax obligations.

Business

1.89 For businesses and intermediaries, (eg, tax agents) affected by this measure, initially there would have been a small cost associated with the training of staff and the modification of internal systems that deal with remuneration to remove the need for normalisation payments. Once any necessary training or changes have been implemented no ongoing compliance costs would have been expected for these businesses.

1.90 The intermediaries would have the usual requirement to keep up to date with a new area of the law and its interpretation. There is no data available on the costs of these intermediaries (eg, on what proportions of their businesses are concerned with cross-border employee taxation) that

would be needed to make an estimate of this impact. However, the new law would mean new business for them.

Administration costs

1.91 The original option would have administrative impacts for the ATO. These centre on the need to interpret the new law as well as ensuring instructional material, return forms and associated instructions reflected the new law. The ATO would also have to deal with computer system changes and compliance issues to ensure that the measure is working as intended.

1.92 The overall cost of these administrative changes, however, is not considered to be significant and was to be absorbed as part of business as usual.

Government revenue

1.93 The original option when re-announced in the 2005-06 Budget had a revenue cost of \$105 million over the forward estimates period (\$50 million in 2007-08 and \$55 million in 2008-09).

Economic benefits

1.94 The New *Business Tax System*, including this measure, is intended to provide Australia with an internationally competitive business tax system that will create the environment for achieving higher economic growth, more jobs and improved savings.

1.95 The measure dealing with the taxation of temporary Australian residents will contribute to these broader economic goals by removing impediments that will assist in attracting internationally mobile labour to Australia. It will also have the effect of reducing business costs (fewer or no normalisation payments) where foreigners are employed temporarily in Australia. Australia should then benefit from the dynamic effects of having business located here, as well as from the expenditure, profits and local employment that such businesses may generate. In addition, the bringing to Australia of foreign executives and skilled employees will facilitate the transfer of new management techniques and information and skills to the Australian economy.

1.96 While this option would have provided a benefit there is neither reliable data nor modelling available as to the size of that benefit.

The new implementation option

Compliance costs

Temporary residents

1.97 The changes to the original option (ie, removal of time limits etc) will mean greater compliance cost reductions than would be possible under the original option, by applying the concession to affected taxpayers regardless of the length of their stay and by simplifying the CGT rules for them. This measure is expected to encourage temporary residents to come to Australia to work here for longer periods. Compliance costs will be further reduced because a number of similar measures have been brought together in one area of the law. However the extent of the reduction in compliance costs is not quantifiable because of lack of data on compliance costs relevant to this area of the law and the asset portfolios of temporary residents.

1.98 Those permanent residents who may be affected by the restriction of the short-term residents CGT exemption on departure from Australia may have additional CGT to pay on a subsequent departure as well as additional compliance costs in calculating that tax. However, they will be relieved of some compliance costs associated with the existing exemption. These impacts can not be quantified because of lack of data on the numbers affected and on their asset portfolios. Tax returns do not require identification of net capital gains arising from individual CGT events nor of net capital gains that are disregarded. The changes to this CGT exemption (to restrict the exemption to temporary residents) may negatively impact on a small group of permanent residents currently not in Australia who return to Australia some time in the future and then leave again. However as mentioned above a transitional rule will operate for five years.

1.99 Some additional compliance costs will be incurred by those who are or have been temporary residents when a CGT event happens in connection with employee shares or rights that relate to employment in Australia. With the exception of those who are foreign residents when the event happens, the additional compliance costs will be incurred to obtain the benefit of a tax concession. Again, no data are available to allow an estimate of the additional compliance costs, which would require information on temporary residents holding employee shares, when they were granted, when they are disposed of and when the persons leave Australia. While the new option is more explicit in this regard there would have been some compliance costs involved in complying with the original option.

Business

1.100 The changes to the original option should result in reduced costs for businesses that employ temporary residents and provide normalisation payments to compensate employees for potential increases in overall taxation during their period of employment in Australia. These businesses will no longer be required to compensate employees who remain in Australia for longer than four years, or who would have breached the requirement for the short-term resident CGT concession. It will probably also mean less tax-induced changes in personnel.

1.101 Business will also benefit as key personnel from overseas may now be more willing to come to Australia as a result of the change in their Australian tax obligations.

Administration costs

1.102 Changes to the original option (ie, the removal of the four year limit, simplification of the rules relating to the CGT concession, and removal of the residency requirement etc) should not result in any additional costs, as the changes to information products have not yet been undertaken for the temporary residents measure, so the further changes to the announced measure can be easily accommodated.

1.103 The changes should actually result in a reduction in costs for the ATO in administering the new law partly because they have facilitated the consolidation in the law of a number of similar measures. However, the references to the *Social Security Act 1991* in the definition of a 'temporary resident' will add to costs for the ATO compared with the original version. On the other hand, the removal of the requirement that a temporary resident be an Australian resident for tax purposes will make it easier to determine if the person is a temporary resident. Similarly, some of the changes to the tax treatment of temporary residents (eg, for CGT) should make administration easier while some (eg, on employee shares) may make it more difficult.

Government revenue

1.104 The revenue cost of the new option over the forward estimates period is \$75 million (\$36 million in 2007-08 and \$39 million in 2008-09) including the relatively small cost of the changes from the original option. The reduction of the cost from that identified for the original option is entirely due to the use of better information.

Economic benefits

1.105 The changes to the original measure will further assist in attracting internationally mobile labour to Australia and keeping them

here for as long as there is a good business case, by removing possible distortions to individual's choices due to arbitrary time limits.

Consultation

1.106 The measure dealing with the taxation of temporary residents to Australia was accepted by the Government in its Stage 2 response to *A Tax System Redesigned* and was announced on 11 November 1999.

1.107 Extensive consultation was conducted on the original option before its previous introduction into Parliament in 2002. For instance a consultation workshop was held in May 2000 in relation to the initial announcements made by the Government. In addition, the Treasury has also received further submissions dealing with the taxation of temporary residents in Australia.

1.108 Discussions have also taken place with the then Department of Immigration and Multicultural and Indigenous Affairs in relation to the visa requirements for people seeking to enter Australia. The Department of Education, Training and Youth Affairs was also consulted in relation to people in Australia on student visas.

1.109 In regard to the changes to the original option, confidential consultation with a small number of tax practitioners and academics in the field has also been conducted, especially on the changes dealing with employee shares or rights. The changes proposed were generally considered to be reasonable. Some concern was expressed about tying the concept of a temporary resident to the treatment of the person's spouse for social security purposes. However, no better way of addressing the perceived integrity concern that led to this feature (see paragraph 1.74) could be found. There also was some opposition to the continued application of CGT to employee shares or rights that relate to employment in Australia. In order to keep the measure closely aligned to its underlying policy of not exempting employment income of temporary residents, and in order to avoid the creation of additional incentives to restructure employment remuneration to obtain tax benefits to the disadvantage of other Australian resident employees, the concerns expressed over these rules were not able to be accommodated in the final measure.

Conclusion

1.110 This proposal dealing with the taxation of temporary residents is expected to address issues concerning the employment of skilled

temporary residents in Australia. The introduction of this measure will therefore help promote Australia as a business location.

1.111 The changes to the original option will further enhance this aim by removing elements that may distort taxpayer choices, and by reducing compliance and administrative costs.

1.112 The Treasury and the ATO will monitor this taxation measure as part of the whole taxation system, on an ongoing basis.

Chapter 2

Business-related costs

Outline of chapter

2.1 Schedule 2 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to:

- allow certain business capital expenditure to be written-off in equal proportions over five income years. The expenditure is deductible only where it is not already taken into account and not denied deductibility for the purposes of the income tax law;
- apply the non-commercial loss provision in certain circumstances to such business capital expenditure;
- increase the range of expenditures that can be included in the cost base of an asset for capital gains tax (CGT) purposes and the cost of a depreciating asset for uniform capital allowances (UCA) purposes; and
- allow deductions for capital expenditure incurred in carrying on or ceasing a business to terminate a lease or licence to be deducted in equal proportions over five income years.

Context of amendments

2.2 Taxpayers may incur business expenditures that fall outside the scope of the various deduction provisions of the income tax law. For example, expenditure may not be deductible under section 8-1 of the ITAA 1997 because it is capital expenditure, but is not included in the cost base of a CGT asset or in the cost of a depreciating asset or there is no other specific capital allowance provision in the income tax law that allows a deduction for the expenditure. Expenditure could also be incurred before a business commences, or after it ceases, therefore a taxpayer may have difficulty in demonstrating the required nexus with the business to enable a deduction under the current law.

2.3 In 1999, the Review of Business Taxation identified a need to address such expenditures, known as 'blackhole' expenditures. The Review of Business Taxation proposed the tax value method as a means of providing recognition for these expenditures. After extensive evaluation of the tax value method, the Board of Taxation recommended against its adoption and the Government accepted the Board's recommendation.

2.4 In 2001, section 40-880 of the ITAA 1997 was introduced to provide a five-year write-off for seven specific types of business capital expenditures, including costs to establish a business structure and costs to cease carrying on a business.

2.5 On 28 August 2002, the Treasurer announced that the Government would develop a systematic solution to business blackhole expenditures by 1 July 2005 (Treasurer's Press Release No. 048 of 28 August 2002). The systematic solution was announced in the 2005-06 Budget (Treasurer's Press Release No. 045 of 10 May 2005).

2.6 By providing deductibility for business capital expenditure, subject to certain criteria to ensure the integrity of the provision, these amendments will recognise such expenditure.

Summary of new law

2.7 Schedule 2 repeals the current section 40-880 and replaces it with a systematic treatment for business-related capital costs. This systematic treatment comprises:

- a five-year straight-line write-off for certain business capital expenditure that:
 - permits deductions for capital expenditures incurred in relation to existing businesses that are carried on for a taxable purpose; and
 - allows deductions for pre- and post-business expenditures where the business is proposed to be carried on, or was formerly carried on, for a taxable purpose; and
- limitations to ensure these expenditures are deductible where they are not already taken into account, and are not denied a deduction, for the purposes of the income tax law. Therefore, the new provision will be a provision of last resort;

- changes to the cost base of CGT assets, and cost of depreciating assets, so that where expenditures are incurred in relation to the asset, the expenditure is appropriately included in the cost or cost base of the asset for taxation purposes; and
- a five-year, straight-line write-off for capital expenditure incurred to terminate a lease or licence if the expenditure is incurred in the course of carrying on or in ceasing a business.

2.8 In addition, the non-commercial loss provisions apply to pre- and post-business expenditures, by individuals (either alone or in partnership) deductible under section 40-880.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>Taxpayers may deduct capital expenditure they incur in relation to a past, present or prospective business, to the extent that the business is, was or is proposed to be carried on for a taxable purpose.</p> <p>The expenditure is deductible to the extent that it is not elsewhere taken into account and is not denied deductibility for the purposes of the income tax law. Specific exclusions apply.</p>	<p>Taxpayers may deduct capital expenditure they incur that is one of the seven specific types of expenditures listed in section 40-880 of the ITAA 1997, to the extent that the business is, was or will be carried on for a taxable purpose.</p> <p>Specific exclusions apply.</p>
<p>The non-commercial loss provisions apply to certain pre- and post-business capital expenditure deductible under section 40-880.</p>	<p>The non-commercial loss provisions do not apply to pre- and post-business capital expenditure deductible under section 40-880.</p>
<p>The first and second elements of cost of depreciating assets are to be extended to include additional types of expenditure.</p>	<p>Certain pre-acquisition expenditures are not included in the first element of cost of a depreciating asset and some costs that are reasonably attributable to a balancing adjustment event occurring for a depreciating asset can only reduce the termination value of the depreciating asset.</p>

<i>New law</i>	<i>Current law</i>
Taxpayers may deduct capital expenditure incurred to terminate a lease or licence that results in the termination of the lease or licence if the expenditure is incurred in the course of carrying on or ceasing a business.	Expenditures to terminate a lease or licences are currently either blackhole expenses or form part of the cost base for the purposes of the CGT regime.
Additional kinds of expenditure qualify for inclusion in the cost base and reduced cost base of CGT assets.	Fewer kinds of expenditure qualify for inclusion in the cost base and reduced cost base of CGT assets.

Detailed explanation of new law

Business-related costs — overview

2.9 This measure provides treatment for business capital expenditure not recognised in some way elsewhere in the tax law. Taxpayers may deduct capital expenditure incurred in relation to an existing, past or prospective business.

2.10 A key principle in determining the deductibility of business capital expenditure is the relationship between the expenditure and the business. This nexus will be a question of fact and in determining the relationship of the expenditure to the business, the former business or the prospective business, and when the expenditure is incurred, are necessarily considered.

2.11 Where the expenditure is incurred in relation to a business being carried on, or incurred in relation to a business that was formerly carried on, the relationship can be ascertained by considering the business that was actually carried on.

2.12 However, where the expenditure is incurred before the business is carried on, it may be more difficult for the taxpayer to establish the necessary relationship between the expenditure and the business. A key aspect, in order to preserve the integrity of the provision, is that the taxpayer would need to be able to show that, on an objective basis, the business is proposed to be carried on. That is, at the time the expenditure was incurred it can objectively be shown that there is a business that is proposed to commence at some time in the future.

[Schedule 2, item 30, subsection 40-880(7)]

2.13 Consistent with general income tax principles, the deduction is available to the taxpayer who incurs the qualifying expenditure.

Generally, the taxpayer incurring the expenditure is the same taxpayer that is carrying on, proposes to carry on or used to carry on the business. In some circumstances a taxpayer will incur expenditure in relation to a business that is proposed to be carried on, or that was formerly carried on by another entity. Specific rules apply in these circumstances to ensure that the taxpayer who incurs the expenditure is entitled to the deduction. *[Schedule 2, item 30, subsection 40-880(4)]*

2.14 Section 40-880 requires that the relevant business is, was or is proposed to be carried on for a taxable purpose. This means that for pre- and post-business expenditure, deductions may be available before and after the gaining or producing of the business's income. The deduction is always limited, however, to the extent the relevant business satisfies this taxable purpose test. The non-commercial loss provisions may also prevent individuals, either alone or in partnership, in certain circumstances, from deducting pre- and post-business expenditures from other assessable income.

2.15 As a provision of last resort, section 40-880 is responsive to subsequent changes in the tax law.

Object

2.16 The object provides that certain business capital expenditure is deductible. The business can be past, current or prospective and must be, was formerly or is proposed to be carried on for a taxable purpose. *[Schedule 2, item 30, subsection 40-880(1)]*

2.17 There are a number of exceptions which require, in effect, that the expenditure must not be taken into account in some way elsewhere in the income tax law. This means that the expenditure would not already be deductible, capitalised, amortised or capped in some way under another provision. The expenditure must also not be denied a deduction, including by limiting or capping the deduction, elsewhere in the tax law. *[Schedule 2, item 30, subsection 40-880(1)]*

Capital expenditure

2.18 The provision only applies to business capital expenditure. What this amounts to in the context of an existing, former or prospective business is determined on a case by case basis having regard to the general principles established by the Courts. This includes expenditure that fails the general deduction provision of section 8-1 by reason only of being capital or of a capital nature. *[Schedule 2, item 30, subsection 40-880(2)]*

2.19 Expenditure on the structure by which an entity carries on (or used to or proposes to carry on) their business and on the profit yielding

structure of the business would ordinarily be expected to be of a capital nature. Capital expenditure can also relate to a business's trading operations or the entity that will carry on the business.

2.20 The structure covers the legal entity (such as a company) or the legal relationship (such as a partnership or trust) that is the entity that carries on the business for a taxable purpose and that holds the business assets.

2.21 For pre- and post-business expenditure, it may also provide a deduction for capital expenditure that falls outside the positive business limb of section 8-1. However, the mere fact that the expenditure fails the positive business limb of section 8-1 does not necessarily bring it into this provision.

2.22 Taxpayers can deduct the following specific types of capital expenditure:

- expenditure to establish your business structure;
- expenditure to convert your business structure to a different structure;
- expenditure to raise equity for your business;
- expenditure to defend your business against a takeover;
- costs to your business of unsuccessfully attempting a takeover; and
- costs to stop carrying on your business,

to the extent that they do not fall within the limitations and exclusions. These expenditures were previously deductible under the provision replaced by the measure.

2.23 In addition, shareholders, beneficiaries of trusts and partners can deduct liquidation and deregistration costs where the company, trust or partnership carried on a business. This specific addition to the general principles of deductibility that relate expenditure to a business (past, prospective or current) is to continue, and expand, deductibility for expenditure incurred in the closing-down phase of a business. Shareholders can only deduct their own expenses, and are not entitled to a share in those that the company has incurred. *[Schedule 2, item 30, paragraph 40-880(2)(d)]*

2.24 This acknowledges that some of these expenses may be incurred during the closing-down phase of the company, and therefore will be

incurred in respect of a current business that may not be the business of the taxpayer for the purposes of paragraph 40-880(2)(a).

In relation to

2.25 The provision is concerned with expenditure that has the character of a business expense because it is relevantly related to the business. The concept used to establish this character or requisite relationship between the expenditure incurred by the taxpayer and the business carried on (current, past or prospective) is ‘in relation to’. The connector ‘in relation to’ allows the appropriate latitude to enable the deductibility of qualifying capital expenditure incurred before the business commences or after it has ceased. [*Schedule 2, item 30, subsection 40-880(2)*]

2.26 There are various pre-business expenses that would be incurred ‘in relation to’ a proposed business. These include, but are not limited to, expenditures to investigate the viability of the business (eg, feasibility studies or market research), establishment costs (such as the costs of establishing the business structure), or expenses that are a necessary precedent to the business being carried on (costs of market testing or putting in a tender).

