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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

SENATE

TAX LAWS AMENDMENT (2007 MEASURES No. 5) BILL 2007

REVISED EXPLANATORY MEMORANDUM

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

This memorandum takes account of amendments made by the House of
Representatives and to the Bill as introduced

Table of contents

Glossary		1
General outline and financial impact		3
Chapter 1	Tax preferred entities (asset financing)	13
Chapter 2	Thin capitalisation — excluded equity interests	107
Chapter 3	Thin capitalisation — application to groups containing certain authorised deposit-taking institutions	109
Chapter 4	Capital gains tax marriage breakdown roll-over for small superannuation funds	119
Chapter 5	Income tax treatment of the Prime Minister's Prize for Australian History and the Prime Minister's Prize for Science	129
Chapter 6	Removal of the same business test cap	131
Chapter 7	Partial capital gains tax roll-over for statutory licences	135
Chapter 8	Australian property trusts and stapled securities	147
Chapter 9	Deductible gift recipients	167
Chapter 10	Film production offsets	171
Chapter 11	Premium 175 per cent research and development tax concession for Australian research and development activities on behalf of a grouped foreign company	219
Chapter 12	Establishment of Innovation Australia	247
Index		255

Glossary

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

Abbreviation	***Definition***
AAT	Administrative Appeals Tribunal
ABN	Australian Business Number
ADI	authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
ATO	Australian Taxation Office
CGT	capital gains tax
Commissioner	Commissioner of Taxation
DGR	deductible gift recipient
IR&D Act	*Industry Research and Development Act 1986*
IR&D Board	Industry Research and Development Board
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
MEC group	multiple entry consolidated group
PDF Act	*Pooled Development Funds Act 1992*
R&D	research and development
TAA 1953	*Taxation Administration Act 1953*
US	United States of America
VC Act	*Venture Capital Act 2002*
VCR Board	Venture Capital Registration Board

General outline and financial impact

Tax preferred entities (asset financing)

Schedule 1 to this Bill amends the income tax law to modify the taxation treatment of leasing and similar arrangements between taxpayers and tax preferred end users (such as tax-exempt entities and non-residents) for the financing and provision of infrastructure and other assets.

Division 250 of the *Income Tax Assessment Act 1997* will apply to a taxpayer if, broadly:

- a tax preferred end user directly or indirectly uses, or effectively controls the use of, an asset; and
- the taxpayer does not have the predominant economic interest in the asset.

Certain relatively short-term and lower value arrangements are specifically excluded from the scope of Division 250.

If Division 250 applies to an arrangement, capital allowance deductions will be denied and the arrangement will be treated as a deemed loan that is taxed as a financial arrangement on a compounding accruals basis.

Date of effect: These amendments apply to arrangements entered into on or after 1 July 2007. Under transitional provisions, Division 250 will apply to arrangements entered into before 1 July 2007 in certain circumstances.

Proposal announced: This measure was announced in the then Minister for Revenue and Assistant Treasurer's Press Release No. 081 of 13 September 2005.

Financial impact: The financial impact of these amendments is unquantifiable.

Compliance cost impact: This measure will reduce ongoing compliance costs for affected stakeholders, although there will be a small transitional cost.

Summary of regulation impact statement

Regulation impact on business

Impact: The tax-exempt asset financing reforms are beneficial to taxpayers as they provide a more uniform set of rules and remove harsh outcomes that can arise under the existing law. This measure is largely

expected to impact a relatively small number of large corporate taxpayers, along with tax-exempt entities (including state governments) and non-resident entities that enter into certain large asset financing arrangements.

Main points:

- The reforms adopt a ‘lease, use and control of use’ of the asset test to determine which entity has the predominant economic interest in an asset. Stakeholders are familiar with the operation of this test. Certain relatively short term and lower value arrangements are specifically excluded from the scope of the measures.
- If this measure applies, capital allowance deductions are denied and the arrangement is treated as a deemed loan that is taxed as a financial arrangement on a compounding accruals basis. This outcome is broadly consistent with the financial accounting treatment of asset financing arrangements.
- This measure is expected to improve the current investment environment for tax-exempt asset financing arrangements through a more uniform set of rules and less administrative complexity, specific carve outs for relatively short term and lower value arrangements, and less onerous tax treatment for arrangements which meet the provisions.

Stakeholders and their advisers may incur some transitional costs in familiarising themselves with the technical detail of the new law. It is not expected that these transitional costs will be significant.

Thin capitalisation — excluded equity interests

Schedule 2 to this Bill amends the *Income Tax Assessment Act 1997* to change the definition of ‘excluded equity interest’. The effect of the change is to exclude from the definition those equity interests that remain on issue for a total period of 180 days or more, whether or not this was the case at a specific valuation day.

Date of effect: This amendment commences on the day this Bill receives Royal Assent and will apply to income years starting on or after 1 July 2002 (the date when the definition of ‘excluded equity interest’ took effect).

Proposal announced: This measure was announced as part of the 2007-08 Budget.

Financial impact: Nil.

Compliance cost impact: Nil.

Thin capitalisation — application to groups containing certain authorised deposit-taking institutions

Schedule 3 to this Bill amends the *Income Tax Assessment Act 1997* to introduce a choice mechanism under which authorised deposit-taking institutions (ADIs) known as specialist credit card institutions may be treated as if they were not ADIs in certain circumstances.

Date of effect: This amendment commences on the day this Bill receives Royal Assent and will apply to income years starting on or after 1 January 2004.

Proposal announced: This measure was announced on 20 December 2006 as part of the Mid-Year Economic and Fiscal Outlook 2006-07.

Financial impact: Unquantifiable, but expected to be negligible.

Compliance cost impact: Nil.

Capital gains tax marriage breakdown roll-over for small superannuation funds

Schedule 4 to this Bill amends the *Income Tax Assessment Act 1997* to extend the capital gains tax (CGT) marriage breakdown roll-over to in specie transfers of personal superannuation interests from a small superannuation fund to another complying superannuation fund under specific conditions. This enables separating spouses to achieve a ‘clean break’ from each other in terms of their superannuation arrangements.

Date of effect: This measure applies to CGT events that happen on or after 1 July 2007.

Proposal announced: This measure was announced in the Minister for Revenue and Assistant Treasurer’s Press Release No. 046 of 8 May 2007.

Financial impact: This measure will have these revenue implications:

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

Compliance cost impact: The compliance cost impact of this measure is expected to be minimal for both implementation costs and ongoing compliance costs.

Income tax treatment of the Prime Minister's Prize for Australian History and the Prime Minister's Prize for Science

Schedule 5 to this Bill amends the *Income Tax Assessment Act 1997* to exempt from income tax the Prime Minister's Prize for Australian History and the Prime Minister's Prize for Science, to the extent that the prizes would otherwise be assessable income.

Date of effect: These amendments apply to assessments for the 2006-07 income year and later years of income.

Proposal announced: This measure was announced in the Prime Minister's Press Release of 20 June 2007.

Financial impact: Negligible.

Compliance cost impact: Negligible.

Removal of the same business test cap

Schedule 6 to this Bill amends the company loss recoupment rules in the *Income Tax Assessment Act 1997* to remove the $100 million total income cap on the same business test.

Date of effect: These amendments apply to losses incurred in an income year commencing on or after 1 July 2005.

Proposal announced: These amendments were announced in the 2007-08 Budget and in the Minister for Revenue and Assistant Treasurer's Press Release No. 048 of 8 May 2007.

Financial impact: This measure will have these revenue implications:

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

Compliance cost impact: These amendments are expected to reduce ongoing compliance costs for companies.

Partial capital gains tax roll-over for statutory licences

Schedule 7 to this Bill amends the *Income Tax Assessment Act 1997* to extend the existing statutory licence capital gains tax (CGT) roll-over under Subdivision 124-C to provide for roll-over where one or more new licences are issued in consequence of the ending of one or more licences and to provide for a partial roll-over. A partial roll-over applies where one or more statutory licences end and are replaced by one or more new

licences and the licensee also received non-licence capital proceeds such as money.

Date of effect: This measure will apply to CGT events that happen in the 2006-07 income year and later years.

Proposal announced: This measure was announced in the Minister for Revenue and Assistant Treasurer's Press Release No. 069 of 8 June 2007.

Financial impact: There is a cost to revenue of $20 million in 2006-07 and $90 million in 2007-08.

The nature of this measure is such that a reliable estimate cannot be provided for the remainder of the forward estimates, however, the impact in the 2008-09, 2009-10 and 2010-11 financial years is expected to be small.

Compliance cost impact: This measure is expected to lead to small increases in implementation and ongoing compliance costs, resulting in an overall low impact.

Australian property trusts and stapled securities

Schedule 8 to this Bill amends the *Income Tax Assessment Act 1997* to provide holders of ownership interests in stapled entities with a capital gains tax (CGT) roll-over when a public unit trust is interposed between those holders and the stapled entities.

This Schedule also amends the *Income Tax Assessment Act 1936* to ensure that such restructures do not result in the interposed head trust being taxed as if it were a company. In addition, public unit trusts will be able to acquire controlling interests in, or control, foreign entities whose business consists primarily of investing in land outside Australia for the purpose, or primarily for the purpose, of deriving rent.

Date of effect: The CGT roll-over amendments apply to CGT events that happen on or after 1 July 2006. The other amendments will apply to the 2006-07 year of income and later years of income.

Proposal announced: These amendments were announced in the Minister for Revenue and Assistant Treasurer's Press Release No. 031 of 4 April 2007.

Financial impact: Unquantifiable.

Compliance cost impact: These amendments will result in a small increase to implementation costs and a small decrease to ongoing compliance costs.

Deductible gift recipients

Schedule 9 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to update the list of deductible gift recipients (DGRs).

Date of effect: Deductions for gifts to the following organisations that are listed as DGRs under this Schedule, apply as follows:

- The Bathurst War Memorial Carillon Public Fund Trust from 3 August 2007 until 2 August 2009;
- Kidsafe ACT (Inc.) from 3 August 2007;
- Kidsafe New South Wales (Inc.) from 3 August 2007;
- Kidsafe QLD (Inc.) from 3 August 2007;
- Kidsafe Vic (Inc.) from 3 August 2007;
- Kidsafe SA Incorporated from 3 August 2007;
- Kidsafe Western Australia (Inc) from 3 August 2007;
- Kidsafe NT (Inc.) from 3 August 2007; and
- Kidsafe Tasmania (Inc) from 3 August 2007.

In addition, this Schedule extends the DGR listing of the Shrine of Remembrance Restoration and Development Trust until 30 June 2009.

Proposal announced: The deductibility of gifts to The Bathurst War Memorial Carillon Public Fund Trust was announced in the Minister for Revenue and Assistant Treasurer's Press Release No. 094 of 7 August 2007.

The deductibility of gifts to the Kidsafe state and territory bodies was announced in the Minister for Revenue and Assistant Treasurer's Press Release No. 095 of 7 August 2007.

The extension for the deductibility of gifts to the Shrine of Remembrance Restoration and Development Trust was announced in the Minister for Revenue and Assistant Treasurer's Press Release No. 092 of 25 July 2007.

Financial impact: This measure will have these revenue implications:

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

Compliance cost impact: Nil.

Film production offsets

Schedule 10 to this Bill reforms the taxation arrangements for the Australian screen media industry by:

- introducing a refundable tax offset for Australian expenditure in making Australian films (the producer offset);
- enhancing the existing refundable film tax offset for Australian production expenditure (the location offset);
- introducing a refundable film tax offset for post, digital and visual effects production in Australia (the PDV offset); and
- phasing-out the existing tax incentives provided to investors in Australian films.

Date of effect: The location offset will apply to films commencing principal photography or production of the animated image on or after 8 May 2007.

The PDV offset will apply to a film that commences post, digital and visual effects production on or after 1 July 2007.

The producer offset applies to qualifying Australian production expenditure incurred:

- on or after 1 July 2007; and
- before 1 July 2007, to the extent that such expenditure is attributable to goods or services provided on or after 1 July 2007.

Proposal announced: This measure was announced in the 2007-08 Budget and in joint press releases from the Minister for Communications, Information Technology and the Arts and the Minister for the Arts and Sport, on 9 May 2007.

Financial impact: This measure will have these financial implications:

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

Compliance cost impact: Nil.

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

Schedule 11 to this Bill amends the *Income Tax Assessment Act 1936* to allow for an additional 75 per cent deduction for additional expenditure on foreign-owned research and development (R&D) activities. A base 100 per cent specific deduction will be allowed for all R&D expenditure contributing to the calculation of the premium 175 per cent R&D tax concession.

Date of effect: Deductions will apply to a company's eligible expenditure in its first full income year after 30 June 2007 and later income years.

Proposal announced: This measure was announced by the Prime Minister and the Minister for Industry, Tourism and Resources in the Australian Government's *Industry Statement* of 1 May 2007.

Financial impact: This measure will have these revenue implications:

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

Compliance cost impact: Medium. All claimants of the premium 175 per cent R&D tax concession will have to understand and comprehend the new law even if their entitlements are unchanged. Ongoing compliance costs are likely to be negligible compared to the compliance costs for the existing premium 175 per cent R&D tax concession.

Establishment of Innovation Australia

Schedule 12 to this Bill amends the administration and oversight arrangements for the Industry portfolio's innovation and venture capital programmes as prescribed in the *Industry Research and Development Act 1986*, the *Pooled Development Funds Act 1992* and the *Venture Capital Act 2002*. There are also consequential amendments to the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997* in relation to the programmes with taxation implications.

These amendments establish a new board, Innovation Australia, combining the roles, responsibilities and functions of the Industry Research and Development Board (IR&D Board) and the Venture Capital Registration Board (VCR Board).

Date of effect: These amendments will apply from a day to be fixed by Proclamation.

Proposal announced: This measure has not previously been announced.

Financial impact: This measure is expected to result in some moderate administrative costs to the Department of Industry, Tourism and Resources to enable it to establish Innovation Australia and combine the roles of the IR&D Board and the VCR Board. There will be negligible change in the ongoing costs of administering the innovation and venture capital programmes as a result of this measure.

Compliance cost impact: This change will have negligible direct impact on clients of the innovation and venture capital programmes.

Chapter 1
Tax preferred entities (asset financing)

Outline of chapter

1.1 Schedule 1 to this Bill amends the income tax law to modify the taxation treatment of leasing and similar arrangements between taxpayers and tax preferred end users (such as tax-exempt entities and non-residents) for the financing and provision of infrastructure and other assets.

1.2 Division 250 of the *Income Tax Assessment Act 1997* (ITAA 1997) will apply to a taxpayer if, broadly:

- a tax preferred end user directly or indirectly uses, or effectively controls the use of, an asset; and
- the taxpayer does not have the predominant economic interest in the asset.

1.3 Certain relatively short-term and lower value arrangements are specifically excluded from the scope of Division 250.

1.4 If Division 250 applies to an arrangement, capital allowance deductions will be denied and the arrangement will be treated as a deemed loan that is taxed as a financial arrangement on a compounding accruals basis.

Context of amendments

1.5 Section 51AD and Division 16D of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) were enacted in the 1984-85 income year to deny access to tax benefits (such as deductions for capital expenditure) in relation to property used by or for tax-exempt entities (including non-residents).

1.6 A general principle of the income tax law is that, in order to claim deductions for expenditure relating to ownership of an asset (such as capital allowances), the owner must show that the asset is used for the purpose of producing assessable income or in carrying on a business for that purpose.

1.7 Arrangements were developed to circumvent this principle. While the taxpayer was the legal owner of the asset and derived assessable income through rental of the asset, arrangements developed under which the taxpayer transferred some or all of the risks and benefits

associated with ownership of the asset to the entity that was the 'real' or 'end' user of the asset. This end user was typically either a government body whose income was exempt from tax or a non-resident that used the asset outside Australia for the purpose of producing income that was exempt from Australian tax (ie, in both cases, a 'tax-exempt entity').

1.8 Often the arrangements between the taxpayer and the tax-exempt entity took the form of a finance lease with, in some cases, a predetermined payment for the asset at the end of the arrangement period. The tax-exempt entity effectively guaranteed the taxpayer a return of the taxpayer's investment in the relevant asset. Thus, the taxpayer was effectively lending money to the tax-exempt entity and had little or no interest in the economic performance of the asset — that is, the taxpayer was essentially the legal but not the economic owner of the asset.

1.9 The tax advantages of such arrangements flowed from tax deferral in a low risk setting. The tax deferral arose from the profile of taxable income over the arrangement. A typical situation was the existence of tax losses in the early years of an arrangement. These tax losses were created by the annual deductions related to the asset (such as capital allowance deductions and interest deductions) being greater than the predetermined annual income under the arrangement. The taxpayer could use these losses to offset assessable income from other sources. While income in later years might exceed allowable deductions, in present value terms the arrangement was tax advantaged.

1.10 Part of the tax benefit from the arrangement was generally passed back to the tax-exempt entity through lower finance charges, thereby lowering the cost to the entity of using the relevant asset.

1.11 Section 51AD was designed to operate as an 'anti-avoidance' provision against this background because the large scale nature of the arrangements posed a significant threat to the revenue base. Section 51AD effectively prevents a tax-exempt body from accessing tax benefits in relation to an asset it uses or effectively controls that is financed by highly leveraged non-recourse debt. If section 51AD applies to an arrangement, the taxpayer is assessed on all the proceeds derived from the arrangement but is denied access to all deductions in respect of the asset (such as capital allowances and interest deductions).

1.12 Division 16D operates to deny capital allowance deductions for the cost of, or capital expenditure on, property which a tax-exempt body uses or effectively controls under a finance lease or similar arrangement. Division 16D does not apply where section 51AD applies.
If Division 16D applies, the arrangement is treated as a loan and payments made under that arrangement are treated as having an interest and principal component. If the asset is not transferred to the tax-exempt end user at the end of the arrangement, then an unrealised loss is effectively allowed for any excess of loan principal over the value of the asset at the end of the arrangement.

1.13 The amendments will replace section 51AD and Division 16D of Part III of the ITAA 1936 with Division 250 of ITAA 1997. Division 250 will improve the taxation regime for asset financing arrangements between taxpayers and the tax-exempt sector as:

- the harsh impact of section 51AD will be removed;
- certain relatively short-term and lower value arrangements will be specifically excluded from the scope of the regime; and
- arrangements which come within the scope of the regime will be taxed as a financial arrangement on a compounding accruals basis.

Summary of new law

1.14 Division 250 will apply to a taxpayer if, broadly:

- an asset is being put to tax preferred use;
- the taxpayer is entitled to capital allowances in relation to the asset; and
- the taxpayer does not have the predominant economic interest in the asset.

1.15 An asset is being put to tax preferred use if a tax preferred end user directly or indirectly uses, or effectively controls the use of, the asset.

1.16 The taxpayer does not have the predominant economic interest in the asset if:

- more than 80 per cent (or 55 per cent for non-residents) of the cost of acquiring or constructing the asset is financed by limited recourse debt;
- a member of the tax preferred sector has a right to acquire the asset at the end of the arrangement period for

consideration that does not reflect the market value of the asset;

- the arrangement is effectively non-cancellable and the arrangement period exceeds the lesser of 30 years or 75 per cent of the remaining effective life of the asset; or
- either:
  - the asset has a guaranteed residual value;
  - the arrangement is a debt interest; or
  - the sum of the present value of financial benefits provided in relation to the tax preferred use of the asset exceeds 70 per cent of the adjustable value of the asset.

1.17 Certain relatively short-term and lower value arrangements are specifically excluded from the scope of Division 250. That is, the Division will not apply to a taxpayer if, broadly:

- the arrangement period does not exceed 12 months;
- the taxpayer is a small business entity for the income year in which the arrangement starts;
- the financial benefits that are reasonably expected to be provided by the tax preferred sector do not exceed $5 million; or
- the arrangement satisfies certain operating and finance risk tests, and:
  - the arrangement period does not exceed three years (or five years if the arrangement is a lease of real property);
  - the financial benefits that are reasonably expected to be provided by the tax preferred sector do not exceed $30 million (or $50 million if the arrangement is a lease of real property); or
  - the total values of assets put to tax preferred use do not exceed $20 million (or $40 million if the arrangement is a lease of real property).

1.18 If Division 250 applies to an arrangement, capital allowance deductions will be denied and the arrangement will be treated as a deemed loan that is taxed as a financial arrangement on a compounding accruals basis.

Comparison of key features of new law and current law

<table>
<tr><th>New law</th><th>Current law</th></tr>
<tr><td>Division 250 applies where, broadly:
a tax preferred end user directly or indirectly uses, or effectively controls the use of, an asset; and
the taxpayer does not have the predominant economic interest in the asset.
Certain relatively lower value and short-term arrangements are specifically excluded from the scope of Division 250.
If Division 250 applies, capital allowance deductions are denied and the arrangement is treated as a deemed loan that is taxed as a financial arrangement on a compounding accruals basis.</td><td>Section 51AD applies where, broadly:
a tax preferred end user directly or indirectly uses, or effectively controls the use of, an asset; and
the property is financed predominantly by non-recourse debt.
If section 51AD applies, deductions (such as capital allowances and interest deductions) are denied and all the proceeds from the arrangement are assessable.
Division 16D of Part III applies where, broadly:
a tax preferred end user directly or indirectly uses, or effectively controls the use of, an asset;
the taxpayer does not have the predominant economic interest in the asset; and
section 51AD does not apply.
If Division 16D applies, capital allowance deductions are denied and the arrangement is treated as a deemed loan that is taxed on a cash receivables basis.</td></tr>
</table>

Detailed explanation of new law

Objects of Division 250

1.19 The main objects of Division 250 are:

- to deny or reduce capital allowance deductions in respect of an asset if the asset is put to a tax preferred use and the taxpayer has insufficient economic interest in the asset; and
- if capital allowance deductions are denied or reduced, to treat the arrangement for the tax preferred use of the asset as a loan that is taxed as a financial arrangement (on a compounding accruals basis).

[Schedule 1, item 1, section 250-5]

1.20 Division 250 will replace section 51AD and Division 16D of Part III of the ITAA 1936. Changes to the wording or the style used in the replacement provisions in Division 250 do not change the objectives of the law as it currently operates under section 51AD and Division 16D of Part III of the ITAA 1936 (see section 1-3 of the ITAA 1997).

Some key concepts

1.21 Key concepts that are central to the operation of Division 250 are:

- the asset that Division 250 applies to;
- who is the end user of the asset;
- what is a lease;
- what is a tax preferred entity;
- what is a tax preferred end user;
- who are members of the tax preferred end user group;
- who are members of the tax preferred sector; and
- what are financial benefits.

Division 250 applies in respect of an asset

1.22 Division 250 applies to a taxpayer in respect of an asset. For these purposes:

- Division 250 applies to an improvement to land or to a fixture on land, whether the improvement or fixture is removable or not, as if it were an asset separate from the land;

- it is a matter of fact and circumstance as to whether a particular composite item is itself an asset or whether its components are separate assets;
- Division 250 applies to a renewal or extension of an asset that is a right as if the renewal or extension was a continuation of the original right. This ensures that Division 250 will apply consistently with Division 40 (subsection 40-3(5)) to one asset rather than several assets; and
- Division 250 applies to an asset (an underlying asset) in which both a taxpayer and one or more other entities have an interest as if the taxpayer's interest in the underlying asset were itself the underlying asset.

[Schedule 1, item 1, section 250-75]

1.23 The identification of the relevant asset is a question that needs to be determined on the facts and circumstances of a particular case. The existing practice of the Commissioner of Taxation (Commissioner) for determining this question will apply for the purposes of Division 250.

Who is the end user of an asset?

1.24 An entity (other than the taxpayer) is an end user of an asset if the entity (or a connected entity):

- uses, or effectively controls the use of, the asset;
- will use, or effectively control the use of, the asset;
- is able to use, or effectively control the use of, the asset; or
- will be able to use, or effectively control the use of, the asset.

