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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

# TAX LAWS AMENDMENT (PERSONAL TAX REDUCTION AND IMPROVED DEPRECIATION ARRANGEMENTS) 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.

| ***Abbreviation*** | ***Definition*** |
|---|---|
| FBT | fringe benefits tax |
| ITAA 1936 | *Income Tax Assessment Act 1936* |
| ITAA 1997 | *Income Tax Assessment Act 1997* |

# General outline and financial impact

## Reducing personal income tax

Schedules 1 to 4 to this Bill amend the tax laws and the *Medicare Levy Act 1986* to provide changes to personal income tax rates and thresholds, the Low Income Tax Offset, the Medicare levy phase-in rate and the fringe benefits tax (FBT) rate. Schedule 1 also makes a range of consequential amendments resulting from the reduction in the top marginal tax rate.

***Date of effect***: All amendments, except the amendments to the *Fringe Benefits Tax Act 1986* and the *Income Tax (Bearer Debentures) Act 1971*, apply to assessments for the 2006-07 year of income and later years of income.

The proposed amendment to the FBT rate will apply from the year of tax beginning 1 April 2006 and all later FBT years. The amendment to the *Income Tax (Bearer Debentures) Act 1971* applies to interest paid or credited after 30 June 2006.

***Proposal announced***: This measure was announced on 9 May 2006 in the 2006-07 Budget.

***Financial impact***: This measure will have these revenue implications:

| ***2006-07*** | ***2007-08*** | ***2008-09*** | ***2009-10*** |
|---|---|---|---|
| –$6.6 billion | –$9.4 billion | –$10.0 billion | –$10.6 billion |

***Compliance cost impact***: Nil.

## Improved depreciation arrangements

Schedule 5 to this Bill amends Division 40 of the *Income Tax Assessment Act 1997* to increase deductions for the decline in value of depreciating assets under the diminishing value method and project pools.

***Date of effect***: These amendments apply to assets that a taxpayer starts to hold under a contract entered into on or after 10 May 2006, assets that commenced to be constructed on or after that day or assets that a taxpayer starts to hold in some other way on or after that day. It also applies to project pools containing project amounts incurred on or after 10 May 2006 for projects that start to operate on or after that day.

***Proposal announced***: This measure was announced in the Treasurer's Press Release No. 041 of 9 May 2006.

***Financial impact***: This measure will have these revenue implications:

| ***2006-07*** | ***2007-08*** | ***2008-09*** | ***2009-10*** |
|---|---|---|---|
| –$500m | –$900m | –$1,100m | –$1,200m |

***Compliance cost impact***: Expected to be low.

# Chapter 1
# Reducing personal income tax

## Outline of chapter

1.1 Schedule 1 to this Bill amends:

- the *Income Tax Rates Act 1986* to increase the 30 per cent threshold from $21,601 to $25,001; to reduce the second highest marginal tax rate from 42 to 40 per cent and increase the threshold to $75,001; and to reduce the highest marginal tax rate from 47 per cent to 45 per cent and increase the threshold to $150,001.

1.2 Schedule 1 to this Bill also makes consequential amendments resulting from the reduction in the top marginal tax rate.

1.3 Schedule 2 to this Bill amends:

- the *Fringe Benefits Tax Act 1986* to reduce the rate of fringe benefits tax (FBT) from 48.5 per cent to 46.5 per cent.

1.4 Schedule 3 to this Bill amends:

- the Income Tax Assessment Act 1936 (ITAA 1936) to increase the Low Income Tax Offset from $235 to $600 and increase the income threshold from which the tax offset begins to phase-out from $21,600 to $25,000.

1.5 Schedule 4 to this Bill amends:

- the *Medicare Levy Act 1986* to provide an increase in the income threshold that applies to taxpayers who are eligible for a rebate of tax under section 160AAAA of the ITAA 1936 — the Senior Australians Tax Offset — and to reduce the Medicare levy phase-in rate from 20 per cent to 10 per cent, which has flow-on consequences to the calculation of the Medicare levy for families and trusts.

1.6 These tax cuts will mean that more than 80 per cent of taxpayers will be in or below the 30 per cent tax bracket over the forward estimates period. They will provide further incentives for individuals to participate in the workforce and improve the international competitiveness of Australia's tax system.

1.7 The seniors Medicare levy threshold will also increase so that senior Australians do not pay the Medicare levy until they begin to incur an income tax liability.

1.8 There are a range of consequential amendments resulting from the reduction in the top marginal tax rate contained in Schedule 1.