2.27 Post-business expenses incurred ‘in relation to’ a past business include capital expenses incurred for the purpose of ceasing to carry on the business as well as expenses that were incurred as a consequence of the business ceasing.

Used to be

2.28 A business that ‘used to be’ carried on by a taxpayer would be a business that either the taxpayer had permanently ceased to carry on themselves or that the taxpayer was permanently no longer relevantly associated with. The relevant association is the one described in paragraph 40-880(4)(b). [*Schedule 2, item 30, paragraphs 40-880(2)(b) and (4)(b)*]

2.29 The effect of the requirement for permanence is to ensure the application of the provision to genuine post-business expenses — that is, the taxpayer would have permanently severed their ties with the business or the business no longer operates. If the relationship with the business still exists, even if in abeyance, then the expenditure is not post-business expenditure, and therefore can only be deductible as expenditure in relation to ‘your’ (ie, the taxpayer) business for the purposes of paragraph 40-880(2)(a).

Proposed to be

2.30 The term ‘proposed to be’ is an objective purpose test about the relationship between an expenditure in the present and a prospective business. It encapsulates expenditure, the purpose and effect of which is relevantly related to the commencement or operation of that business. Such expenditure would be for the purpose of assessing or advancing, or lead to the commencement of a future business. This phrase will enable the provision to recognise such preliminary expenditures as legitimate business costs in relation to the prospective business activity.

2.31 For a business to be proposed to be carried on for the purposes of this provision, the taxpayer needs to be able to demonstrate a commitment of some substance to commence the business, and sufficient identity about the business that is proposed to be carried on. The deductibility of expenses in advance of the business being carried on will rest on the facts of each case, but this commitment and identity must be tangible: that is, there would need to be some evidence that would enable an objective assessment of the existence of that commitment and identity.

2.32 Further guidance as to the level of commitment required to deduct pre-business expenditure is provided by subsection 40-880(7). In essence, this requires that, having regard to relevant circumstances, it must be reasonable to conclude that the commitment exists. One of these circumstances is that the business be proposed to be carried on within a reasonable time. This may vary according to the industry or the nature of the business and would recognise the long lead times that may be involved. [*Schedule 2, item 30, paragraph 40-880(2)(c), subsection 40-880(7)*]

2.33 Such commitment could be shown by, but is not limited to, at least some of the following:

- a business plan;
- the establishment of a business premises;
- research into the likely markets or profitability of the business; and
- capital investment in assets of the business.

Example 2.1

After being retrenched from her job as a graphic designer, Mary decides to investigate starting her own graphic design business. She spends \$2,000 on market research, a consultant to put together a business plan, brochures and contacts former clients to compile a client database. On an objective basis, Mary's pre-business activities would be considered indicative of a genuine commitment to carry on a graphic design business. Subject to the non-commercial loss provisions in Division 35, Mary is entitled to deduct the \$2,000 over five income years under the new business-related costs provision once she commences her business activity.

2.34 The expenditure would need to relate, in a real sense, to the prospective business. For example, the expenditure could not be for the purpose of pursuing a hobby or other leisure activity of the taxpayer, where the benefit of the expenditure accrues to the taxpayer in the present, rather than to the business in the future.

Example 2.2

Greg plays the drums in a band as a hobby. Greg spends money to investigate the possibility of customising a room in his house for the purposes of rehearsing with the band. The expenditure is not of the type to which a capital works deduction under Division 43 applies. Greg seeks to claim the expenditure as being in relation to a business he proposes to carry on. However, Greg has no evidence that he proposes to carry on a prospective business, so on an objective basis the only benefit of the expenditure is to Greg himself: that is, the expenditure is of a private nature. Greg is not entitled to a deduction as the expenditure is not a business-related cost.

2.35 The deduction will be available before the business is carried on where the requisite purpose is satisfied. However, there must be evidence of a commitment to carry on the business at the time the expenditure was incurred.

Example 2.3

In 2006, Pershing Pty Ltd which carries on a mobile dogwash business, spends \$3,100 on research into the market for soft drinks for the purpose of establishing a new business. The research indicates that a new softdrink business is unlikely to be profitable and consequently a new business is not established. As Pershing Pty Ltd proposed to carry on the business for a taxable purpose, a deduction over five years is available for the \$3,100 under the new business-related costs provision.

2.36 Where a taxpayer is able to demonstrate that they proposed to carry on a business, the reason why the business did not eventuate would not later be inconsistent with the grounds relied on to support that demonstration. An unforeseen change in circumstances for example, would be one such case.

Example 2.4

Ab-one Coy incurs expenditure on due diligence prior to purchasing an existing business that Ab-one Coy proposes to carry on. Before the sale can be finalised, the seller withdraws from the sale. The expenditure is deductible over five years as a business-related cost.

Equal proportions over five income years

2.37 The taxpayer can deduct 20 per cent of the expenditure for the income year in which it is incurred. ‘Income year’ is a defined term for the purposes of the ITAA 1997. [*Schedule 2, item 30, subsection 40-880(2)*]

2.38 The taxpayer can then deduct 20 per cent of the expenditure for each of the following four income years.

2.39 This continues the treatment under the current section 40-880.

2.40 Eligibility for deduction is a once only up-front test established as at the time when the expenditure is incurred. This means that, once eligibility is established, the deduction is able to be written-off over the five income years even if the relevant business later ceases or the prospective business does not commence.

Example 2.5

Eleanor and Olivia own a small but successful coffee shop and are seeking to expand their business. They incur qualifying expenditure during the 2006 income year for the purpose of establishing another coffee shop in a newly constructed shopping mall. Eleanor and Olivia deduct 20 per cent of the expenditure for the 2006 income year. The following income year, 2007, Eleanor and Olivia are forced to sell the new coffee shop due to unforeseen personal circumstances. They are able to continue to claim the remaining 80 per cent of the expenditure in equal proportions for each of the 2007 to 2010 income years.

2.41 For individual taxpayers, the non-commercial loss provision will also apply so that a deduction otherwise available may be deferred.

Limitations and exceptions

2.42 There are two limitations that link the taxpayer to the business. The first limits the deduction to the extent the relevant business is carried on, was carried on or is proposed to be carried on for a taxable purpose. The second limits the deduction depending on the relationship between the taxpayer and the business.

2.43 The exceptions ensure that deductibility is provided only for business expenditures not elsewhere recognised in some way by the income tax law so that the provision is one of last resort.

2.44 The limitations and exceptions are based on those in the current subsection 40-880(3), with some refinement as a consequence of the broader application of the new law.

Taxable purpose

2.45 Expenditure in relation to a business is only deductible to the extent that the business is, was, or is proposed to be carried on for a taxable purpose. [Schedule 2, item 30, subsection 40-880(3), paragraph 40-880(4)(a)]

2.46 The definition of ‘taxable purpose’ is provided by subsection 40-25(7) of the ITAA 1997 and covers various purposes, including the purpose of producing assessable income. The term *purpose of producing assessable income* is further defined in subsection 995-1(1) of the ITAA 1997 as being something done:

- for the purpose of gaining or producing assessable income; or
- in carrying on a business for the purpose of gaining or producing assessable income.

2.47 A taxpayer whose business is not carried on for a taxable purpose cannot deduct expenditure to that extent. This limitation is not an annual test: that is, it is not to limit deductions to only the income years in which the business is carried on for a taxable purpose. The test as to the taxable purpose of the business is applied — as at the time the expenditure is incurred — to the taxable purpose of the business by reference to all known and predictable facts in all years.

Example 2.6

In January 2007, Jo incurs qualifying capital expenditure to expand her existing business in an off-shore jurisdiction. The expansion will result in Jo’s business deriving 10 per cent of all of its foreseeable

future income in an exempt form. Any deduction to which Jo is entitled would be reduced under this provision to the extent the business is not carried on for a taxable purpose.

Business of the taxpayer

2.48 The business to which the expenditure relates is that most relevant to the expenditure. This could be either the activity of the taxpayer entity or various separate activities carried on by the taxpayer. This will depend on the facts under which the expenditure is incurred.

2.49 As the taxpayer that incurs the qualifying expenditure is the only taxpayer entitled to the deduction, whether the business is the taxpayer's business is also relevant. This entitlement may occur in one of two ways.

2.50 First, where the taxpayer who incurs the expenditure carries on an existing business, used to carry on the former business or proposes to carry on a new business, they are entitled to deduct the expenditure. This means that for an existing business, only the taxpayer that carries on the business, and no other taxpayer, is entitled to deduct the expenditure. *[Schedule 2, item 30, subsection 40-880(2)]*

2.51 Therefore, if the entity that incurs the expenditure is a separate taxpayer from that carrying on an existing business and to which the expenditure relates, then the business is not 'your' business for the purposes of paragraph 40-880(2)(a). *[Schedule 2, item 30, paragraph 40-880(2)(a)]*

2.52 Secondly, where a taxpayer incurs expenditure in relation to a prospective or former business, and the taxpayer is not the same entity that will carry on the business, or that formerly carried on the business, special rules apply.

2.53 The deduction is limited to qualifying expenditure in relation to either a former business or a prospective business where the taxpayer that carried on the former business or proposes to carry on the new business (the 'operating entity') is not the same taxpayer who incurred the expenditure (the 'incurring entity'). In both cases, only the incurring entity is entitled to a deduction. For example, pre-business costs such as incorporation fees may be incurred (by an incurring entity) in relation to a business proposed to be carried on by the entity the individual incorporated (the operating entity). *[Schedule 2, item 30, subsection 40-880(4)]*

2.54 The expenditure must be in connection with the taxpayer deriving their assessable income from the business. *[Schedule 2, item 30, paragraph 40-880(4)(b)]*

2.55 This is to provide a proxy for the relationship between the taxpayer and 'their' (ie, the taxpayer) business, where the taxpayer that

incurs the expenditure is not the same taxpayer that carries on the business. Deriving assessable income refers to the entitlement to a share in the profits from the business. The way in which the profit is derived can be direct or indirect. The expenditure also needs to be 'in connection with' the business that was carried on or is proposed to be carried on.

2.56 Just because the profit derived is indirect, when taken together with the second requirement, expenditure purely for investment (ie, not business) purposes does not fall for consideration as a business related cost. [*Schedule 2, item 30, paragraph 40-880(4)(b)*]

2.57 This means that the expenditure must have some connection with the income so derived, or that is proposed to be derived from the business. The relationship between the taxpayer and the business is relevant. A company employee would not have the requisite connection with the company as they derive their income as a consequence of their employment. However a taxpayer that is seeking to start a new business, and operate it as a company, rather than as a sole trader, would be doing so with the purpose of deriving income from the new entity. Therefore, the nature of the income must be that to which the expenditure contributes in order to incur the expenditure for the purposes of subsection 40-880(4).

2.58 The character of the expenditure must be that connected with the business itself (eg, pertaining to the business structure, or its operations).

2.59 Put another way, the taxpayer would expect a return on that expenditure in the form of profits from the business. The expenditure need not of itself be directly productive of the taxpayer's assessable income.

2.60 The taxpayer does not need to be actually deriving income from the activity at the time the expenditure is incurred to qualify for the deduction.

Example 2.7

Anthea carries on a business of making and selling hand-made shoes as a sole trader from her home. She decides to incorporate her business, so the business will be carried on by the incorporated entity, and Anthea will be the sole shareholder of the company and is entitled to receive all the profits from the business. As the business proposed to be carried on is not, for legal purposes, carried on by Anthea but by the company, the limitation in subsection 40-880(3) does not permit her to deduct the expenditure. However, the expenses to incorporate her existing business are capital business expenditure for the purposes of section 40-880 and subject to the non-commercial loss provision, Anthea has the requisite connection to the company for her to be entitled to deduct the expenditure on incorporation under subsection 40-880(4).

Example 2.8

Dorothy is a director of a company. Upon default by her employer, Dorothy satisfies a personal guarantee provided in respect of the employer. As an employee of the company, the capacity in which Dorothy incurs the expenditure is in connection with deriving her salary income, rather than for the purpose of deriving a profit from the business. Therefore, Dorothy does not have the requisite relationship with the business conducted by the company nor does the expenditure. Dorothy's expenditure does not qualify for a deduction as a business-related cost.

Other excluded expenditure

2.61 Section 40-880 is intended to operate as a provision of last resort. It achieves this by providing that the deduction is only allowed to the extent that the expenditure is not taken into account in some way elsewhere in the income tax law. The ways in which an expenditure can be taken into account are listed in subsections 40-880(5) to (8).

2.62 The exclusions provide guidance on the interaction of the measure with the broader tax law. They are based on those in the current subsection 40-880(3), with some refinement as a consequence of the broader application of the new law.

2.63 The specific exclusions provide that expenditure of the following types do not qualify for a deduction.

Cost of depreciating assets held, formerly held or which will be held

2.64 These expenditures are included in the cost of the depreciating asset which is depreciated for tax purposes under the UCA provisions. For expenditure in relation to starting to hold a depreciating asset to be included in the cost of the asset, the asset must be held, formerly held or will ultimately be held by the taxpayer incurring the expenditure. *[Schedule 2, item 30, paragraph 40-880(5)(a)]*

Example 2.9

In April 2006, a poultry company spends \$14,000 to demolish an old income producing barn located on its business premises. As the cost of demolition falls within the expanded second element of cost of the barn it is excluded from deductibility under the new business-related costs provision.

2.65 However, where the expenditure is business related and can not be included in the cost of the asset, it may fall for deduction as a business-related cost under section 40-880.

Example 2.10

In November 2005, two companies, O'Keefe Pty Ltd and Hamblen Pty Ltd each incur \$5,000 on a pre-acquisition check of one particular depreciating asset they both intend to purchase for their respective business. However, in January 2006 O'Keefe Pty Ltd is successful in purchasing the asset and Hamblen Pty Ltd misses out (ie, the sale falls through). O'Keefe Pty Ltd includes the \$5,000 in the first element of cost of the depreciating asset it starts to hold and writes-off the cost over the effective life of the asset. As Hamblen Pty Ltd, did not acquire a depreciating asset, it is able to claim a deduction over five years for the \$5,000 pre-acquisition expenditure under the new business-related costs provision.

Expenditure that can be deducted under other provisions of the income tax law

2.66 Expenditure that qualified or qualifies for deduction elsewhere under the income tax law is not deductible. This applies even if the expenditure has not yet been or can no longer be deducted. *[Schedule 2, item 30, paragraph 40-880(5)(b)]*

Example 2.11

In October 2006, QOTSA Pty Ltd undertakes a feasibility study directly connected with a project that they propose to operate during the 2008 income year. The expenditure qualifies as a project amount under the project pools provisions. While the expenditure is not yet deductible as the project is only at the preliminary stage, it would not qualify as a business-related cost under section 40-880 as it will be deductible for the 2008 income year when the project starts to operate. Alternatively, a deduction would be available for the income year in which the project was abandoned.

Expenditure that is part of the cost of land

2.67 Expenditure that forms part of the cost of land, whether or not the land is held by the taxpayer, is not deductible. This exclusion is transferred from the repealed section 40-880. [*Schedule 2, item 30, paragraph 40-880(5)(c)*]

Expenditure in relation to a lease or other legal or equitable right

2.68 This exclusion replicates that found in the repealed section 40-880, having been added in 2002 in the context of the Government's review of the treatment of expenditure incurred on leases or other legal or equitable rights. The 2005-06 Budget announced that the Government would take a case-by-case approach in relation to the taxation of rights. [*Schedule 2, item 30, paragraph 40-880(5)(d)*]

Example 2.12

In January 2006, AORT Pty Ltd was seeking to obtain a prospecting right over a particular tract of land. It undertakes an investigation to determine if there are any other rights held over that land. The investigation finds that a farmer holds a right of access over the land, and AORT Pty Ltd agrees to pay the farmer compensation to access the land. As the taxpayer's expenditure is in relation to a right (being compensation for the right to access the land) it is not deductible under the business-related costs provision.

However, the expenses would be included in the expanded first element of cost of a depreciating asset the taxpayer starts to hold as being in relation to starting to hold that asset, being the exploration right.

2.69 This exclusion does not apply to intra-group assets or transactions within a consolidated group, as these are not recognised as leases, or other legal or equitable rights for income tax purposes. Further

information on the operation of the exclusion in relation to consolidations is provided in paragraph 2.82 and Example 2.16.

2.70 Expenditure is deductible where it is incurred in relation to a lease or other legal or equitable right, and the value of the expenditure to the taxpayer arises solely from the effect that the right has in preserving, but not enhancing, the value of goodwill. For example, capital expenditure may be incurred in relation to a right that is both unlimited in duration, and which merely prevents goodwill from being damaged. Such a right has no distinct value in itself. Its value lies in the effect its existence has upon the value of the goodwill. Such expenditure represents in substance a blackhole expense even though it is in relation to an asset. *[Schedule 2, item 30, subsection 40-880(6)]*

2.71 Where a taxpayer incurs an expense in relation to a right and that right enhances the value of the goodwill, or has an inherent value in itself then it would not be appropriate to allow a deduction as a business related cost as the expenditure does not represent a loss to the taxpayer.