[Schedule 1, items 1 and 6, subsection 250-50(1) and definition of 'end user' in subsection 995-1(1) of the ITAA 1997]

1.25 For these purposes, the control of the asset may be direct control or indirect control. ***[Schedule 1, item 1, subsection 250-50(2)]***

1.26 An entity will not be taken to be the end user of an asset if that entity takes control of the asset temporarily for the purpose of ensuring public health or safety, protecting the environment or continuing the supply of an essential service. ***[Schedule 1, item 1, subsection 250-50(3)]***

1.27 The question as to whether an entity takes control of the asset temporarily for the purpose of ensuring public health or safety, protecting the environment or continuing the supply of an essential service needs to be determined on the facts and circumstances of a particular case.

Example 1.1

> A statutory authority enters into a concession arrangement with a JF Co, a private sector transport company, for the supply of transport to a city. Under the arrangement, the statutory authority has step-in rights to temporarily take control of the assets in the event of default. As these rights are temporary rights for the purpose of ensuring the supply of an essential service, the statutory authority will not be taken to be the end user of those assets under section 250-50 merely because of the step-in rights.

1.28 To avoid doubt, an entity is taken to be an end user of an asset if the entity (or a connected entity) holds rights as a lessee under a lease of the asset. ***[Schedule 1, item 1, subsection 250-50(4)]***

1.29 Section 250-50 explains the relationship that must exist between an entity and an asset for the entity to be the end user of the asset. However, Division 250 will apply to a taxpayer in respect of an asset only if, in a practical sense, a tax preferred end user has, or will have, the control or use of the asset during the arrangement period.

1.30 To determine whether an entity effectively controls the use of an asset, it is necessary to examine the whole commercial arrangement, including the financial arrangements, surrounding the ownership and operation of the asset. This question ultimately turns on the facts and circumstances of each particular case.

1.31 One key factor that is relevant in determining the question is the day-to-day operations surrounding the ownership and operation of the asset (including staffing arrangements). For example, if the tax preferred entity, rather than the taxpayer, has responsibility for the day-to-day operations of the arrangement (including the power to employ and direct staff), that would be factor that would indicate that the tax preferred entity effectively controls the use of an asset.

1.32 A second key factor that is relevant in determining the question is the financial arrangements relating to the acquisition of the asset, the output generated by the asset and the purchase of inputs needed to operate the asset. In this regard, particular arrangements that may be encountered that might suggest that a tax preferred entity, rather than the taxpayer, effectively controls the use of an asset include:

- fixed return charges whereby the tax preferred entity agrees to buy the output of the taxpayer's asset on a fixed return basis;
- fixed fee arrangements whereby the tax preferred entity agrees to pay a minimum or maximum regular fixed amount to the taxpayer regardless of the amount of output actually supplied;

- an agreement to transfer ownership of the asset to the tax preferred entity after a specified number of years, or an option for the tax preferred entity to acquire the asset at a future time; and
- contracts for the supply of inputs by the tax preferred entity to the taxpayer that do not reflect arm's length prices and a relatively long supply period.

1.33 While any of these factors may be present in any particular arrangement, no one factor will necessarily be decisive of the question of control.

1.34 Division 250 applies a test of effective control that is consistent with the test in section 51AD and Division 16D. In addition, because Division 250 contains specific exclusions and has more generous safe harbour tests, it is likely that Division 250 will have a narrower scope than section 51AD and Division 16D.

Example 1.2

Nu Co, a taxable Australian company, enters into an arrangement with a state government (a tax preferred entity) to build and operate a hospital for a period of 20 years. Under the arrangement, Nu Co must comply with the directions of the state government in relation to the building and operation of the hospital. If Nu Co fails to comply with the state government's directions, the state government can step in and take control over the operation of the hospital. In these circumstances, the state government will be taken to be the end user of the hospital under section 250-50.

1.35 If the arrangement is primarily for the provision of services, the taxpayer (rather than the service recipient) would generally have control of the use of the assets used to provide the services (and therefore the arrangement would generally be outside the scope of Division 250).

1.36 An entity will generally not be taken to be the end user of an asset under section 250-50 merely because an asset reverts to entity at the end of the arrangement period.

Example 1.3

Coal Co is a subsidiary of a publicly listed mining company and has developed a coal mine to supply thermal coal to a neighbouring power station. It is the owner and manager of the mine. Coal Co has all the day-to-day operational control over the coal mine and carries all the commercial risks associated with the operation of the mine.

The power station is owned and managed by State Power Co (which is a tax-exempt entity wholly-owned by a state government).

A long-term coal supply agreement is entered into with State Power Co prior to the construction of the mine. The coal supply agreement is executed between Coal Co and State Power Co requiring five million

tonnes of coal to be supplied to State Power Co each year. A set price per tonne is negotiated between the parties. This price remains in place for the entire period of the agreement, but is indexed each year by movements in the consumer price index. The long-term price provides an appropriate risk weighted return on Coal Co's assets. There is an opportunity for either party to seek a renegotiation of the price every five years. There is no take or pay obligation, but ordinary rights exist for both parties to sue for damages if either party does not meet its obligations under the contract. The coal supply agreement is not classified as a lease for accounting purposes.

The question as to whether State Power Co effectively controls the use of Coal Co's assets can only be determined having regard to all the facts and circumstances of the particular arrangement. The terms of the coal supply agreement between Coal Co and State Power Co is one factor that needs to be considered in determining this question but, by itself, would not lead to the conclusion that Division 250 applies to the arrangement. Other features of the arrangement, such as the fact that Coal Co maintains the day-to-day control over the operation of the assets, are also relevant in determining where effective control lies.

Even if the conclusion is reached that State Power Co effectively controls the use of Coal Co's assets, Division 250 would not apply to those assets if, because of the operation of the safe harbour tests, Coal Co does not lack a predominant economic interest in the assets.

Example 1.4

Gas Co owns a number of petroleum leases from which it extracts coal bed methane gas. It has also built a gas production facility, from which it processes the gas and distributes it into a gas pipeline owned by a private sector infrastructure trust. Gas Co has all the day-to-day operational control over the gas production facility and carries all of the commercial risks associated with the operation of the facility.

Gas Co has entered into a long-term gas supply agreement with State Energy Co (which is a tax-exempt entity wholly-owned by a state government). State Energy Co takes the gas from the pipeline and on-sells it to a number of industrial users.

Under the gas supply agreement, State Energy Co must take or pay for 70 per cent of the output of Gas Co's facility. The price agreed is contained in a formula, which includes a fixed capacity charge, a variable charge based on output taken, and a profit margin. The price negotiated between the parties provides an appropriate risk weighted return on Gas Co's assets. The gas supply agreement is not classified as a lease for accounting purposes.

A take or pay arrangement is an agreement between a purchaser and a seller that provides for the purchaser to pay specified amounts periodically in return for products or services. The purchaser must make the specified minimum payments even if it does not take delivery of the contracted products or services. In this regard, the take or pay arrangement between Gas Co and State Energy Co is a fixed fee arrangement that is not dependant on the output actually supplied by

Gas Co to State Energy Co and therefore exhibits features which may indicate that State Energy Co effectively controls the use of Gas Co's assets.

However, the question as to whether State Energy Co effectively controls the use of Gas Co's assets can only be determined having regard to all the facts and circumstances of the particular arrangement. The terms of the take or pay arrangement between Gas Co and State Energy Co is one factor that needs to be considered in determining this question but, by itself, would not lead to the conclusion that Division 250 applies to the arrangement. Other features of the arrangement, such as the fact that Gas Co maintains the day-to-day control over the operation of the assets, are also relevant in determining where effective control lies.

Even if the conclusion is reached that State Energy Co effectively controls the use of Gas Co's assets, Division 250 would not apply to those assets if, because of the operation of the safe harbour tests, Gas Co does not lack a predominant economic interest in the assets.

Example 1.5

A statutory authority enters into a concession arrangement with AR Ltd to build and operate a user-pay toll-road on leased Crown land. At the end of the 30-year lease arrangement period, the toll-road will revert to the statutory authority for no consideration. The statutory authority will not be taken to be the end user of the toll-road under section 250-50 merely because of the reversion of the asset to the statutory authority at the end of the lease.

1.37 An entity will generally not be taken to be the end user of an asset under section 250-50 if it merely has the incidental use or control of the asset.

Example 1.6

The statutory authority in Example 1.5 retains rights to travel on the toll-road, inspect or test facilities, and perform various monitoring and traffic management activities during the arrangement period. The statutory authority also retains rights to perform certain activities on the toll-road in the event of an emergency. As these rights merely give the statutory authority the incidental or temporary control or use of the toll-road, the statutory authority will not be taken to be the end user of the toll-road under section 250-50.

Example 1.7

A statutory authority enters into a contract with RK Co, a private sector energy supply company, for the supply of electricity to a city. Under the contract, the statutory authority has the right to read electricity meters of the residential users of the electricity. As these rights merely give the statutory authority the incidental control or use of the assets used to supply the electricity, the statutory authority will not be taken to be the end user of those assets under section 250-50.

What is a lease?

1.38 For the purposes of Division 250, a lease includes an arrangement that, in substance or effect:

- depends on the use of a specific asset that is real property, or goods or a personnel chattel (other than money or a money equivalent); and
- gives a right to control the use of the asset (other than temporarily for the purpose of ensuring public health or safety, protecting the environment or continuing the supply of an essential service).

[Schedule 1, item 1, section 250-80]

1.39 The question as to whether an arrangement is a lease for the purposes of Division 250 primarily turns on whether, in substance or effect, the arrangement gives a right to control the use of an asset (other than temporarily for the purpose of ensuring public health or safety, protecting the environment or continuing the supply of an essential service). The classification of the arrangement as lease under the accounting standards does not necessarily determine this question.

1.40 Even if an arrangement between a taxpayer and a tax preferred entity is treated as a lease because of section 250-80, the requirements in section 250-50 still need to be satisfied before an entity can be an end user of the asset. In addition, the requirements of section 250-60 need to be satisfied before Division 250 will apply to the arrangement.

Example 1.8

> BF Co enters into a contract with a state government for the use of a sporting stadium. The contract is not in the form of a lease but effectively gives the state government the right to control the use of the stadium.
>
> As the contract gives the state government the right to control the use of the stadium, it is in substance or effect a lease. Section 250-80 will ensure that the contract is taken to be a lease for the purposes of Division 250.

What is a tax preferred entity?

1.41 A tax preferred entity is an exempt entity, an exempt Australian government agency, an associated government entity of an exempt Australian government agency, a 'prescribed excluded STB' (State/Territory body) as defined in section 24AT of the ITAA 1936 or an 'exempt foreign government agency' as defined in subsection 995-1(1) of the ITAA 1997. ***[Schedule 1, items 8, 16 and 23, definitions of 'excluded STB', 'prescribed excluded STB' and 'tax preferred entity' in subsection 995-1(1) of the ITAA 1997]***

Who is a tax preferred end user?

1.42 An end user of an asset is a tax preferred end user if:

- the end user (or a connected entity) is a tax preferred entity; or
- the end user is an entity that is not an Australian resident.

[Schedule 1, items 1 and 22, section 250-55 and definition of 'tax preferred end user' in subsection 995-1(1) of the ITAA 1997]

Who are the members of the tax preferred end user group?

1.43 If an asset is being put to a tax preferred use, then the members of the tax preferred end user group are the tax preferred end user and connected entities of the tax preferred end user. ***[Schedule 1, items 1 and 12, subsection 250-60(4) and the definition of 'member of the tax preferred end user group' in subsection 995-1(1) of the ITAA 1997]***

Who are the members of the tax preferred sector?

1.44 If an asset is being put to a tax preferred use, then the members of the tax preferred sector are the tax preferred end user (and connected entities), any tax preferred entity (or connected entity) and any non-resident entity. ***[Schedule 1, items 1 and 13, subsection 250-60(4) and the definition of 'member of the tax preferred sector' in subsection 995-1(1) of the ITAA 1997]***

What are financial benefits?

1.45 The term 'financial benefit' is defined in section 974-160 of the ITAA 1997 to mean, broadly, anything of economic value. Something is of economic value if it is money, a money equivalent, or a non-monetary benefit (such as property or services) even if the transaction that confers the benefit on an entity also imposes an obligation on the entity. Therefore, financial benefits include the provision of economic benefits in relation to the use of an asset (including benefits such as repairs and improvements, asset risk insurance or loan guarantees). General tax and charges exemptions will be financial benefits only if there is an obligation on the taxpayer to pay those taxes and charges.

1.46 A ***money equivalent*** is defined to mean a right to receive money or something that is a money equivalent. ***[Schedule 1, item 14 and the definition of 'money equivalent' in subsection 995-1(1) of the ITAA 1997]***

When does Division 250 apply?

1.47 Division 250 applies to a taxpayer in respect of an asset at a particular time if the general test in section 250-15 is satisfied and none of the specific exclusions apply. ***[Schedule 1, item 1, section 250-10]***

1.48 The specific exclusions, which are outlined in paragraphs 1.109 to 1.137, primarily ensure that Division 250 does not apply to certain

relatively short-term and lower value arrangements — that is, broadly, where:

- the arrangement period does not exceed 12 months;
- the taxpayer is a small business entity for the income year in which the arrangement starts;
- the financial benefits that are reasonably expected to be provided by the tax preferred sector do not exceed $5 million; or
- the arrangement satisfies certain operating and finance risk tests, and:
  - the arrangement period does not exceed three years (or five years if the arrangement is a lease of real property);
  - the financial benefits that are reasonably expected to be provided by the tax preferred sector do not exceed $30 million (or $50 million if the arrangement is a lease of real property); or
  - the total values of assets put to tax preferred use do not exceed $20 million (or $40 million if the arrangement is a lease of real property).

1.49 In addition, Division 250 will not apply to hire purchase arrangements with a tax preferred entity that come within the scope of Division 240. This is because taxpayers are not entitled to a deduction for capital allowances for assets acquired under hire purchase arrangements.

The general test for applying Division 250

1.50 Under the general test, Division 250 will apply to a taxpayer in respect of an asset at a particular time if:

- the asset is being put to a tax preferred use; and
- the arrangement period for the tax preferred use of the asset is greater than 12 months; and
- financial benefits in relation to the tax preferred use of the asset have been, will be or can reasonably be expected to be, provided to the taxpayer (or a connected entity) by:
  - a tax preferred end user (or a connected entity); or
  - any tax preferred entity (or a connected entity); or
  - any entity that is not an Australian resident; and

- disregarding Division 250, the taxpayer would be entitled to a capital allowance in relation to a decline in the value of the asset or expenditure in relation to the asset; and
- the taxpayer lacks a predominant economic interest in the asset.

[Schedule 1, item 1, section 250-15]

First element of the general test — the asset is being put to a tax preferred use

1.51 The first element of the general test for applying Division 250 to a taxpayer in respect of an asset is that the asset is being put to a tax preferred use. ***[Schedule 1, item 1, paragraph 250-15(a)]***

Tax preferred use if the end user is a lessee

1.52 If an end user (or a connected entity) holds rights as lessee under a lease of an asset, then the asset is put to a tax preferred use if:

- the asset is, or is to be, used by or on behalf of an end user who is a tax preferred end user because they are a tax preferred entity; and/or
- the asset is, or is to be, used wholly or principally outside Australia and an end user of the asset is a tax preferred end user because they are a non-resident.

[Schedule 1, items 1 and 24, subsection 250-60(1) and definition of 'tax preferred use' in subsection 995-1(1) of the ITAA 1997]

1.53 In this event, the tax preferred use of the asset is the lease of the asset. ***[Schedule 1, item 1, subsection 250-60(1)]***

Tax preferred use if goods, services or facilities are provided to the end user

1.54 If an asset is, or is to be, used (whether or not by the taxpayer) wholly or partly in connection with:

- the production, supply, carriage, transmission or delivery of goods; or
- the provision of services or facilities (including hospital or medical facilities, prison facilities, educational facilities, land transport facilities, other transport facilities, the supply of water, gas or electricity, housing or accommodation, or premises from which to operate a business or other undertaking),

then the asset is put to a tax preferred use if:

- some or all of the goods, services or facilities are, or are to be, produced for or supplied, carried, transmitted or delivered

to or for an end user who is a tax preferred end user because they are a tax preferred entity (other than an exempt foreign government agency); and/or

- the asset is, or is to be, used wholly or principally outside Australia and an end user of the asset is a tax preferred end user because they are a non-resident.

[Schedule 1, items 1 and 24, subsections 250-60(2) and (3) and definition of 'tax preferred use' in subsection 995-1(1) of the ITAA 1997]

1.55 In this event, the tax preferred use of the asset is the production, supply, carriage, transmission, delivery or provision of the goods, services or facilities. ***[Schedule 1, item 1, subsection 250-60(2)]***

1.56 The exclusion of exempt foreign government agencies from the scope of subparagraph 250-60(2)(b)(i) will ensure that Division 250 will not apply to, for example, an arrangement involving the use of assets in Australia by a taxpayer who enters into a long-term contract with a foreign government for the supply of minerals.

Example 1.9

NS Petroleum Co, a taxable Australian company, enters into a long term contract to supply gas to a foreign government agency. The assets used by NS Petroleum Co to satisfy its contractual obligations will be outside the scope of Division 250 because of the operation of subparagraph 250-60(2)(b)(i).

1.57 The tax-exempt use of an asset does not generally include a situation where a government owned corporation merely provides services to the owner of the asset provided the owner effectively controls the use of that asset.

Second element of the general test — the arrangement period for the tax preferred use must be greater than 12 months

1.58 The second element of the general test for applying Division 250 to a taxpayer in respect of an asset is that the arrangement period for the tax preferred use of the asset must be greater than 12 months. ***[Schedule 1, item 1, paragraph 250-15(b)]***

Start of the arrangement period

1.59 Generally, the arrangement period for a particular tax preferred use of an asset begins when an asset is first put to a tax preferred use. ***[Schedule 1, items 1 and 2, subsection 250-65(1) and the definition of 'arrangement period' in subsection 995-1(1) of the ITAA 1997]***

End of the arrangement period

1.60 The arrangement period for a particular tax preferred use of an asset ends on the earliest of:

- the day that the tax preferred use may reasonably be expected to, or is likely to, end; and
- the day that Division 250 no longer applies to the taxpayer and the asset.

[Schedule 1, item 1, subsections 250-65(2) and (3)]

1.61 In determining when the arrangement period for a tax preferred use of an asset ends, the taxpayer must have regard to:

- the terms of, and any other circumstances relating to, any arrangement dealing with the tax preferred use of the asset; and
- the terms of, and any other circumstances relating to, any arrangement dealing with the provision of financial benefits in relation to that tax preferred use.

[Schedule 1, item 1, paragraph 250-65(4)(a)]

1.62 For this purpose, the taxpayer must assume that any right that an entity has to renew or extend such an arrangement will not be exercised unless it is reasonable to assume that the right to renew or extend will be exercised because of the commercial consequences for the entity (or a connected entity) of not exercising that right. ***[Schedule 1, item 1, paragraph 250-65(4)(b)]***

1.63 In determining the arrangement period, the tax preferred use of an asset by an entity and the tax preferred use of the same asset by a connected entity are taken to be a single tax preferred use of an asset. ***[Schedule 1, item 1, subsection 250-65(5)]***

1.64 It follows that, where there is a right to renew or extend an arrangement, the arrangement period will include the extended period only if it is reasonably likely that the taxpayer would incur a significant financial penalty if the right was not exercised. For example:

- the taxpayer may suffer a loss of financial benefits that are payable at the end of the arrangement period;
- the taxpayer may be subject to a fine; or
- the taxpayer may lose the right to enter into future business with the tax preferred entity.

Example 1.10

Nu Co, a taxable Australian company, enters into an arrangement with a state government (a tax preferred entity) to build and operate a hospital for a period of 20 years. Under the arrangement, the state government is the end user of the hospital. The state government has two options to extend the arrangement for a further 10 years. The first option may be exercised at the end of 20 years while the second option may be exercised (if applicable) at the end of 30 years.

The arrangement period for the tax preferred use of the asset will be 20 years. However, if it is reasonable to assume that the first option will be exercised (because of the significant adverse commercial consequences for the state government of not doing so), the arrangement period for the tax preferred use of the asset will be 30 years. The arrangement period would extend to 40 years only if it is reasonable to assume that both options to extend will be exercised.

Continued tax preferred use of an asset after the end of arrangement period

1.65 If the arrangement period for the tax preferred use of an asset to which Division 250 applies ends on a particular date (the termination date) and the tax preferred use of the asset continues beyond that date, the tax preferred use beyond the termination date is taken to be a separate and distinct tax preferred use of the asset. ***[Schedule 1, item 1, section 250-70]***

1.66 As a consequence, the new tax preferred use arrangement will be retested under section 250-15 to determine whether Division 250 will apply to the taxpayer and the asset against the circumstances as they stand immediately before the termination date.

1.67 This is an integrity measure that ensures the correct treatment under Division 250 where the tax preferred use of an asset continues beyond the original arrangement period. In the absence of this provision there may be an incentive to understate the arrangement period so that subsequent tax preferred use falls outside Division 250.

Third element of the general test — financial benefits must be provided in relation to the tax preferred use of the asset

1.68 The third element of the general test for applying Division 250 to a taxpayer in respect of an asset is that financial benefits in relation to the tax preferred use of the asset have been, or will be or can reasonably be expected to be, provided to the taxpayer (or a connected entity) by:

- a tax preferred end user (or a connected entity);
- any tax preferred entity (or a connected entity); or
- any entity that is not an Australian resident.

[Schedule 1, item 1, paragraph 250-15(c)]

What financial benefits are provided in relation to the tax preferred use of an asset?

1.69 For the purposes of Division 250, the financial benefits provided in relation to the tax preferred use of an asset include:

- a financial benefit provided directly or indirectly in relation to the readying of the asset for tax preferred use (such as

bringing the asset into a state, condition or location in which it can be put to tax preferred use);

- a financial benefit provided directly or indirectly in relation to the end of the tax preferred use of the asset (including the amount of any guaranteed residual value of the asset);
  - an asset has a guaranteed residual value if the tax preferred sector provides a guarantee to the effect that it will pay the taxpayer (or a connected entity) up to a specified amount if the disposal value of the asset at the end of the arrangement period is less than that specified amount;
- a financial benefit provided directly or indirectly in relation to the termination or expiration of an arrangement that deals with the tax preferred use of the asset or provision of financial benefits in relation to the tax preferred use of the asset;
- a financial benefit provided directly or indirectly in relation to the purchase of the asset by, or transfer of the asset to, the tax preferred entity user or a connected entity; and
- if an asset is put to a tax preferred use and the entity is an end user because it manages the asset or the use to which it is put, any financial benefit provided directly or indirectly by the entity that is calculated by reference to receipts, revenue or income generated by the use of the asset.

[Schedule 1, items 1, 11 and 18, subsections 250-85(1) to (4), section 250-90 and the definitions of 'guaranteed residual value' and 'provided in relation to a tax preferred use of an asset' in subsection 995-1(1) of the ITAA 1997]

1.70 However, financial benefits do not include any payments merely collected by a member of the tax preferred sector on behalf of an entity that is not a member of the tax preferred sector. ***[Schedule 1, item 1, subsection 250-85(5)]***

1.71 For example, financial benefits do not include:

- road tolls paid by road users that are merely collected by a tax preferred entity to the extent that they are passed on to the taxpayer; or
- financial benefits provided under the national marketing and distribution arrangements for electricity by a tax preferred authority to the generators of electricity that would represent financial benefits payable by the users of the electricity.