## Summary of new law

1.9 The amendments to the *Income Tax Rates Act 1986* will raise the 30 per cent threshold from $21,601 to $25,001, reduce the top two marginal tax rates to 45 and 40 per cent respectively, and increase the thresholds to which the top two marginal income tax rates apply to $75,001 and $150,001 for resident and non-resident taxpayers.

1.10 The amendments to the ITAA 1936 will provide for an increase in the Low Income Tax Offset and the income threshold from which the Low Income Tax Offset begins to phase-out.

1.11 The amendment to the *Fringe Benefits Tax Act 1986* will reduce the FBT rate from 48.5 per cent to 46.5 per cent and apply to the FBT year of tax beginning 1 April 2006 and later FBT years.

1.12 The amendments to the *Medicare Levy Act 1986* will increase the income threshold that applies to taxpayers who are eligible for the Senior Australians Tax Offset and reduce the Medicare levy phase-in rate from 20 per cent to 10 per cent.

1.13 The consequential amendments reflect the changes to the rates and thresholds.

## Comparison of key features of new law and current law

1.14 The personal income tax rates and thresholds will be increased as follows. For assessments for the 2006-07 year of income:

- the 30 per cent marginal tax rate threshold will rise from $21,601 to $25,001;
- the 42 per cent marginal tax rate will be cut to 40 per cent and the threshold will increase to $75,001; and
- the 47 per cent marginal tax rate will be cut to 45 per cent and the threshold will increase to $150,001.

1.15 The Low Income Tax Offset will increase from $235 to $600 and will begin to phase-out from $25,000.

1.16 The Medicare levy low income phase-in rate will be cut from 20 per cent to 10 per cent, ensuring more low income taxpayers pay a reduced rate of Medicare levy.

1.17 The FBT rate will be cut from 48.5 per cent to 46.5 per cent, effective from 1 April 2006.

1.18 The consequential amendments will reduce taxation rates and thresholds in other specified legislation.

1.19 The Medicare levy threshold for single seniors will also increase from $21,968 to $24,867 from 1 July 2006, so that senior Australians will not pay the Medicare levy until they begin to incur an income tax liability.

## Detailed explanation of new law

### Resident taxpayers

1.20 Item 1 of Schedule 1 to this Bill replaces the table in clause 1 of Part I of Schedule 7 to the *Income Tax Rates Act 1986*, which sets out the rates of tax on the taxable income of a resident taxpayer.

1.21 Table 1.1 sets out the current thresholds for resident taxpayers and the proposed tax thresholds that will apply to assessments for the 2006-07 income year, and later years.

**Table 1.1**

| ***Tax thresholds from 1 July 2005*** | ***Tax rate*** | ***Tax thresholds from 1 July 2006*** | ***Tax rate*** |
|---|---|---|---|
| **Income range($)** | **%** | **Income range($)** | **%** |
| 0 – 6,000 | 0 | 0 – 6,000 | 0 |
| 6,001 – 21,600 | 15 | 6,001 – **25,000** | 15 |
| 21,601 – 63,000 | 30 | **25,001 – 75,000** | 30 |
| 63,001 – 95,000 | 42 | **75,001 – 150,000** | **40** |
| 95,001 + | 47 | **150,001** + | **45** |

## Non-resident taxpayers

1.22 The new income tax thresholds will also apply to non-resident taxpayers.

1.23 Item 2 of Schedule 1 to this Bill replaces the table in clause 1 of Part II of Schedule 7 to the *Income Tax Rates Act 1986,* which sets out the rates of tax on the taxable income of a non-resident taxpayer.

1.24 Table 1.2 sets out the current thresholds for non-resident taxpayers and the proposed tax thresholds that will apply to assessments for the 2006-07 income year and later years.

**Table 1.2**

| ***Tax thresholds from 1 July 2005*** | ***Tax rate*** | ***Tax thresholds from 1 July 2006*** | ***Tax rate*** |
|---|---|---|---|
| **Income range($)** | **%** | **Income range($)** | **%** |
| 0 – 21,600 | 29 | 0 – 25,000 | 29 |
| 21,601 – 63,000 | 30 | **25,001 – 75,000** | 30 |
| 63,001 – 95,000 | 42 | **75,001 – 150,000** | **40** |
| 95,001 + | 47 | **150,001 +** | **45** |

## Increase in the Low Income Tax Offset

1.25 From 1 July 2006, the Low Income Tax Offset will be increased from $235 to $600 per year ***[Schedule 3, item 2]***. In addition, the income threshold from which the tax offset begins to phase-out will be increased from $21,600 to $25,000 ***[Schedule 3, item 2]***.