Expenditure that would be taken into account in working out a profit or a loss

2.72 Expenditure that has been used to calculate a profit included in the taxpayer is assessable income, or that has been included in working out a loss that can be deducted, is excluded as it has already been taken into account for the purposes of the income tax law. This replicates the exclusion in the repealed section 40-880. *[Schedule 2, item 30, paragraph 40-880(5)(e)]*

Expenditure that could be taken into account in working out a capital gain or loss

2.73 Where an amount can be taken into account in working out a capital gain or loss from a CGT event, it is not deductible. A capital gain or loss that has not yet been realised or where the capital gain or loss is disregarded (eg, because it is a pre-CGT asset) or reduced is excluded from deduction under section 40-880 by paragraph 40-880(5)(f). An amount is not taken into account in working out a capital gain or loss if the expenditure cannot be included in the cost base or reduced cost base of the asset (eg, expenses related to the sale of a CGT asset that falls through). In relation to non-residents, this provision excludes a capital gain or loss from an asset that does not have the necessary connection with Australia or any other kind of capital gain or loss that an Australian resident can make but a non-resident cannot. This exclusion has been transferred from the repealed section 40-880 with minor modification to reflect the broader application of the law. *[Schedule 2, item 30, paragraph 40-880(5)(f)]*

Example 2.13

On 1 May 2006, Chooks Pty Ltd, a restaurateur, enters into a franchise agreement under which it pays \$100,000 for the right to use the franchisee's name. Therefore, Chooks has acquired a CGT asset, that is, the right, with a cost base of \$100,000. The cost will ultimately be recognised at the time of a subsequent CGT event, for example, were Chooks to dispose of the right.

The expenditure is expressly made non-deductible under another provision

2.74 Where expenditure is made non-deductible by an express provision of the tax law (including where it is limited or capped), it is also non-deductible under section 40-880. This ensures that if a particular type of expenditure is specifically denied a deduction for the purposes of the income tax law, then the expenditure should not be considered under this provision. This exclusion maintains the non-deductibility even if the expenditure is capital, or capital in nature. Expenditure that fails under section 8-1 of the ITAA 1997 is not excluded for the purposes of this paragraph as it is not considered to be expressly excluded for the purposes of the income tax law. However, the expenditure would need to satisfy the requirements of the provision to be deductible. [*Schedule 2, item 30, paragraph 40-880(2)(g)*]

Expenditure excluded but not necessarily capital in nature

2.75 This excludes expenditure that is denied a deduction, for example, entertainment expenses. Paragraph 40-880(5)(h) specifically excludes such expenditures where they are of a capital nature. Put another way, if the excluded item was of a revenue nature, this provision does not make it deductible merely because it is capital. [*Schedule 2, item 30, paragraph 40-880(5)(h)*]

Private or domestic expenditure

2.76 If capital expenditure is of a private or domestic nature it is not deductible under section 40-880. [*Schedule 2, item 30, paragraph 40-880(5)(i)*]

Example 2.14

In May 2007, Shirley, a wage and salary earner, travels to the Whitsundays for a holiday. In June 2007, after considering the business opportunities that her visit alerted her to, Shirley decides to establish a tourism venture in the Whitsundays, and seeks to deduct her travel and accommodation expenses as pre-business expenses in relation to the tourism venture she proposes to carry on. As the expenditure was of a private nature when it was incurred, Shirley is not

entitled, with the benefit of hindsight, to the deduction under the business-related costs provision. This would remain the case even if Shirley decided to establish her tourism venture while on her holiday because the costs were not incurred in relation to a business she proposed to carry on at the time those costs were incurred.

Non-assessable, non-exempt income

2.77 Expenditure incurred in gaining or producing ‘non-assessable, non-exempt income’ (a defined term), or exempt income (also a defined term), is not deductible under section 40-880. [*Schedule 2, item 30, paragraph 40-880(5)(j)*]

Market value substitution rules

2.78 This applies where the market value substitution rules in the UCA or CGT regimes have prescribed an amount to be included in the cost or cost base of the asset respectively. The prescription of market value in these cases, in effect substitutes market value for the amount that would otherwise have been included under the operation of the general cost and cost base rules. Under this exclusion, the other amount (generally being capital expenditure) is considered to have already been taken into account for the purposes of section 40-880. [*Schedule 2, item 30, subsection 40-880(8)*]

Returns of capital

2.79 Some capital amounts are not considered legitimate blackhole expenditures as they comprise the transfer or distribution of funds, repayments, or do not give rise to any income tax consequences. As such, the expenditure does not represent an economic loss to the taxpayer and is not deductible. [*Schedule 2, item 30, subsection 40-880(9)*]

2.80 Expenditures excluded by this provision include, but are not limited to:

- dividends paid by companies;
- distributions by trustees;
- margin calls;
- payments made by a company to buy back its own shares;
and
- repayments of loan principal.

2.81 This exclusion does not preclude deductibility for fees and charges related to these transactions.

Interaction with the consolidation regime

2.82 Under the consolidation regime, intra-group assets and intra-group transactions are ignored for income tax purposes. Consequently, under the current law, business-related capital expenses that are incurred by a head company to a third party in relation to intra-group transactions may not be appropriately recognised for income tax purposes (if at all). For example, capital costs in relation to the transfer of a non-intra-group asset between members of a consolidated group may not be deductible under section 8-1 of the ITAA 1997 (because they are capital in nature) and may not be included in the cost base and reduced cost base of the asset (because the head company may not have acquired a CGT asset and/or there is no CGT event).

2.83 The amendments will ensure that third party expenditure in relation to intra-group transactions is appropriately recognised.

Expenditure included in the cost base

2.84 If the third party expenditure is incurred by the head company and reasonably relates to a CGT asset held by the head company, it will be an incidental cost that is included in the second element of the cost base and reduced cost base of the asset. [*Schedule 2, items 39 and 41, subsections 110-35(1) and (10)*]

2.85 The head company of a consolidated group can only 'hold' a CGT asset if the asset is recognised for income tax purposes (ie, if it is a non-intra-group asset). As intra-group assets are ignored under the single entity rule a head company does not 'hold' these assets.

Example 2.15

A consolidated group comprises Head Co, A Co and B Co. A Co transfers a building to B Co and incurs legal costs and stamp duty in association with the transfer. As these costs reasonably relate to a CGT asset that is held by Head Co they will be included in the second element of the cost base and reduced cost base of the building.

Expenditure deductible under section 40-880

2.86 If the third party expenditure is incurred in connection with an asset that the head company does not hold (such as intra-group assets), it will be a business-related cost that is deductible over five income years (provided all of the requirements of section 40-880 are satisfied).

2.87 In order to determine whether business capital expenditure incurred by a head company is deductible under section 40-880, the nature of the expenditure must be characterised in the hands of the head company, taking into account the effect of the single entity rule.

2.88 The expenditure must be characterised at the time it is incurred by the head company. That is, a head company is not required to anticipate whether or not the expenditure is related to an asset that may become recognised for tax purposes at some time in the future. For example, expenditure incurred by a head company in relation to membership interests in a subsidiary member will be deductible under section 40-880 despite the fact that the expenditure is in relation to an asset that may at some point in the future become recognised for tax purposes (eg, immediately before the subsidiary member exits the consolidated group).

Example 2.16

A Co, from the previous example, leases some plant and equipment to B Co and incurs capital expenditure in relation to the lease. Intra-group assets are ignored for income tax purposes under the single entity rule. As the expenditure does not relate to a CGT asset that is held by the head company it is not included in the cost base and reduced cost base of the intra-group asset. As the expenses are incurred by Head Co in relation to carrying on its business, they will be a business-related cost under section 40-880 that is deductible over five income years.

Expenditure in relation to contractual or equitable rights between members of a consolidated group are not excluded by paragraph 40-880(5)(d), as such a right is treated as an arrangement between divisions of one company, and is therefore not treated as a lease or other equitable right for the purposes of working out the head company's income tax liability.

Example 2.17

A consolidated group incorporates a new subsidiary company, which becomes a subsidiary member of the consolidated group. The capital expenditure the head company incurs in doing so is deductible under paragraph 40-880(2)(a) as it does not relate to an asset that is held by

the head company. Under the single entity rule, shares in a subsidiary member would be ignored for income tax purposes. If the subsidiary member is later sold by the group, the subsidiary cannot deduct amounts for that expenditure.

Non-commercial loss provision

2.89 The non-commercial loss provisions in Division 35 of the ITAA 1997 aim to improve the integrity of the tax system by preventing losses from non-commercial activities that are carried on as businesses being offset against other assessable income such as wages and salaries.

2.90 The provisions apply to the business activities of individuals, operating alone or in partnership.

2.91 Under the provisions, a taxpayer can offset a loss from a business activity carried on in an income year against other income if at least one of the four objective tests is satisfied for that year. The four tests are the assessable income test (section 35-30), the profits test (section 35-35), the real property test (section 35-40) or the other assets test (section 35-45). Where a taxpayer does not satisfy one of the four tests, the Commissioner may exercise a discretion to allow any losses to be offset against other income in certain circumstances.

2.92 If a loss is unable to be offset against other income in the year that it arises, it is not lost altogether, but can be deferred and offset in a future year when there is a profit from the same activity, or a like activity, or against other income when the taxpayer satisfies one of the tests for that activity.

2.93 The definition of the term 'business' means that the non-commercial loss provisions do not currently apply to pre-business or post-business expenditures.

2.94 As pre- and post-business expenditures deductible under the amended section 40-880 are related to the business activity (forming the basis for deductibility), it is consistent to apply the non-commercial loss provisions to these expenditures.

2.95 Therefore, pre- and post-business expenditures deductible under section 40-880 will not be generally prevented from being deducted against other assessable income where the pre- and post-business expenditures relates to a business activity that satisfies one of the tests in Division 35, or where the Commissioner exercises a discretion.

2.96 The amendments to Division 35 only apply to pre- and post-business expenditure deductible under section 40-880.

2.97 The amendments improve the integrity of the tax system by preventing pre-business and post-business expenditure by individuals (alone or in partnership) in relation to non-commercial activities being deductible under section 40-880 unless certain exceptions apply. *[Schedule 2, item 3, subsection 35-5(1)]*

2.98 A taxpayer cannot deduct an amount under section 40-880 for post-business expenditure, in relation to a business activity that the taxpayer used to carry on (either alone or in partnership, whether or not some other entity is a member of the partnership), unless:

- the business activity satisfied one of the four tests (set out in sections 35-30 to 35-45);
- the Commissioner exercised the discretion under section 35-55 for the business activity which the taxpayer used to carry on; or
- the business activity was a primary production business or professional arts business and the income from other sources was less than \$40,000,

for the income year in which the business activity ceased to be carried on or an earlier income year. *[Schedule 2, item 5, subsection 35-10(2A)]*

2.99 This ensures that a deduction for post-business expenditure is not denied where the business activity in the current or an earlier income year was not subject to the non-commercial loss provisions.

2.100 A taxpayer cannot deduct an amount under section 40-880 for pre-business expenditure in relation to a business activity that the taxpayer proposes to carry on (either alone or in partnership, whether or not some other entity is a member of the partnership) in an income year before the one in which the business activity starts to be carried on. *[Schedule 2, item 5, paragraph 35-10(2B)(a)]*

Example 2.18

Anupam, a wage and salary earner, incurs expenditure otherwise deductible under section 40-880 during the 2006 income year for the purpose of establishing a supermarket business in the 2008 income year. Subsection 35-10(2B) prevents Anupam from deducting the amounts arising from the pre-business expenditure prior to the business commencing.

2.101 Subsection 35-10(2C) deems the amount, prevented from deduction under paragraph 35-10(2B)(a) as an amount in relation to a business activity carried on by the taxpayer (either alone or in partnership) otherwise deductible under section 40-880, as if it were an amount attributable to the business activity that the taxpayer can deduct from assessable income from the activity for the income year in which the activity starts to be carried on.

2.102 This amount, deemed under subsection 35-10(2C) as if it were attributable to the business activity in the income year the activity starts to be carried on, by the taxpayer (either alone or in partnership), is subject to the operation of the quarantining rule in subsection 35-10(2). [*Schedule 2, item 5, subsection 35-10(2C)*]

2.103 That is, in the income year a business activity starts to be carried on, a taxpayer can only offset a loss (calculated inclusive of the amounts that could have been deducted apart from paragraph 35-10(2B)(a)) from the business activity carried on against other income if:

- the business activity satisfies one of the four tests (set out in sections 35-30 to 35-45);
- the Commission exercised the discretion under section 35-55 for the business activity; or
- the business activity was a primary production business or professional arts business and the income from other sources was less than \$40,000.

2.104 Where this loss (calculated inclusive of the amounts that could have been deducted apart from paragraph 35-10(2B)(a)) cannot be offset against other income in the income year that it arises, it is not lost altogether, but can be deferred and offset in a future year when there is a profit from the same activity, or a like activity, or against other income when the taxpayer satisfies one of the tests for that activity.

Example 2.19

Naomi, a wage and salary earner, incurs a \$1,000 expenditure during the 2006 income year (otherwise deductible under section 40-880 in equal proportions for the 2006 to 2010 income years apart from Division 35) for the purpose of establishing an ice-cream shop in the 2008 income year.

Subsection 35-10(2B) prevents Naomi from deducting the amounts arising from the pre-business expenditure in the 2006 and 2007 income years. Therefore, the deductions under section 40-880 from those two income years (\$200 + \$200) are quarantined until the business commences in 2008.

The ice-cream business passes the assessable income test in Division 35 for the 2008 income year. Under section 35-10, Naomi can offset the two amounts (\$200 + \$200) quarantined from the 2006 and 2007 income years against the income from her ice-cream business and against her wage and salary income in the 2008 income year.

2.105 An individual taxpayer is prevented from deducting an amount that is otherwise deductible under subsection 40-880(4) for expenditure in relation to a business activity another entity, other than an individual (either alone or in partnership), proposes to carry on until the income year the activity starts to be carried on. The individual taxpayer can deduct amounts, quarantined during the income years before the business activity starts to be carried on by the other entity (other than an individual either alone or in partnership), in the income year the business activity starts to be carried on by the other entity. [*Schedule 2, item 5, paragraph 35-10(2B)(b), subsection 35-10(2D)*]

2.106 In the event that the business activity ceases, amounts otherwise deductible after this event under section 40-880 would be prevented if the business activity, which was carried on by the individual (either alone or in partnership), failed to pass one of the tests and if the Commissioner does not exercise a discretion and if the primary production business or professional arts business exclusions are not met prior to the business ceasing. [*Schedule 2, item 5, subsection 35-10(2A)*]

Example 2.20

Jenny-Lee, a wage and salary earner, incurs a \$1,000 expenditure — otherwise deductible under section 40-880 — during the 2006 income year for the purpose of establishing a supermarket business in the 2007 income year. She intends to carry on the business activity as a sole trader. Apart from Division 35, section 40-880 would provide deductions in equal proportions for the \$1,000 expenditure for the 2006 to 2010 income years.

Her business ceases at the end of the 2008 income year and the supermarket business did not pass any of the tests in Division 35 and the Commissioner did not exercise his discretion while the business activity was carried on. As a result, subsection 35-10(2A) prevents Jenny-Lee from deducting the amounts arising from the pre-business expenditure in the 2009 and 2010 income years.

2.107 A consequential amendment is made to subsection 35-10(4) to ensure that the non-commercial loss provisions do not apply to pre-business expenditure or post-business expenditure where the associated business activity is a primary production business or professional arts business and the income from other sources is less than \$40,000. *[Schedule 2, item 6, subsection 35-10(4)]*

2.108 Section 35-20 currently ensures that losses from non-commercial business activities, which were incurred prior to the date of a business becoming bankrupt and were deferred under Division 35, cannot be offset after the date of bankruptcy. Consistent with this principle, where an amount arising from an expenditure (otherwise deductible under section 40-880) that has not been deducted before the date of bankruptcy due to the operation of Division 35, a deduction should not be available after the date of bankruptcy if the business activity subsequently satisfies one of the tests under Division 35. *[Schedule 2, item 8, subsection 35-20(1)]*

2.109 Consequential amendments are also made to the four tests in sections 35-30 to 35-45 to ensure that they apply for the purposes of subsections 35-10(2A) to (2C). In particular, section 35-35 is amended so that quarantined amounts from previous years, otherwise deductible under section 40-880 apart from the operation of Division 35, do not affect the operation of the profits test in the current year. A consequential amendment is also made to subsection 35-15(1) to ensure that it only applies in relation to subsection 35-10(2). *[Schedule 2, items 7, 9 to 16]*

2.110 The Commissioner's discretion in section 35-55 is amended to enable the Commissioner to exercise a discretion to allow a taxpayer to deduct pre-business expenditure under section 40-880 where the Commissioner is satisfied that it would be unreasonable to defer a deduction for the pre-business expenditure because special circumstances prevented the business activity from being carried on.

2.111 Consistent with the existing Commissioner's discretion, special circumstances are those circumstances which are outside of the control of the operators of the business activity, including drought, flood, bushfire or some other natural disaster. Consequently, if a taxpayer incurs pre-business expenditure in relation to a business activity which the taxpayer proposes to carry on, but due to special circumstances the business activity is prevented from starting, the Commissioner may decide that subsection 35-10(2B) does not apply to defer a deduction for the pre-business expenditure. This is intended to provide for a case where a business activity would have begun to be carried on and satisfied one of the tests if it were not for the special circumstances. *[Schedule 2, item 18, subsection 35-55(2)]*

Capital expenditure to terminate lease

2.112 Taxpayers can deduct capital expenditure incurred to terminate a lease or licence (including an authority, permit or quota) that results in the termination of the lease or licence if the expenditure is incurred in the course of carrying on a business or in ceasing a business. [*Schedule 2, item 2, subsection 25-110(1)*]

2.113 In part, the deduction will provide a write-off for expenditure that would otherwise be blackhole in nature, as lease surrender payments by a lessee to a lessor are not currently recognised under the income tax law as deductible or for write-off. Other lease and licence surrender payments are provided with the same treatment for income tax purposes. There are many business reasons why a lease may be terminated.