1.72 In addition, financial benefits do not include payments in relation to the tax preferred use of an asset to the extent that those

payments are solely for routine maintenance of the asset. ***[Schedule 1, item 1, subsection 250-85(6)]***

1.73 If a financial benefit is provided in relation to the use of a number of assets, a separate financial benefit is to be reasonably attributed to each of the assets. ***[Schedule 1, item 1, subsection 250-85(7)]***

1.74 A financial benefit may be provided in relation to a tax preferred use of an asset even though it is provided before the tax preferred use of the asset starts. ***[Schedule 1, item 1, subsection 250-85(8)]***

1.75 A financial benefit that is not a monetary amount (such as a financial benefit in the form of goods or services) is taken to become due and payable when the entity (including the tax preferred end user or a connected entity of the tax preferred end user) providing the benefit becomes liable to provide the benefits and is taken to be paid when it is provided. ***[Schedule 1, item 1, paragraph 250-85(9)(a)]***

1.76 A financial benefit that is paid without becoming due and payable is taken to have become due and payable on the day on which it was paid. ***[Schedule 1, item 1, paragraph 250-85(9)(b)]***

What are the expected financial benefits in relation to an asset put to tax preferred use?

1.77 The expected financial benefits at a particular time in relation to an asset that is put to a tax preferred use are the financial benefits that at that time have been, will be (assuming normal operating conditions), or can reasonably be expected to be (assuming normal operating conditions) provided in relation to the tax preferred use of the asset by a member of the tax preferred sector to someone who is not a member of the tax preferred sector. ***[Schedule 1, item 1, section 250-95]***

What is the present value of a financial benefit that has already been provided?

1.78 The present value of a financial benefit at a particular time that has been provided before that time is the nominal amount or value of the financial benefit. ***[Schedule 1, item 1, section 250-100]***

Fourth element of the general test — the taxpayer would be entitled to capital allowances

1.79 The fourth element of the general test for applying Division 250 to a taxpayer in respect of an asset is that, disregarding Division 250, the taxpayer would be entitled to a capital allowance in relation to a decline in the value of the asset or expenditure in relation to the asset. ***[Schedule 1, item 1, paragraph 250-15(d)]***

Fifth element of the general test — the taxpayer lacks a predominant economic interest in the asset

1.80 The fifth element of the general test for applying Division 250 to a taxpayer in respect of an asset is that the taxpayer lacks a predominant economic interest in the asset. ***[Schedule 1, item 1, paragraph 250-15(e)]***

1.81 The taxpayer lacks a predominant economic interest in an asset at a particular time only if one or more of the following tests apply to the taxpayer and the asset at that time:

- the 'limited recourse debt test';
- the 'right to acquire asset test';
- the 'effectively non-cancellable, long term arrangement test'; and/or
- the 'level of expected financial benefits test'.

[Schedule 1, item 1, section 250-110]

1.82 The predominant economic interest tests effectively operate as safe harbour tests. An arrangement will come within the scope of Division 250 if it fails one or more of the safe harbour tests.

The 'limited recourse debt test'

1.83 Under the 'limited recourse debt test' the taxpayer lacks a predominant economic interest in an asset at a particular time if:

- where the asset is put to tax preferred use by an end user that is a tax preferred entity, more than the 80 per cent of the cost of acquiring or constructing the asset is financed (directly or indirectly) by limited recourse debt; or
- where the asset is put to tax preferred use by an end user that is a non-resident, more than the 55 per cent of the cost of acquiring or constructing the asset is financed (directly or indirectly) by limited recourse debt.

[Schedule 1, item 1, subsections 250-115(1) and (3)]

1.84 'Limited recourse debt' is defined in section 243-20 to mean, broadly, an obligation imposed on an entity (the debtor) to pay another entity (the creditor) where the rights of the creditor as against the debtor in the event of default in payment of the debt or of interest are limited wholly or predominantly to:

- rights in relation to the debt property, use of the debt property, goods produced or services provided by means of the debt property, or the loss or disposal of the debt property;
- rights in respect of the mortgage or other security over the debt property; or

- rights that arise out of any arrangement relating to the financial obligations of an end user over the financed property towards the debtor and are financial obligations in relation to the financed property.

1.85 However, for the purpose of applying the 'limited recourse debt test' in section 250-115:

- the amount of limited recourse debt is to be reduced by the value of any debt property (other than the financed property) that is provided as security for the debt; and
- if the limited recourse debt finances the acquisition or construction of two or more assets, only the amount of the debt that is reasonably attributable to the asset that is being put to tax preferred use is to be taken into account.

[Schedule 1, item 1, subsection 250-115(2)]

Example 1.11

VR Co acquires two assets that are put to tax preferred use costing $10 million and $20 million respectively.

The amount of limited recourse debt used to acquire the assets is $25 million (which is greater than 80 per cent of the cost of acquiring the asset).

Property (debt property), other than the financed property, to the value of $2 million is provided as security.

The limited recourse debt amount is reduced by the $2 million to $23 million (which is less than the 80 per cent of the cost of acquiring the asset). Therefore, VR Co will not lack the predominant economic interest in the assets because of the operation of the limited recourse debt test.

1.86 If the taxpayer is a corporate tax entity, the limited recourse debt test does not apply if:

- the tax preferred use of the asset:
  - is not the lease or hire of an asset; or
  - is the lease of an asset that is real property where members of the tax preferred sector occupy as tenants less than half of the area within the property that is occupied or available to be occupied by tenants; and
- the asset is put to the tax preferred use wholly or principally in Australia; and
- no member of the tax preferred sector provides financing, or support for financing, in relation to the taxpayer's interest in the asset (including by way of a loan, a guarantee, an indemnity, a security, hedging or undertaking to provide

financial benefits in the event of the termination of the arrangement).

[Schedule 1, item 1, subsections 250-115(4) and (5)]

1.87 If the taxpayer is a trust, the limited recourse debt test does not apply if:

- the tax preferred use of the asset is the lease of real property where members of the tax preferred sector occupy as tenants less than half of the area within the property that is occupied or available to be occupied by tenants;
- the asset is put to the tax preferred use wholly or principally in Australia; and
- no member of the tax preferred sector provides financing, or support for financing, in relation to the taxpayer's interest in the asset (including by way of a loan, a guarantee, an indemnity, a security, hedging or undertaking to provide financial benefits in the event of the termination of the arrangement).

[Schedule 1, item 1, subsection 250-115(6)]

Example 1.12

> BF Co owns a 30 storey office building. Ten floors of the building are leased by BF Co to a Australian government department. Another four floors are leased to a state government public authority. As members of the tax preferred sector occupy as tenants less than half of the area within the building that is occupied or available to be occupied by tenants, the limited recourse debt test will not apply to the arrangement.

1.88 The effect of the 'limited recourse debt test' (in combination with the level of expected financial benefits test) is that for the duration of the arrangement the taxpayer must hold some equity or investment effectively at risk in an asset to be treated as having the predominant economic interest in the asset. This is appropriate because, if an arrangement is outside the scope of Division 250, the taxpayer is entitled to capital allowance deductions in respect of assets used under the arrangement.

The 'right to acquire asset test'

1.89 Under the 'right to acquire asset test' the taxpayer lacks a predominant economic interest in an asset at a particular time if the asset is to be transferred to a member of the tax preferred sector after the end of the arrangement period and the consideration for the transfer is not fixed as the market value of the asset at the time of the transfer. ***[Schedule 1, item 1, subsection 250-120(1)]***

1.90 In addition, the taxpayer lacks a predominant economic interest in an asset at a particular time under this test if:

- a member of the tax preferred end user group has, or will have:
  - a right or an obligation to purchase or acquire the asset or a legal or equitable interest in the asset; or
  - a right to require the transfer of the asset or a legal or equitable interest in the asset; and
- the consideration for the purchase, acquisition or transfer of the asset is not fixed as the market value of the asset at the time of purchase, acquisition or transfer.

[Schedule 1, item 1, subsection 250-120(2)]

1.91 The 'right to acquire an asset test' does not apply to an asset just because a taxable entity's interest in the asset is one that ceases to exist after the passing of a particular period of time. ***[Schedule 1, item 1, subsection 250-120(2)]***

Example 1.13

Nu Co, from Example 1.10, builds the hospital on leased crown land. The interest in the land will revert to the state government at the end of the lease for no consideration if it is not renewed during the lease period. Accordingly, the right to acquire the asset test will not apply to the arrangement.

1.92 The 'right to acquire asset test' is relevant in determining whether the taxpayer has the predominant economic interest in an asset because the right or obligation of the tax preferred end user to acquire the asset during or at the end of the arrangement indicates that the arrangement is a financing arrangement as the tax preferred end user effectively has the risks and benefits of ownership of the asset.

The 'effectively non-cancellable, long term arrangement test'

1.93 Under the 'effectively non-cancellable, long term arrangement test' the taxpayer lacks a predominant economic interest in an asset at a particular time if:

- any arrangement that relates to the tax preferred use of the asset, or that relates to the financial benefits to be provided by the members of the tax preferred sector in relation to the tax preferred use of the asset, is effectively non-cancellable; and
- the arrangement period for the tax preferred use of the asset is:
  - greater than 30 years; or

– if the arrangement period is less than or equal to 30 years — 75 per cent or more of that part of the asset's effective life that remains when the tax preferred use starts (disregarding any statutory caps specified in section 40-102).

[Schedule 1, item 1, section 250-125]

1.94 An arrangement in relation to the tax preferred use of an asset is effectively non-cancellable if:

- the arrangement can be cancelled only with the permission of the taxpayer, a connected entity of the taxpayer, or an agent of or an entity acting on behalf of a taxpayer or a connected entity; or
- if the arrangement can be cancelled without such permission (including default), a member of the tax preferred sector would be required to enter into a replacement arrangement or incur a penalty of such magnitude that it would discourage cancellation (such as a payment equivalent to the unrecouped investment in the asset).

[Schedule 1, items 1 and 5, section 250-130 and the definition of 'effectively non-cancellable' in subsection 995-1(1) of the ITAA 1997]

1.95 The 'effectively non-cancellable long term arrangement test' is relevant in determining whether the taxpayer has the predominant economic interest in an asset because it discourages the tax preferred end user from cancelling the arrangement. This generally means that the end user has to make payments in relation to the asset for a period that is unrelated to the effective use of the asset. The payments are therefore likely to cover all or a substantial proportion of the unrecouped cost of the asset. Consequently, all or a substantial proportion of the risks and benefits of ownership of the asset are borne by the tax preferred end user rather than the taxable entity.

Example 1.14

Under the arrangement between Nu Co and the state government to build and operate a hospital, the state government is able to cancel the arrangement if Nu Co fails to achieve specified service standards. If the state government cancels the arrangement in these circumstances, it is not required to pay any financial benefits on cancellation (other than any unpaid amounts for services provided).

The arrangement between Nu Co and the state government will not satisfy the 'effectively non-cancellable long term arrangement test' because:

- Nu Co's permission is not required to cancel the contract; and
- there is no requirement for the state government to enter into a new contract or make any penalty or other agreed payment.

The 'level of expected financial benefits test'

1.96 Under the 'level of expected financial benefits test' the taxpayer lacks a predominant economic interest in an asset at a particular time if the asset has a guaranteed residual value at that time. ***[Schedule 1, item 1, subsection 250-135(1)]***

1.97 An asset has a guaranteed residual value if the tax preferred sector provides a guarantee to the effect that it will pay the taxpayer (or a connected entity) up to a specified amount if the disposal value of the asset at the end of the arrangement period is less than the specified amount. ***[Schedule 1, items 1 and 11, subsection 250-85(3) and the definition of 'guaranteed residual value' in subsection 995-1(1) of the ITAA 1997]***

1.98 In addition, the taxpayer lacks a predominant economic interest in an asset at a particular time under the 'level of expected financial benefits test' if:

- the arrangement under which the asset is put to the tax preferred use (either alone or together with any other arrangement in relation to the tax preferred use of the asset or the provision of financial benefits in relation to the tax preferred use of the asset) is a debt interest; or
- the sum of the present values of the expected financial benefits that members of the tax preferred sector have provided, or are or are reasonably likely to provide, to the taxpayer (or a connected entity) in relation to the tax preferred use of the asset exceeds:
  - if (assuming Division 250 did not apply) the taxpayer would be entitled to capital allowance deductions in relation to the asset, 70 per cent of the market value of the relevant asset; or
  - if (assuming Division 250 did not apply) the taxpayer would be entitled to a deduction for capital expenditure, 70 per cent of so much of the market value that is attributable to the capital expenditure.

[Schedule 1, item 1, subsection 250-135(2)]

1.99 For these purposes, for a newly acquired asset, the market value of the relevant asset or capital expenditure will generally reflect the cost of acquiring the asset that is recognised for capital allowance purposes.

1.100 The discount rate to be used in working out the present value of a future amount under section 250-135 is a rate that reflects a constant periodic rate of return (worked out on a compounding basis) on the investment in the relevant asset, or the relevant capital expenditure, that is implicit in the arrangements under which the asset is put to a tax preferred

use and financial benefits are provided in relation to that tax preferred use. ***[Schedule 1, item 1, subsection 250-105(2)]***

1.101 For these purposes, the investment in the relevant asset or capital expenditure will generally reflect the market value of the asset or expenditure and includes the estimated end value of the asset.

1.102 The level of expected financial benefits test is relevant in determining whether the taxpayer has the predominant economic interest in an asset because it is an indicator of whether the arrangement is in the nature of financing by the taxpayer of an asset purchased for a tax preferred entity.

Retesting of predominant economic interest against the 'level of expected financial benefits test'

1.103 If the 'level of expected financial benefits test' (section 250-135) does not apply when the tax preferred use of the asset starts, the test is taken to continue not to apply unless the taxpayer (or a connected entity), or a member of the tax preferred sector, does something, or omits to do something, at a particular time that increases the value of the expected financial benefits in relation to the tax preferred use of the asset. ***[Schedule 1, item 1, subsections 250-140(1) to (4) and (6)]***

1.104 For the purpose of retesting against the 'level of expected financial benefits test', financial benefits provided before the time of retesting are disregarded. ***[Schedule 1, item 1, subsection 250-140(5)]***

1.105 This ensures that taxpayers do not need to continuously retest the 'level of expected financial benefits test' to determine whether the taxpayer has the predominant economic interest in an asset.

1.106 That is, if the 'level of expected financial benefits test' does not apply to the arrangement when the tax preferred use of the asset starts, the arrangement does not need to be retested against section 250-135 unless a party to the arrangement does something that increases the value of the expected financial benefits in relation to the tax preferred use of the asset.

1.107 If, after the arrangement has been retested, the taxpayer continues to have a predominant economic interest in the asset that is put to tax preferred use under the arrangement, then the arrangement will continue to be outside the scope of Division 250.

1.108 Alternatively, if, after the arrangement has been retested, the taxpayer lacks a predominant economic interest in the asset that is put to tax preferred use under the arrangement, then Division 250 will start to apply to the arrangement (assuming that all the other requirements for Division 250 to apply are satisfied).

Specific exclusions from Division 250

1.109 Specific exclusions ensure that Division 250 does not apply to:

- arrangements where the arrangement period does not exceed 12 months;
- arrangements involving taxpayers that are small business entities;
- arrangements where the financial benefits do not exceed $5 million;
- certain short term or lower value operating arrangements;
- arrangements where the present value of the Division 250 assessable amount is less than the amount otherwise assessable; and
- arrangements that are excluded at the discretion of the Commissioner.

The first exclusion — arrangement period less than 12 months

1.110 Division 250 will not apply to a taxpayer and an asset if the arrangement period for the tax preferred use of the asset does not exceed 12 months. ***[Schedule 1, item 1, paragraph 250-15(b)]***

The second exclusion — small business entities

1.111 Division 250 will not apply to a taxpayer and an asset if the taxpayer is a small business entity for the income year in which the arrangement period starts and is able to deduct capital allowances under Subdivision 328-D for the asset. ***[Schedule 1, item 1, section 250-20]***

1.112 Under section 328-110, a taxpayer is a small business entity if:

- the taxpayer carries on a business; and
- the taxpayer satisfies the $2 million aggregated turnover test (ie, the taxpayer's aggregated turnover in the prior full income year, or its actual or expected turnover in the current full income year, is less than $2 million).

The third exclusion — financial benefits under $5 million

1.113 Division 250 will not apply to a taxpayer and an asset that is being put to tax preferred use under an arrangement if, at the start of the arrangement period, the total of the nominal values of all the financial benefits that have been, will be, or can reasonably expected to be, provided to the taxpayer (or a connected entity) by members of the tax preferred sector in relation to the tax preferred use of the asset (or any other asset that is being put to a tax preferred use under the arrangement) does not exceed $5 million. ***[Schedule 1, item 1, subsection 250-25(1)]***

1.114 The $5 million threshold is indexed annually in accordance with Subdivision 960-M. That is, the threshold is indexed by movements in the All Groups Consumer Price Index number (being the weighted

average of the eight capital cities) first published by the Australian Statistician for a quarter. ***[Schedule 1, item 1, subsection 250-25(2)]***

Example 1.15

PM Co, a cleaning contractor, enters into an arrangement with a local government council to provide office cleaning services. Under the contract, the total financial benefits expected to be payable to PM Co are $4 million.

The arrangement will be excluded from Division 250 under section 250-25 because the total amount of the financial benefits that are to be provided to PM Co under the arrangement do not exceed $5 million.

The fourth exclusion — certain short term or lower value operating arrangements

1.115 Division 250 will not apply to a taxpayer and an asset that is being put to a tax preferred use under certain operating arrangements if:

- the arrangement period for the tax preferred use of the asset does not exceed:
  - in the case of the lease of real property, five years; or
  - in any other case, three years;
- at the start of the arrangement period, the nominal value of all the financial benefits that have been, or are to be, provided to the taxpayer (or a connected entity) by members of the tax preferred sector in relation to the tax preferred use of the asset, or any other asset that is being, or is to be, put to a tax preferred use under the arrangement, does not exceed:
  - in the case of the lease of real property, $50 million; or
  - in any other case, $30 million; or
- at the start of the arrangement period, the total of the values of all the assets that are put to tax preferred use under the arrangement does not exceed:
  - in the case of the lease of real property, $40 million; or
  - in any other case, $20 million.

[Schedule 1, item 1, subsection 250-30(1)]

1.116 The monetary thresholds are indexed annually in accordance with Subdivision 960-M. That is, the thresholds are indexed by movements in the All Groups Consumer Price Index number (being the weighted average of the eight capital cities) first published by the Australian Statistician for a quarter. ***[Schedule 1, item 1, subsection 250-30(2)]***

1.117 As a result of this exclusion, Division 250 will not apply to many short term operating leases and service arrangements that come within the monetary thresholds. However, an arrangement will not qualify for the exclusion under section 250-30 if any of the tests in section 230-35 are satisfied.

1.118 First, an arrangement will not qualify for the exclusion under section 250-30 if the arrangement (either alone or together with any arrangement in relation to the tax preferred use of the asset or the provision of financial benefits in relation to the tax preferred use of the asset) is a debt interest. ***[Schedule 1, item 1, subsections 250-35(1) and (2)]***

1.119 Second, an arrangement will not qualify for the exclusion under section 250-30 if, under the arrangement, a member of the tax preferred sector has:

- a right, or an obligation, to purchase or acquire the asset or a legal or equitable interest in the asset for an amount other than the market value of the asset at the end of the arrangement period;
- a right to require the transfer of the asset or a legal or equitable interest in the asset for an amount other than the market value of the asset at the end of the arrangement period; or
- a residual or reversionary interest in the asset that will arise or become exercisable at or after the end of the arrangement period for an amount other than the market value of the asset at the end of the arrangement period.

[Schedule 1, item 1, subsection 250-35(3)]

1.120 For these purposes, a residual or reversionary interest in the asset will not arise or become exercisable at or after the end of the arrangement period merely because of the operation of a statutory provision that has no connection to the arrangement (such as the expiration of a 99-year lease in respect of property held in the Australian Capital Territory).

1.121 Third, an arrangement will not qualify for the exclusion under section 250-30 if, under the arrangement, a member of the tax preferred sector provides financing, or support for financing, in relation to the taxpayer's interest in the asset (including by way of a loan, a guarantee, an indemnity, a security, hedging or undertaking to provide financial benefits in the event of the termination of the arrangement). ***[Schedule 1, item 1, subsection 250-35(4)]***

1.122 In this regard, a long term supply agreement that is entered into on arm's length commercial terms with a tax-exempt entity which is

necessary for the commencement of a project would not generally be taken to be support for financing.

1.123 Fourth, an arrangement will not qualify for the exclusion under section 250-30 if the arrangement in relation to the tax preferred use of the asset, or the provision of financial benefits in relation to the tax preferred use of the asset, is or involves a finance lease, a non-cancellable operating lease, or a service concession or similar arrangement that generally accepted accounting principles (as in force at the start of the arrangement period) require to be included as an asset or a liability in the balance sheet of the taxpayer. ***[Schedule 1, item 1, subsection 250-35(5)]***

1.124 Fifth, an arrangement will not qualify for the exclusion under section 250-30 if, under the arrangement, the financial benefits that have been, or are to be, provided to the taxpayer (or a connected entity) by members of the tax preferred sector in relation to the tax preferred use of the asset:

- are not provided on a regular periodic basis (and at least annually);
- are not based on comparable market-based rates; or
- do not reflect the value of the tax preferred use of the asset.

[Schedule 1, item 1, subsection 250-35(6)]

1.125 Finally, the arrangement will not qualify for the exclusion under section 250-30 if:

- the tax preferred use of the asset is a lease or hire of an asset (or the use of an asset under a lease or hire arrangement), and:
  - the asset is so specialised that the end user could not carry out one or more of its functions without the asset; and
  - the taxpayer would be unlikely to be able to re-lease, re-hire or resell the asset to another person who is not a member of the tax preferred end user group; or
- the tax preferred use of the asset is not the lease or hire of an asset (or the use of an asset under a lease or hire arrangement), and:
  - a member of the tax preferred sector has a right, if particular circumstances occur, to manage or to assume control over the asset (other than temporarily for the purpose of ensuring public health or safety, protecting the environment or continuing the supply of an essential service);

- the asset is so specialised that it is unlikely that it could effectively be put to any use other than the tax preferred use; or
- the taxpayer (or a connected entity) does not have effective day to day control and physical possession of the asset.

[Schedule 1, item 1, subsections 250-35(7) and (8)]

1.126 The question as to whether an entity takes control of the asset temporarily for the purpose of ensuring public health or safety, protecting the environment or continuing the supply of an essential service needs to be determined on the facts and circumstances of a particular case.

1.127 Similarly, the question as to whether an asset is so specialised that it is unlikely that it could effectively be put to any use other than the tax preferred use also needs to be determined on the facts and circumstances of a particular case. However, examples of assets that might be specialised assets include special purpose buildings (such as hospitals and court houses) and rolling stock.

Example 1.16

> BF Co leases a building to a Australian government department for a period of five years. The total amount of the financial benefits that are to be provided to the BF Co under the lease arrangement are $50 million. The value of the building that is being leased is $25 million. The lease arrangement satisfies the conditions in section 250-35.
>
> The lease arrangement will be excluded from Division 250 under section 250-30 because the conditions in section 250-35 are satisfied and the arrangement period does not exceed five years.