1.26 As a result of these changes, the maximum amount of Low Income Tax Offset of $600 per year will be available to taxpayers on incomes up to $25,000. The income limit up to which the tax offset can be claimed will increase from $27,475 to $40,000 ***[Schedule 3, item 1]***. Those eligible for the full Low Income Tax Offset will not pay tax until their annual income exceeds $10,000.

### Increase in the Medicare levy threshold for senior Australians

1.27 As a result of the increase in the 30 per cent threshold and the increase in the Low Income Tax Offset (a maximum offset of $600), from 1 July 2006, the income level up to which senior Australians will receive the Senior Australians Tax Offset will increase. This will mean that eligible single senior Australians will not pay tax until $24,867.

1.28 From 1 July 2006, the Medicare levy threshold for single seniors will be increased accordingly from $21,968 to $24,867, to ensure that they do not pay the Medicare levy until they are liable for income tax. ***[Schedule 4, item 2]***

1.29 The phase-in limit where a single senior (eligible for the Senior Australians Tax Offset) does not pay the full Medicare levy rate, has been raised to $29,255. ***[Schedule 4, item 1]***

1.30 Senior couples for whom the $24,867 Medicare levy threshold is not sufficient to ensure that they incur no Medicare levy liability until they incur an income tax liability — for example because one partner earns significantly more than the other — are able to access a seniors' family threshold. From 1 July 2006, the new senior family threshold of $33,500 will ensure that senior couples do not incur a Medicare levy until they incur an income tax liability. ***[Schedule 4, item 7]***

## Reduction in the Medicare levy phase-in rate

1.31 The Medicare levy phase-in rate will be reduced from 20 per cent to 10 per cent from 1 July 2006. ***[Schedule 4, item 3]***

1.32 The change in the phase-in rate impacts on the calculation of the Medicare levy for families and trusts. ***[Schedule 4, items 4 to 6]***

# Fringe benefits tax

1.33 Schedule 2 to this Bill amends section 6 of the *Fringe Benefits Tax Act 1986* to reduce the FBT rate from 48.5 per cent to 46.5 per cent, with effect from 1 April 2006. ***[Schedule 2, item 1]***

1.34 The rate of FBT is set by section 6 of the *Fringe Benefits Tax Act 1986*. FBT is imposed on employers in respect of the value of certain fringe benefits provided in respect of the employment of employees. This change will ensure that the FBT rate aligns with the top personal income tax rate (including the Medicare levy).

## Application and transitional provisions

1.35 The changes to personal income tax rates and thresholds, the Low Income Tax Offset, the Medicare levy threshold for senior Australians and the Medicare levy phase-in rate will apply to assessments for the 2006-07 year of income and later years. ***[Schedule 3, item 4; Schedule 4, item 8; Schedule 1, Part 3, subitem 32(1)]***

1.36 The reduction in the FBT rate will apply to the FBT year of tax beginning on 1 April 2006 and later FBT years. ***[Schedule 2, item 2]***

1.37 Although this amendment will be retrospective it will be beneficial to affected employers by reducing the amount of FBT payable.

## Consequential amendments

1.38 The change to the top marginal tax rate results in consequential amendments to other areas of the law. These are detailed in Part 2 of Schedule 1 to this Bill.

1.39 All consequential amendments in Schedule 1, except the amendment to the *Income Tax (Bearer Debentures) Act 1971*, apply to assessments for the 2006-07 year of income and later years of income. ***[Schedule 1, Part 3, subitem 32(1)]***

1.40 The amendment of the *Income Tax (Bearer Debentures) Act 1971* made by Schedule 1 applies to interest paid or credited after 30 June 2006. ***[Schedule 1, Part 3, subitem 32(2)]***

# Chapter 2
# Improved depreciation arrangements

## Outline of chapter

2.1 Schedule 5 to this Bill amends Division 40 of the *Income Tax Assessment Act 1997* (ITAA 1997) to increase deductions for the decline in value of depreciating assets under the diminishing value method and project pools.

## Context of amendments

2.2 On 9 May 2006, the Treasurer announced that incentives for investing in plant and equipment would be enhanced by raising the diminishing value rate used for calculating the decline in value of a depreciating asset from 150 to 200 per cent, and applying the new rate to determine the decline in value of project pools (Treasurer's Press Release No. 041 of 9 May 2006).