2.114 The taxpayer can deduct 20 per cent of the capital expenditure in the income year in which the lease or licence is terminated. The taxpayer can then deduct 20 per cent of the expenditure in each of the four following income years. [*Schedule 2, item 2, subsection 25-110(2)*]

2.115 This provision applies to a payment or payments, to include those made in instalments. However the expenditure must result in the termination of the lease. Therefore, the deduction will not be allowed until the lease is terminated and payments will be quarantined until such time.

2.116 The parties that qualify for a deduction can include a lessee or licensee, a lessor or licensor but may also include additional parties wanting to induce the surrender of a lease or licence, for example, where there is third party involvement.

2.117 If a payment is made to terminate a lease or licence but does not result in the termination of the lease or licence, a deduction under Division 25 is not allowed.

2.118 The write-off is available for expenditure incurred to terminate leases and licences. For this purpose, licence includes, but would not be limited to, an authority, permit or quota.

Example 2.21

Beverley holds a 10-year lease over premises for her jewellery store in a shopping centre. After four years of the term of the lease, she finds cheaper premises to lease across town which are also more suitable for her business. Beverley makes a payment to terminate her current lease. The payment is able to be deducted in equal proportions over five years under the new provision.

2.119 This provision is only intended to allow deductions for lease payments where the lease provides the right to use an asset for a determined period or term, such as operating leases. It will not allow deductions for payments which, in effect, confer all the risks and rewards of ownership of the asset. Capital expenditure incurred to terminate a lease that is, in accordance with accounting standards, or statements of accounting concepts made by the Australian Accounting Standards Board (AASB), is classified as a finance lease, is specifically excluded from this provision. The Accounting Standard AASB 117 as at July 2004, defines a finance lease as:

‘...a lease that transfers substantially all the risks and rewards incidental to ownership of an asset.’

[Schedule 2, item 2, subsection 25-110(3)]

2.120 A market value substitution rule will apply to this provision to prevent deductions for inflated lease and licence termination payments. The rule will ensure the amount of expenditure taken into account is the market value of the lease or licence. The market value will be equal to the value arrived at as if the termination did not occur and was never proposed to occur (ie, the value of the lease immediately prior to termination). It will apply where the expenditure is incurred under an arrangement and there is at least one other party to the arrangement with whom the taxpayer did not deal at arm’s length; and the amount of expenditure is more than the market value of what it was for. *[Schedule 2, item 2, subsection 25-110(4)]*

2.121 A deduction will be denied under this provision for a termination payment that is made to enter into another lease or licence with the same party; and where the lease or licence is of the same kind as the original one. ‘Of the same kind’ refers to a lease or licence agreement in which the term and/or cost of the payments associated with the lease or licence do not vary significantly, and it cannot be demonstrated that there is a need to have a new lease or licence. This exclusion has been applied to prevent payments being brought forward simply to gain a five-year deduction. *[Schedule 2, item 2, subsection 25-110(5)]*

2.122 Where capital expenditure is incurred to terminate a lease or licence for the granting of another lease or licence in relation to the asset that was the subject of the original lease or licence, it will be specifically excluded from this provision. This is because, rather than the removal of an onerous obligation, the payment is to acquire a new lease. The expenditure may form part of the cost base of the new lease, a CGT asset. *[Schedule 2, item 2, subsection 25-110(6)]*

Example 2.22

Nicholas holds a lease over a suburban office space with the office building manager, Tim. James has been looking for a suitable office in that area, and approaches Tim to negotiate taking over the lease. Tim agrees, subject to the payment of a lease surrender payment. James makes the payment. As the payment is for the purpose of James taking over the lease and gives rise to a new lease, it is expenditure for the granting of a new lease so is not deductible under this provision.

2.123 Lease and licence-related termination payments will generally be assessable income in the hands of the recipients under section 6-5 of the ITAA 1997, if received in the circumstances set out in Australian Taxation Office Ruling TR 2005/6.

Changes to elements of cost of a depreciating asset under the uniform capital allowances regime

2.124 The expanded concept of cost of a depreciating asset under the UCA regime increases the range of expenditures included as part of both the first and second elements of cost of a depreciating asset.

2.125 Presently, expenditure to hold a depreciating asset is included in the first element of cost — this requires a direct relationship between the expenditure and starting to hold the asset. The meaning of ‘hold’ a depreciating asset is covered by section 40-40. In the most common situation, a taxpayer is taken to hold an asset if he or she owns the asset. *[Schedule 2, item 20, subsection 40-180(3)]*

Example 2.23

Russ wishes to buy a computer for his business that is not available in Australia. After adequate research he concludes he would be able to obtain the computer from a company in Silicon Valley in the United States. Russ travels to Silicon Valley for the sole purpose of purchasing the computer. The travel costs would be included as part of the first element of cost of the computer because they are directed to and result in the purchase of the computer.

2.126 A broader range of costs, those incurred in relation to starting to hold — owning in the most common situation — a depreciable asset will now be included in the cost of that asset.

2.127 The first element of cost of a depreciating asset does not include any amount that forms part of the second element of cost of any other depreciating asset. *[Schedule 2, item 20, subsection 40-180(4)]*

2.128 A consequential amendment has been made to paragraph 40-185(1)(b) to change the wording from ‘for holding the asset or receiving the benefit’ to ‘in relation to holding the asset or receiving the benefit’. This will ensure consistency with section 40-180. [*Schedule 2, item 21, paragraph 40-185(1)(b)*]

2.129 The second element of cost includes expenditure incurred that is reasonably attributable to a balancing adjustment event occurring for a depreciating asset. Expanding the second element of cost will allow all costs reasonably attributable to a balancing adjustment event to be taken into account in working out a balancing adjustment rather than such costs reducing the termination value of the asset as is currently the case in section 40-315. Expansion of the second element of cost in this way will allow all such costs to be taken into account in working out a balancing adjustment rather than such costs being taken into account to the extent only of the termination value. [*Schedule 2, item 24, subsection 40-190(2)*]

2.130 The combination of the current *splitting a depreciating asset* rules (section 40-115) and the amendments to the *elements of cost* together will provide that expenditure incurred in selling part of a depreciating asset will be wholly attributed to the sold part of the asset.

2.131 The amendments to the second element of cost now incorporate subsection 40-315(1). Subsection 40-315(2) was an exclusion to subsection 40-315(1) and as such it has been relocated so paragraph 40-190(2)(b) does not apply to specified items of the termination table in subsection 40-300(2). [*Schedule 2, item 27, subsection 40-190(3)*]

CGT amendments

2.132 The amendments expand the coverage of the cost base and reduced cost base provisions for CGT purposes. *Cost base* is used to calculate a capital gain, while *reduced cost base* is used to calculate a capital loss. The proposed provisions affected are those for the second element (incidental costs) of cost base and reduced cost base, the third element (ownership costs) of cost base, and the fourth element (improvement expenditure) of cost base and reduced cost base.

2.133 The CGT changes apply both to taxpayers carrying on a business and those not carrying on a business.

Second element

2.134 The second element of cost base and reduced cost base comprises various specified incidental costs incurred to acquire the CGT

asset or dispose of it. Section 110-35 lists the costs. They include stamp duty and the remuneration of a legal adviser or other consultant.

2.135 The additional qualifying costs now being included are marketing expenses, search fees relating to a CGT asset, the cost of a conveyancing kit (or a similar cost), borrowing expenses (such as loan application fees and mortgage discharge fees) and certain expenses incurred by a head company of a consolidated group or multiple entry consolidated group (MEC group).

2.136 An example of marketing expenses is furniture hire to help sell a rental property.

2.137 Search fees essentially relate to fees payable in checking land titles and similar fees and would not include costs such as travelling expenses to find an asset suitable for purchase.

2.138 An additional ninth incidental cost has been added to ensure that certain expenses incurred by a head company of a consolidated group or MEC group are appropriately included in the second element of cost base and reduced cost base. This additional cost need not relate to the acquisition or disposal of a CGT asset. Paragraphs 2.84 to 2.85 contain further information on the operation of the new rule. [*Schedule 2, items 34, 39 to 41 and 49, subsection 110-25(3), section 110-35 and definition of 'incidental costs' in subsection 995-1(1)*]

Third element

2.139 At present, the third element of cost base comprises non-capital costs of ownership of assets acquired after 20 August 1991. The amendments remove the requirement that the costs be non-capital in nature. They also clarify that only costs of owning the asset (as distinct from costs of becoming the owner) are recognised. The taxpayer still needs to acquire the asset after 20 August 1991. [*Schedule 2, items 31, 32, 35, 46 and 48, sections 108-17 and 108-30, subsection 110-25(4), section 114-1, note 3 and subsection 960-275(4)*]

Fourth element

2.140 At present, the fourth element of cost base and reduced cost base is capital expenditure incurred to increase the asset's value (subsection 110-25(5)). There is also at present a requirement that the expenditure be reflected in the state or nature of the asset at the time of the CGT event. The amendments make four changes to the fourth element.

2.141 The first change is that it is no longer necessary that the purpose of the expenditure be to increase the asset's value. Instead, it is now

sufficient that the purpose *or expected effect* be to increase *or preserve* the asset's value. An example of expenditure that would now qualify for inclusion in the fourth element would be legal and other expenses incurred to preserve the value of a rental property by opposing a nearby development that would adversely affect the rental property's value. Another example would be the costs incurred in unsuccessfully applying for zoning changes.

2.142 The second change is that there is no longer a requirement that the expenditure be reflected in the state or nature of the asset at the time of the CGT event.

2.143 The third change is that the element now includes capital expenditure that relates to installing or moving the asset.

2.144 The fourth change is that the element does not apply to capital expenditure incurred in relation to goodwill. A consequence of this exclusion is that expenditure in relation to goodwill already attracting deductibility over five years does not receive less generous CGT treatment by reason of the enlargement of the fourth element. [*Schedule 2, items 36 and 38, subsections 110-25(5) and (5A) and subsection 110-25(1), note 1*]

Exclusions from cost base and reduced cost base

2.145 The amendments include provisions to prevent expenditure on entertainment, penalties and bribes from being included in cost base or reduced cost base. This mirrors the approach taken in provisions that prevent income tax deductions for this kind of expenditure. At present, bribes are excluded from cost base but not from reduced cost base. There is at present no exclusion from either cost base or reduced cost base of entertainment expenses or penalties. [*Schedule 2, items 33, 37, 42 to 45 and 47, subsections 110-25(1), (7) to (11), sections 110-36 and 110-38, subsections 110-55(9A), 114-5(2) and (3)*]

Application and transitional provisions

2.146 The amendments in relation to the new business-related costs provision (Part 1 of the Schedule) apply to expenditure incurred on or after 1 July 2005, as announced by the Treasurer in the 2005-06 Budget.

2.147 The amended CGT provisions (Part 2 of the Schedule) will apply to CGT events happening on or after 1 July 2005.

REGULATION IMPACT STATEMENT

Specification of the policy objective

2.148 The objective of this measure is to provide recognition in the income tax laws for business blackhole expenditures, that is, business capital expenses not elsewhere recognised within the taxation laws.

Background

2.149 Blackhole expenditures are currently dealt with under section 40-880 of the ITAA 1997 which specifies certain business-related costs that have a straight-line write-off over five years. It is a provision of last resort that only applies if expenditures are not deductible elsewhere under the tax law.

2.150 Such blackhole expenditures can be grouped broadly into the following categories:

- expenditure in relation to a non-depreciating or depreciating asset that is not incorporated into its cost base for CGT purposes, or the cost of a depreciating asset for UCA purposes (an example is some demolition costs, where expenditure is incurred to demolish an asset and there is no new asset for the cost to be attributed to);
- costs of ceasing a business (some costs to stop carrying on a business are deductible under paragraph 40-880(1)(g) of the ITAA 1997);
- preliminary (pre-business) costs (these are not generally deductible under the ITAA 1997 as they require a nexus between the income earned and the expenditure incurred. Some specified pre-business capital costs are deductible, for example business start-up costs under section 40-880 of the ITAA 1997); and
- costs incurred after a business has ceased.

Identification of implementation options

Systematic tax treatment

2.151 The Treasurer has previously announced that the Government will develop, in consultation with the business community, a systematic tax treatment of such blackhole expenditures, with a view to implementing these changes by July 2005.¹

2.152 The Treasurer announced the systematic treatment for blackhole expenditures in the 2005-06 Budget².

2.153 This was developed having regard to the parameters set out by the then Minister for Revenue and Assistant Treasurer, including that reform will be confined to business-related expenditures and will take into account any risks to tax law integrity and the Government's overall fiscal strategy.³

2.154 Blackhole expenditures are proposed to be recognised as follows:

- amending the CGT provisions to enhance the incorporation of certain expenditures into the cost base. This will cover expenditures identified in the first dot point of paragraph 2.150;
- introducing a third element of cost for UCA assets to enhance the incorporation of certain expenditures into the cost of depreciating assets. This will also cover expenditures identified in the first dot point of paragraph 2.150;
- introducing a new provision that allows a straight-line write-off for business capital expenditures where these expenditures are not currently recognised by the income tax laws. This will capture expenditures identified in the second to fourth dot points of paragraph 2.150; to the extent that the business is carried on for a taxable purpose. It is also intended to include those expenditures specified in the current section 40-880 of the ITAA 1997.

¹ Treasurer's Press Release No. 048 of 28 August 2002, available at www.treasurer.gov.au.

² Treasurer's Press Release No. 045 of 10 May 2005, available at www.treasurer.gov.au.

³ The then Minister for Revenue and Assistant Treasurer's Press Release No.C017/03 of 21 March 2003, available at www.treasurer.gov.au.

2.155 Under this proposal, section 40-880 of the ITAA 1997 will be repealed and replaced by the new provision outlined above. The integrity measures in subsection 40-880(3) will be transferred to the new provision to ensure that it is a provision of last resort.

2.156 Transitional provisions are not required as the provision allows for expenditures that are currently deductible under section 40-880 of the ITAA 1997, to continue to be deductible under the new provision.

2.157 The proposed amendments to the ITAA 1997 will not require the Australian Taxation Office (ATO) to adopt alternative administrative arrangements. Options for ensuring taxpayer compliance, both administrative and integrity measures, will be considered in consultations with taxpayers.

2.158 As part of the integrity measures, it is proposed that the non-commercial loss provisions (in Division 35 of the ITAA 1997) be amended so that individuals (whether alone or in partnership) cannot offset against other assessable income deductions for pre-and post-business expenses under the proposed section 40-880, unless they satisfy one of the relevant tests in the non-commercial loss provisions.

Tax value method

2.159 In 1999, the Review of Business Tax proposed the tax value method as a means of capturing blackhole expenditure. After extensive evaluation of the tax value method, the Board of Taxation recommended against its adoption and the Government accepted the Board's recommendation.⁴

Assessment of impacts (benefits and costs) of implementation

2.160 As the proposal treats only business expenditure, small and large businesses who seek to deduct blackhole business expenditure will be able to utilise the proposed new provisions. There is not expected to be any disproportionate impact on small business.

⁴ Treasurer's Press Release No. 048 of 28 August 2002, available at www.treasurer.gov.au.

2.161 While there is insufficient information to quantify the number of businesses that will be directly affected by the proposal, submissions to the Treasury represented a significant number of taxpayers.

2.162 Submissions to the Treasury have not identified any obvious impacts on different geographical areas.

2.163 There will be implications for the ATO in terms of ensuring taxpayer compliance.

Assessment of benefits

2.164 Blackholes place a burden on taxpayers through increased compliance costs. These arise from:

- seeking to construct complex arrangements to achieve deductions for legitimate business expenditures; and
- uncertainty as to what expenditures can be deducted, leading to unnecessary record-keeping and an ongoing requirement to consult the ATO on its interpretation of the tax laws.

2.165 Businesses have raised concerns about the burden placed on them by the existing treatment of blackhole expenditures.

2.166 Therefore, the main impacts on business from adopting a systematic approach are anticipated to be:

- permitting business to seek deductions where there is no existing tax treatment, providing a financial benefit to the taxpayer;
- providing greater certainty for business as to what is deductible thus removing delays in decision making and reducing unnecessary record-keeping; and
- reducing the need for businesses to seek ATO guidance on what falls within section 40-880 or other provisions (eg, project pools), reducing costs and time delays for business.

2.167 The new provision will be a provision of last resort which minimises the potential for arbitrage as deductions will only be possible where the expenditures are not already recognised under the income tax laws.

2.168 The ATO has formally advised that the current uncertainty and non-deductibility in relation to blackhole expenditures causes taxpayers to challenge aspects of the law and seek the ATO's views in relation to the expenditure and its deductibility under provisions that were not intended to apply, or at least where the application of the law is uncertain.

2.169 Hence moving to a regime that provides greater certainty and deductibility should provide an associated reduction in costs.

2.170 Whilst it is expected that the new legislation will have an overall positive outcome, some benefits for both taxpayers and the ATO cannot be quantified.

Economic impact

2.171 The anticipated reduction in distortions from taxpayers seeking to construct complex arrangements will improve resource allocation for businesses and for the economy generally.

Assessment of costs

Administration costs

2.172 There may be some implementation costs for the ATO in terms of staff training and business education. However the new provision is an extension of an established area of the law, thus the ATO already has arrangements in place to draw on which will help to minimise these costs.

2.173 Administration costs for the ATO have not been able to be quantified.

Compliance costs

2.174 As is standard with new measures, groups affected by them will need to incur a small up-front cost in either familiarising themselves with the new law or having advisers familiarise themselves with the new law and, if necessary, communicating the necessary information to taxpayers affected.