The fifth exclusion — arrangements where the present value of the Division 250 assessable amount is less than the amount otherwise assessable

1.128 Division 250 will not apply to a taxpayer and an asset that is being put to tax preferred use under an arrangement if, when that tax preferred use of the asset starts, the Division 250 assessable amount is less than the alternative assessable amount. ***[Schedule 1, item 1, subsection 250-40(1)]***

1.129 This calculation is a once-off calculation that is made at the start of the arrangement period.

1.130 The Division 250 assessable amount is the sum of the present values of all the amounts that would be likely to be included in assessable income under the Division in relation to the tax preferred use of an asset. ***[Schedule 1, item 1, subsection 250-40(2)]***

1.131 The alternative assessable amount is the difference between:

- the present values of the amounts that would be included in assessable income in relation to the financial benefits provided in relation to the tax preferred use of the asset during the arrangement period if Division 250 did not apply; and
- the present values of the amounts that would be deductible as capital allowances in relation to the asset in relation to the arrangement period if Division 250 did not apply.

[Schedule 1, item 1, subsection 250-40(3)]

1.132 The discount rate to be used in working out the present value of a future amount under section 250-40 is:

- the average, expressed as a decimal fraction, of the assessed secondary market yields in respect of 10-year non-rebate Treasury bonds published by the Reserve Bank during the financial year in which the relevant arrangement period starts; or
- if no assessed secondary market yield in respect of bonds of that kind was published by the Reserve Bank during the year, the decimal fraction determined by the Treasurer for the purposes of the definition of 'long-term bond rate' in section 2 of the *Petroleum Resource Rent Tax Assessment Act 1987* in relation to the financial year in which the relevant arrangement period starts.

[Schedule 1, item 1, subsection 250-105(1)]

1.133 The long-term bond rate determined by the Treasurer for the purposes of the *Petroleum Resource Rent Tax Assessment Act 1987* in 2006 was 5.40 per cent. This rate is published annually on the Australian Taxation Office (ATO) website.

1.134 Section 250-40 ensures that Division 250 does not apply to an arrangement that would otherwise come within its scope if the arrangement is not tax advantaged. Consistent with a similar exclusion in the current law, the practical operation of this exclusion may result in the building component of many ordinary commercial long-term property leasing arrangements falling outside the scope of Division 250. The operation of this exclusion is illustrated in Example 1.26.

The sixth exclusion — Commissioner's discretion

1.135 To ensure that Division 250 will not apply inappropriately, a taxpayer may request the Commissioner to make a determination, having regard to the circumstances under which Division 250 would apply and other relevant circumstances, that it is unreasonable that Division 250 should apply to the taxpayer and the asset. ***[Schedule 1, item 1, section 250-45]***

1.136 In making the determination, the Commissioner should give consideration to the objects of the Division set out in section 250-5.

1.137 It is expected that the Commissioner would consider applying the discretion, for example, to prevent an arrangement from coming within the scope of Division 250 due to:

- an unintended or marginal breach of one of the safe harbour tests; or
- an unintended or marginal breach of one of the tests that need to be satisfied to qualify for the specific exclusion for certain operating and service arrangements.

Example 1.17

BF Co owns a 30 storey office building. Ten floors of the building are leased by BF Co to a Australian government department. Another four floors are leased to a state government public authority. The Australian government department temporarily enters into a short term lease for an additional two floors of the building.

The building is financed by limited recourse debt. If the limited recourse debt test in section 250-115 did not apply, the lease arrangement would be outside the scope of Division 250.

Even though the members of the tax preferred sector occupy as tenants more than half of the area within the building that is occupied or available to be occupied by tenants, the Commissioner may exercise his discretion not to apply the limited recourse debt test because of the temporary nature of the short term lease for an additional two floors of the building.

Example 1.18

RP Co, a cleaning contractor, enters into an arrangement with a local government council to provide office cleaning services. Under the contract, the total financial benefits expected to be payable to RP Co are $5.1 million.

The arrangement does not qualify for the exclusion under section 250-25 because the total financial benefits expected to be payable under the arrangement marginally exceed the $5 million threshold.

However, bearing in mind the compliance cost implications of applying Division 250 to the arrangement and that the threshold for the exclusion in section 250-25 was only marginally exceeded, the Commissioner may exercise his discretion to exclude the arrangement from the scope of Division 250.

What happens if an arrangement comes within the scope of Division 250?

1.138 If Division 250 applies to an arrangement:

- capital allowance deductions are denied; and

- the arrangement is treated as a deemed loan that is taxed as a financial arrangement on a compounding accruals basis.

Capital allowance deductions are denied

1.139 If Division 250 applies to a taxpayer and an asset at a particular time, during the arrangement period the taxpayer is generally taken not to satisfy any condition that needs to be satisfied for the taxpayer to be able to deduct an amount under a capital allowance provision in relation to:

- a decline in the value of the asset; or
- expenditure in relation to the asset.

[Schedule 1, item 1, section 250-145]

1.140 A 'capital allowance' is defined in subsection 995-1(1) to mean a deduction under:

- Division 40 (capital allowances);
- Division 43 (capital works);
- Subdivision 328-D (capital allowances for small business entities);
- Division 10BA of Part III of the ITAA 1936 (Australian films);
- Division 10B of Part III of the ITAA 1936 (copyright in Australian films); or
- section 73B of the ITAA 1936 (research and development).

Capital allowance partly allowed in some circumstances

1.141 In some circumstances a partial capital allowance deduction may be allowed in respect of the asset that is put to tax preferred use. A partial capital allowance deduction will be allowed if:

- Division 250 applies to the taxpayer and the asset;
- it is reasonable to expect that during the arrangement period for the tax preferred use of the asset, particular financial benefits will be provided to the taxpayer (or a connected entity);
- it is reasonable to expect that those financial benefits will be provided in relation to a use of the asset that is not a tax preferred use or a private use or will be provided for tax preferred use of the asset but are not attributable to financial benefits provided by members of the tax preferred sector (disregarding financial benefits that are provided under an arrangement that is a debt interest);

- the amount or value of those financial benefits is known or can reasonably be estimated; and
- the taxpayer chooses for the section to apply.

[Schedule 1, item 1, subsection 250-150(1)]

1.142 The choice to apply the apportionment rule:

- must be made before the day that the taxpayer lodges an income tax return for the income year in which the arrangement period for the tax preferred use of the asset starts;
- must be for the whole of the arrangement period for the tax preferred use of the asset;
- must extend to all assets that are, or are to be, put to tax preferred use under the arrangement; and
- is irrevocable.

[Schedule 1, item 1, subsection 250-150(2)]

1.143 If the taxpayer makes a choice under section 250-150, capital allowance deductions in respect of the asset are denied only to the extent of the 'disallowed capital allowance percentage'. ***[Schedule 1, items 1 and 4, subsection 250-150(3) and the definition of 'disallowed capital allowance percentage' in subsection 995-1(1) of the ITAA 1997]***

1.144 The disallowed capital allowance percentage is worked out applying the following formula (expressed as a percentage):

$$\frac{\text{The sum of the present values of the financial benefits that are subject to deemed loan treatment}}{\text{Market value of asset}}$$

[Schedule 1, item 1, subsection 250-150(4)]

1.145 The discount rate to be used in working out the present values of the financial benefits provided, or to be provided, by the members of the tax preferred sector for the tax preferred use of the asset under subsection 250-150(4) is a rate that reflects a constant periodic rate of return (worked out on a compounding basis) on the investment in the relevant asset, or the relevant capital expenditure, that is implicit in the arrangements under which the asset is put to a tax preferred use and financial benefits are provided in relation to that tax preferred use. ***[Schedule 1, item 1, subsection 250-105(2)]***

1.146 For these purposes, the investment in the relevant asset or capital expenditure will generally reflect the market value of the asset or expenditure.

1.147 If the disallowed capital allowance percentage worked out under subsection 250-150(4) is inappropriate, the Commissioner may approve an alternative method for working out the disallowed capital allowance

percentage. The alternative method must be approved by the Commissioner before the day that the taxpayer lodges an income tax return for the income year in which the arrangement period for the tax preferred use of the asset starts. ***[Schedule 1, item 1, subsection 250-150(5)]***

1.148 If the Commissioner approves an alternative method under subsection 250-150(5), the disallowed capital allowance percentage is percentage worked out in accordance with that alternative method. ***[Schedule 1, item 1, subsection 250-150(6)]***

Example 1.19

Nu Co enters into an arrangement involving the tax preferred use of an asset. As some financial benefits will be provided in relation to a use of the asset that is not a tax preferred use, Nu Co makes an election under section 250-150 so that not all capital allowance deductions in respect of the asset are denied.

The sum of the present values of the financial benefits that are subject to deemed loan treatment is $25 million and the market value of the asset is $40 million. Therefore, the disallowed capital allowance percentage is to be 62.5 per cent ($25 million ÷ $40 million × 100).

Consequently, Nu Co is entitled to 37.5 per cent of the capital allowances in respect of the asset.

The arrangement is treated as a deemed loan

1.149 If Division 250 applies to a taxpayer and an asset at a particular time in an income year, a financial arrangement in the form of a loan is taken to exist at that time for the purposes of working out the taxpayer's taxable income for that income year. The characteristics of the loan are set out in section 250-155. ***[Schedule 1, item 1, subsection 250-155(1)]***

Who is the lender?

1.150 The taxpayer is taken to be the lender in relation to the deemed loan. ***[Schedule 1, item 1, subsection 250-155(2)]***

What is the amount lent at the start of the arrangement period?

1.151 The amount that is taken to be the amount lent by the taxpayer at the start of the arrangement period is, generally:

- if (assuming Division 250 did not apply) the taxpayer would be entitled to capital allowance deductions in relation to the asset, the adjustable value of the asset at the start of the arrangement period reduced by the sum of all financial benefits that are subject to deemed loan treatment and that have become due and payable before the start of the arrangement period; or
- if (assuming Division 250 did not apply) the taxpayer would be entitled to a deduction for capital expenditure, the amount

of the undeducted capital expenditure (in the case of a Division 40 asset) or the undeducted construction expenditure (in the case of a Division 43 asset) reduced by the sum of all financial benefits that are subject to deemed loan treatment and that have become due and payable before the start of the arrangement period.

[Schedule 1, item 1, subsections 250-155(3) to (5)]

1.152 If the taxpayer has made a choice under subsection 250-150(3), the amount that is taken to be the amount lent by the taxpayer at the start of the arrangement period is:

- if (assuming Division 250 did not apply) the taxpayer would be entitled to capital allowance deductions in relation to the asset, the disallowed capital allowance percentage of adjustable value of the asset at the start of the arrangement period reduced by the sum of all financial benefits that are subject to deemed loan treatment and that have become due and payable before the start of the arrangement period; or
- if (assuming Division 250 did not apply) the taxpayer would be entitled to a deduction for capital expenditure, the disallowed capital allowance percentage of the amount of the undeducted capital expenditure (in the case of a Division 40 asset) or the undeducted construction expenditure (in the case of a Division 43 asset) reduced by the sum of all financial benefits that are subject to deemed loan treatment and that have become due and payable before the start of the arrangement period.

[Schedule 1, item 1, subsections 250-155(3) to (5)]

When is an amount paid by the borrower under the loan?

1.153 Any financial benefit that a person provides and is subject to deemed loan treatment is taken to be an amount that the borrower pays to the taxpayer under the loan. ***[Schedule 1, item 1, subsection 250-155(6)]***

What is the period of the loan?

1.154 The arrangement period is taken to be the period of the loan. ***[Schedule 1, item 1, subsection 250-155(7)]***

How does Subdivision 250-E apply to the loan?

1.155 The amount of the gain or loss included in a taxpayer's assessable income in respect of a deemed loan that is taken to be a financial arrangement because of section 250-155 is worked out under Subdivision 250-E. For the purposes of applying Subdivision 250-E to the deemed loan:

- the taxpayer is taken to have an overall gain from the deemed loan and that overall gain is taken to be sufficiently certain at the start of the loan;
- the amount of that overall gain is taken to be the sum of the financial benefits that are subject to deemed loan treatment reduced by the amount that is taken to be lent at the start of the arrangement period;
- the taxpayer is taken:
  - to start to have the loan at the start of the arrangement period; and
  - to cease to have the loan at the end of the arrangement period;
- any right that the taxpayer (or a connected entity) has to a financial benefit that is subject to deemed loan treatment is taken to be a right that the taxpayer has under the loan;
- if a connected entity transfers to another person a right to a financial benefit subject to deemed loan treatment:
  - the taxpayer is taken to transfer the right to that other person; and
  - any consideration that the connected entity receives in relation to the transfer is taken to be consideration that the taxpayer receives in relation to the transfer;
- if a right that a connected entity has to a financial benefit subject to deemed loan treatment ceases and the connected entity receives consideration in relation to that cessation, the taxpayer is taken to receive that consideration in relation to the cessation; and
- the taxpayer is taken to start to have the financial arrangement, or to cease to have the financial arrangement, as consideration for something else if the taxpayer starts to have the rights to the financial benefits that are subject to deemed loan treatment, or cease to have those rights, as consideration for that thing.

[Schedule 1, item 1, paragraphs 250-155(8)(a) to (g)]

1.156 In addition, in working out the balancing adjustment at the end of the arrangement under section 250-265 to section 250-275:

- the amount that is taken to have been lent are the only financial benefits that the taxpayer is taken to provide under the deemed loan; and
- the financial benefits received by the taxpayer, or that the taxpayer has a right to receive, under the deemed loan are taken to include financial benefits that are subject to deemed loan treatment that a person is, at the end of the arrangement period, liable to provide to the taxpayer.

[Schedule 1, item 1, paragraph 250-155(8)(h)]

1.157 If a particular percentage of a reasonable estimate of the end value of the asset is taken to be a financial benefit that is subject to deemed loan treatment, subsection 250-275(1) applies to the loan at the end of the arrangement period as if the taxpayer had received under the loan a financial benefit equal to the relevant percentage of the end value of the asset. ***[Schedule 1, item 1, subsection 250-155(9)]***

Example 1.20

Nu Co sells its interest in the asset to another taxpayer entity. The arrangement between Nu Co and the tax preferred entity ends and section 250-275 applies. The relevant percentage of the end value of the asset would be included in the section 250-275 calculations. The sale of the asset would be treated as a transaction occurring immediately after Division 250 ceases to apply to Nu Co.

Financial benefits subject to deemed loan treatment

1.158 A financial benefit is subject to deemed loan treatment if:

- the financial benefit has been, will (assuming normal operating conditions) be or can (assuming normal operating conditions) reasonably be expected to be provided to a taxpayer (or a connected entity of the taxpayer);
- the financial benefit has been, will be or can reasonably be expected to be provided directly or indirectly by a member of the tax preferred sector in relation to the tax preferred use of the asset (as distinct, for example, from the performance of services);
- the right to receive, or the obligation to provide, the financial benefit is cash settlable; and
- the financial benefit has not been, will not be or can be expected not to be provided by a connected entity of the taxable entity.

[Schedule 1, items 1 and 21, subsection 250-160(1) and the definition of 'subject to deemed loan treatment' in subsection 995-1(1) of the ITAA 1997]

Example 1.21

> PT Co enters into a project deed with a state government agency. The project deed requires PT Co to construct a facility for use by the tax preferred entity. Once the facility is constructed, PT Co will service the facility for 30 years. PT Co finances the construction wholly by limited recourse debt and subcontracts the construction to another entity. At the completion of the construction, the state government agency starts to make payments to PT Co. The payments partly cover the debt obligations of PT Co and partly cover the costs of servicing the facility. The servicing of the facility has been subcontracted to a service entity. The payments to PT Co that are attributable to the servicing of the debt would be subject to deemed loan treatment.

1.159 The relevant percentage of a reasonable estimate of the end value of the asset is also taken to be a financial benefit that is subject to the deemed loan treatment if:

- the asset is not to be purchased or acquired by or transferred to the tax preferred end user or a connected entity at the end of the arrangement accrual period under a legally enforceable arrangement; or
- the asset is a privatised asset or would become a privatised asset if it were a depreciating asset — this ensures that section 250-160 interacts appropriately with Division 58 of the ITAA 1997.

[Schedule 1, items 1 and 21, subsection 250-160(2) and the definition of 'subject to deemed loan treatment' in subsection 995-1(1) of the ITAA 1997]

1.160 The relevant percentage is:

- if section 250-150 applies, the disallowed capital allowance percentage; or
- otherwise, 100 per cent.

[Schedule 1, item 1, subsection 250-160(2)]

1.161 A financial benefit is subject to the deemed loan treatment only to the extent to which it represents a return of or on an investment in the asset as distinct from, for example, representing consideration for services rendered or the recovery of production costs. *[Schedule 1, item 1, subsection 250-160(3)]*

Example 1.22

> Under a long term arrangement that falls within the scope of Division 250, Nu Co receives monthly payments from a state government. Forty five per cent of the monthly payments represent consideration for services provided by Nu Co in connection with the

arrangement for the tax preferred use of the asset. The remaining 55 per cent of the monthly payments represent financial benefits that are subject to the notional loan treatment.

1.162 In determining the extent that the financial benefits reflect a return of or on an investment in an asset, factors to be considered include the market value of the asset, the discount rate implicit in the arrangement for the asset and the taxpayer's cost in relation to funding the asset. The regulations may provide rules to determine the extent to which a financial benefit is a return on an asset. ***[Schedule 1, item 1, subsection 250-160(3)]***

1.163 If the tax preferred use of an asset started before Division 250 starts applying to the asset, only those financial benefits provided after Division 250 starts applying to a taxpayer and an asset are subject to the deemed loan treatment. ***[Schedule 1, item 1, subsection 250-160(4)]***

What is a financial arrangement?

1.164 If Division 250 applies to a taxpayer and an asset at a particular time in an income year, a financial arrangement in the form of a loan is taken to exist at that time. The financial arrangement is taken to exist (with the characteristics provided for in section 250-155) whether or not the definition of a 'financial arrangement' is otherwise satisfied.
[Schedule 1, item 1, subsection 250-155(1)]

1.165 Financial benefits subject to deemed loan treatment that a person provides are taken to be the relevant financial benefits paid to the taxpayer under the loan which is the financial arrangement. The right to receive, or obligation to provide, these financial benefits must be cash settlable. In this sense, notwithstanding that the definition of 'financial arrangement' itself may not always have to be relied on, the concept of cash settlable is crucial for financial arrangements deemed to exist under section 250-155.
[Schedule 1, items 1 and 3, subsection 250-155(6), paragraph 250-160(1)(c) and the definition of 'cash settlable' in subsection 995-1(1) of the ITAA 1997]

Cash settlable financial arrangements

1.166 A taxpayer has a financial arrangement if, under an arrangement, the taxpayer has a cash settlable legal or equitable right to receive or obligation to provide a financial benefit, or a combination of one or more such rights and/or obligations, unless:

- in comparison with this right, obligation or combination, the taxpayer also has, under the arrangement, one or more significant legal or equitable rights or obligations to receive or provide something where:
  - the thing that the taxpayer has the right to receive, or the obligation to provide, is not a financial benefit; or
  - the right or obligation is not cash settlable.

[Schedule 1, item 1, subsection 250-165(1)]

1.167 If the entity meets these conditions at any time under an arrangement, then at that time the entity will have a financial arrangement that consists only of any cash settlable legal or equitable rights to receive and obligations to provide financial benefits under that arrangement. That is, the cash settlable legal or equitable right, obligation or combination constitutes the financial arrangement. ***[Schedule 1, items 1 and 10, subsection 250-165(1) and the definition of 'financial arrangement' in subsection 995-1(1) of the ITAA 1997]***

When is a financial benefit cash settlable?

1.168 A right that a taxpayer has to receive, or an obligation a taxpayer has to provide, a financial benefit is cash settlable if, and only if:

- the benefit is money or a money equivalent (which includes a right to receive money and a right to receive such rights);
- in the case of a right — the taxpayer intends to satisfy or settle it by receiving money or a money equivalent or by starting to have, or ceasing to have, another financial arrangement;
- in the case of an obligation — the taxpayer intends to satisfy or settle it by providing money or a money equivalent or by starting to have, or ceasing to have, another financial arrangement;
- the taxpayer has a practice of satisfying or settling similar rights or obligations by receiving or paying money or a money equivalent, or by starting or ceasing to have another financial arrangement (whether or not the taxpayer intends to satisfy or settle the right or obligation in that way);
- the taxpayer deals with the right or obligation, or with similar rights or obligations, in order to generate a profit from short-term fluctuations in price, from a dealer's margin, or from both;
- none of above points apply but:
  - the financial benefit is readily convertible into money or a money equivalent or there is a market for the financial benefit that has a high degree of liquidity; and
  - the taxpayer does not have, as their sole or dominant purpose for entering into the arrangement under which they are to receive or provide the financial benefit, the purpose of receiving or delivering the benefit as part of the expected purchase, sale or usage requirements in the ordinary course of business; or

- the taxpayer is able to settle the right or obligation by receiving or paying money or a money equivalent, or by starting or ceasing to have another financial arrangement (whether or not the taxpayer intends to satisfy or settle the right or obligation in that way) and the taxpayer does not have, as the their sole or dominant purpose for entering into the arrangement under which they are to receive or provide the financial benefit, the purpose of receiving or delivering the financial benefit as part of the expected purchase, sale or usage requirements in the ordinary course of business.

[Schedule 1, item 1, subsection 250-165(2)]

An equity interest or right or obligation in relation to an equity interest

1.169 A taxpayer also has a financial arrangement if the taxpayer has an equity interest. In this case, the equity interest constitutes the financial arrangement. ***[Schedule 1, items 1 and 10, subsection 250-170(1) and the definition of 'financial arrangement' in subsection 995-1(1) of the ITAA 1997]***

1.170 A taxpayer also has a financial arrangement if:

- the taxpayer has, under an arrangement:
  - a legal or equitable right to receive or obligation to provide an equity interest, or a combination of one or more such rights or obligations where this does not constitute a cash settlable financial arrangement; or
  - a legal or equitable right to receive or obligation to provide such a right, obligation or combination where this does not constitute a cash settlable financial arrangement; and
- the right, obligation or combination does not constitute a financial arrangement under section 250-165.

[Schedule 1, item 1, subsection 250-170(2)]

1.171 In this case, the right, obligation or combination constitutes the financial arrangement. ***[Schedule 1, items 1 and 10, subsection 250-170(2) and the definition of 'financial arrangement' in subsection 995-1(1) of the ITAA 1997]***

Grouping and disaggregation rules

1.172 For the avoidance of doubt, if a taxpayer has a right to receive (or obligation to provide) two or more financial benefits, the taxpayer is taken, for the purposes of Division 250, to have a separate right to receive (or obligation to provide) each of those financial benefits. ***[Schedule 1, item 1, subsections 250-175(1) to (3)]***

1.173 For the purposes of Division 250, whether a number of rights and/or obligations are themselves an arrangement or are two or more separate arrangements is a question of fact and degree that is determined having regard, both in relation to the rights and/or obligations separately and in relation to the rights and/or obligations in combination with each other, to the following:

- the nature of the rights and/or obligations;
- the terms and conditions (including those relating to any payment or other consideration for them) of the rights and/or obligations;
- the circumstances surrounding the creation of the rights and/or obligations and their proposed exercise or performance (including what can reasonably be seen as the purposes of one or more of the persons involved);
- whether the rights and/or obligations can be dealt with separately or must be dealt with together;
- normal commercial understandings and practices in relation to the rights and/or obligations (including whether they are regarded commercially as separate things or as a group or series as whole); and
- the objects of Division 250.

[Schedule 1, item 1, subsection 250-175(4) of the ITAA 1997]

End value of an asset

1.174 If the asset has a guaranteed residual value, the end value of the asset is:

- if (assuming Division 250 did not apply) the taxpayer would be entitled to capital allowance deductions for a decline in value of the asset, the guaranteed residual amount; or
- if (assuming Division 250 did not apply) the taxpayer would be entitled to a deduction for capital expenditure, so much of the guaranteed residual amount that is attributable to the expenditure.