## Summary of new law

2.3 Section 40-72 (diminishing value method for post-9 May 2006 assets) applies a higher rate for determining the decline in value of a depreciating asset.

2.4 Section 40-832 (project pools for post-9 May 2006 projects) applies a higher rate for determining the decline in value of a project pool.

## Comparison of key features of new law and current law

| ***New law*** | ***Current law*** |
|---|---|
| Under the diminishing value method, taxpayers deduct the decline in value in depreciating assets they started to hold on or after 10 May 2006 using the formula: $\text{base value} \times \frac{\text{days held}}{365} \times \frac{200\%}{\text{asset's effective life}}$ | Under the diminishing value method, taxpayers deduct the decline in value in depreciating assets they held before 10 May 2006 using the formula: $\text{base value} \times \frac{\text{days held}}{365} \text{ x } \frac{150\%}{\text{asset's effective life}}$ |
| Taxpayers deduct the decline in value of a post-10 May 2006 project pool using the formula: $\frac{\text{pool value} \times 200\%}{\text{DV project pool life}}$ | Taxpayers deduct the decline in value of a pre-10 May 2006 project pool using the formula: $\frac{\text{pool value} \times 150\%}{\text{DV project pool life}}$ |

## Detailed explanation of new law

### Diminishing value method

2.5 Section 40-25 of the ITAA 1997 allows a deduction equal to the decline in value for an income year of a depreciating asset that a taxpayer held for any time during the income year.

2.6 A ***depreciating asset*** is defined as an asset that has a limited effective life and that can reasonably be expected to decline in value over the time it is used. Land, trading stock and most intangible assets are not depreciating assets.

2.7 Deductions are reduced by the part of the asset's decline in value that is attributable to using an asset, or having it installed ready for use, for a purpose other than a taxable purpose. ***Taxable purpose*** is defined as the purpose of:

- producing assessable income;
- exploration or prospecting;
- mining site rehabilitation; or
- environmental protection activities.

2.8 Whether a taxpayer holds an asset is determined by section 40-40 of the ITAA 1997. The holder of an asset includes the owner or the lessee of an asset in certain circumstances.

2.9 Generally, there are two methods for determining the decline in value of a depreciating asset — diminishing value method or the prime cost (straight-line) method. Some assets must use the prime cost method or otherwise have special depreciation arrangements.

2.10 Under the diminishing value method, taxpayers are able to deduct an amount equal to a fixed proportion of the written-down value of an asset each year. For assets that they start to hold on or after 10 May 2006, the proportion they are able to write-off is determined by the diminishing value rate of 200 per cent and the asset's effective life.

2.11 The formula for calculating the decline in value is given as:

$$\text{base value} \times \frac{\text{days held}}{365} \times \frac{200\%}{\text{asset's effective life}}$$

***[Schedule 5, subsection 40-72(1)]***

2.12 The base value of an asset is either:

- for an income year where the asset's start time occurs, its cost; or
- for a later income year, the sum of its opening adjustable value for that year and any amount included in the second element of its cost (improvement expenditure) for that year. Adjustable value is the asset's value as at the end of the previous income year, as defined by section 40-85 (meaning of 'adjustable value' and 'opening adjustable value' of a depreciating asset).

**Example 2.1**

Joan purchases a new truck, a depreciating asset, to use for her business on 10 July 2006. Joan uses the diminishing value method to calculate the decline in value of the truck, and can use the 200 per cent rate.

2.13 For depreciating assets that a taxpayer started to hold prior to 10 May 2006 the following formula continues to apply:

$$\text{base value} \times \frac{\text{days held}}{365} \times \frac{150\%}{\text{asset's effective life}}$$

**Example 2.2**

> ZoZo Co, a construction company, purchased a new forklift to use in its business on 1 May 2006. As ZoZo Co started to hold the asset before 10 May 2006, the 150 per cent rate is used to calculate the forklift's decline in value under the diminishing value method.

2.14 ***Days held*** is defined as the number of days the taxpayer held the asset in the income year from its start time. If the asset has not been used or been installed ready for use on any days in the year, these are not included in the number of days held.

2.15 The 200 per cent rate does not apply if the effective life of an asset held by a taxpayer before 10 May 2006 is recalculated after that date.