2.175 The provision will require businesses to seek a straight line write-off over a period to be prescribed in the statute. This methodology is already utilised by the current section 40-880 of the ITAA 1997, therefore business familiarisation costs are expected to be small.

2.176 Individual taxpayers claiming deductions arising from pre- and post-business costs (under the proposed amendments) against other

income will need to become familiar with the amended non-commercial loss provisions. These taxpayers will need to determine whether the tests apply to them and if so whether they satisfy any one of the tests, in order to be able to offset losses from a particular business activity (or a like activity) against their other income.

2.177 Individuals who fail to satisfy any of the tests for a particular business activity (or a like activity) will need to maintain records of those loss amounts in order to defer them to a future year in which they pass any of the tests. These records will need to separately identify the deductions from each activity which were not previously permitted to be claimed.

2.178 Compliance costs have not been able to be quantified.

Revenue costs

2.179 The expected revenue cost over the forward estimates for the taxation treatment of business 'blackhole' expenditure is shown in Table 2.1:

Table 2.1

<i>2005-06</i>	<i>2006-07</i>	<i>2007-08</i>	<i>2008-09</i>
Nil	-\$37m	-\$73m	-\$109m

Consultation

2.180 Relevant stakeholders have provided their views on the treatment of blackhole expenditures. Initial consultation was in respect to a call for submissions by the then Minister for Revenue and Assistant Treasurer on expenditures considered to be blackholes for taxation purposes. The Government received 10 formal submissions from peak industry and tax bodies representing a substantial number of taxpayers.

2.181 The views expressed in these submissions were taken into account in developing the proposal. Not all types of blackhole expenditures identified by taxpayers were considered to be genuine blackhole expenditures.

2.182 Further confidential targeted consultation was undertaken subsequent to the Treasurer's Press Release of 10 May 2005⁵. The consultation applied the details of the proposal and:

⁵ Treasurer's Press Release No. 045 of 10 May 2005, available at www.treasurer.gov.au

- considered expenditures that will be covered by the new provision;
- integrity measures; and
- compliance and administration matters,

through the release of Treasury discussion papers and draft legislation.

2.183 The legislation has incorporated proposals which were raised in discussions by key stakeholders.

Conclusion and preferred option

2.184 The proposed systematic tax treatment meets the parameters set out previously by the Treasurer and the then Minister for Revenue and Assistant Treasurer.⁶

2.185 It is expected to provide net benefits for businesses and the ATO by increasing certainty, reducing complexity and minimising the risk of arbitrage. Ongoing compliance costs are expected to be lower.

2.186 Further, the proposal is broadly in line with taxpayer views as expressed in submissions.

2.187 The Treasury and the ATO will monitor this taxation measure as part of the whole taxation system on an ongoing basis.

⁶ Treasurer's Press Release No. 048 of 28 August 2002 and Treasurer's Press Release No. 045 of 10 May 2005, available at www.treasurer.gov.au.

Chapter 3

Deterring the promotion of tax exploitation schemes

Outline of chapter

3.1 Schedule 3 to this Bill amends the *Taxation Administration Act 1953* (TAA 1953) and the *Income Tax Assessment Act 1997* (ITAA 1997) to introduce measures to deter:

- the promotion of tax avoidance and evasion schemes (collectively referred to in the Bill as tax exploitation schemes); and
- the implementation of schemes that have been promoted on the basis of conformity with a product ruling, in a way that is materially different to that described in the product ruling.

Context of amendments

3.2 On 5 December 2003, the then Minister for Revenue and Assistant Treasurer announced that the Government would introduce a civil penalty regime to deter the promotion of tax exploitation schemes.

3.3 Currently, there are no civil or administrative penalties for the promotion of these schemes, with the result that promoters can obtain substantial profits while investors may be subject to penalties under the TAA 1953. This represents a significant asymmetry in risk exposure.

3.4 Furthermore, the Commissioner of Taxation (Commissioner) cannot currently take legal action to stop the promotion of tax schemes. It is possible to warn investors about the risk that tax benefits will not be available, but educational initiatives have limited ‘real time’ impact. In contrast, the ‘real time’ remedies of injunctions and voluntary undertakings in this Bill can stop the promotion of schemes before investors participate.

Summary of new law

3.5 To deter tax exploitation schemes, this Bill amends the tax laws to enable the Commissioner to:

- request the Federal Court of Australia (the Federal Court) to impose a civil penalty;
- seek an injunction to stop the promotion of a scheme or implementation of a scheme not in conformity to its product ruling; and
- enter into voluntary undertakings with promoters or implementers about the way in which schemes are being promoted or implemented.

3.6 A civil penalty, injunction, or enforceable undertaking may apply to an entity that:

- engages in conduct that results in them or another entity being a promoter of a tax exploitation scheme; or
- implements a scheme that has been promoted on the basis of conformity with a product ruling in a way that is materially different to that described in the product ruling.

3.7 A penalty or injunction may only be imposed by the Federal Court of Australia (the Federal Court). The maximum penalty the Federal Court can impose is the greater of:

- 5,000 penalty units (currently equal to \$550,000) for an individual or 25,000 penalty units (currently equal to \$2.75 million) for a body corporate; and
- twice the consideration received or receivable, directly or indirectly, by the entity or its associates in respect of the scheme.

3.8 In deciding what penalty is appropriate, the Federal Court can have regard to all matters it considers relevant, including the amount of loss or damage incurred by scheme participants and the honesty and deliberateness of the promoter's conduct.

3.9 The penalty provisions are framed to apply to entities, including individuals, to prevent individual promoters from using a business structure to avoid personal liability for the penalty. However, in cases where the individuals involved are not the controlling minds, but merely employees following directions from their arms' length employer, the employer entity will usually be the appropriate subject for the penalty.

3.10 The penalty provisions will not apply to entities or their employees who are peripherally involved in a contravention of the promoter penalties provisions through giving advice or minor involvement in implementing the scheme. Moreover, the Commissioner will not be able to seek penalties against an employee if a penalty has already been imposed on the employer entity.

3.11 In addition, an entity is not liable for penalty if:

- the conduct in respect of which the proceedings are instituted is due to:
 - a reasonable mistake of fact; or
 - the act or default of another, or due to an accident or some other cause beyond the entity's control, if they took reasonable precautions and exercised due diligence to avoid the conduct;
- a scheme treats the taxation law as applying in a way that agrees with a statement or advice given to the promoter (or their agent) by, or on behalf of, the Commissioner; and
- more than four years has elapsed since the entity last engaged in the relevant conduct. This mirrors the period for which taxpayers are at risk of scheme penalties.

3.12 The Commissioner may seek statutory injunctions against entities in addition to, or instead of penalties. The Commissioner can apply to the Federal Court for an interim, restraining or performance injunction to stop or remedy the promotion of a tax exploitation scheme or implementation of a scheme in a materially different way to its product ruling.

3.13 The Commissioner may also enter into voluntary undertakings relating to the promotion of a tax exploitation scheme or the implementation of a scheme in a way that is materially different to that described in its product ruling. Such undertakings are enforceable by the Federal Court.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
There will be a civil penalty regime in the TAA 1953, allowing the Commissioner to apply to the Federal Court for injunctions and penalties to deter the promotion of tax avoidance and tax evasion schemes.	No equivalent.

Detailed explanation of new law

3.14 This Bill introduces three measures to deter the promotion of tax avoidance and tax evasion schemes (collectively referred to hereafter as ‘tax exploitation schemes’) and the implementation of ‘schemes’ that have been promoted on the basis that they conform with a ‘product ruling’, inconsistently with that ruling.

3.15 The Commissioner has a flexible range of remedies to achieve these outcomes. The Commissioner can accept a voluntary undertaking, apply to the Federal Court for an injunction, or seek a civil penalty.

Civil penalties

3.16 The Commissioner may apply to the Federal Court for a civil penalty against an ‘entity’ that may have contravened the penalty provisions in this Bill. If the Federal Court is satisfied that the entity has breached the penalty provisions, the court can order the entity to pay a financial penalty to the Commonwealth. [*Schedule 3, item 1, subsection 290-50(3)*]

3.17 **Entity** is defined in subsection 995-1(1) of the ITAA 1997 to include an individual (in his or her personal capacity or in another capacity, such as a trustee), a company, a partnership, an unincorporated association, a trust or a superannuation fund.

Conduct resulting in entities being promoters of tax exploitation schemes

3.18 The first civil penalty provision proscribes an entity from engaging in conduct that results in that entity or another entity being a promoter of a tax exploitation scheme. [*Schedule 3, item 1, subsection 290-50(1)*]

3.19 There are two separate proscriptions contained in the provision. First, an entity must not engage in conduct that would result in them being

a promoter of a tax exploitation scheme. The concepts ‘promoter’ and ‘tax exploitation scheme’ are defined terms and are discussed in detail in paragraphs 3.40 to 3.67. The provision will be breached if an entity’s (including an individual’s) conduct amounts to them being a promoter of a tax exploitation scheme. Generally entities act through their employees and agents — therefore an authorised act of an employee or agent on behalf of an entity is usually regarded as the act of that entity also.

3.20 Secondly, the proscription states that an entity must not engage in conduct that would result in another entity being a promoter of a tax exploitation scheme. This proscription does not apply to conduct that is merely peripheral to the conduct that makes the second entity a promoter. There needs to be a degree of active engagement by an entity in causing another entity to be a promoter. The conduct of the entity must result in the second entity satisfying each of the elements of the term ‘promoter’ in subsection 290-60(1). For example, as corporations and other non-individual entities usually require individuals to act for them, those individuals must not take decisions that result in the entity being a promoter of a tax exploitation scheme. For example, a managing director of a company or partner in a partnership could trigger the provision by taking decisions that result in the company or partnership being a promoter of a tax exploitation scheme.

3.21 This approach is important as an individual may operate through another entity in promoting a tax exploitation scheme. Subsection 290-50(1) therefore enables the Commissioner to take action against the individual in these cases. This ensures that individual promoters cannot use a business structure with minimal assets to avoid liability for the penalty. The mechanism also enables the Commissioner to apply for a penalty against a key person promoting a tax exploitation scheme from within a larger entity. However the intention is not to make employees who merely carry out actions as lawfully directed by their arms’ length employer responsible for the employer’s actions.

3.22 To ensure that employees, subcontractors and others merely carrying out instructions are not unnecessarily brought into the scope of the provision, there are exceptions to the penalty for reasonable mistakes and reasonable precautions and where entities do not know that their conduct will result in the promotion of a tax exploitation scheme. In addition, employees are not to be taken to have had a substantial role in promotion merely because they distribute material provided by another, and cannot be penalised where the employer already has been. Finally, the definition of ‘promoter’ excludes merely providing advice. These exceptions and qualifications are discussed in detail from paragraph 3.31.

Implementation of a scheme not in conformity with a product ruling

3.23 The second civil penalty provision is contravened where an entity engages in conduct that results in a scheme that has been promoted on the basis of conformity with a product ruling being implemented in a way that is materially different to that described in the product ruling. *[Schedule 3, item 1, subsection 290-50(2)]*

3.24 The note to this provision emphasises that a scheme will not have been implemented in a way that is materially different from a product ruling if the tax outcome for participants in the scheme is the same as that described in the product ruling. However, the law does not require that taxpayers need to experience a particular tax outcome before the provision is triggered.

Amount of penalty

3.25 To deter the promotion of schemes, it is important that the potential penalty for the promoter is greater than the expected benefit from illegal activity. Therefore, the maximum amount of penalty the Federal Court can impose is the greater of:

- 5,000 penalty units (currently equal to \$550,000) for an individual or 25,000 penalty units (currently equal to \$2.75 million) for a body corporate; and
- twice the consideration received, directly or indirectly, by the entity and associates of the entity from the promotion or implementation of the scheme.

[Schedule 3, item 1, subsection 290-50(4)]

3.26 There may be more than one promoter of a tax exploitation scheme. Where more than one promoter is identified, each promoter will be individually liable for the civil penalty. The maximum penalty for each promoter may be different if each received a different amount of consideration.

3.27 Consideration in this context refers to the total payment or financial reward derived from a scheme. Direct consideration encompasses, amongst other things, any fee, payment for services rendered, money, property, benefit, reward, compensation or recompense received or receivable that is directly related to the scheme. Indirect consideration includes in-kind payments, payments to third party associates and other payments that are indirectly related to the scheme promotion, even if they are described as something else.

3.28 It is important to note that the type of consideration to be taken into account for calculation of the maximum penalty is not constrained by the narrower consideration (related to marketing or encouragement) that is used to determine whether an entity is a promoter (see paragraph 290-60(1)(b) of this Bill).

Principles relating to penalties

3.29 The Federal Court may have regard to all relevant matters when determining the penalty, including:

- the consideration receivable in respect of the conduct;
- the deterrent effect of the penalty;
- the loss or damage incurred by scheme participants;
- the nature and extent of the contravention;
- the circumstances in which the contravention took place, including the deliberateness of the conduct and the period over which it extended:
 - this can include whether there was an honest and reasonable mistake about the law;
- whether the entity took any steps to avoid the contravention;
- whether the entity has previously been found by a court to have engaged in the same or similar conduct; and
- the degree of cooperation with the Commissioner.

[Schedule 3, item 1, subsection 290-50(5)]

Recovery of the penalty

3.30 The civil penalty is not a tax-related liability. If the penalty is not paid to the Commonwealth within the time stated in the Federal Court order, the Commissioner may initiate proceedings for its recovery in the relevant jurisdiction and may apply for orders including judgment interest.

[Schedule 3, item 1, subsection 290-50(6)]

Exceptions to the penalty provisions

Reasonable mistake or reasonable precautions

3.31 An entity is not liable for a civil penalty if the conduct is due to:

- a reasonable mistake of fact; or
- the act, or failure to act, of another entity (not including an employee or agent), or due to an accident or some other cause beyond the entity's control, and the entity took reasonable precautions and exercised due diligence to avoid the conduct.

[Schedule 3, item 1, subsections 290-55(1) and (2)]

Reliance on the Commissioner's advice

3.32 An exception is also provided for the promoter of a scheme if a scheme is based on treating the taxation laws in a way that agrees with advice given to the promoter (or their agent) by or on behalf of the Commissioner, or a statement in a publication approved in writing by the Commissioner. *[Schedule 3, item 1, subsection 290-55(3)]*

3.33 The advice that is the subject of this exception will not generally include private rulings, as such rulings are not advice to the promoter, but rather, advice to the entity getting the scheme benefit. However, a scheme where all participants are covered by binding rulings from the Commissioner — including public rulings, product rulings, class rulings or private rulings for all scheme participants — is, by definition, not a tax exploitation scheme (see section 290-65).

3.34 The exception for reliance on advice from the Commissioner covers promoters of schemes for whom it may not currently be possible to obtain a legally binding ruling. For example, a promoter may seek advice from the Commissioner about the way the tax law would apply to a proposed scheme that is to be entered into by a company that is not yet incorporated. In such a case a binding private ruling cannot be given to the non-existing company, but nevertheless administratively-binding advice can be given to the promoter. The promoter would be protected by acting in accordance with the administratively-binding advice. The Australian Taxation Office (ATO) publishes guidance as to the different types of advice on the ATO's on-line Legal Database.

Time for the Commissioner to initiate proceedings

3.35 The Commissioner must generally begin civil penalty proceedings within four years of the entity's involvement in the conduct proscribed in the penalty provisions. This time limit reflects the amendment period for taxpayers involved in tax avoidance schemes. *[Schedule 3, item 1, subsections 290-55(4) and (5)]*

3.36 However, consistent with the risk and amendment periods for taxpayers who have been involved in fraud or tax evasion, there is no time

limit on the Commissioner instigating proceedings against the promoter or implementer of a tax evasion scheme or a scheme involving fraud.

[Schedule 3, item 1, subsection 290-55(6)]

Exception where entity does not know result of conduct

3.37 There may be circumstances where, for example, an employee of a company unknowingly engages in conduct that is later found to have resulted in another entity being a promoter of a tax exploitation scheme, or a subcontractor unknowingly engages in conduct that results in a scheme being implemented otherwise than in accordance with a product ruling obtained for the scheme.

3.38 An exception is provided for these cases to protect employees, subcontractors and others who did not know and could not reasonably be expected to have known that their actions would result in unlawful conduct, while preserving the Commissioner's ability to institute proceedings against other parties in relation to the promotion of the scheme. *[Schedule 3, item 1, subsection 290-55(7)]*

No penalty for employee if employer is penalised

3.39 The Commissioner may not apply for penalties in relation to an employee of an entity if a penalty has been imposed on the employer in relation to the same scheme. *[Schedule 3, item 1, subsection 290-55(8)]*

Who is a promoter?

3.40 The civil penalty regime applies to promoters of tax exploitation schemes. An **entity** is a promoter of a tax exploitation scheme if:

- the entity markets the scheme or otherwise encourages the growth of the scheme or interest in it;
- the entity or an 'associate' of the entity receives (directly or indirectly) consideration in respect of that marketing or encouragement; and
- having regard to all relevant matters, it is reasonable to conclude that the entity has had a substantial role in respect of that marketing or encouragement.

[Schedule 3, item 1, subsection 290-60(1)]

3.41 While the general expression '...encouraging the growth of the scheme or interest in it...' would ordinarily include most forms of

marketing, the specific reference to *marketing* highlights the most common case. The broader phrase makes it clear that the civil penalty regime is not restricted to schemes that are directly marketed in a conventional sense. [Schedule 3, item 1, paragraph 290-60(1)(a)]

3.42 For an entity to be a promoter of a tax exploitation scheme, that entity, or an associate, must receive consideration in respect of the marketing of that scheme or in relation to encouraging the growth of, or interest in, the scheme. [Schedule 3, item 1, paragraph 290-60(1)(b)]

3.43 An *associate* is defined in section 318 of the *Income Tax Assessment Act 1936* (ITAA 1936) to include relatives, partners, trusts that benefit the primary entity, and companies influenced by the primary entity.