[Schedule 1, items 1 and 7, subsections 250-180(1) and (2) and the definition of 'end value' in subsection 995-1(1) of the ITAA 1997]

Example 1.23

A long term arrangement between AR Ltd and a state government in relation to an asset falls within the scope of Division 250 because the state government is the end user of the asset. Under the arrangement, the state government guarantees to pay $10 million to AR Ltd on the disposal of the asset at the end of the arrangement period. As the asset

has a guaranteed residual value, the end value of the asset is $10 million.

1.175 If the asset does not have a guaranteed residual value and is a depreciating asset, the end value of the asset is:

- if (assuming Division 250 did not apply) the taxpayer would be entitled to capital allowance deductions for a decline in value of the asset, the amount that would have been the adjustable value of the asset at the end of the arrangement period if Division 250 had not applied to the asset and the decline in the asset's value were worked out on the basis of the asset's effective life (disregarding any statutory caps specified in section 40-102) and using the prime cost method; or
- if (assuming Division 250 did not apply) the taxpayer would be entitled to a deduction for capital expenditure, so much of the amount that would have been the adjustable value of the asset at the end of the arrangement period if Division 250 had not applied to the asset and the decline in the asset's value were worked out on the basis of the asset's effective life (disregarding any statutory caps specified in section 40-102) and using the prime cost method that is attributable to the expenditure.

[Schedule 1, items 1 and 7, subsections 250-180(1), (3) and (4) and the definition of 'end value' in subsection 995-1(1) of the ITAA 1997]

Example 1.24

A long term arrangement between AR Ltd and a state government in relation to an asset falls within the scope of Division 250. The asset does not have a guaranteed residual value. However, the asset's adjustable value at the end of the arrangement period (disregarding any statutory caps specified in section 40-102 and using the prime cost method) is estimated to be $25 million. Therefore, the end value of the asset will be $25 million.

1.176 If an asset does not have a guaranteed residual value and is not a depreciating asset, and an estimate of the value of the asset is recognised for accounting purposes, the end value of the asset is:

- if (assuming Division 250 did not apply) the taxpayer would be entitled to capital allowance deductions for a decline in value of the asset, the value of the relevant asset at the end of the arrangement period that would be recognised for accounting purposes; or

- if (assuming Division 250 did not apply) the taxpayer would be entitled to a deduction for capital expenditure, so much of the value of the relevant asset at the end of the arrangement period that would be recognised for accounting purposes that is attributable to the expenditure.

[Schedule 1, items 1 and 7, subsections 250-180(1) and (5) and the definition of 'end value' in subsection 995-1(1) of the ITAA 1997]

1.177 If none of subsections 250-180(2), (3) and (5) apply to the asset, the end value of the asset is:

- if (assuming Division 250 did not apply) the taxpayer would be entitled to capital allowance deductions for a decline in value of the asset, a reasonable estimate of the market value of the asset at the end of the arrangement period that does not exceed the amount that is taken have been lent; or
- if (assuming Division 250 did not apply) the taxpayer would be entitled to a deduction for capital expenditure, so much of a reasonable estimate of the market value of the asset at the end of the arrangement period that is attributable to the expenditure and that does not exceed the amount that is taken have been lent.

[Schedule 1, items 1 and 7, subsections 250-180(1) and (6) and the definition of 'end value' in subsection 995-1(1) of the ITAA 1997]

What happens if financial benefits are subject to deemed loan treatment?

1.178 A financial benefit is not included in a taxpayer's assessable income if the financial benefit:

- is provided to the taxpayer in relation to the tax preferred use of the asset; and
- is provided directly or indirectly by a member of the tax preferred sector; and
- is subject to deemed loan treatment.

1.179 The financial benefit is not assessable income and is not exempt income. ***[Schedule 1, item 1, section 250-185]***

1.180 This ensures that there is no double taxation of any financial benefits that are subject to deemed loan treatment. Any gains or losses on the deemed loan are recognised using the compounding accruals method outlined in Subdivision 250-E.

Taxation of the deemed loan

1.181 Subdivision 250-E outlines the tax treatment of gains and losses from a deemed loan that is taken to be a financial arrangement under

section 250-155. Gains and losses from the financial arrangement are recognised over the life of the loan (ignoring distinctions between income and capital) using a compounding accruals method. A change in circumstances may cause a re-estimation of gains and losses that the accruals method is being applied to. A balancing adjustment is made if particular rights or obligations are transferred or cease. ***[Schedule 1, item 1, section 250-190]***

1.182 Subdivision 250-E applies for the purposes of working out the amount of the gain or loss that is to be included in assessable income or allowed as a deduction in relation to the deemed loan financial arrangement. ***[Schedule 1, item 1, section 250-195]***

1.183 The objects of Subdivision 250-E are:

- to properly recognise gains and losses from the financial arrangement by allocating them to appropriate periods of time; and
- to minimise tax deferral.

[Schedule 1, item 1, section 250-200]

1.184 Gains from the deemed loan financial arrangement are included in assessable income. ***[Schedule 1, item 1, subsection 250-205(1)]***

1.185 Any losses from the deemed loan financial arrangement are deductible to the extent that they are made in gaining or producing assessable income or are necessarily made in carrying on a business for the purpose of gaining or producing assessable income. ***[Schedule 1, item 1, subsection 250-205(2)]***

1.186 Gains on the deemed loan financial arrangement that are included in assessable income because of Subdivision 250-E, and any associated financial benefits making up the calculation of that gain, are not to any extent included in assessable income or allowable as a deduction under any other provision of the ITAA 1936 or the ITAA 1997. ***[Schedule 1, item 1, section 250-210]***

1.187 Similarly, any losses that are allowable as a deduction because of Subdivision 250-E, and any associated financial benefits making up the calculation of that loss, are not to any extent allowable as a deduction or included in assessable income under any other provision of the ITAA 1936 or the ITAA 1997. ***[Schedule 1, item 1, section 250-210]***

1.188 This anti-overlap rule will ensure that gains and losses from deemed loan financial arrangements (including any component parts of such gains and losses) are only recognised once for tax purposes. The anti-overlap rule does not prevent these amounts from being included in other calculations. For example, these amounts can be included in calculations for various tax-thresholds, such as the thin capitalisation tests in Division 820 of the ITAA 1997 and the calculations for tainted income

under the controlled foreign corporation rules in Division 7 of Part X of the ITAA 1936.

Methods to be applied to take account of the gain or loss

1.189 The methods available to take account of the gain or loss that a taxpayer makes from the deemed loan financial arrangement are:

- the accruals method provided for in sections 250-235 to 250-255; and
- a balancing adjustment provided for in sections 250-265 to 250-275.

[Schedule 1, item 1, section 250-215]

1.190 A gain or loss that a taxpayer makes from the deemed loan financial arrangement is not taken into account under the accruals method to the extent that it has been taken into account under the balancing adjustment. ***[Schedule 1, item 1, section 250-215]***

Consistency in working out gains or losses

1.191 As an integrity measure, a taxpayer must work out any gains and losses arising under Subdivision 250-E in a consistent manner. Therefore:

- if Subdivision 250-E provides that a particular method applies to gains or losses a taxpayer makes from a deemed loan financial arrangement and that method allows the taxpayer to choose the particular manner in which to apply that method, the taxpayer must use that manner consistently for the arrangement for all income years; and
- if Subdivision 250-E provides that a particular method applies to gains or losses a taxpayer makes from two or more deemed loan financial arrangements and that method allows the taxpayer to choose the particular manner in which to apply that method, the taxpayer must use that same manner consistently for all of those financial arrangements that are essentially of the same nature — it is likely that any deemed loan financial arrangements that are taken to arise under Division 250 will be of essentially the same nature.

[Schedule 1, item 1, section 250-220]

Rights and obligations include contingent rights and obligations

1.192 To avoid doubt:

- a right is treated as a right for the purposes of Division 250 even it is subject to a contingency; and
- an obligation is treated as an obligation for the purpose of Division 250 even if it is subject to a contingency.

[Schedule 1, item 1, section 250-225]

The gain or loss is worked out using the accruals method

1.193 The accruals method provided for in sections 250-235 to 250-255 applies to a gain or loss a taxpayer makes from a deemed loan financial arrangement if:

- the gain or loss is an overall gain or loss from the arrangement; and
- the gain or loss is sufficiently certain at the start of the arrangement period.

[Schedule 1, item 1, section 250-230]

1.194 For these purposes, the taxpayer is taken to have an overall gain from a deemed loan financial arrangement and that overall gain is taken to be sufficiently certain at the start of the arrangement period. *[Schedule 1, item 1, paragraph 250-155(8)(a)]*

1.195 To work out the gain or loss on the deemed loan financial arrangement the taxpayer must establish:

- the period over which the gain or loss is spread, which is worked out under section 250-240 (together with paragraph 250-155(8)(c));
- the method used to allocate the gain or loss to particular intervals within the period over which the gain or loss is spread, which is worked out under section 250-245; and
- if an interval to which part of the gain or loss is allocated straddles two income years, the method for working out how the gain or loss is allocated between those income years, which is worked out under section 250-250.

[Schedule 1, item 1, section 250-235]

The period over which the gain or loss is to be spread

1.196 The period over which the gain or loss on the deemed loan financial arrangement is to be spread is the period that:

- starts when the taxpayer starts to have the arrangement; and
- ends when the taxpayer ceases to have the financial arrangement, assuming that the taxpayer continues to hold the arrangement for the rest of the life of the arrangement.

[Schedule 1, item 1, section 250-240]

1.197 In the case of a deemed loan financial arrangement that arises under Division 250:

- a taxpayer is taken to start to have the loan at the start of the arrangement period; and
- the taxpayer is taken to cease to have the loan at the end of the arrangement period.

[Schedule 1, item 1, paragraph 250-155(8)(c)]

1.198 The time when the arrangement period starts and ends is established by section 250-65. It is these times that will determine the period over which the gain or loss on the deemed loan financial arrangement is to be spread.

How the gain or loss is spread

1.199 The gain or loss on the deemed loan financial arrangement is spread using:

- a compounding accruals method, with intervals to which parts of the gain or loss are allocated not exceeding 12 months and all being of the same length (other than the first and last intervals which may be shorter); or
- a method whose results approximate those obtained using the compounding accruals method (having regard to the length of the period over which the gain or loss is to be spread).

[Schedule 1, item 1, subsections 250-245(1) to (3)]

1.200 Whichever method is chosen, the method is to be applied to spread the gain or loss on the assumption that the taxpayer will continue to have the deemed loan financial arrangement for the rest of the life of the arrangement. ***[Schedule 1, item 1, subsection 250-245(4)]***

1.201 To apply the compounding accruals method a taxpayer estimates the rate of return (the discount rate) that equates the net present value of all cash flows (financial benefits) to zero. A taxpayer applies that rate to the initial investment to provide an estimated year-by-year gain which forms the basis for taxation. However, the amounts that are brought to account under Subdivision 250-E are to be in nominal terms.

1.202 A method other than the prescribed compounding accruals method may be used to spread a sufficiently certain overall gain or loss where the outcome under that method approximates the outcome under the compounding accruals method. The focus of the provision is in relation to the method used and not only the result from the application of that method. As long as the alternative method can be shown to have approximated what would have been the outcome under the compounding accruals method, that alternative method is acceptable.

1.203 The interval periods at the start and end may be shorter than the other intervals because the start or end of a financial arrangement may

occur some time within an interval period. For example, the start or end of the arrangement might be such that it occurs in the middle of what otherwise would have been a three-month interval period. If this occurs that shorter period is taken to be an interval period for the purposes of subsection 250-245(3).

Allocating gain or loss to income years

1.204 That part of an overall gain or loss that has been allocated under the compounding accruals or other acceptable method to a particular interval must be brought to account under section 250-205 as:

- assessable income in the income year in which the interval falls; or
- an allowable deduction in the income year in which the interval falls, provided the conditions in subsection 250-205(2) are satisfied.

[Schedule 1, item 1, subsection 250-250(1)]

1.205 If the relevant interval straddles an income year, such that it starts in one income year and ends in the subsequent income year, the part of the gain or loss that relates to that interval must be allocated between the income years on a reasonable basis. The relevant amount that is brought to account under section 250-205 is so much of that part of the gain or loss that has been allocated to each income year. ***[Schedule 1, item 1, subsection 250-250(2)]***

1.206 If a subsidiary member of a consolidated group or multiple entry consolidated group (MEC group) leaves the group and takes a financial arrangement with it, for the purposes of applying section 250-250 to the group and the financial arrangement, an income year of the group is taken to end at the time that the subsidiary member leaves the group — that is, at the exit time. ***[Schedule 1, item 1, subsection 250-250(3)]***

Re-estimation of a gain or loss

1.207 Generally, for many deemed loan financial arrangements, the taxpayer will apply the compounding accruals method to the relevant gain or loss for the term of the arrangement. However, some circumstances may arise where, during the term of the arrangement, the calculation of the gain or loss to be accrued must be re-estimated.

1.208 A taxpayer must re-estimate a gain or loss from a deemed loan financial arrangement if circumstances arise that materially affect:

- the amount or value of the financial benefits that were taken into account in working out the amount of the gain or loss; or
- the timing of the financial benefits that were taken into account in working out the amount of the gain or loss.

[Schedule 1, item 1, subsection 250-255(1)]

1.209 The taxpayer must make the re-estimation as soon as reasonably practicable after becoming aware of the material change in circumstances affecting the timing of the financial benefits that were taken into account in working out the amount of the gain or loss. ***[Schedule 1, item 1, subsection 250-255(1)]***

1.210 Particular types of change to the relevant circumstances that would require a re-estimation include, but are not limited to:

- a material change in market conditions that are relevant to the amount or value of financial benefits that are to be received or provided under the financial arrangement;
- where the cash flows that were previously estimated become known; and
- where the right to or part of a right to a financial benefit under the arrangement is written off as a bad debt.

[Schedule 1, item 1, subsection 250-255(2)]

1.211 A taxpayer is not required to do a re-estimation of the amount of the gain or loss if the change to the value or amount of the financial benefit or the timing for when the financial benefit is to be paid or received is not significant. This is reflected in the requirement that the relevant change to those circumstances affecting a financial benefit is a material change. For example, a change to the circumstances in respect of a financial benefit may result in the cash flows that were previously estimated becoming known, but the difference between the estimated value of the cash flows and the actual value of the cash flow is small or negligible. In such a case, the change would not seem to be material.

1.212 A circumstance where a re-estimation will be required is if a financial benefit that has been taken into account in calculating the gain or loss is written off as a bad debt. Taxation Ruling TR 92/18 provides guidance as to when a debt is a bad debt. A debt will not be a bad debt if it is simply doubtful that the debt will be recovered.

1.213 A re-estimate of a gain or loss from a financial arrangement is not required under subsection 250-255(4) merely because of:

- a change in the credit rating, or the creditworthiness, of a party or parties to the financial arrangement; and/or
- the impairment (within the meaning of the accounting standards) of the arrangement or a debt that forms part of the arrangement.

[Schedule 1, item 1, subsection 250-255(3)]

1.214 A re-estimation in relation to a gain or loss involves:

- a fresh determination of the amount of the gain or loss from the deemed loan financial arrangement; and
- a reapplication of the accruals method to the redetermined gain or loss to make a fresh allocation of that part of the redetermined gain or loss that has not already been allocated to intervals ending before the re-estimation is made to intervals ending after the re-estimation is made.

[Schedule 1, item 1, subsection 250-255(4)]

1.215 The fresh allocation of the gain or loss under subsection 250-255(4) must be made using one of the following methods:

- the first method is to maintain the rate of return that was used prior to the re-estimation and adjust the amount to which that rate of return is applied to the present value of the estimated future cash flows discounted at the maintained rate of return; or
- the second method is to maintain the amount to which the rate of return was applied prior to the re-estimation and adjust the rate of return that is applied to that amount.

[Schedule 1, item 1, subsection 250-255(5)]

1.216 The adjusted amount to which the rate of return is applied for the first method refers to a change in the carrying amount of the deemed loan financial arrangement at the time of re-estimation to an amount representing the net present value of the future cash flows under the arrangement using the maintained discount rate. Together with the compensating adjustment for any over-accrued or under-accrued amounts (referred to below), this method will bring to account the remaining part of the redetermined gain or loss calculated under paragraph 250-255(4)(a).

1.217 The object of the two methods is to bring the remainder of the gain or loss based on the new estimates properly to account over the remainder of the period which the gain or loss is spread.

1.218 Compliance cost issues would arise if the taxpayer were required to amend prior year's returns each time a re-estimation of an amount is required. Hence, the fresh allocation of the gain or loss applies from the income year in which the taxpayer makes the re-estimation until the end of the arrangement:

- Where the first method is used, a wash-up of over-accrued or under-accrued amounts is achieved by way of a specific accrual adjustment (see paragraphs 1.220 to 1.224).
- Where the second method is used, a similar adjustment is made under the disposal (balancing adjustment) provisions.

1.219 Once a particular basis for a fresh allocation has been adopted in respect of a deemed loan financial arrangement, the taxpayer must apply the same basis to all other re-estimations of gains or losses in respect of all of their deemed loan financial arrangements. ***[Schedule 1, item 1, subsection 250-255(6)]***

Accrual adjustment following a re-estimation

1.220 Where a taxpayer has chosen to make a fresh allocation of the re-estimated gain or loss by maintaining the original rate of return and adjusting the amount to which the rate of return is applied, an amount is brought to account in the income year in which the re-estimation is made. ***[Schedule 1, item 1, subsection 250-255(7)]***

1.221 The adjustment captures the amount of the difference between the amount of the re-estimated gain or loss that should have been brought to account up until the time of re-estimation and the amount of the previously estimated gain or loss that had been brought to account.

1.222 On applying the accrual adjustment provisions, a gain will arise in the income year in which the re-estimation is made if:

- the re-estimated amount is a gain and the amount to which the maintained rate of return is applied has increased in value as a result of the re-estimation — the amount of the gain is equal to that increase; or
- the re-estimated amount is a loss and the amount to which the maintained rate of return decreases in value as a result of the re-estimation — the amount of the gain is equal to that decrease.

[Schedule 1, item 1, paragraphs 250-255(7)(a) and (d)]

1.223 On applying the accrual adjustment provisions, a loss will arise in the income year in which the re-estimation is made if:

- the re-estimated amount is a gain and the amount to which the maintained rate of return is applied has decreased in value

as a result of the re-estimation — the amount of the loss is equal to that decrease; or

- the re-estimated amount is a loss and the amount to which the maintained rate of return increases in value as a result of the re-estimation — the amount of the loss is equal to that increase.

[Schedule 1, item 1, paragraphs 250-255(7)(b) and (c)]

1.224 The gain or loss that is made on applying the accrual adjustment provision in subsection 250-255(6) is brought to account as assessable income or an allowable deduction (provided the conditions in subsection 250-205(2) are satisfied) in the income year in which the re-estimation is made.

Re-estimation if balancing adjustment on partial disposal

1.225 A re-estimate of a gain or loss from a financial arrangement must also be made if a balancing adjustment is made in relation to the financial arrangement under sections 250-265 to 250-275 because:

- the taxpayer transfers to another person a proportionate share of their rights and/or obligations under the financial arrangement;
- the taxpayer transfers to another person a right or obligation that the taxpayer has under a financial arrangement to a specifically identified financial benefit; or
- the taxpayer transfers to another person a proportionate share of a right or obligation the taxpayer has under a financial arrangement to a specifically identified financial benefit.

[Schedule 1, item 1, subsection 250-260(1)]

1.226 The re-estimate must be made as soon as reasonably practicable after the transfer occurs. ***[Schedule 1, item 1, subsection 250-260(1)]***

1.227 Although these conditions would satisfy the requirements of section 250-255, where a partial disposal of the deemed loan financial arrangement has occurred, section 250-260 must be applied to do the re-estimation. That is, there is no choice between applying the method under section 250-255 and the method under section 250-260 in such circumstances.

1.228 The re-estimation in relation to a gain or loss involves:

- a fresh determination of the amount of the gain or loss, disregarding:
  - financial benefits; and

– amounts of the gain or loss that have already been allocated to intervals ending before the re-estimation is made, to the extent to which they are reasonably attributable to the proportionate share, or the right or obligation that has been transferred; and

- a reapplication of the accruals method to the redetermined gain or loss to make a fresh allocation of the gain or loss that has not already been allocated to intervals ending before the re-estimation is made to intervals ending after the re-estimation is made.

[Schedule 1, item 1, subsection 250-260(2)]

1.229 In making the re-estimation, a fresh allocation of the gain or loss is made by maintaining the rate of return being used and adjusting the amount to which the rate of return is applied to the present value of the estimated future cash flows discounted at the maintained rate of return. The object of the fresh allocation is to bring the remainder of the redetermined gain or loss properly to account over the remainder of the period which the gain or loss is spread. ***[Schedule 1, item 1, subsection 250-260(3)]***

1.230 The adjusted amount to which the rate of return is applied for the first method refers to a change in the carrying amount of the deemed loan financial arrangement at the time of re-estimation to an amount representing the net present value of the future cash flows under the arrangement using the maintained discount rate.

1.231 The adjustment under paragraph 250-260(2)(a) ensures that the amount brought to account on the disposal of the relevant rights is taken into account when redetermining the gain. The adjustment under subsection 250-260(3) ensures that the allocation of the redetermined gain takes account of amounts already brought to account in previous years under the accruals methodology.

1.232 The re-estimation is done in the same year as the balancing adjustment under sections 250-265 to 250-275.

What happens when the arrangement comes to an end?

1.233 A balancing adjustment is made under section 250-275 if:

- the taxpayer transfers to another person all of their rights and obligations under the deemed loan financial arrangement;
- all of the taxpayer's rights and obligations under the deemed loan financial arrangement otherwise substantially cease; or
- the taxpayer transfers to another person:

– a proportionate share of all the rights and/or obligations under the arrangement;

– a right or obligation under the arrangement to a specifically identified financial benefit; or

– a proportionate share of a right or obligation under the arrangement to a specifically identified financial benefit.

[Schedule 1, item 1, subsection 250-265(1)]

1.234 However, the following modifications are made if the financial arrangement is an asset of the taxpayer at the time the arrangement comes to an end:

- paragraphs 250-265(1)(a) and (c) do not apply unless the effect of the transfer is to transfer to the other person substantially all the risks and rewards of ownership of the interest transferred; and
- for the purposes of applying section 250-275 to the arrangement, the right under the arrangement is taken to be transferred by the taxpayer to another person if:
  - the taxpayer retains the right but assumes a new obligation;
  - the taxpayer's assumption of the new obligation has the same effect, in substance, as transferring the right to another person;
  - the new obligation arises only to the extent to which the right to financial benefits under the financial arrangement is satisfied;
  - the taxpayer cannot sell or pledge the right (other than as security in relation to the new obligation); and
  - the taxpayer must, under the new obligation, provide financial benefits received in relation to the right to the person to whom they owe the new obligation without delay.

[Schedule 1, item 1, subsection 250-265(2)]

1.235 However, a balancing adjustment is not made under section 250-275 if a subsidiary member of a consolidated group or MEC group, that has the deemed loan financial arrangement, ceases to be a member of the group. *[Schedule 1, item 1, section 250-270]*

What amount is recognised for income tax purposes as a result of the financial arrangement coming to an end?

1.236 The amount to be recognised for income tax purposes as a result of a transfer or cessation (ie, the balancing adjustment) is that amount which ensures that the entity's overall gain or loss from having the deemed loan financial arrangement (or a part of it) is recognised.

1.237 Therefore, amounts recognised prior to the transfer or cessation are taken into account in working out the amount of any balancing adjustment gain or loss. This process corrects for any under-allocation or over-allocation prior to the time of transfer or cessation.