## Project pools

2.16 The declining value rate of 200 per cent also provides the basis for calculating the amortisation rate for project pool expenditure, where the project pool only contains project amounts incurred on or after 10 May 2006, for projects that start to operate on or after that day. ***[Schedule 5, subsection 40-832(1)]***

2.17 A project amount is:

- mining and transport capital expenditure; or
- specified capital expenditure that is directly connected with a project carried on or proposed to be carried on for a taxable purpose, for example, feasibility studies.

2.18 A project amount cannot be part of the cost of a depreciating asset that is held or has been formerly held.

2.19 Deductions commence in the first income year in which the project starts to operate.

2.20 Section 40-832 (project pools) allows deductions for project amounts allocated to a project pool as follows:

$$\frac{\text{pool value} \times 200\%}{\text{DV project pool life}}$$

***[Schedule 5, subsection 40-832(1)]***

**Example 2.3**

Judy incurs expenditure on a feasibility study for a project on 10 June 2006. As the feasibility study forms part of a project pool that only contains amounts incurred on or after 10 May 2006, the decline in the pool's value is worked out using the 200 per cent rate. The amounts will be deductible once the project starts to operate.

2.21 Project amounts allocated to a project pool prior to 10 May 2006 continue to use the following formula to determine the depreciation deduction:

$$\frac{\text{pool value} \times 150\%}{\text{DV project pool life}}$$

**Example 2.4**

Bernard incurs expenditure on an environmental assessment for a project on 5 June 2006. Bernard first allocated a project amount to the project pool in March 2006. Although the expenditure on the environmental assessment was incurred after 10 May 2006, and the project has not yet started to operate, the project pool contains amounts that were incurred before 10 May 2006. Therefore, the decline in value of the pool is worked out using the 150 per cent rate.

## Integrity measures

2.22 Taxpayers who dispose of and reacquire their assets for the main purpose of qualifying for the new diminishing value method rate, or acquire substitute assets mainly for that purpose, must use the rate that would apply as though the asset was held before 10 May 2006, that is, 150 per cent.

2.23 If a taxpayer splits a depreciating asset into two separate depreciating assets or merges two assets into another depreciating asset and it is reasonable to conclude this was done for the main purpose of ensuring the 200 per cent rate applied, the taxpayer will be deemed to have held the split or merged asset or assets prior to 10 May 2006. ***[Schedule 5, subsection 40-72(1) of the Income Tax (Transitional Provisions) Act 1997]***

2.24 A taxpayer will be deemed to have held a depreciating asset before 10 May 2006 where:

- the taxpayer held the depreciating asset before 10 May 2006;
- they stopped holding the asset on or after 10 May 2006; and

- it was reasonable to conclude that the main purpose they stopped holding the asset was to calculate the decline in value under section 40-72.

***[Schedule 5, subsection 40-72(2) of the Income Tax (Transitional Provisions) Act 1997]***

2.25 A taxpayer will also be deemed to have held the depreciating asset before 10 May 2006 where:

- they held a depreciating asset before 10 May 2006 (the original asset);
- they substituted another asset for the original asset and started to hold the substituted asset on or after 10 May 2006;
- the substituted asset is identical to, or has a similar purpose to, a depreciating asset that another entity acquired from the taxpayer on or after that day;
- the taxpayer did not deal with the other entity at arm's length; and
- it is reasonable to conclude that the main purpose of entering the arrangement was to calculate the decline in value of the substitute asset under section 40-72.

***[Schedule 5, subsection 40-72(3) of the Income Tax (Transitional Provisions) Act 1997]***

**Example 2.5**

Catherine and Barbara each hold depreciating assets purchased before 10 May 2006 and used them in earning their assessable income. In June 2006, Catherine and Barbara agree to purchase each other's assets, so that they qualify for the 200 per cent rate and for no other reason. As the scheme was entered into for the main purpose of being able to obtain a deduction greater than would be available to either of them under the 150 per cent rate, they are deemed to have held the depreciating assets before 10 May 2006.

2.26 Similarly, a taxpayer who abandons, sells or otherwise disposes of a project for the purpose of reviving the same project for the main purpose of applying the 200 per cent rate must use the rate that would apply as though the project pool was established before 10 May 2006, that is, 150 per cent. ***[Schedule 5, section 40-832 of the Income Tax (Transitional Provisions) Act 1997]***

## Application and transitional provisions

2.27 These amendments apply to depreciating assets a taxpayer:

- started to hold under a contract entered into on or after 10 May 2006;
- constructed, where the construction started on or after that day; or
- started to hold in some other way on or after that day.

2.28 These amendments also apply to project pools that only contain project amounts incurred on or after 10 May 2006 for projects that start to operate on or after that day.