3.44 Scheme promoters generally undertake promotional activities to earn higher financial rewards than would be available for providing independent and objective tax advice. Those scheme profits constitute consideration received from the marketing or encouragement of a tax exploitation scheme and help to establish that an entity is a promoter.

3.45 Salary, wages and other professional fees that reflect the time and expertise spent advising clients about a scheme are unlikely to constitute consideration in the context of the promoter definition because the consideration must be linked to the promotional activity. However, to avoid creating an incentive for promoters to attempt to characterise scheme profits as something else (such as professional fees for advice), no specific types of remuneration are excluded. (Provision of professional advice is dealt with from paragraph 3.49.)

What is a substantial role?

3.46 Numerous entities may participate in the promotion of a tax exploitation scheme. However, not all of these will be liable to a penalty, because only promoters who receive financial rewards from promotional activity and who also have a *substantial* role will satisfy the criteria for being a promoter under the civil penalty provisions.

3.47 Whether a particular promoter has a *substantial* (considerable or large) role will turn on the facts of the case, having regard to all matters the Federal Court thinks relevant. [Schedule 3, item 1, paragraph 290-60(1)(c)]

3.48 The matters that are relevant in this context are determined by the subject matter, scope and purpose of the provisions. They would include, for example, the degree of involvement of the relevant entity in the activities whereby the scheme was marketed or encouraged, the significance of that entity's role compared to the role played by others in those activities (ie, someone who plays a key role in devising the scheme

and giving instructions to others in the course of its establishment and implementation will have a more significant role than someone who merely acts in accordance with those instructions), the nature and level of the consideration received by the entity in respect of the scheme, and the degree of the entity's participation in the management of the marketing or encouraging of the scheme.

Advisers

3.49 An entity is not a promoter merely because they provide advice about the scheme. As a result, financial planners, tax agents, accountants, legal practitioners and others are not promoters merely because they provide advice about a tax exploitation scheme, even if that advice provides alternative ways to structure a transaction, or sets out the tax risks of the alternatives. [*Schedule 3, item 1, subsection 290-60(2)*]

3.50 The civil penalty regime is not intended to inhibit the provision of independent and objective tax advice, including advice regarding tax planning. Advisers who advise on tax planning arrangements, even those who advise favourably on a scheme later found to be a tax exploitation scheme, are not at risk of civil penalty to the extent that they have merely provided independent, objective advice to clients.

Example 3.1: When are tax advisers at risk of being promoters?

A partner (Graeme) in a major accounting firm approaches a high wealth client (Matthew) to advise him on an arrangement to minimise his tax liability by moving taxable income to an offshore tax haven.

The tax haven arrangement was initially developed by another partner (Brett) for another of the firm's clients and the firm decided it should offer similar arrangements to other clients in similar circumstances.

Brett receives a fixed percentage of the fee obtained by other accountants in the firm who offer the arrangement to other clients. The other partners — including Graeme — who offer the scheme to clients receive a fee that is significantly higher than the billing rate for routine tax advice and that partly reflects the magnitude of the tax savings for scheme participants.

Graeme is able to persuade Matthew to adopt the tax haven arrangement because Matthew will be paying much less tax. Graeme puts in place the offshore financial facilities to enable Matthew not to declare income in Australia.

Matthew then tells his friend Barbara about his offshore tax arrangements and Barbara takes the initiative to contact the accounting firm mentioned by Matthew. Graeme is not taking on new clients and therefore Barbara goes to Deborah, in another firm.

Deborah explains to Barbara how the offshore tax haven works, including the tax risks involved. Deborah bills Barbara her usual fee for advice.

In this example, Graeme and Brett would be likely to satisfy the criteria for being a promoter. This is because they have played a substantial role in marketing the scheme and encouraging client interest, and have also received consideration related to their promotional role. Deborah is not a promoter because she has only advised her client and would qualify for the advice exception.

Employees

3.51 Employees are not taken to have a substantial role in respect of the marketing and encouragement of a scheme merely because they distribute information or material prepared by another entity (who may be their employer) [*Schedule 3, item 1, subsection 290-60(3)*]. There are several other measures in the civil penalty regime to protect employees of entities. Subsection 290-55(1) provides an exception for reasonable mistake or reasonable precautions (discussed in paragraph 3.31), subsection 290-55(7) provides an exception for an employee with no reasonable knowledge that their actions would result in unlawful conduct (discussed in paragraphs 3.37 and 3.38) and subsection 290-55(8), which provides that no action will be taken against an employee where the employer has been ordered to pay a penalty (discussed in paragraph 3.39).

Example 3.2: Are employees promoters of their employer's scheme?

An investment bank develops a loan package for clients who wish to borrow money for both private and investment purposes. The loan is based on clients claiming tax benefits not available in normal financing arrangements.

The bank approves the marketing of the product and arranges for an information package to be prepared for investment consultants in bank branches, outlining the advantages of the product over standard loan products and the types of customers to whom the product should be offered. The branch consultants receive performance bonuses related to sales of all investment products.

When borrowers claim tax benefits, those benefits are disallowed by the Commissioner, who issues Part IVA (anti-avoidance) determinations in respect of these financial products. The Federal Court upholds these determinations.

In this example, irrespective of whether the bank is found to have promoted a tax exploitation scheme, the consultants in the bank branches can rely on the employee exclusion (and/or the advice exclusion) to protect them from civil penalty.

What is a tax exploitation scheme?

3.52 Tax exploitation schemes are schemes that exploit the tax system through avoidance or evasion. The terms and concepts used to define a tax exploitation scheme in this Bill are taken from the anti-avoidance provisions of the ITAA 1936, the ITAA 1997 and the TAA 1953. These terms and concepts are well established in case law and administrative practice.

3.53 There are two preconditions for a tax exploitation scheme or a scheme that, if implemented, would be a tax exploitation scheme. At the time the scheme is promoted:

- it must be reasonable to conclude that an entity that entered into or carried out the scheme has a sole or dominant purpose of getting a scheme benefit; and
- it must not be reasonably arguable that the scheme benefit is available under the tax laws.

[Schedule 3, item 1, section 290-65]

3.54 Both these tests are to be applied at the time of the promotion by the entity. That entity is not liable for penalty if, at some time *after* the promotion of the scheme, another entity alters that scheme and uses it for tax avoidance in a way not intended or foreseen by the entity who first promoted the scheme.

Example 3.3: A promoter not liable for a different scheme or purpose

A financial institution offers a range of loan products tailored to different circumstances. One of its products is designed to minimise the risk exposure of investors, albeit at a lower return.

Brian, a promoter of a managed agricultural investment scheme decides to utilise this low-risk financing package for scheme investors. The financing package enables taxpayers to claim losses as tax deductions, even though they are not carrying commercial risks. Investors have their tax benefits denied, with the Commissioner relying on Part IVA of the ITAA 1936 and pointing to the nature of the low-risk financing arrangements as the distinctive tax avoidance feature.

In this example, the financial institution is not a promoter of a tax exploitation scheme. The institution offered an arrangement designed to be used in legitimate commercial situations. It was not reasonable to conclude that anyone entering into this arrangement would do so predominantly for tax avoidance purposes.

Note that the use of the financing product in connection with a managed agricultural investment scheme constitutes a completely separate scheme or arrangement that was not promoted by the financial institution. Brian may be a promoter of such a tax exploitation scheme.

The sole or dominant purpose test

3.55 The purpose tests in paragraph 290-65(1)(a) is modelled on the tests that apply to taxpayers in the scheme penalty provisions in subsection 284-145(1) of Schedule 1 to the TAA 1953.

3.56 Subdivision 284-C provides for penalties for taxpayers involved in a tax avoidance or evasion scheme, including taxpayers who claim scheme benefits and have those benefits disallowed under the general anti-avoidance rule (Part IVA of the ITAA 1936).

3.57 The use of the terminology in Subdivision 284-C in this Bill, including the requirement that it is reasonable to conclude that participants enter into or carry out the scheme with the sole or dominant purpose of receiving a scheme benefit, incorporates into the definition of 'tax exploitation scheme' the precondition that the scheme involves tax avoidance or evasion.

3.58 This approach helps ensure that promoters are generally at risk of penalty when taxpayers are at risk of penalties for participation in tax avoidance or evasion schemes under Subdivision 284-C. However, whereas taxpayers are only subject to scheme penalties *after* the event, the definition of 'tax exploitation scheme' operates where the Commissioner takes action against a scheme *before* taxpayers have entered into that scheme. Accordingly, the Federal Court may postulate a hypothetical purpose where the Commissioner makes an application before the scheme has been implemented. [*Schedule 3, item 1, subparagraph 290-65(1)(a)(ii)*]

3.59 **Scheme benefit** is defined in subsection 284-150(1) of Schedule 1 to the TAA 1953. An entity gets a scheme benefit if a tax-related liability is less than it would be, or a tax credit is more than it would be, for an accounting period, apart from the scheme or part of the scheme.

3.60 **Scheme** is defined in subsection 995-1(1) of the ITAA 1997 as:

- any arrangement; or
- any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise.

3.61 **Arrangement** is similarly defined broadly in subsection 995-1(1) as any arrangement, agreement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable, or intended to be enforceable, by legal proceedings.

3.62 The definition of ‘scheme’ in the ITAA 1997 is substantially the same as the definition of scheme in section 177A of the ITAA 1936.

When is it not reasonably arguable that a scheme benefit is available at law?

3.63 For a scheme that has been implemented, a condition for the penalty is that it is not *reasonably arguable* that the scheme benefit is available under the tax laws at the time the promotional conduct takes place. [*Schedule 3, item 1, subparagraph 290-65(1)(b)(i)*]

3.64 For a scheme that has not been implemented, it is a condition that it is not *reasonably arguable* that the scheme benefit would be available at law if the scheme were to be implemented. [*Schedule 3, item 1, subparagraph 290-65(1)(b)(ii)*]

3.65 A promoter’s liability to penalty is independent of any action that may be taken against scheme participants. The test of whether it is reasonably arguable that a scheme benefit is available at law is applied when the promoter’s conduct takes place, and not with the benefit of hindsight once the review and appeal rights for scheme participants have been exhausted.

3.66 When examining what is reasonably arguable at the time of the promoter’s conduct, the Federal Court may take into account anything that the Commissioner can do under a taxation law, including issuing a determination under Part IVA of the ITAA 1936 or exercising a discretion. [*Schedule 3, item 1, subsection 290-65(2)*]

Example 3.4: Not reasonably arguable at the time of the promotion

A large wholesaling operation is advised by its accountant (Naomi) of a method of valuing trading stock that will considerably reduce the company’s tax liability. Naomi obtains a favourable legal opinion from a respected tax counsel (Rona Silk SC) that the valuation method she is proposing is allowed under the tax laws.

Naomi makes a compelling presentation to the company’s Board of Directors focusing on the tax savings that will flow from this new method. The company’s Chief Financial Officer (Gavin) recommends to the Board the adoption of the trading stock valuation proposal presented by Naomi. The Board is impressed with the potential tax savings and is reassured by the legal opinion about the scheme.

The company's financial position improves significantly because of the tax savings from the trading stock arrangement and Gavin gets a bonus based on the company's good financial performance. Naomi gets remuneration based on the tax savings from the scheme she has prepared for the company. Rona received a professional fee based on her normal billing rate.

Some years later, the Commissioner disallows the tax benefits claimed under Part IVA of the ITAA 1936. The company challenges the Part IVA determination in the Federal Court and loses; however, it is clear from the split decision in the case and the reasons that it was a *close call* and that Rona's opinion was not seriously flawed.

In this example, it is likely that none of the people named will be liable for civil penalties as promoters of a tax exploitation scheme. Naomi could rely on an argument that it was *reasonably arguable* that scheme benefits were available at the time of her promotion. Rona is able to rely on the adviser's exception since she did no more than provide a legal opinion. Gavin did not receive consideration in respect of marketing or encouraging interest in the scheme.

Note that, even if Naomi were a promoter of a tax exploitation scheme, Rona's conduct would not render her liable under the second limb of subsection 290-50(1) because it is not a cause of Naomi being a promoter. To conclude that the second limb is satisfied would subvert the adviser exception, which is not intended.

Effect of rulings

3.67 Where scheme benefits are guaranteed by legally binding rulings from the Commissioner that cover all scheme participants the scheme is not a tax exploitation scheme (because the rulings bind the Commissioner at law to make those benefits available to taxpayers). For additional certainty, this is explained in a note. [*Schedule 3, item 1, subsection 290-65(1), note*]

Implementation of a scheme otherwise than in accordance with its ruling

3.68 If a scheme with a product ruling is not implemented in conformity with its ruling, with potential tax consequences for investors, then a penalty may apply under the second civil penalty provision. [*Schedule 3, item 1, subsection 290-50(2)*]

What is a product ruling?

3.69 A product ruling is a form of public ruling issued by the Commissioner. Product rulings were introduced in 1998 to rule on the availability of tax benefits from particular investment products. The

Commissioner has published information about how and when a product ruling is issued.

3.70 Scheme promoters or implementers can apply for a product ruling. The Commissioner can then issue a product ruling confirming that a tax benefit is available at law provided the scheme is implemented in the manner described to the Commissioner in the ruling application.

3.71 Where a scheme is implemented in a materially different way to that described in its product ruling, there is a risk that investors may lose the protection of the ruling and may have scheme benefits disallowed, and be charged penalties and interest. The second civil penalty provision ensures that the entity responsible for the scheme not being implemented in conformity with its product ruling is at risk of penalty.

Implementing a scheme in a materially different way

3.72 Since product rulings are about tax impact, a *material* difference only arises where there is potential for a different tax outcome for investors. A change in the way the scheme is implemented will not be *materially different* if it is merely a difference in the physical implementation of the arrangement with no potential for a tax impact.

3.73 An example of a non-material difference would be where a plantation scheme installs a drip system for watering seedlings instead of micro-sprayers, on advice from experts that this would result in more efficient irrigation of the plantation. If such a departure from the implementation plan set out in the product ruling application does not impact on the commercial viability of the scheme or on the tax consequences for investors, then it would not constitute a material difference. [*Schedule 3, item 1, subsection 290-50(2), note*]

3.74 It is not necessary that scheme investors have received an *actual* tax outcome different from that outlined in the product ruling for the civil penalty provision to be operative. The Federal Court may decide, on the facts of the case, if there has been a material difference in implementation with *potential* tax consequences for investors.

3.75 A person who is merely employed or contracted to carry out implementation tasks (such as planting seedlings or installing irrigation) at the direction of a scheme manager and without any knowledge of the departure from any relevant product ruling would be protected by the exceptions due to reasonable mistake, or the act or default of another entity or because they could not know the result of their conduct. [*Schedule 3, item 1, paragraph 290-55(1)(b) and subsection 290-55(7)*]

The interaction of civil penalty provisions with other penalty provisions in the tax laws

3.76 The present system of imposing penalties on investors in tax evasion and avoidance schemes set out in Subdivision 284-C of Schedule 1 to the TAA 1953 will not be affected by the introduction of these amendments. The calculation of the penalty payable by the promoter or scheme implementer is not affected by any administrative penalties imposed on taxpayers or on the promoter in their capacity as taxpayer.

3.77 Civil penalty amounts paid under a court order are not deductible for income tax purposes (section 26-5 of the ITAA 1997).

Injunctions

3.78 The Commissioner may apply to the Federal Court for injunctive relief if any entity is engaging, or proposing to engage, in conduct to which the regime applies. Injunctions may be granted, for example, to stop the promotion of a tax exploitation scheme or implementation of a scheme in a way that is materially different from its product ruling (restraining injunction), or to require an entity to do something to remedy a perceived contravention of the law (performance injunction). *[Schedule 3, item 1, section 290-125]*

3.79 Injunctions can be used as an alternative to civil penalty proceedings or in addition to them if the Federal Court considers the circumstances of a case warrant both injunctive relief and a civil penalty order.

3.80 The Federal Court may grant an interim injunction against an entity to stop the promotion or implementation of a scheme when it has not yet fully considered the Commissioner's application for an injunction. *[Schedule 3, item 1, section 290-130]*

3.81 The Federal Court may grant an injunction against an entity on such terms as it thinks appropriate. The Court may grant an injunction restraining an entity from engaging, or continuing to engage, in the promotion of a tax exploitation scheme or implementation of a scheme in a manner materially different from that described in the scheme's product ruling. The Federal Court may grant performance injunctions requiring the entity to do something if it is satisfied that the entity has not done that thing and/or is likely not do the thing required without compulsion. *[Schedule 3, item 1, subsection 290-145(2)]*

3.82 The ability to seek injunctions and interim injunctions allows the Commissioner to take immediate action against scheme promoters and implementers, limiting the period during which Commonwealth revenue

and investors are exposed to potential losses and risks from tax exploitation schemes.

Delay in making a ruling

3.83 A promoter may apply to the Commissioner for a product ruling in relation to the scheme. If the promoter has applied for a product ruling and the Commissioner either fails to make a ruling or fails to advise that he or she declines to make a ruling, the Commissioner cannot apply for an injunction under section 290-125 in relation to the applicant's promotion of that scheme. *[Schedule 3, item 1, section 290-135]*

3.84 The provision dealing with delays in determining product ruling applications ensures that a promoter cannot have the marketing of a scheme stopped (by a Federal Court injunction) merely as a result of delays by the ATO in processing a request for a product ruling.