1.238 In broad terms, the way in which the balancing adjustment for cessation or transfer of the whole financial arrangement is worked out for a particular entity under subsection 250-275(1) can be summarised in the formula:

$$\text{Balancing adjustment} = (a + b + c) - (d + e + f)$$

where:

- **a** = total of all financial benefits provided to the taxpayer under the financial arrangement;
- **b** = amount or value of any other consideration received by the taxpayer in relation to the transfer or cessation;
- **c** = total of amounts that have been (or would have been) allowed as deductions for losses from the financial arrangement (if all the losses until the transfer or cessation were allowable as deductions);
- **d** = total of all financial benefits provided by the taxpayer under the financial arrangement;
- **e** = amount or value of any other consideration provided by the taxpayer in relation to the transfer or cessation; and
- **f** = total of amounts that have been or would have been included in assessable income as gains from the financial arrangement (if all the gains until the transfer or cessation were amounts of assessable income).

1.239 If the balancing adjustment is positive, the amount is a gain made from the financial arrangement. If the balancing adjustment is negative, the amount is a loss made from the arrangement. ***[Schedule 1, item 1, subsection 250-275(1)]***

1.240 If a balancing adjustment arises for a partial disposal, the variables in the above formula are adjusted to take into account the nature of the partial disposal.

1.241 Where there is a disposal of a proportionate share of all the rights and/or obligations under the arrangement, the following variables are reduced by that proportion: **a**, **c**, **d** and **f**. ***[Schedule 1, item 1, subsection 250-275(2)]***

1.242 Where there is a disposal of a right or obligation under the arrangement to a specifically identified financial benefit, it is necessary to determine what has happened in relation to that right or obligation — for example, in terms of the cost and the previous allocation of gain or loss — in order to determine the gain or loss to be brought to account as a balancing adjustment. This is done by determining, in relation to **a**, **c**, **d** and **f**, what is reasonably attributable to the right or obligation. ***[Schedule 1, item 1, subsection 250-275(3)]***

1.243 Where there is a disposal of a proportionate share of a right or obligation under the arrangement to a specifically identified financial benefit, the two types of adjustment discussed above are combined. That is, the starting point for **a**, **c**, **d** and **f** in the formula are amounts reasonably attributable to the particular right or obligation. These amounts are then reduced by the disposal proportion to arrive at the amounts actually used for **a**, **c**, **d** and **f** in the formula. ***[Schedule 1, item 1, subsection 250-275(4)]***

1.244 Any adjustment to **a**, **c**, **d** and **f** in respect of one or more particular rights and/or obligations must reflect appropriate and commercially accepted valuation principles that take into account:

- the nature of the rights and obligations under the financial arrangement;
- the risks associated with the financial benefits under the arrangement; and
- the time value of money (ie, characteristics of the financial benefits).

[Schedule 1, item 1, subsection 250-275(5)]

1.245 The gain or loss that is taken to be made under the balancing adjustment is a gain or loss the taxpayer is taken to have made from the deemed loan financial arrangement in the income year in which the balancing adjustment event occurs. ***[Schedule 1, item 1, subsection 250-275(6)]***

1.246 In the case of a deemed loan financial arrangement that arises under Division 250, in working out the balancing adjustment at the end of the arrangement under section 250-265 to section 250-275, or when having to re-estimate the amount of the gain or loss from the deemed loan:

- the amount that is taken to have been lent are the only financial benefits that the taxpayer is taken to provide under the deemed loan; and

- the financial benefits received by the taxpayer, or that the taxpayer has a right to receive, under the deemed loan are taken to include financial benefits that are subject to deemed loan treatment that a person is, at the end of the arrangement period, liable to provide to the taxpayer.

[Schedule 1, item 1, paragraph 250-155(8)(h)]

Financial arrangements received or provided as consideration

1.247 If:

- Subdivision 250-E applies in relation to a taxpayer's gains and losses from the financial arrangement; and
- the taxpayer starts to have the financial arrangement (or a part of the financial arrangement) as consideration (or as part of the consideration) for:
  - something (the thing provided) that the taxpayer provided, or will provide, to someone else; or
  - something (the thing acquired) that someone else has provided, or is to provide, to the taxpayer; and
  - the thing provided or the thing acquired is not money,

then the amount of the benefit (or that part of the benefit) that the taxpayer obtained for the thing provided, or gave for the thing acquired, is taken, for the purposes of applying the ITAA 1936 or the ITAA 1997 to the taxpayer, to be the market value of the financial arrangement (or that part of the financial arrangement) at the time when the taxpayer started to have the financial arrangement. ***[Schedule 1, item 1, subsection 250-280(1)]***

1.248 If subsection 250-280(1) applies, the taxpayer is taken to have received, or provided, as consideration for starting to have the financial arrangement (or the part of the financial arrangement), financial benefits whose value is equal to the market value of the financial arrangement (or that part of the financial arrangement) at the time when the taxpayer started to have the financial arrangement. ***[Schedule 1, item 1, subsection 250-280(2)]***

1.249 If subsection 250-280(2) would apply to a taxpayer starting to have a financial arrangement, subsections 250-280(1) and (4) will not apply to that financial arrangement. That is, subsection 250-280(2) takes precedence over subsections 250-280(1) and (4). ***[Schedule 1, item 1, subsection 250-280(3)]***

1.250 If:

- Subdivision 250-E applies in relation to a taxpayer's gains and losses from the financial arrangement; and
- the taxpayer ceases to have the financial arrangement (or a part of the financial arrangement) as consideration (or as part of the consideration) for:
  - something (the thing acquired) that someone else provides, or is to provide, to the taxpayer; or
  - something (the thing provided) that the taxpayer provided, or will provide, to someone else; and
  - the thing provided or the thing acquired is not money,

then the amount of the benefit (or that part of the benefit) that the taxpayer provided for the thing acquired, or obtained for the thing provided, is taken, for the purposes of applying the ITAA 1936 and the ITAA 1997 to the taxpayer, to be the market value of the financial arrangement (or that part of the financial arrangement) at the time when the taxpayer ceases to have the financial arrangement (or that part of the financial arrangement). ***[Schedule 1, item 1, subsection 250-280(4)]***

1.251 These amounts may be relevant, for example, for the purposes of applying the provisions of the ITAA 1936 and the ITAA 1997 dealing with capital gains, capital allowances or trading stock to the thing provided. For example, where a capital gains tax (CGT) asset is disposed of in return for acquiring a financial arrangement, the proceeds received on disposal of that CGT asset will be taken to be the market value of the financial arrangement at the time the taxpayer starts to have the financial arrangement (instead of the proceeds that would otherwise have been determined under Parts 3-1 and 3-3 of the ITAA 1997).

1.252 If subsection 250-280(4) applies, the taxpayer is taken to have received, or provided, as consideration for ceasing to have the financial arrangement (or the part of the financial arrangement), financial benefits whose value is equal to the market value of the financial arrangement (or that part of the financial arrangement) at the time when the taxpayer ceased to have the financial arrangement. ***[Schedule 1, item 1, subsection 250-280(5)]***

1.253 If subsection 250-280(5) would apply to a taxpayer ceasing to have a financial arrangement, subsections 250-280(1) and (4) will not apply to that financial arrangement. That is, subsection 250-280(5) takes precedence over subsections 250-280(1) and (4). ***[Schedule 1, item 1, subsection 250-280(6)]***

1.254 Without limiting subsections 250-285(1) and (4), the thing provided, or the thing acquired, need not be a tangible thing and may take the form of services, conferring a right, incurring an obligation or

extinguishing or varying a right or obligation. ***[Schedule 1, item 1, subsection 250-280(7)]***

Examples illustrating the application of Division 250

1.255 The following examples illustrate the application of Division 250 in two different scenarios.

Example 1.25

Wal Co, a taxable entity, enters into a 30 year agreement with a state government that involves the tax preferred use of a depreciating asset. The arrangement comes within the scope of Division 250.

Wal Co acquired the asset for $1 million and incurs additional costs of $115,625 to modify the asset to make it suitable for the tax preferred use. The effective life of the asset is 40 years.

The following factors are relevant in determining the gain on the deemed loan that is included in Wal Co's assessable income:

- the arrangement period starts on 1 July 2008 and ends on 30 June 2038 — that is, a period of 30 years;
- the adjustable value of the asset at the start of the arrangement is $1,115,625 (ie, $1,000,000 + $115,625);
- the annual payment for the tax preferred use of the asset by the state government to Wal Co is $90,000 (paid in arrears);
- the estimated value of the asset at the end of the arrangement period is $178,125 — that is, the estimated adjustable value of the asset after 30 years; and
- the asset is not to be purchased by the state government at the end of the arrangement period.

Wal Co subsequently decides to sell the asset for $1 million to another taxpayer entity on 30 June 2018 — that is, 10 years after the commencement of the arrangement period. The adjustable value of the asset at the end of the 10 years is $1 million.

As Division 250 applies to the arrangement, the arrangement is taken to be a financial arrangement in the form of a loan (subsection 250-155(1)).

Wal Co is taken to be the lender in relation to the loan (subsection 250-155(2)).

The amount of the loan amount is taken to be the adjustable value at the start of the arrangement period — that is, $1,115,625 (subsections 250-155(3) and (4)).

The amount that is taken to be paid under the loan to Wal Co by the borrower is the sum of financial benefits provided by the state government that are subject to deemed loan treatment (subsection 250-155(6)). The *sum* of the financial benefits that are subject to deemed loan treatment is the *sum* of financial benefits that

can reasonably be expected to be paid or to become due and payable to Wal Co for the tax preferred use of the asset over the arrangement period *plus* the estimated value of the asset at the end of the arrangement — that is, $2,878,125 ($90,000 × 30 years + $178,125) (section 250-160).

The arrangement period is taken to be the period of the loan — that is, 30 years (subsection 250-155(7)).

The gain on the deemed loan that is included in Wal Co's assessable income is worked out under Subdivision 250-E, which specifies the taxation treatment of financial arrangements. For the purposes of applying Subdivision 250-E to the deemed loan:

- Wal Co is taken to have an overall gain from the loan that is taken to be sufficiently certain at the start of the loan (paragraph 250-155(8)(a));
- the amount of the overall gain is taken to be the *sum* of the financial benefits that are subject to deemed loan treatment ($2,878,125) *less* the amount of the loan ($1,115,625) — that is, $1,762,500 (paragraph 250-155(8)(b)); and
- the loan is taken to start at the start of the arrangement period (1 July 2008) and cease at the end of the arrangement period (30 July 2038) (paragraph 250-155(8)(c)).

The estimated annual compounding accrual rate applicable to work out the amount of gain to be accrued each year is 7.2 per cent — that is, the internal rate of return based on the expected cash flows (including the estimated end value) under the arrangement over the arrangement period.

The amount of gain on the deemed loan that is included in Wal Co's assessable income under section 250-205 in each year is illustrated in Table 1.1.

Table 1.1: Gain on the deemed loan that is assessable

Year	*Gain on the deemed loan that is assessable*
2008-09	$80,445
2009-10	$79,756
2010-11	$79,018
2011-12	$78,226
2012-13	$77,377
2013-14	$76,467
2014-15	$75,491
2015-16	$74,445
2016-17	$73,323
2017-18	$72,120
Total	**$766,668**

A balancing adjustment is made under section 250-275 when Wal Co sells the asset on 30 June 2018 for $1 million. The amount of the balancing adjustment is worked out as follows:

Total of financial benefits received (ie, $90,000 × 10 + $1,000,000)	$1,900,000
Less	
Total of financial benefits provided (ie, the amount of the loan)	($1,115,625)
Total amount assessed	($766,668)
Balancing adjustment	$17,707

The balancing adjustment gain of $17,707 is assessable in the 2017-18 income year.

Therefore, the total amount that is included in Wal Co's assessable income as a result of Division 250 applying is $784,375 (ie, $766,668 + $17,707). This amount is the same as the total amount that would be assessable if Division 250 did not apply. However, Division 250 has the effect of altering the amount that would be assessable in each income year.

Example 1.26

Court Co contracts on 1 July 2007 to design, construct and fit out a special purpose court building on land leased from a state government. There is nominal ground lease rental of $1. Court Co contracts to provide the completed court building to the state government and to provide facilities management services, both commencing from completion of the two-year construction period on 1 July 2009 and ending on 30 June 2034 (ie, a 25-year period).

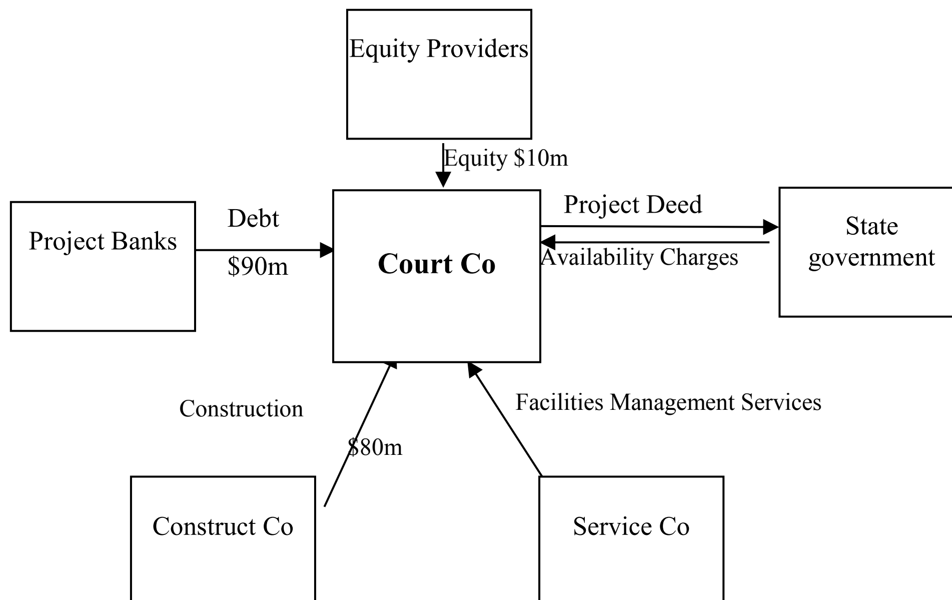
Court Co will receive annual availability charges from the state government commencing on 1 July 2009 for 25 years made up of a capital component of $9.77 million per annum (fixed with no escalation) and a facilities maintenance component (escalating at movements in the consumer price index). The availability charges are subject to abatement for non-availability of facilities and failure to meet performance benchmarks.

Court Co has entered into two arm's length fixed price subcontracts:

- One subcontract is with Construct Co for the design and construction of the buildings and plant for $80 million.
- The second subcontract is with Services Co for the provision of the facilities management for a 25-year term for a price matching the facilities maintenance component of the availability charge.

The court building will revert to the state government (with nil consideration for the improvements) at expiry of the ground lease on 30 June 2034. Depreciable plant will be transferred to the state government at the same time for nil consideration.

The arrangements can be illustrated as follows:



The project costs for Court Co can be broken down as follows:

- Division 43 building capital expenditure — $70 million;
- Division 40 depreciable plant — $10 million;
- Other incidental costs/reserves — $20 million; and

- Total Project Funding — $100 million.

For the purposes of applying Division 250, the arrangement period commences at completion of construction on 1 July 2009 (ie, when the tax preferred use commences) and ends on 30 June 2034.

The financial benefits that are subject to deemed loan treatment need to be identified and then allocated separately to each asset on a reasonable basis.

The capital component of the availability charge (ie, the annual payments of $9.77 million) represents a financial benefit in respect of the investment in the project assets. In the circumstances it is reasonable to allocate:

- 70 per cent of the capital component of the availability charge to the Division 43 capital expenditure; and
- 10 per cent of the capital component of the availability charge to Division 40 depreciable plant.

This represents the proportion of the total project investment represented by those items (subsection 250-160(3)).

There is no end value amount required to be included as a financial benefit for either the Division 43 capital expenditure or the Division 40 depreciable plant (subsection 250-160(2)) because the Division 43 asset and the Division 40 depreciable plant will be transferred to the state government for nil consideration at the end of the arrangement period (paragraphs 250-85(1)(b) to (d)).

In relation to the Division 43 asset:

- Table 1.2 illustrates the Division 250 assessable amount in respect of the Division 43 asset — that is, the present value (applying a 5.40 per cent discount rate) of the assessable income calculated under Division 250 in respect of the Division 43 asset; and
- Table 1.3 illustrates the alternative assessable amount — that is, the present value of the net assessable income of Court Co under general principles.

As the Division 250 assessable amount ($62.107 million) is less than the alternative assessable amount ($68.947 million), the exclusion in section 250-40 will apply and the asset will not be subject to deemed loan treatment.

Table 1.2: Division 250 assessable amount

Year	*Availability charge (building capital component)* *($'000s)*	*Division 250 assessable amount* *($'000s)*	*Present value of assessable amount* *($'000s)*
2010	6,840	5,950	5,645
2011	6,840	5,874	5,288
2012	6,840	5,792	4,947
2013	6,840	5,703	4,621
2014	6,840	5,607	4,310
2015	6,840	5,502	4,013
2016	6,840	5,388	3,729
2017	6,840	5,265	3,457
2018	6,840	5,131	3,196
2019	6,840	4,986	2,946
2020	6,840	4,828	2,707
2021	6,840	4,657	2,477
2022	6,840	4,471	2,257
2023	6,840	4,270	2,045
2024	6,840	4,052	1,841
2025	6,840	3,815	1,644
2026	6,840	3,557	1,455
2027	6,840	3,278	1,272
2028	6,840	2,976	1,096
2029	6,840	2,647	925
2030	6,840	2,291	759
2031	6,840	1,904	599
2032	6,840	1,485	443
2033	6,840	1,030	291
2034	6,840	536	144
Total present value of assessable income			**62,107**

Table 1.3: Alternative assessable amount

Year	*Alternative assessable income* *($'000s)*	*Present value of alternative income* *($'000s)*	*Alternative allowable deductions* *($'000s)*	*Present value of alternative deductions* *($'000s)*	*Total alternative present value* *($'000s)*
2010	6,840	6,489	(1,750)	(1,660)	4,829
2011	6,840	6,157	(1,750)	(1,575)	4,582
2012	6,840	5,841	(1,750)	(1,495)	4,347
2013	6,840	5,542	(1,750)	(1,418)	4,124
2014	6,840	5,258	(1,750)	(1,345)	3,913
2015	6,840	4,989	(1,750)	(1,276)	3,712
2016	6,840	4,733	(1,750)	(1,211)	3,522
2017	6,840	4,491	(1,750)	(1,149)	3,342
2018	6,840	4,261	(1,750)	(1,090)	3,171
2019	6,840	4,042	(1,750)	(1,034)	3,008
2020	6,840	3,835	(1,750)	(981)	2,854
2021	6,840	3,639	(1,750)	(931)	2,708
2022	6,840	3,452	(1,750)	(883)	2,569
2023	6,840	3,275	(1,750)	(838)	2,437
2024	6,840	3,108	(1,750)	(795)	2,313
2025	6,840	2,948	(1,750)	(754)	2,194
2026	6,840	2,797	(1,750)	(716)	2,082
2027	6,840	2,654	(1,750)	(679)	1,975
2028	6,840	2,518	(1,750)	(644)	1,874
2029	6,840	2,389	(1,750)	(611)	1,778
2030	6,840	2,267	(1,750)	(580)	1,687
2031	6,840	2,151	(1,750)	(550)	1,600
2032	6,840	2,040	(1,750)	(522)	1,518
2033	6,840	1,936	(1,750)	(495)	1,441
2034	6,840	1,837	(1,750)	(470)	1,367
Total present value of assessable income					**68,947**

In relation to the Division 40 asset, the asset is subject to Division 250 and deemed loan treatment will apply to the asset.

The amount of the deemed loan is $10 million (paragraph 250-155(4)(a)). An amount of 10 per cent of the capital component of the availability charge payment stream received from the

state government (ie, $977,000) is treated as repayment of principal and interest under the deemed loan.

The amount of the gain on the deemed loan is included in the assessable income of Court Co under subsection 250-205(1).

Treatment of the asset after Division 250 ceases to apply

Implications for Division 40 purposes

1.256 For the purposes of Division 40, the adjustable value of the asset at the end of the arrangement period is modified if:

- Division 250 ceases to apply to a taxpayer and an asset because the arrangement period for the tax preferred use of the asset ends; and
- the asset would have had an adjustable value at that time if Division 250 had never applied to the asset.

[Schedule 1, item 1, subsection 250-285(1)]

1.257 In these circumstances, the adjustable value of an asset at the end of the arrangement period is:

- if section 250-150 does not apply, so that all capital allowances in relation to the asset are denied during the arrangement period because of the operation of Division 250, the amount of the end value of the asset; or
- if section 250-150 applies, so that only some of the capital allowances in relation to the asset are denied during the arrangement period because of the operation of Division 250, the sum of the following amounts:
  – the amount worked out by *multiplying* the end value of the asset at the end of the arrangement period by the disallowed capital allowance percentage; and
  – the amount worked out by *multiplying* the adjustable value of the asset at the end of the arrangement period (worked out under section 40-85) by 100 per cent *minus* the disallowed capital allowance percentage.

[Schedule 1, item 1, subsection 250-285(1)]

Implications for capital gains tax purposes

1.258 If Division 250 has applied to a taxpayer and an asset and the arrangement period for the tax preferred use of the asset ends, then for the purpose of working out the amount of any capital gain or loss, the cost base and reduced cost base of the asset is adjusted. The adjustments effectively reduce the cost base and the reduced cost base by the capital component of the deemed loan that has been excluded from assessable

income (and therefore effectively allowed as a deduction). ***[Schedule 1, item 1, subsections 250-285(2) and (3)]***

1.259 If a net amount is included assessable income in relation to financial benefits that are subject to deemed loan treatment (taking into account the adjustments under Subdivision 250-E), the cost base and reduced cost base are each taken to be reduced at the end of the arrangement period by the difference between:

- the total financial benefits that were subject to the deemed loan treatment (disregarding the reasonable estimate of the end value of the asset); and
- the net amount included in assessable income.

[Schedule 1, item 1, subsections 250-285(2) and (6)]

1.260 If a net amount is allowed as a deduction in relation to financial benefits that are subject to deemed loan treatment (taking into account the adjustments under Subdivision 250-E), the cost base and reduced cost base are each taken to be reduced at the end of the arrangement period by the sum of:

- the total financial benefits that were subject to the deemed loan treatment (disregarding the reasonable estimate of the end value of the asset); and
- the net amount allowed as a deduction.

[Schedule 1, item 1, subsections 250-285(3) and (6)]

Example 1.27

In Example 1.25, Wal Co sold the asset to another taxable entity for $1 million on 30 June 2018. The cost base of the asset for CGT purposes is $1,115,625 — that is, the *sum* of the amount paid to acquire the asset ($1 million) *plus* the cost of modifying the asset to make it suitable for tax preferred use ($115,625).

If the asset is a CGT asset, for the purpose of working out the amount of the capital gain included in assessable income on the disposal of the asset, the cost base of the asset is reduced by $115,625 — that is, the difference between:

- the total financial benefits that were subject to the deemed loan treatment (disregarding the reasonable estimate of the end value of the asset) – that is, $900,000 (ie, $90,000 × 10 years); and
- the net amount of the gain on the deemed loan that is included in assessable income — that is, $784,375 (ie, the *gain* on the deemed loan that is assessable ($766,668) *plus* the balancing adjustment ($17,707)).

Therefore, if the asset is a CGT asset, the capital gain made by Wal Co will be nil — that is, the capital proceeds ($1 million) *less* the adjusted cost base ($1,115,625 – $115,625 = $1 million).

Implications for assets on revenue account

1.261 If Division 250 has applied to a taxpayer and an asset and the arrangement period for the tax preferred use of the asset ends, then for the purpose of working out the amount of the profit or loss on sale of the asset, the amount that is allowed as a deduction is adjusted. The adjustments effectively increase the taxable profit, or reduces the loss, on the sale of the asset by the capital component of the deemed loan that has been excluded from assessable income (and therefore effectively allowed as a deduction). ***[Schedule 1, item 1, subsections 250-285(2) and (3)]***

1.262 If a net amount is included assessable income in relation to financial benefits that are subject to deemed loan treatment (taking into account the adjustments under Subdivision 250-E), then in determining the profit or loss on the sale of the asset, a deduction is taken to have been allowed for expenditure by the taxpayer in connection with the asset for an amount equal to the difference between:

- the total financial benefits that were subject to the deemed loan treatment (disregarding the reasonable estimate of the end value of the asset); and
- the net amount included in assessable income.

[Schedule 1, item 1, subsections 250-285(3) and (6)]

1.263 If a net amount is allowed as a deduction in relation to financial benefits that are subject to deemed loan treatment (taking into account the adjustments under Subdivision 250-E), then in determining the profit or loss on the sale of the asset, a deduction is taken to have been allowed for expenditure by the taxpayer in connection with the asset for an amount equal to the sum of:

- the total financial benefits that were subject to the deemed loan treatment (disregarding the reasonable estimate of the end value of the asset); and
- the net amount allowed as a deduction.

[Schedule 1, item 1, subsections 250-285(4) and (6)]

Balancing adjustment under Subdivision 40-D

1.264 For the purposes of applying Subdivision 40-D to an asset, the basis for working out the balancing adjustment is modified if:

- the arrangement period for the tax preferred use of the asset ends because a particular event happens; and
- the event would have been a balancing adjustment event for the asset for the purposes of Subdivision 40-D if Division 250 did not apply to the asset when the event happened.

[Schedule 1, item 1, subsection 250-290(1)]

1.265 In these circumstances, the balancing adjustment is made under Subdivision 40-D as if:

- the event were a balancing adjustment event for the asset;
- the adjustable value of the asset just before the event happened was the adjustable value worked out under subsection 250-285(1); and
- section 40-290 (which reduces the balancing adjustment amount where the asset has been put to a non-taxable use) and section 40-292 (which adjusts the balancing adjustment amount where deductions for the decline in value have been allowed under research and development provisions of the ITAA 1936) did not apply.

[Schedule 1, item 1, subsection 250-290(2)]

Example 1.28

In Example 1.25, Wal Co acquired the depreciating asset for $1 million on 1 July 2008 and sold it to another taxable entity for $1 million on 30 June 2018. In working out the amount of the balancing adjustment:

- the sale of the depreciating asset is taken to be a balancing adjustment event under Subdivision 40-D (section 250-290);
- the adjustable value of the asset is taken to be the amount that is the end value of the asset at the end of the arrangement period — that is, $1 million (step 2 in the method statement in subsection 250-285(1)).

The amount of the balancing adjustment, which is worked out under section 40-305, is nil — that is, the difference between the amount received by Wal Co on the sale of the asset ($1 million) and the amount that is taken to be adjustable value of the asset ($1 million).

Objections against the Commissioner's determinations and decisions

1.266 A person who is dissatisfied with a determination made by the Commissioner under section 250-45, which allows the Commissioner to make a determination that it is unreasonable that Division 250 applies to a taxpayer and an asset at a particular time, may object against the determination under Part IVC of the *Taxation Administration Act 1953* (TAA 1953). ***[Schedule 1, item 1, subsections 250-295(1) and (3)]***

1.267 Similarly, a person who is dissatisfied with a decision made by the Commissioner under subsection 250-150(5), which allows the Commissioner to approve an alternative method for working out the disallowed capital allowance percentage of an asset, may object against the determination or decisions under Part IVC of the TAA 1953. ***[Schedule 1, item 1, subsections 250-295(2) and (3)]***

Application and transitional provisions

Division 250 applies to arrangements entered into on or after 1 July 2007

1.268 Division 250 will apply to all relevant arrangements where the tax preferred use of an asset starts on or after 1 July 2007 under a legally enforceable arrangement that is entered into on or after that date. ***[Schedule 1, subitem 71(1)]***

1.269 Section 51AD and Division 16D of Part III of the ITAA 1936 will not apply to an asset (including property) if the tax preferred use of that asset starts on or after 1 July 2007 under a legally enforceable arrangement that is entered into on or after that date.

Taxpayers can elect to apply Division 250 to certain arrangements entered into before 1 July 2007

1.270 Taxpayers can elect to apply Division 250 to certain arrangements entered into before 1 July 2007. This transitional provision applies if an asset is first put to tax preferred use on or after 1 July 2007. In that event, the taxpayer can elect to apply Division 250 to the arrangement even though the arrangement was entered into before 1 July 2007.

1.271 That is, Division 250 will apply to relevant arrangements where the tax preferred use of an asset starts on or after 1 July 2007 under a legally enforceable arrangement entered into before that date if:

- section 51AD or Division 16D of Part III of the ITAA 1936 would otherwise apply to the asset; and
- the taxpayer elects to have Division 250 apply.

[Schedule 1, subitem 71(2)]

1.272 The election to apply Division 250:

- must be made by the day the taxpayer lodges an income tax return for the income year in which the tax preferred use starts;
- must be made for the whole of the arrangement period for the tax preferred use of the asset;
- must extend to all assets that are, or are to be, put to tax preferred use under the arrangement under which the asset is put to that use; and
- is irrevocable.

[Schedule 1, subitem 71(3)]

1.273 The effect of making an election is that Division 250 (rather than section 51AD or Division 16D) will apply to the tax preferred use of the asset. ***[Schedule 1, subitem 71(4)]***

Division 250 applies where an arrangement is materially altered on or after 1 July 2007

1.274 Division 250 will apply to an arrangement entered into before 1 July 2007 where, broadly:

- section 51AD or Division 16D did not apply before 1 July 2007; and
- there was a material alteration to the arrangement after 1 July 2007 that would, in the absence of this transitional provision, cause section 51AD or Division 16D to apply.

1.275 This will ensure that Division 250 applies to an arrangement entered into before 1 July 2007 where that arrangement would otherwise come within the scope of section 51AD or Division 16D because of a material alteration to the arrangement. In practical terms, this proposal will allow arrangements entered into by taxpayers to come within the scope of Division 250 by materially altering an existing arrangement rather than by achieving the same outcome by entering into a new arrangement.

Tax preferred use starts after commencement

1.276 Division 250 will apply to an asset that is put to a tax preferred use where:

- the tax preferred use starts on or after 1 July 2007;
- the tax preferred use is under a legally enforceable arrangement entered into before 1 July 2007;
- immediately before 1 July 2007, neither section 51AD nor Division 16D applied to the asset (assuming that the asset was in existence and was being put to a tax preferred use at that time);
- the arrangement is materially altered on or after 1 July 2007; and
- section 51AD or Division 16D would otherwise apply to the asset immediately after the alteration.

[Schedule 1, subitem 71(5)]

1.277 A material alteration to an arrangement will occur only if there is a significant change to the arrangement. For example, a material alteration may arise because the taxpayer subsequently agrees to incur a substantial amount of additional capital expenditure in relation to the

arrangement. In contrast, the removal of a contingent equity agreement in relation to an arrangement is not a material alteration of that arrangement.

1.278 For the purpose of determining whether Division 16D would otherwise have applied to the arrangement, section 159GL of the ITAA 1936 is to be disregarded. ***[Schedule 1, subitem 71(9)]***

1.279 Section 159GL excludes from the operation of Division 16D certain qualifying arrangements relating to buildings in respect of which capital expenditure deductions are available under Division 10C or 10D. The section ensures that a taxpayer cannot, because of the application of Division 16D, receive a benefit that would not have been available had Division 16D not applied.

1.280 If subitem 71(5) applies, Division 250 (rather than section 51AD or Division 16D) will apply to the tax preferred use of the asset and the arrangement period will be taken to start on the day on which the alteration occurs. ***[Schedule 1, subitems 71(6) and (10)]***

Tax preferred use starts before commencement

1.281 Division 250 will apply to an asset that it is put to a tax preferred use where:

- the tax preferred use starts before 1 July 2007;
- immediately after 1 July 2007 neither section 51AD nor Division 16D applied to the asset;
- the arrangement is materially altered on or after 1 July 2007; and
- section 51AD or Division 16D would otherwise apply to the asset immediately after the alteration.

[Schedule 1, subitem 71(7)]

1.282 For the purpose of determining whether Division 16D would otherwise have applied to the arrangement, section 159GL of the ITAA 1936 is to be disregarded. ***[Schedule 1, subitem 71(9)]***

1.283 If subitem 71(7) applies, Division 250 (rather than section 51AD or Division 16D) will apply to the tax preferred use of the asset and the arrangement period will be taken to start on the day on which the alteration occurs. ***[Schedule 1, subitems 71(8) and (10)]***

Section 51AD switched off from 1 July 2003

1.284 Section 51AD will not apply to arrangements entered into before 1 July 2007 where the tax preferred use started between 1 July 2003 and 30 June 2007. In these circumstances, Division 16D will generally apply to these arrangements. However, if there is a material alteration to the

arrangement on or after 1 July 2007, Division 250 may apply to the arrangement.

1.285 That is, section 51AD will cease to apply to an asset in respect of an income year beginning on or after 1 July 2007 if:

- the asset is put to tax preferred use under a legally enforceable arrangement;
- the arrangement was entered into before 1 July 2007; and
- the tax preferred use starts on or after 1 July 2003 and before 1 July 2007.

[Schedule 1, subitem 71(11)]

1.286 For the avoidance of doubt, an asset that is put to a tax preferred use includes property that falls within the scope of section 51AD.

1.287 This transitional rule will effectively switch off the adverse consequences of section 51AD with effect from 1 July 2003. This transitional rule will ensure that taxpayers are not disadvantaged by the delay in introducing Division 250 and, in practical terms, will reduce compliance costs as taxpayers will be able to remove contingent equity arrangements entered into for the purpose of avoiding the application of section 51AD.

Amendments to the *Taxation Administration Act 1953*

1.288 The consequential amendments to the TAA 1953 apply in relation to an income year that begins on or after 1 July 2008. ***[Schedule 1, subitem 71(2)]***

Consequential amendments

Development Allowance Authority Act 1992

1.289 The *Development Allowance Authority Act 1992* provides support for major capital works in the form of tax concessions for lenders. The scheme is administered by a certificate being issued for a project. The effect of the certificate is that interest payments made by companies, corporate unit trusts and public trading trusts on capital borrowings related to specific property are not taxable. The ability to apply for new certificates under the scheme was terminated in 1997.

1.290 Section 93R of the *Development Allowance Authority Act 1992* requires that an applicant for a certificate does not do anything that causes section 51AD or Division 16D of Part III of the ITAA 1936 to apply to the relevant facilities. Section 93ZB allows the Development Allowance Authority to cancel a certificate if the conditions under which it was granted are not complied with.

1.291 Consequential amendments to section 93R of the *Development Allowance Authority Act 1992* will ensure that the conditions for granting the certificate are not altered by the introduction of Division 250 of the ITAA 1997. ***[Schedule 1, items 25 and 26, subparagraphs 93R(b)(v) and (c)(ii) of the Development Allowance Authority Act 1992]***

Income Tax Assessment Act 1936

Section 51AD

1.292 Section 51AD is being replaced by Division 250. If Division 250 applies to an asset (including property), section 51AD will not apply to that asset.

1.293 Section 51AD will continue to apply to property that is put to a tax preferred use under a legally enforceable arrangement that is entered into before 1 July 2007. Therefore, section 51AD will not apply to:

- property that is put to a tax preferred use if that tax preferred use starts on or after 1 July 2007 under a legally enforceable arrangement that is entered into on or after that date;
- property that is acquired on or after 1 July 2007 under a legally enforceable arrangement that is entered into on or after that date;
- property that is put to a tax preferred use if that tax preferred use starts on or after 1 July 2007 under a legally enforceable arrangement that is entered into before that date and the taxpayer makes an election under item 71 to apply Division 250 to the arrangement; or
- property that Division 16D applies to before 1 July 2007.

[Schedule 1, items 27 and 28, subsections 51AD(1A) to (1D) and (4) of the ITAA 1936]

1.294 For the avoidance of doubt, the reference to 'property that is put to a tax preferred use' in item 27 applies to property that would otherwise fall within the scope of section 51AD.

Research and development activities

1.295 Section 73B allows a deduction for certain expenditure on research and development activities. Section 73BA allows a deduction for certain assets used for the purpose of carrying on those activities.

1.296 Consequential amendments are made to add guidance notes to subsections 73B(15AA) and 73BC(2) that refer to Division 250 in appropriate circumstances. ***[Schedule 1, items 29 to 31, subsections 73B(15AA) and 73BC(2) of the ITAA 1936]***

Consequential amendments related to Subdivision 250-E

1.297 Subdivision 250-E outlines the tax treatment of gains and losses from a deemed loan that is taken to be a financial arrangement because of section 250-155. A consequential amendment is made to the 12-month prepayment rules in the ITAA 1936 to ensure that they interact appropriately with Subdivision 250-E. ***[Schedule 1, item 32, section 82KZLA of the ITAA 1936]***

Division 16D of Part III

1.298 Division 16D is being replaced by Division 250. If Division 250 applies to an asset (including an item of eligible property), Division 16D will not apply to that asset.

1.299 Division 16D will continue to apply to an item of eligible property that is put to a tax preferred use under a legally enforceable arrangement that is entered into before 1 July 2007. Therefore, Division 16D will not apply to:

- an item of eligible property that is put to a tax preferred use if that tax preferred use starts on or after 1 July 2007 under a legally enforceable arrangement that is entered into on or after that date; or
- an item of eligible property that is put to tax preferred use if that tax preferred use starts on or after 1 July 2007 under a legally enforceable arrangement entered into before that date and the taxpayer makes an election under item 71 to apply Division 250 to the arrangement.

[Schedule 1, items 33 and 34, subsections 159GH(1A), (1B) and (1) of the ITAA 1936]

1.300 For the avoidance of doubt, the reference to ‘eligible property that is put to a tax preferred use’ in item 33 applies to eligible property that would otherwise fall within the scope of Division 16D.

Amendment of assessments

1.301 Subsections 170(10) and (10AA) extend the period for amending assessments to give effect to specified provisions (including section 51AD and Division 16D). A consequential amendment ensures that the period for amending assessments to give effect to Division 250 is also extended. ***[Schedule 1, item 35, subsection 170(10AA) of the ITAA 1936]***

Income Tax Assessment Act 1997

Checklists

1.302 The ITAA 1997 contains various checklists to guide the reader. The amendments will insert references to various terms used in Division 250 in the checklist of non-assessable non-exempt income and the checklist of deductions. ***[Schedule 1, items 36 to 42, sections 11-55 and 12-5]***

Capital allowances

1.303 Division 40 contains the capital allowance regime. Section 40-25 allows a taxpayer to deduct the decline in value of a depreciating asset held by a taxpayer during an income year to the extent that, so far as is relevant, the asset is used for a taxable purpose. The amendments will modify the definition of 'taxable purpose' if Division 250 applies to a taxpayer and an asset that is a depreciating asset so that:

- if section 250-150 applies, the taxpayer will be taken to be using the depreciating asset for a taxable purpose to the extent specified in a determination made under subsection 250-150(3); and
- otherwise, the taxpayer will be taken not to be using the depreciating asset for a taxable purpose.

[Schedule 1, items 43 and 44, subsections 40-25(7) and (8)]

1.304 Consequential amendments are also made to add guidance notes to various provisions in Division 40 to refer to Division 250 in appropriate circumstances. ***[Schedule 1, items 45 to 56, sections 40-85, 40-525, 40-630, 40-730, 40-735, 40-750, 40-755, 40-835 and 40-880]***

Capital works

1.305 Division 43 allows specific deductions for capital works. Consequential amendments are made to add a guidance note in section 43-140. ***[Schedule 1, items 57 and 58, subsection 43-140(1)]***

Capital gains tax

1.306 Division 110 sets out the cost base and reduced cost base for a CGT asset in most circumstances. Division 112 outlines various modifications to the cost base and reduced cost base. Modifications that are made outside Division 112 are listed in section 112-97. A consequential amendment is being made to add a reference to the cost base modification rules that apply when Division 250 no longer applies to an asset in the list in section 112-97. ***[Schedule 1, item 59, section 112-97]***

1.307 In addition, an amendment is made to the CGT provisions to ensure that a capital gain or loss that is made from a CGT asset is disregarded if the asset is, or is part of, a deemed loan financial arrangement. ***[Schedule 1, item 60, section 118-27]***

Land transport facilities borrowing

1.308 Division 396 allows a lender to get a tax offset for certain interest it derives on an approved borrowing by another entity for the construction of land transport facilities. To qualify for the tax offset, the borrower must, among other things, enter into a land transport facilities borrowings agreement.

1.309 Section 396-85 specifies the conditions that are required to be included in the agreement. One of those conditions is that the borrower must not do anything that causes either section 51AD or Division 16D of Part III of the ITAA 1936 to apply to any of the relevant facilities. This condition is modified so that, in addition, the borrower must not do anything that causes Division 250 to apply to any of the relevant facilities. In addition, the example in subsection 396-75(2) is modified to reflect this change. ***[Schedule 1, items 61 and 62, subsection 396-75(2) and paragraph 396-85(1)(c)]***

Consolidation

1.310 If an entity joins a consolidated group or MEC group, the tax cost of the joining entity's asset must be reset. If the asset is a right to receive a specified amount of Australian currency, for example, the asset is a retained cost base asset (subsection 705-25(5)). In this event, the tax cost setting amount is generally equal to the amount of Australian currency concerned (subsection 705-25(2)).

1.311 An amendment is made to the consolidation provisions to modify this outcome if an entity that joins a consolidated group or a MEC group holds a deemed loan financial arrangement that is a retained cost base asset. In that event:

- the tax cost setting amount is the terminating value for the retained cost base asset immediately before the joining time; and
- the terminating value of the deemed loan financial arrangement is equal to the amount of consideration that the joining entity would need to receive were it to dispose of the asset just before the joining time (without an amount being assessable or allowed as a deduction under Subdivision 250-E).

[Schedule 1, items 63 and 64, subsections 705-25(4A) and 705-30(3A)]

Foreign currency rules

1.312 Under the foreign currency and functional currency translation rules in Subdivisions 960-C and 960-D of the ITAA 1997, an amount of foreign currency must be converted into Australian dollars or into the taxpayer's functional currency. This generally applies to all amounts relevant to calculating an entity's income tax liability.

1.313 Generally, if the amount that is taken into account for income tax purposes is the *sum* of or the result of two or more other amounts, each element of that calculation must be translated into an amount of Australian currency or functional currency (subsections 960-50(1) and 960-80(1)). However, if the amount is a 'special accrual amount', only the amount that is *sum* of or the result of the calculation is translated into an amount of Australian currency or functional currency (subsections 960-50(5) and 960-80(5)).

1.314 If all the financial benefits provided and received under a deemed loan financial arrangement are denominated in a particular foreign currency, the amount that is included in assessable income under Subdivision 250-E will be a special accrual amount. ***[Schedule 1, item 20, definition of 'special accrual amount' in subsection 995-1(1) of the ITAA 1997]***

1.315 Consequently, if the financial benefits received in respect of a deemed loan financial arrangement are denominated in foreign currency, only the gain on the deemed loan that is included in assessable income must be translated into an amount of Australian currency or functional currency.

Indexation of certain amounts

1.316 The threshold limits in sections 250-25 and 250-30 that apply to determine whether certain arrangements are excluded from Division 250 are indexed. Subdivision 960-M contains provisions to show how to index amounts and how to calculate the indexation factor. A consequential amendment is made to include references to sections 250-25 and 250-30 in the list of provisions for which indexation is relevant. ***[Schedule 1, item 65, section 960-265]***

Debt / equity measures

1.317 Division 974 contains rules to determine whether an interest is a debt interest or an equity interest. Subsection 974-130(1) specifies when a scheme is a financing arrangement.

1.318 Subsection 974-130(4) outlines schemes that are taken not to be entered into or undertaken to raise finance for the purpose of working out whether a scheme is a financing arrangement. Consequential amendments to subsection 974-130(4) ensure that arrangements that come within the scope of Division 250 are treated consistently with arrangements that previously came within the scope of Division 16D. ***[Schedule 1, items 66 and 67, paragraphs 974-130(4)(a) and (d)]***

Taxation Administration Act 1953

1.319 Subdivision 250-E outlines the tax treatment of gains and losses from a deemed loan that is taken to be a financial arrangement because of section 250-155. As gains and losses on deemed loan financial arrangements are statutory income rather than ordinary income, an

amendment is made to the TAA 1953 to ensure that these amounts are included in the calculation of a taxpayer's instalment income. Only the net amount, if that amount is positive, of the gains and losses that are attributable to the period are included in instalment income. ***[Schedule 1, items 68 to 70, sections 45-5, 45-120 and 45-330 of the TAA 1953]***

REGULATION IMPACT STATEMENT

Policy objective

1.320 The policy objective of the provisions in the income tax law affecting tax-exempt asset financing arrangements is to restrict the transfer of tax preferences between taxable entities and tax-exempt entities (including non-residents). The objective of this measure is to provide a more coherent and neutral tax treatment that reflects the economic substance of the arrangement.

Background

1.321 Section 51AD and Division 16D of Part III of ITAA 1936 were enacted in the 1984-85 income year to deny access to tax benefits (such as deductions for capital expenditure) in relation to property used by or for tax-exempt entities (including non-residents).

1.322 A general principle of income tax law is that, in order to claim deductions for expenditure relating to ownership of an asset (such as capital allowances), the owner must show that the asset is used for the purpose of producing assessable income or in carrying on a business for that purpose.

1.323 Arrangements were developed to circumvent this principle. While the taxpayer was the legal owner of the asset and derived assessable income through rental of the asset, arrangements developed under which the taxpayer transferred some or all of the risks and benefits associated with ownership of the asset to the entity that was the 'real' or 'end' user of the asset. This end user was typically either a government body whose income was exempt from tax or a non-resident that used the asset outside Australia for the purpose of producing income that was exempt from Australian tax (ie, in both cases, a 'tax-exempt entity').

1.324 Often the arrangements between the taxpayer and the tax-exempt entity took the form of a finance lease with, in some cases, a predetermined payment for the asset at the end of the arrangement period. The tax-exempt entity effectively guaranteed the taxpayer a return of the taxpayer's investment in the relevant asset. Thus, the taxpayer was

effectively lending money to the tax-exempt entity and had little or no interest in the economic performance of the asset — that is, the taxpayer was essentially the legal but not the economic owner of the asset.

1.325 The tax advantages of such arrangements flowed from tax deferral in a low risk setting. The tax deferral arose from the profile of taxable income over the arrangement. A typical situation was the existence of tax losses in the early years of an arrangement. These tax losses were created by the annual deductions related to the asset (such as capital allowance deductions and interest deductions) being greater than the predetermined annual income under the arrangement. The taxpayer could use these losses to offset assessable income from other sources. While income in later years might exceed allowable deductions, in present value terms the arrangement was tax advantaged.

1.326 Part of the tax benefit from the arrangement was generally passed back to the tax-exempt entity through lower finance charges, thereby lowering the cost to the entity of using the relevant asset.

1.327 Section 51AD was designed to operate as an 'anti-avoidance' provision against this background because the large scale nature of the arrangements posed a significant threat to the revenue base.
Section 51AD effectively prevents a tax-exempt body from accessing tax benefits in relation to an asset it uses or effectively controls that is financed by highly leveraged non-recourse debt. If section 51AD applies to an arrangement, the taxpayer is assessed on all the proceeds derived from the arrangement but is denied access to all deductions in respect of the asset (such as capital allowances and interest deductions).