3.85 Until the ruling is granted or denied, the scheme promoter may promote the scheme without being at risk of an injunction (although the promoter would be wise not to implement the scheme, as the Commissioner will not generally issue a product ruling on a scheme that has already been implemented). However, if the Commissioner declines to make a ruling and notifies the promoter, and the promoter continues to promote the scheme, the Commissioner may then take action.

Discharge of injunctions

3.86 The Federal Court may discharge or vary an injunction, at any time. *[Schedule 3, item 1, section 290-140]*

Certain limits on granting injunctions are not to apply

3.87 The Federal Court has broad discretion to grant restraining or performance injunctions. *[Schedule 3, item 1, section 290-145]*

Other powers of the Federal Court are unaffected

3.88 The powers conferred on the Federal Court under this Bill do not limit or replace any other powers of the Federal Court. *[Schedule 3, item 1, section 290-150]*

Voluntary undertakings

3.89 The Commissioner may enforce a voluntary undertaking through an application to the Federal Court. *[Schedule 3, item 1, subsection 290-200(3)]*

3.90 A voluntary undertaking is a written undertaking given to the Commissioner in connection with a matter for which the Commissioner has a function or power. Enforcement is confined to voluntary undertakings given in furtherance of the purpose of this Bill — that is, to deter the promotion of tax exploitation schemes and the implementation of schemes in ways that do not conform to their product rulings. [*Schedule 3, item 1, subsection 290-200(1)*]

3.91 Voluntary undertakings allow the Commissioner to tailor enforcement responses to individual circumstances. They also result in outcomes that are more flexible, timely and cost-effective than would normally be achievable by injunction or penalty proceedings. They may be used as a preliminary step to prevent an entity from implementing an arrangement in a way that is materially different to the terms of the applicable product ruling. An undertaking may provide a timeframe for compliance with the undertaking.

3.92 Undertakings may be varied or withdrawn at any time, but only with the consent of the Commissioner. [*Schedule 3, item 1, subsection 290-200(2)*]

3.93 The Commissioner cannot compel an individual to give an undertaking. Equally, the Commissioner cannot be compelled to accept an undertaking. The Commissioner is under no legal obligation to explore the possibility of obtaining a voluntary undertaking before proceeding to injunction or penalty proceedings under this regime. However, in practice he or she is likely to do so in the majority of cases.

3.94 A voluntary undertaking can be made without either party admitting any liability.

3.95 If an entity breaches its undertaking, the Commissioner can apply to the Federal Court. The Court may issue an order directing the entity to comply with the undertaking, or any other order that it considers appropriate. [*Schedule 3, item 1, subsections 290-200(3) and (4)*]

Other civil procedure rules

3.96 This Bill incorporates standard civil penalty procedural provisions in the TAA 1953 that would also apply to any future civil penalties introduced to the tax laws.

3.97 The Federal Court must apply the rules of evidence and procedure for civil matters when hearing civil penalty proceedings under these provisions. [*Schedule 3, item 2, section 298-85*]

3.98 The Federal Court cannot make a civil penalty order against a scheme promoter or implementer if they have been found guilty of a criminal offence with respect to the conduct for which the civil penalty order would be made. *[Schedule 3, item 2, section 298-90]*

3.99 Criminal proceedings may be started against a scheme promoter or implementer for the same conduct for which a civil penalty order could be, or has been, made. *[Schedule 3, item 2, section 298-100]*

3.100 If criminal proceedings — for an offence constituted by conduct that might also be the subject of civil penalty proceedings — could commence, or have already commenced, the civil proceedings must be stopped. If the promoter or implementer is not convicted of the offence, the civil penalty proceedings may be resumed. If the promoter or implementer is convicted of the criminal offence, the civil penalty proceedings will be dismissed. *[Schedule 3, item 2, section 298-95]*

3.101 If there are criminal proceedings against an entity in relation to conduct that is also the subject of civil penalty proceedings, evidence given in the civil proceedings is not admissible in the criminal proceedings. *[Schedule 3, item 2, section 298-105]*

Civil double jeopardy

3.102 An entity that is ordered by the Federal Court to pay a civil penalty for a breach of these provisions is not liable to a civil penalty under some other provision of a Commonwealth law in respect of the same conduct. *[Schedule 3, item 2, section 298-110]*

Application and transitional provisions

3.103 The regime will apply to promoters of tax exploitation schemes offered to entities on or after the date of Royal Assent. The regime will apply to entities that implement a scheme in a materially different way to its product ruling on or after the date of Royal Assent. *[Schedule 3, item 17]*

Consequential amendments

3.104 Three new terms are included in the Dictionary (subsection 995-1(1) of the ITAA 1997), namely:

- ‘product ruling’ (a public ruling under the TAA 1953 that is stated to be a product ruling);

- ‘promoter’ (as defined in this Bill); and
- ‘tax exploitation scheme’ (as defined in this Bill).

[Schedule 3, items 3 to 5]

3.105 As this Bill introduces a civil penalty regime into the TAA 1953, certain notes and headings in the TAA 1953 must be amended to include a reference to the new civil penalties. *[Schedule 3, items 6 to 8, 11 to 13 and 16]*

3.106 Civil penalties under this regime are not tax-related liabilities, in contrast to other liabilities arising under the tax laws. For this reason, it is necessary to exclude the civil penalties in this Bill from the general rule in section 255-1 of the TAA 1953 which characterises pecuniary liabilities arising under a taxation law as tax-related liabilities. *[Schedule 3, items 9 and 10]*

3.107 Item 2 of this Bill amends Division 298 of the TAA 1953, which currently only covers administrative penalties. Accordingly, it is necessary to convert the existing administrative penalty provisions into a new Subdivision 298-A. *[Schedule 3, items 14 and 15]*

REGULATION IMPACT STATEMENT

Policy objective

3.108 The main objective is to deter the promotion of tax avoidance and tax evasion schemes. An additional objective is to enhance the integrity of the product ruling system by deterring implementation of a scheme in a materially different manner to that described in its product ruling where doing so may have potential tax consequences for investors.

Implementation options

Preferred option

Penalty provisions

3.109 This measure will amend the taxation laws to introduce a civil penalty regime to apply to an entity, including an individual, that:

- is a promoter of a tax avoidance or tax evasion scheme; or

- implements a tax scheme that has been promoted as having a taxation product ruling, but in a materially different way to that described in its product ruling, with the potential for a different tax outcome for investors.

3.110 The maximum penalty the courts may impose is the greater of:

- 5,000 penalty units (currently \$550,000) for an individual, 25,000 penalty units (currently \$2.75 million) for a corporation; and
- twice the consideration received directly, or indirectly, by the entity in respect of the scheme.

3.111 The Federal Court has discretion to impose whatever penalty is regarded as appropriate in the circumstances. Where a promoter has received scheme profits in excess of the prescribed penalty units, the Federal Court can impose a penalty of up to twice the consideration received to ensure that the penalty has its intended deterrent effect.

Supplementary measures

3.112 Additional remedies of enforceable voluntary undertakings and statutory injunctions will be available to the Commissioner. This will enable a graduated preventative enforcement response to emerging schemes that appear to be ineffective. Some potential breaches of the law may be able to be addressed quickly and at low cost through a promoter giving voluntary undertakings to remedy any shortcomings in a scheme. Higher risk cases may warrant an application to the court for an injunction, involving short delays and some compliance costs. Serious cases may warrant penalty proceedings that can involve substantial legal costs for the parties involved.

3.113 The Commissioner cannot apply for a statutory injunction where an entity has applied for a product ruling in relation to a scheme until the Commissioner has either made the ruling or informed the entity in writing that the Commissioner has declined to make the ruling.

3.114 The Federal Court may require the Commissioner to give an undertaking as to damages as a condition of granting an interim injunction.

Exceptions to penalty and/or injunction

3.115 There are exceptions to penalty and/or injunctions to ensure that certain individuals and entities are not inadvertently caught by the regime. This includes special exceptions for:

- reasonable mistakes of fact or causes beyond the entity's control (provided the entity took reasonable precautions and exercised due diligence to avoid the conduct);
- reliance on advice from, or on behalf of, the Commissioner;
- certain entities who did not know, and could not reasonably be expected to have known, that their conduct would result in a contravention of the law;
- employees, where they are merely distributing information provided by someone else or where their employer has been penalised for the same scheme;
- financial planners, tax agents, accountants and lawyers and others who merely provide advice about a scheme; and
- scheme promoters who have sought a product ruling from the Commissioner but have not been notified of an outcome (with the protection ceasing to apply once they are notified of an outcome).

3.116 These exceptions protect entities in the specified circumstances so that the focus of court action can be on the active promoters of tax exploitation schemes and not those whose conduct is peripheral to the promotion of tax exploitation schemes. In particular, it is not intended that the regime will deter the giving of tax advice — even where that advice might mistakenly endorse a scheme that is subsequently found to be a tax exploitation scheme. This is because the regime seeks to deter the promotion of tax exploitation schemes, not to deter the giving of advice about those schemes. However if tax advisers encourage their clients to enter a particular scheme, and receive consideration in respect of that encouragement, they will not be covered by the adviser exception.

Time limitations

3.117 Except where fraud or evasion is involved (in which circumstances taxpayers are also at risk indefinitely), the Commissioner cannot institute action under the promoter penalties regime more than four years after the entity last engaged in the conduct proscribed by the civil penalty provisions. This period mirrors the period for which taxpayers are at risk of amended assessments and penalties for participation in a tax avoidance scheme.

Who is a promoter?

3.118 Generally, there are several parties involved in the development and implementation of schemes. For the purposes of the penalty regime, an entity, which can be an individual, will be a promoter of a particular tax avoidance or tax evasion scheme if:

- the entity markets the scheme or encourages the growth of, or interest in, the scheme;
- the entity receives consideration in respect of that marketing or encouragement; and
- it is reasonable to conclude that the entity has had a substantial role in that marketing or encouragement.

3.119 The penalty provision for promotion of a tax exploitation scheme will only apply to promoters who satisfy all of these three criteria, or whose conduct results in another entity satisfying these criteria, as well as the conditions for a tax exploitation scheme, discussed below.

What is a tax exploitation scheme?

3.120 For a scheme to be characterised as a tax exploitation scheme, it must meet two basic conditions at the time the scheme was promoted:

- It must be reasonable to conclude that participants have a sole or dominant purpose of obtaining a tax benefit — this is tantamount to a sole or dominant tax avoidance or tax evasion purpose.
- It is not reasonably arguable that the tax benefit sought is available at law.

3.121 The test as to whether the scheme benefit is available at law is satisfied where the Commissioner has issued a binding ruling, such as a public ruling, or a product ruling, in relation to the scheme.

3.122 Scheme benefits are considered unavailable at law where it is reasonable to conclude the Commissioner would invoke anti-avoidance provisions to cancel claimed benefits.

Alternative options

3.123 Consideration was given to amending the taxation laws to allow the Commissioner to impose administrative penalties on promoters. Having the Federal Court determine whether promotion of tax schemes was unlawful and then setting an appropriate civil penalty was considered a fairer and more objective process and justified on the basis of the expected likely use.

3.124 It would be possible to supplement the civil penalty regime by introducing additional record-keeping and reporting requirements. This could include requiring promoters to report certain tax effective schemes to the Commissioner and to keep additional records in relation to financing arrangements and investor details. These requirements were considered to involve unduly high compliance costs for promoters. There were also privacy concerns over the information collected and held by the promoters.

Assessment of impacts

Impact group identification

Impact groups affected by the penalty proposal

3.125 The regime will have little impact on promoters and investors involved in tax effective schemes that are within the tax laws. Many tax schemes are now marketed with a taxation product ruling and are implemented in conformity with that ruling. In such circumstances, there will be no risk of penalty under the regime and there will be no additional compliance costs.

3.126 Investors in tax avoidance and tax evasion schemes will still be required to pay back any tax shortfall, any penalties incurred as well as applicable interest charges for late payment. However, the introduction of the civil penalty regime — and particularly the injunction and undertakings remedies — should reduce the number of ineffective schemes being promoted, and thus decrease the likelihood of investors incurring such shortfalls.

3.127 Advisers such as financial planners, accountants, tax agents and lawyers who merely give tax advice are not at risk under the new regime. Nonetheless, they may need to familiarise themselves with the new law to ensure they do not *cross the line* from advice to promotion. However, awareness of the law is not anticipated to involve significant costs for advisers that are small businesses since the concepts on which the measure is based either currently exist in the tax law, or are of a non-technical nature. Furthermore, their representative organisations have been active in the consultation process on this measure and have encouraged a high level of awareness of the new law.

3.128 Promoters of tax avoidance and tax evasion schemes and entities who implement schemes not in conformity with a product ruling will now be financially *at risk* for any unlawful behaviour under the new measures.

Analysis of costs / benefits

Compliance costs

3.129 The implementation of this measure will not impose any additional compliance costs on investors.

3.130 Promoters of schemes offering tax benefits that are available at law, including schemes that have product rulings, will not need to incur additional compliance costs. It is relevant that many promoters now recognise that a tax product ruling offers significant marketing advantages for a scheme.

3.131 Promoters of high risk schemes who wish to preclude the risk of penalty may seek a product ruling or a class ruling from the Commissioner, or may encourage investors to seek private binding rulings, or may seek advice directly. In this context, it is important to note that no charges are imposed by the Commissioner for rulings or advice. Any costs involved in obtaining a ruling will arise in the preparation of an application for a ruling. The ATO has published on its website a checklist of information that is to be provided in a product ruling application.

3.132 Promoters hold all the information required to apply for such rulings. There will be some costs incurred by promoters in the lodgement of requests for a taxation product ruling. The level of costs incurred in applying for a ruling will depend on the complexity of the arrangements, and whether promoters prepare ruling applications themselves or engage professional advisers to obtain a ruling on their behalf. No quantitative information is available on typical costs incurred in preparing a ruling application, nor on the number of additional promoters that might seek a ruling as a result of the civil penalty regime. It is assumed a ruling will only be sought where a promoter identifies a net benefit in doing so. Product rulings offer marketing advantages as they provide certainty to investors; the costs involved in obtaining a product ruling need to be seen in this context as well as in the risk management context.

3.133 There may be some small transitional costs for tax advising firms who are in the business of promoting legitimate tax minimisation schemes. These firms will need to acquire an understanding of the new law to manage their exposure to promoter penalties. These costs have not been able to be quantified. However, as mentioned above, the high level of awareness of the measure generated in extended consultation on the draft legislation and the use of existing tax terminology is likely to minimise such costs.

Administration costs

3.134 The implementation of this measure will give rise to an increase in ongoing administration and enforcement costs for the ATO in the order of \$7.6 million per year, plus \$1.5 million start-up costs for systems modification and legal advice, all of which will be absorbed by the ATO within its existing budget.

Government revenue

3.135 The financial impact of this measure is estimated to result in a gain to the revenue of \$15 million in the 2007-08 income year, \$25 million in the 2008-09 income year, and \$35 million in the 2009-10 income year, assuming a start date of 1 July 2006. These estimates are based solely on the anticipated deterrent effect of the regime.

Economic and social benefits

3.136 The introduction of a penalty regime will remedy an existing asymmetry in the risks faced by scheme promoters and investors. By putting promoters *at risk* financially for the promotion of ineffective tax schemes, rather than allowing all risks to be passed on to investors, the market for investment schemes is likely to operate more efficiently, with the potential for investment capital to be redirected to legitimate and productive investments.

3.137 It is envisaged that the introduction of a penalty regime for promoters of tax avoidance and tax evasion schemes will enhance confidence in the integrity of Australia's taxation system, with potential flow-on benefits for tax compliance.

Consultation

3.138 In late 2001 the ATO held a number of consultative meetings with tax practitioners and industry groups to discuss possible measures to address the promotion of tax avoidance schemes. There was broad support from tax practitioners and industry groups for effective sanctions against promoters of such schemes.

3.139 There was consensus that any proposal should be designed to avoid adverse impacts on genuine commercial arrangements or legitimate investment products, that any reporting obligations be designed to target mischievous arrangements, and that compliance costs be kept to a minimum.

3.140 The Government announced in December 2003 that it would introduce a new civil penalty regime to deter the promotion of tax avoidance and tax evasion schemes. Treasury undertook consultation throughout most of 2005 on draft legislation to give effect to this measure.

3.141 The Treasury consultation process included:

- confidential consultation with representatives of the tax-advising professions and scheme promoters on an exposure draft and explanatory material in February and March 2005, culminating in a roundtable discussion held on 16 March 2005. Treasury received over 20 written submissions on the exposure draft;
- a round of public consultation, announced by the then Minister for Revenue and Assistant Treasurer in a press release dated 10 August 2005. There were more than 20 submissions received for this round of consultation which officially closed on 2 September 2005 (but submissions continued to be received after that date); and
- further confidential targeted consultation as directed by the then Minister.

Themes and outcomes of consultation

3.142 A key concern in consultation was that the promoter penalties regime had not been confined to the promotion of mass-marketed schemes and would catch promoters of *boutique* tax exploitation schemes, including those designed for only one client. The Government's policy objective to deter all forms of scheme promotion could not be effectively achieved by restricting the regime to mass-marketed schemes.

3.143 Apart from the scope of the regime to include all tax exploitation schemes, the most contentious issues were the definitions of 'promoter' and 'tax exploitation scheme' that govern the scope of the main penalty provisions. To address concerns raised in consultation, the definitions were refined as follows:

- design and implementation functions were taken out of the definition of 'promoter', leaving the more active promotional functions of *marketing and encouragement*;
- for the purposes of determining if someone is a promoter, the consideration they receive has been confined to *consideration in respect of promotion* of the scheme;
- the promoter must have a substantial *promotional* role and not just a substantial role in relation to a scheme;
- it must be reasonable to conclude at the time of promotion that participants in a scheme have a sole or dominant *purpose* of obtaining a tax (scheme) benefit for there to be a tax exploitation scheme; and
- a scheme is not a tax exploitation scheme if it is *reasonably arguable* (at the time of promotion) that scheme benefits are available to investors, regardless of whether those benefits are eventually found to be available at law.

3.144 There were also concerns about employees of entities promoting schemes and tax agents and other advisers who merely give advice to their clients, often on the basis of material prepared by others, or who could not reasonably have been expected to know that their conduct would result in promotion. Employees and advisers have been given special exceptions in the law.

3.145 Clarity has also been provided in the new law about the concept of ‘materially different’ which is important for the second penalty provision of implementing a scheme not in conformity to its product ruling. This addressed a concern of scheme promoters who operate with product rulings.

3.146 Numerous other small changes to the exposure draft and the explanatory material were made in response to concerns raised during consultation.

Conclusion and recommended option

3.147 The introduction of a civil penalty regime to deter the promotion of tax exploitation schemes is expected to enhance community confidence in the tax system and produce a more efficient market for investment products, including tax effective investments, by providing for promoters to be at risk of penalties when they expose taxpayers to scheme penalties. This measure will not impose significant administrative or compliance costs on legitimate business arrangements and may assist them to compete for investment funds.

3.148 The civil penalty regime is preferred to the options of administrative penalties and increased reporting / disclosure requirements because it is a more targeted and transparent measure that provides for substantial remedies to be imposed by the Federal Court against illegitimate promoters, while imposing low or no compliance costs on legitimate businesses.

3.149 The Treasury and the ATO will monitor this measure, as part of the whole taxation system, on an ongoing basis. In addition, the ATO has consultative arrangements in place to obtain feedback from professional and business associations through other taxpayer forums.

Chapter 4

Goods and services tax and vouchers — prepaid phone products

Outline of chapter

4.1 Schedule 4 to this Bill amends the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act) to ensure that prepaid phone cards or facilities are treated as vouchers for the purposes of Division 100 of that Act. Division 100 will also be amended to clarify that goods and services tax (GST) should be calculated on the stated monetary value of the voucher. A further amendment will also be made to Division 100 to include a rule which simplifies accounting for GST on commissions and similar payments on a supply of a voucher through a distribution chain.

4.2 In addition, this Bill will make an amendment to subsection 29-25(2) of the GST Act to provide an additional circumstance where the Commissioner of Taxation (Commissioner) can determine that GST, input tax credits and adjustments should be attributed to a particular tax period.

Context of amendments

4.3 Under Division 100 of the GST Act, the sale of certain vouchers is not subject to GST, but GST is payable when the voucher is redeemed. This provides an exception to the basic rules of the GST Act under which the sale of a non-Division 100 voucher is taxable, but supplies on redemption of that voucher are not taxable if no additional consideration is provided (paragraph 9-15(3)(a)).

4.4 Division 100 operates so that instead, GST is payable at the time the voucher is redeemed for goods or services. This treatment applies because generally the tax status of the underlying supplies is unknown at the time the voucher is issued and the supply of the underlying goods or services could be GST-free, input taxed or taxable. For example, a prepaid phone card or facility could be redeemed for both taxable and GST-free supplies.

Meaning of voucher

4.5 The existing law is unclear on whether certain prepaid phone cards or facilities are eligible ‘vouchers’ for the purposes of Division 100. The Australian Taxation Office has expressed its view in GST Ruling 2003/5 on the existing law that not all prepaid phone products are eligible Division 100 vouchers.

4.6 When the GST was introduced it was intended that all prepaid phone cards be treated as vouchers. This is because the GST status of the underlying supply is not known until redemption of the card. If these products are not treated as eligible vouchers it would be necessary for suppliers to make adjustments if the product has been redeemed for supplies that are GST-free or input taxed. Suppliers and their distributors would incur additional compliance costs in maintaining a different accounting system for these products.

Amount of GST to be remitted on redemption of a voucher

4.7 Division 100 is intended to apply so that, on redemption of a voucher, the supplier of the goods or services is required to remit GST calculated on the stated monetary value on the voucher. The monetary value may be stated on the voucher or in documents accompanying the voucher. If, on redemption of the voucher, the supplier of the goods and services did not remit GST based on the stated monetary value, any value added by distributors of vouchers, initially supplied to them at an amount less than the value stated on the voucher, would not be subject to GST.

4.8 For example, an issuer of the voucher sells a voucher with a stated monetary value of \$44.00 to a retailer for \$33.00 and the retailer subsequently sells the voucher to the consumer for \$44.00. On the basis that all supplies on redemption are taxable supplies, GST should be paid on the \$44.00 worth of goods and services purchased by the consumer on redemption of the voucher (which is also the amount received by the retailer) rather than the \$33.00 that has been received by the issuer. The entity making the taxable supply of the goods or services is liable for the GST. The difference between the monetary value (\$44.00) and the amount paid by the retailer (\$33.00) may represent either the mark-up by the retailer or a commission paid by the issuer of the voucher to the retailer.

4.9 Section 100-15 of the GST Act sets out the increasing adjustment that is required to account for GST that becomes payable on any voucher that is wholly or partly unredeemed. If GST is remitted on the monetary value stated on a voucher then any increasing adjustment that may be required on the unredeemed or partly redeemed voucher should be based on the monetary value stated on the voucher.

Accounting for GST on Division 100 vouchers

4.10 The GST law currently applies so that where a Division 100 voucher such as a prepaid phone card or facility is provided through a distribution network, retailers/distributors are required to remit GST on any commission or similar payment and the supplier of the voucher can claim a corresponding input tax credit. An arrangement under Subdivision 153-B of the GST Act which applies to simplify accounting for GST between principals and agents is not operative for Division 100 vouchers as the effect of the arrangements only applies to taxable supplies. In the example outlined in paragraph 4.8, where the difference represents a commission, a retailer/distributor is required to remit GST of \$1.00 on the commission of \$11.00 and the supplier of the voucher can claim a corresponding input tax credit of \$1.00. This requirement can result in significant compliance costs, in particular where there are thousands of distributors and retailers of Division 100 vouchers.

GST attribution rules

4.11 Section 29-25 of the GST Act sets out circumstances when the Commissioner may determine special rules for when GST, input tax credits and adjustments should be attributed to a particular tax period.

Summary of new law

4.12 This Bill amends the GST law to ensure that prepaid phone cards or facilities are eligible ‘vouchers’ for the purposes of the GST Act and also to clarify that GST should be calculated on the monetary value stated on a voucher or in accompanying documents.

4.13 In addition, subsection 29-25(2) of the GST Act will be amended to provide a further circumstance where the Commissioner can make a determination that GST, input tax credits and adjustments should be attributed to a particular tax period.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Prepaid phone cards or facilities will be treated as eligible vouchers for the purpose of Division 100 of the GST Act.	It was intended that all prepaid phone cards or facilities be treated as eligible vouchers for the purpose of Division 100 of the GST Act. However, this outcome is uncertain.

<i>New law</i>	<i>Current law</i>
This amendment clarifies rather than changes the existing law. Division 100 will be amended to put beyond doubt that GST is to be remitted on the stated monetary value of a voucher.	Division 100 is intended to apply so that when a voucher is redeemed, the supplier of the taxable goods or services is required to remit GST calculated on the stated monetary value stated on the voucher.
This amendment provides a rule which simplifies accounting for GST on commissions where Division 100 vouchers are provided through a distribution chain.	Retailers/distributors of Division 100 vouchers are required to remit GST on any commissions or similar payments made to them and suppliers can claim a corresponding input tax credit.
The Commissioner will be able to determine that GST, input tax credits and adjustments can be attributed to a particular tax period in a further circumstance. That is where a supply or acquisition is made but the GST status will be unknown until a later supply is made.	The GST attribution rules in section 29-25 of the GST Act set out circumstances when the Commissioner can make a determination that GST, input tax credits and adjustments should be attributed to a particular tax period.

Detailed explanation of new law

Definition of voucher

4.14 The definition of ‘voucher’ contained in section 100-25 of the GST Act is amended to ensure prepaid phone products or facilities are included as eligible vouchers for the purposes of Division 100. [*Schedule 4, item 14, subsection 100-25(1)*]

4.15 A ‘prepaid phone card or facility’ is defined to include any article or facility that is supplied on a prepaid basis for the primary purpose of enabling the holder to use telephone or like services, or to make acquisitions that are facilitated by using telephone or like services [*Schedule 4, item 14, subsection 100-25(2)*]. ‘Like services’ are intended to include services such as mobile phone messaging services (short message service (SMS) or multimedia messaging service (MMS)), text, graphics, images, sound, video, information, software content and data transmission services (including email) and Internet access services.

Example 4.1

A prepaid phone card for a mobile phone includes a facility which allows soft drink products to be purchased through a vending machine by making a phone call. The cost of the soft drink is deducted from the prepaid phone card account. Even though the prepaid phone card may also be used to acquire supplies other than telephone or like services it is an eligible Division 100 voucher if its primary purpose is to enable the holder to use it on a prepaid basis to acquire telecommunications supplies.

4.16 The definition of ‘prepaid phone card or facility’ is intended to cover:

- phone cards sold with an initial store of value for use on payphones or home phones, which may or may not be rechargeable or topped up; and
- prepaid mobile phone cards which are sold with a subscriber identity module (SIM) card or as a bundled kit (eg, mobile handset and SIM card — although it is a mixed supply).

4.17 If a Division 100 voucher is supplied as part of a bundled kit (eg, a mobile handset, a SIM card and an entitlement to telephone or other supplies that are facilitated by the voucher), the supply of the kit is a mixed supply. This means that the consideration for the supply of the kit is apportioned between its taxable and non-taxable components.

4.18 Prepaid phone cards or facilities that have a credit facility (eg, attached to a bank account) are financial supplies and are input taxed under Chapter 3 of the GST Act. These are not eligible vouchers for the purpose of Division 100. As well, a stored value card⁷ linked to an account provided by an Australian authorised deposit-taking institution is not a voucher. Furthermore, a mobile phone account where the user pays a monthly access fee or rental fee in advance and call costs under a ‘plan’ are not covered by this measure.

⁷ The term ‘stored value card’ refers to a product taking the form of a card where value is stored on the card itself. Some stored value cards may be linked to accounts provided by an Australian authorised deposit-taking institution.

GST is to be remitted on the basis of the stated monetary value of the voucher

4.19 This Bill clarifies that when a voucher is redeemed, the consideration is the stated monetary value on the voucher *less* any amounts refunded, *plus* any additional consideration provided for the supply on redemption. If the voucher is only partly redeemed, the consideration for the supply is the amount of the stated monetary value on the voucher that is redeemed when it is used to purchase goods and services *plus* any additional consideration provided. [*Schedule 4, item 9, section 100-12*]

Example 4.2

Michael uses a \$20.00 voucher supplied by a retailer to purchase goods valued at \$17.00. The retailer gives Michael change of \$3.00. The consideration for the supply of goods to Michael is the stated monetary value on the voucher, \$20.00, *less* the refund of \$3.00. The retailer will remit GST of 1/11 of \$17.00.

4.20 For this purpose, the ‘stated monetary value’ means the monetary value stated on the voucher, or documents accompanying the voucher when it is issued [*Schedule 4, item 7, subsection 100-5(2A)*]. If the voucher is a prepaid phone card or facility the stated monetary value is the monetary value stated on the voucher or in documents accompanying the voucher when supplied by the telecommunications provider. If the card is topped up, the stated monetary value includes the topped up amount that has not been redeemed. If a telecommunications supplier makes any bonus supplies such as extra credits, additional time and/or bonus or text messages, (ie, for no additional consideration) the value of these supplies are not included in the stated monetary value [*Schedule 4, item 7, subsection 100-5(2B)*]. The value of bonus supplies will be evident from documentation issued by telecommunications suppliers.

4.21 Where a prepaid phone card or facility can be topped up, the stated monetary value once topped up may not be the same amount as the stated monetary value of the voucher when it was issued.

Example 4.3

Jill purchases a rechargeable prepaid mobile phone card which has a stated monetary value of \$100. Over the period of initial redemption of the card the supplier remits GST on \$100. Once the card is fully redeemed Jill recharges the card to the value of \$80.00 (the ‘topped up’ amount). The stated monetary value of the card is \$80.00. In the relevant tax period, Jill uses the card to make calls within Australia to the value of \$60.00. The supplier of the voucher (the telecommunications supplier) will remit GST on 1/11 of the \$60.00. The unredeemed amount of the card is \$20.00.

Example 4.4

Following from Example 4.3, in the next tax period Jill recharges the card by \$60.00. The stated monetary value of the card is now \$80.00, reflecting the remaining value of supplies that can be obtained under that card.

Example 4.5

A telecommunications supplier, as part of a marketing strategy, provides a customer with bonus credits valued at \$250 if the customer tops up the card for \$50.00. The customer accepts the offer. The stated monetary value of the voucher is \$50.00, not \$300. GST is not payable on redemption for the additional supplies provided by the telecommunications supplier.

4.22 The 'stated monetary value' means the monetary amount explicitly set out on or incorporated on the voucher or in documents accompanying the voucher. A voucher which exists partly in a physical form and partly in an electronic or machine readable form, can still satisfy this requirement. For example, if the voucher exists on a plastic card, the monetary value may be incorporated in a bar code or magnetic strip or on a database maintained by or for the supplier. The bar code, magnetic strip or database may also incorporate the unredeemed value remaining on the voucher including any recharge of that voucher.

4.23 This Bill inserts the word 'fully' into paragraph 100-15(1)(c). This clarifies the intention to apply the section not only where a voucher has not been redeemed at all, but also where a voucher has been partly redeemed. [*Schedule 4, item 11*]

4.24 This Bill also ensures that any increasing adjustment to account for the GST that becomes payable on unredeemed vouchers (or partly redeemed vouchers) is calculated on the stated monetary value of the voucher [*Schedule 4, item 12, subsection 100-15(2)*]. A voucher is considered fully redeemed upon redemption of the stated monetary value of the voucher or top up. (See Example 4.5 — once the customer utilises the first \$50.00 of services available the voucher is considered fully redeemed.)

Example 4.6

Café Piazza sells a \$100 voucher to Patrick in March 2005. The voucher is valid for 12 months from the date of issue. Patrick uses the voucher to acquire goods to a total cost of \$67.00 before it expires in March 2006. When Café Piazza writes back the unused credit of \$33 to current income, there is an increasing adjustment of \$3.00 for GST purposes, that is, 1/11 of \$33.00.

Arrangement to simplify accounting for GST

4.25 This Bill inserts section 100-18 into Division 100 which allows suppliers of Division 100 vouchers and their distributors to voluntarily enter into an arrangement to simplify the accounting for GST. The arrangement will apply so that where a supplier of a voucher enters into an arrangement with a distributor of the voucher, the supply of commission services is not a taxable supply. That is, any commission or similar payment made or payable to the retailer or distributor will not be for a taxable supply. [*Schedule 4, item 13, section 100-18*]

4.26 The effect of treating a commission or similar payment as not being consideration for a taxable supply is that it is not necessary for the distributor or retailer in a distribution chain to remit GST on the services for which the commission or similar payment is consideration, and the supplier of the voucher cannot claim the corresponding input tax credit. The correct amount of GST will be paid as the supplier of the underlying supplies is required to remit GST on the stated monetary value of the voucher. In the example in paragraph 4.8, where the difference represents a commission, the retailer or distributor will not be required to remit GST of \$1.00 on the commission of \$11.00 and the supplier of the voucher will not be able to claim a corresponding input tax credit of \$1.00.

4.27 This arrangement is only available where a voucher is supplied through a distribution chain and the supplier of the voucher is liable to pay a commission or similar payment for on-supplying the voucher. This may include, for example, where under an agreement between the supplier of the voucher and its distributor, the commission is offset against the payment made by the distributor to the supplier where the distributor sells the voucher on behalf of the supplier.

GST attribution rules

4.28 This Bill amends subsection 29-25(2) to provide a further circumstance whereby the Commissioner can determine when GST, input tax credits and adjustments should be attributed to a particular tax period. The Commissioner will be able to make such a determination where a supply or acquisition is made but the GST treatment will be unknown until a later supply is made [*Schedule 4, item 1, paragraph 29-25(2)(h)*]. This circumstance will include where a supply is made through a distribution chain.

Application and transitional provisions

4.29 Items 1, 13 and 18 apply from the date of Royal Assent. *[Schedule 4, subitem 20(1)]*

4.30 Items 2 to 8, 10, 14, 16, 17 and 19 apply from 1 July 2000, the commencement date of the GST. These amendments clarify the operation of the regime and are beneficial to taxpayers. *[Schedule 4, subitem 20(2)]*

4.31 Items 9, 11, 12 and 15 apply to supplies made from 11 May 2005. *[Schedule 4, subitem 20(3)]*

4.32 A transitional rule applies which ensures that suppliers and distributors of Division 100 vouchers who have entered into an agreement (under Subdivision 153-B) that is operative on the date of Royal Assent will be effective or valid in relation to supplies of vouchers made after the date of Royal Assent. *[Schedule 4, item 21]*

Consequential amendments

4.33 Items 2 to 6, 8 and 10 update references to ensure consistency of terminology in Division 100 as a result of the amendments. *[Schedule 4, items 2 to 6, 8 and 10]*

4.34 Items 14 to 19 insert new definitions and update an existing definition in section 195-1 of the GST Act. *[Schedule 4, items 15 to 19]*

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