1.328 Division 16D operates to deny capital allowance deductions for the cost of, or capital expenditure on, property which a tax-exempt body uses or effectively controls under a finance lease or similar arrangement. Division 16D does not apply where section 51AD applies.
If Division 16D applies, the arrangement is treated as a loan and payments made under that arrangement are treated as having an interest and principal component. If the asset is not transferred to the tax-exempt end user at the end of the arrangement, then an unrealised loss is effectively allowed for any excess of loan principal over the value of the asset at the end of the arrangement.

1.329 The Review of Business Taxation recommended that:

- section 51AD be removed; and
- Division 16D be replaced with a provision under which tax-exempt asset financing arrangements where the taxpayer does not have a predominant economic interest in the relevant asset are taxed as sale and loan arrangements applying a compounding accruals methodology.

1.330 Reflecting these recommendations, the then Minister for Revenue and the Assistant Treasurer announced in Press Release No. C057/02 of 14 May 2002 that the Government would implement changes to reform section 51AD and Division 16D and the taxation of treatment of asset financing arrangements with tax-exempt entities.

Implementation options

Identification of arrangements that come within the scope of the measure

1.331 An asset financing arrangement will come within the scope of the measure if a tax-exempt entity has the predominant economic interest in the asset. Two options were considered for determining which entity has the predominant economic interest in the asset.

Option 1

1.332 Option one would be for asset risk tests to be used to determine which entity has the predominant economic interest in an asset. That is, the tax-exempt entity would have the predominant economic interest in the asset if it carried the greater share of the risks and benefits associated with the ownership of the asset.

1.333 A range of safe harbour tests would apply to exclude arrangements that may satisfy this primary test from the scope of the provisions. In addition, certain relatively short-term and lower value arrangements would be specifically excluded from the scope of the measure.

1.334 This option was recommended by the Review of Business Taxation. The Review recommended this approach because it more accurately reflects who has the predominant economic interest in an asset than a test based on the lease, use or control of use of an asset. Exposure draft legislation reflecting this option was released in June 2003.

1.335 This option was not considered feasible because of stakeholder resistance to this approach. In particular:

- stakeholders raised concerns about being unfamiliar with the practical operation of the proposed asset risk tests;
- stakeholders were concerned that, because of this lack of familiarity, the proposed asset risk tests would lead to increased compliance costs; and
- stakeholders were concerned that, compared to the current law, the proposed asset risk tests would broaden the scope of arrangements that come within the measure.

Option 2

1.336 The second and preferred option is to apply a 'lease, use and control of use' test to determine which entity has the predominant economic interest in an asset. That is, the tax-exempt entity will have the predominant economic interest in the asset if it uses, or effectively controls the use of, the asset. If the arrangement is a lease (in form or in substance), the tax-exempt entity is taken to effectively control the use of the asset.

1.337 A range of safe harbour tests will apply to exclude arrangements that satisfy this primary test from the scope of the provisions. In addition, certain relatively short-term and lower value arrangements will be specifically excluded from the scope of the measure.

1.338 This option was strongly supported by stakeholders because stakeholders are familiar with the practical operation of tests based on the lease, use or control of use of an asset (and therefore there will be no increase in compliance costs). In addition, the financial accounting standards apply tests based on the lease, use or control of use of an asset to these types of arrangements.

Consequences that arise when an arrangement comes within the scope of the measure

1.339 Two options were considered for determining the consequences that arise when an arrangement comes within the scope of the measure.

Option 1

1.340 The first option is to modify the operation of the income tax law so that, if an asset financing arrangement comes within the scope of the measure:

- capital allowance deductions in relation to the asset will be denied; and
- the arrangement will be treated as a deemed loan that is taxed as a financial arrangement on a compounding accruals basis.

1.341 This option is preferred because it is broadly consistent with the approach in the existing law and with the financial accounting principles that apply to these arrangements. In addition, this approach was recommended by the Review of Business Taxation.

Option 2

1.342 The second option would be to modify the operation of the income tax law so that, if an asset financing arrangement comes within the scope of the measure, capital allowance deductions would be allowed on a straight line basis over the life of the project (rather than over the life of

the asset). As an integrity measure, losses arising from the arrangement would be quarantined so that they could be offset only against income arising from the arrangement.

1.343 This option was not supported because it would be inconsistent with the income tax treatment of similar arrangements and with financial accounting principles. Stakeholders also raised concerns about the operation of the proposed integrity measure.

Assessment of impacts

Impact group identification

1.344 This proposed measure is expected to impact on:

- corporate taxpayers engaged in arrangements to provide goods and services to tax-exempt entities (including non-residents);
- tax-exempt entities (including non-residents) who are engaged in arrangements with taxpayers for the provision of goods or services;
- advisers and consultants who provide advice to parties engaged in these arrangements; and
- the ATO.

1.345 Consistent with the current law, the amendments are expected to impact primarily on large companies that enter into asset financing arrangements with governments or with non-residents (such as public private partnerships).

1.346 Examples of the types of arrangements that could be affected include:

- arrangements for the construction of transport infrastructure (such as toll-roads, bridges, railways and harbours);
- arrangements for the construction of power stations and the supply of electricity;
- arrangements for the construction of telecommunications facilities;
- arrangements for the construction and maintenance of public buildings (including hospitals, educational facilities, courts, police stations, correctional facilities, convention centres and public housing); and
- arrangements involving the long-term leveraged lease of buildings or other property (such as aircraft).

1.347 However, because taxpayers usually structure arrangements to limit the application of the existing law, there is no data available about the number of taxpayers affected.

1.348 In this regard, if section 51AD applies to an arrangement, generally the arrangement will not be commercially viable. Although the harsh impact of section 51AD is being removed, it is likely that, where possible, taxpayers will continue to structure arrangements to limit the application of proposed Division 250 of the ITAA 1997.

1.349 To reduce compliance costs, certain relatively short-term and lower value arrangements are to be specifically excluded from the scope of Division 250. That is, the Division will not apply to a taxpayer if, broadly:

- the arrangement period does not exceed 12 months;
- the taxpayer is a small business entity for the income year in which the arrangement starts — that is, if the taxpayer carries on a business and satisfies the $2 million aggregated turnover test;
- the financial benefits that are reasonably expected to be provided by the tax preferred sector under the arrangement do not exceed $5 million; or
- the arrangement satisfies certain operating and finance risk tests: and
  - the arrangement period does not exceed three years (or five years if the arrangement is a lease of real property);
  - the financial benefits that are reasonably expected to be provided by the tax preferred sector do not exceed $30 million (or $50 million if the arrangement is a lease of real property); or
  - the total values of assets put to tax preferred use do not exceed $20 million (or $40 million if the arrangement is a lease of real property).

1.350 For the purpose of applying these tests, the financial benefits that are reasonably expected to be provided by the tax preferred sector are generally the amount that the taxpayer expects to receive from the tax preferred sector under the terms of the contract that is entered into between the parties.

1.351 Under the current law, the Commissioner has discretion to exclude arrangements from the scope of the provisions. At the request of stakeholders, this discretion is being retained.

1.352 It is expected that the Commissioner would consider applying the discretion, for example, to prevent an arrangement from coming within the scope of Division 250 due to:

- an unintended or marginal breach of one of the safe harbour tests; or
- an unintended or marginal breach of one of the tests that need to be satisfied to qualify for the specific exclusion for certain operating and service arrangements.

Analysis of costs and benefits

Compliance costs

1.353 This proposed measure is largely expected to impact a relatively small number of large corporate taxpayers, along with tax-exempt entities (including state governments) and non-resident entities that enter into certain large asset financing arrangements.

1.354 There has been extensive consultation with stakeholders during the development of the proposed reforms. Due to stakeholder concerns about compliance costs, Division 250 has adopted the same capture tests as section 51AD and Division 16D as these tests are already familiar to stakeholders and their tax advisors. Therefore, the compliance costs to taxpayers in determining whether their arrangements are caught by the new Division 250 are expected to be minimal.

1.355 However, the affected parties may incur some costs in either familiarising themselves with the technical detail of the new law or having advisers familiarise themselves with the new law. It is not expected that these costs of familiarisation will be significant.

1.356 The proposed new rules in Division 250 are designed to utilise the clearer drafting approach adopted in the ITAA 1997 and therefore may reduce compliance costs.

1.357 In addition, compliance costs may be reduced because taxpayers will no longer need to structure their affairs to avoid the harsh impact of section 51AD. In this regard, taxpayers currently enter into contingent equity arrangements that are designed to protect against the possibility that an arrangement will come within the scope of section 51AD.

1.358 The specific exclusions for relatively short-term and lower value arrangements from the scope of Division 250 will also reduce compliance costs.

1.359 A specific estimate of the change in compliance costs cannot be prepared as this would require an assessment of the existing compliance costs borne by taxpayers and the change in these costs following the

amendments. It is not possible to isolate these changes independently of any broader changes to the business environment.

Administration costs

1.360 The legislation will be administered by the ATO. In relation to ATO administration costs, the proposed amendments are expected to have minimal impact. In the short term, there may be a small increase in costs associated with the training of ATO staff and with informing taxpayers of the law. However, these are likely to be offset over the long term as the reforms are expected to reduce overall complexity of the taxation law in this area.

Revenue estimate

1.361 The impact on revenue is unquantifiable.

Consultation

1.362 Business, legal and accounting representatives, representatives of state governments and the ATO have been consulted extensively and have actively assisted in developing this measure. A thorough consultation process has been essential because of the complexity of the issues involved and the need to reconcile the different views of various stakeholders.

1.363 Consultation has primarily been conducted on a targeted confidential basis and has included representatives from the following bodies:

- Infrastructure Partnerships Australia (including the Australian Council for Infrastructure Development);
- state governments;
- Institute of Chartered Accountants of Australia;
- Minerals Council of Australia;
- Property Council of Australia;
- Australian Bankers' Association;
- Energy Supply Association of Australia; and
- Australian Equipment Lessors Association.

1.364 Key steps in the consultation process were:

- In June 2003, exposure draft legislation to implement the reform recommendations of the Review of Business Taxation was released. The exposure draft legislation proposed a

range of risk tests to determine which arrangements will come within the scope of the reforms.

- Following extensive consultations with stakeholders, the Government decided to explore alternative options to address concerns raised by stakeholders about the scope and effect of the proposed reforms. To assist consultation on this matter, a discussion paper was released to stakeholders in March 2005.
- In September 2005, a change in the direction of the reforms was announced. A 'lease, use or control of use of the asset' test to determine which arrangements will come within the scope of the reforms was adopted.
- Two exposure drafts of the legislation, and draft explanatory material, which detailed the legislative approach to be taken were subsequently circulated to stakeholders.

1.365 In addition, throughout this process, numerous consultation meetings have been held with stakeholders.

1.366 As a result of these consultations, significant changes were made to the legislation in response to stakeholder concerns. Key changes included:

- the details of the 'lease, use or control of use of the asset' test to determine which arrangements will come within the scope of the reforms;
- significant refinements to the operation of the safe harbour tests;
- significant refinements to the exclusions for certain short to medium term and relatively lower value operating leases and service arrangements;
- the basis for defining the concept of a lease;
- modifications to the notional loan treatment (such as the basis for working out the end value of an asset); and
- transitional arrangements that allow Division 250 to apply to arrangements entered into before 1 July 2007 in certain circumstances and that effectively switch off section 51AD with effect from 1 July 2003.

1.367 Some issues raised by stakeholders are not supported. These include:

- increases in the thresholds for the safe harbour tests;
- specific exclusions for particular industry groups;

- modification of the definition of a lease so that it is based on the form, rather than the substance and the effect, of the arrangement; and
- the removal of the limited recourse debt test as a safe harbour test.

1.368 These issues were not supported as they would significantly reduce the impact of the proposed reforms.

1.369 Some stakeholders also raised concerns about minor technical aspects of the draft legislation.

1.370 However, the introduction of the legislation is strongly supported by most members of the consultation group as it will significantly improve the operation of the existing law.

Conclusion and recommended option

1.371 It is recommended:

- to apply a 'lease, use and control of use' test to determine which entity has the predominant economic interest in an asset; and
- if the measure applies, to deny capital allowance deductions and treat the arrangement as a deemed loan that is taxed as a financial arrangement on a compounding accruals basis.

1.372 Stakeholders are familiar with this approach and it is broadly consistent with financial accounting principles.

1.373 This measure is expected to improve the current investment environment for tax-exempt asset financing arrangements through:

- a more uniform set of rules and less administrative complexity;
- specific carve outs for relatively short term and lower value arrangements; and
- less onerous tax treatment for arrangements which meet the provisions — in particular, the removal of section 51AD will mean that taxpayers will no longer need to maintain contingent equity arrangements.

1.374 This measure is to apply to all relevant arrangements where the tax preferred use of an asset starts on or after 1 July 2007 under a legally enforceable arrangement that is entered into on or after that date. Under transitional provisions, this measure will also apply to arrangements entered into before 1 July 2007 in certain circumstances.

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

Chapter 2
Thin capitalisation — excluded equity interests

Outline of chapter

2.1 Schedule 2 to this Bill amends the definition of 'excluded equity interest' in subsection 820-946(2A) of the *Income Tax Assessment Act 1997* (ITAA 1997). The effect of this amendment is to exclude from the definition certain long-term equity interests.

2.2 Unless otherwise stated, all legislative references are to the ITAA 1997.

Context of amendments

2.3 The thin capitalisation rules in Division 820 are designed to ensure that both Australian and foreign-owned multinational entities do not allocate an excessive amount of debt to their Australian operations. The rules operate to disallow a proportion of otherwise deductible finance expenses (eg, interest) where the debt used to fund the Australian operations exceeds certain thresholds.

2.4 The thin capitalisation rules contain a number of integrity measures to prevent entities manipulating these rules.

2.5 An example of an integrity measure is the concept of an 'excluded equity interest', defined in subsection 820-946(2A). This provision is intended to prevent an entity (other than an authorised deposit-taking institution) from issuing a short-term equity interest just prior to the day on which its assets are valued for thin capitalisation purposes (the valuation day) — thereby increasing its assets and potentially allowing the entity to hold more debt under the safe harbour test — and then cancelling the interest shortly thereafter.

2.6 Manipulation of the value of an entity's assets by the use of short-term equity interests is possible where the interest holder is not subject to the thin capitalisation rules (eg, because it is an exempt entity), or where the issuer and holder of the interest are both subject to the rules but have different valuation days.

2.7 An equity interest that is an excluded equity interest is deducted from the total assets of the entity that issues the interest, which in turn reduces its maximum allowable debt. Thus, the issuer is prevented from

gaining an advantage where such equity interests are issued prior to a valuation day and cancelled shortly thereafter.

2.8 The current definition of excluded equity interest excludes from thin capitalisation calculations equity interests that have been on issue for less than 180 days at the valuation day, regardless of how long those interests ultimately remain on issue. This is an unintended consequence of the definition, as it may capture equity interests that remain on issue for a total period of 180 days or more and are genuinely intended to be long-term.

Detailed explanation of new law

2.9 The definition of excluded equity interest in subsection 820-946(2A) currently applies to equity interests that have been on issue for less than 180 days at a valuation day.

2.10 This amendment removes equity interests that remain on issue for a total period of 180 days or more from the definition of excluded equity interest. ***[Schedule 2, item 1, definition of 'excluded equity interest' in subsection 820-946(2A)]***

Application and transitional provisions

2.11 This amendment will commence on the day this Bill receives Royal Assent and will apply to income years starting on or after 1 July 2002 (the date from which the definition of 'excluded equity interest' took effect). The amendment corrects an unintended consequence and will be advantageous to taxpayers. ***[Schedule 2, item 2]***

Chapter 3
Thin capitalisation — application to groups containing certain authorised deposit-taking institutions

Outline of chapter

3.1 Schedule 3 to this Bill introduces a choice mechanism under which a particular type of authorised deposit-taking institution (ADI) — known as a specialist credit card institution — may, in certain circumstances, be treated for thin capitalisation purposes as if it was not an ADI but rather as if it was a financial entity.

3.2 Unless otherwise stated, all legislative references are to the *Income Tax Assessment Act 1997*.

Context of amendments

3.3 The thin capitalisation rules in Division 820 are designed to ensure both Australian and foreign-owned multinational entities do not allocate an excessive amount of debt to their Australian operations. The rules operate to disallow a proportion of otherwise deductible finance expenses (eg, interest) where the debt used to fund the Australian operations exceeds certain thresholds.

3.4 Entities may determine their thin capitalisation position using various tests — the 'safe harbour' test, the 'arm's length' test and the 'worldwide gearing' test. The tests require the calculation of an entity's debt, assets and/or equity.

3.5 The calculation methods depend on whether the entity is an ADI (as defined in the *Banking Act 1959*), a financial entity that is not an ADI, or a general entity (neither an ADI nor a financial entity).

3.6 Entities are also classified on the basis of whether they are outward investing or foreign-controlled, and calculation methods differ to a degree depending on this classification.

3.7 In relation to consolidated or multiple entry consolidated groups (MEC groups), the thin capitalisation rules applied to the head company of the group depend on the composition of the group (eg, whether it contains ADIs or non-ADIs; inward or outward-investors).

3.8 If the consolidated or MEC group contains an entity that is an 'outward investing entity (ADI)', the thin capitalisation rules are applied to the head company as if it was such an entity (subsection 820-583(7)). Thus, the head company is required to adopt the calculations applying to outward investing ADIs in Subdivision 820-D.

3.9 If the head company uses the safe harbour test in Subdivision 820-D, it must calculate the 'safe harbour capital amount', which requires determination of the risk-weighted assets of entities within the group in accordance with prudential standards (section 820-310). Risk-weighted assets also form part of the calculation of the 'worldwide capital amount' for the purposes of the worldwide gearing test (section 820-320).

3.10 At the time the current thin capitalisation rules commenced in 2001, all ADIs were prudentially supervised (including the setting of capital adequacy requirements) on both a stand-alone and a consolidated group basis. This meant the requirement to risk-weight assets was applied to the ADI as an individual entity, and to other financial entities in the same group as the ADI (with some exceptions).

3.11 In view of this, it was seen as appropriate that the thin capitalisation rules provide for groups containing ADIs to adopt calculations similar to those required for prudential purposes, in order to minimise compliance costs.

3.12 In 2003, as part of reforms to the credit card market, a new class of ADI, known as specialist credit card institutions, was established by the Australian Prudential Regulation Authority (APRA). Specialist credit card institutions are authorised to conduct only limited banking business and, consequently, APRA supervises them differently to other ADIs.

3.13 In particular, unlike other ADIs, the capital adequacy of specialist credit card institutions is not determined on a consolidated group basis where a specialist credit card institution is part of a group that does not contain any other types of ADI. In this case, the capital adequacy requirements apply to a specialist credit card institution and its subsidiaries (if any) on a consolidated basis but not to the wider corporate group.

3.14 The advent of ADIs whose capital adequacy is not determined on a consolidated group basis for prudential purposes was not foreseeable when the thin capitalisation rules were introduced. Hence, the rules require all consolidated or MEC groups containing ADIs to determine capital adequacy taking into account risk-weighted assets on a group-wide basis. In the case of groups containing only specialist credit card institutions, this would unnecessarily increase compliance costs.

Summary of new law

3.15 These amendments will allow the head company of a consolidated or MEC group containing one or more ADIs to apply the thin capitalisation rules as if the group did not contain an ADI, where all the ADIs in the group are specialist credit card institutions. Each specialist credit card institution will instead be treated as if it was a financial entity.

3.16 A ***specialist credit card institution*** is defined as an ADI authorised under the *Banking Act 1959* to conduct banking business that is confined to credit card acquiring and/or credit card issuing and involves participation in a payment system that is a credit card scheme, where that payment system is designated under section 11 of the *Payment Systems (Regulation) Act 1998*.

3.17 These amendments will also allow:

- the head company of a consolidated or MEC group; or
- a single Australian resident company that cannot consolidate,

that chooses to treat as part of itself the Australian permanent establishments of a foreign bank (the 'establishment entity'), to apply the thin capitalisation rules as if the head company or single company was an outward investing entity (non-ADI) or inward investing entity (non-ADI), as the case may be, where, if any of the head company, single company or establishment entity is an ADI, they are also a specialist credit card institution.

3.18 The exemption from the thin capitalisation rules for the head company of a consolidated group under section 820-585 will not apply where all of the ADIs in the group are specialist credit card institutions.

Comparison of key features of new law and current law

New law	*Current law*
The head company of a consolidated	The head company of a consolidated

New law	*Current law*
or MEC group that contains one or more ADIs may choose to apply the thin capitalisation rules as if the group did not contain any ADIs, where all the ADIs in the group are specialist credit card institutions. Each specialist credit card institution will be treated as if it was a financial entity.	or MEC group that contains one or more ADIs must apply the thin capitalisation rules as if the head company was an ADI.
Section 820-587 will not apply to the head company of a MEC group, where the only ADIs in the group are specialist credit card institutions and the head company of the group makes the choice to apply the thin capitalisation rules as if the group did not contain any ADIs.	Section 820-587 applies the outward-investing ADI rules to head companies of certain MEC groups that contain a foreign-controlled ADI.
Section 820-585 will not apply to the head company of a consolidated group containing one or more ADIs, where all of those ADIs are specialist credit card institutions.	Under section 820-585, the head company of a consolidated group does not have any debt deductions denied where that company is, in its own right, either a foreign-controlled Australian ADI that does not qualify as an outward investing entity (ADI), or a foreign-controlled Australian company that is a pure ADI holding company.
The head company of a consolidated or MEC group — or a single Australian resident company that cannot consolidate — that treats as part of itself the Australian permanent establishments of a foreign bank (the 'establishment entity'), may choose to apply the thin capitalisation rules as if the head company or single company was an outward investing entity (non-ADI) or an inward investing entity (non-ADI) where, if any of the head company, single Australian resident company or establishment entity is an ADI, they are also a specialist credit card institution.	The head company of a consolidated or MEC group — or a single Australian resident company that cannot consolidate — that treats as part of itself the Australian permanent establishments of a foreign bank, must apply the thin capitalisation rules as if the head company or single Australian resident company was an ADI.

Detailed explanation of new law

Choice to treat specialist credit card institutions as financial entities

3.19 Subsection 820-583(7) sets out the circumstances in which the head company of a consolidated or MEC group will be treated as an outward investing entity (ADI). These conditions are (disregarding the consolidation provisions) that:

- at least one member of the group is an outward investing entity (ADI); or
- at least one member of the group is an outward investing entity (non-ADI) and at least one other member of the group is an ADI.

3.20 Where, during a period that is all or part of an income year, a consolidated or MEC group contains one or more ADIs and all of those ADIs are specialist credit card institutions, the head company may choose to apply the thin capitalisation rules as if the group did not contain any ADIs during that period. If there is more than one period in an income year where all of the ADIs in the group are specialist credit card institutions, and the head company makes the choice mentioned above, that choice applies in respect of all of those periods within that income year. ***[Schedule 3, item 2, subsections 820-588(1) and (2)]***

3.21 If the choice is made, each specialist credit card institution in the group will be treated, for the purposes of Division 820, as if it was a financial entity during the relevant period(s). The result is that the head company of the group will no longer be classified under section 820-583 as an outward investing entity (ADI) during the period(s), but rather will be classified as either an 'outward investing entity (non-ADI)' and an 'outward investor (financial)', or an 'inward investing entity (non-ADI)' and an 'inward investment vehicle (financial)', as the case may be. Hence, Subdivision 820-B or 820-C will apply to the head company instead of Subdivision 820-D. ***[Schedule 3, item 2, subsection 820-588(1), notes 1 and 2]***

3.22 A ***specialist credit card institution*** is defined as an ADI authorised to carry on banking business (as defined in the *Banking Act 1959*) consisting only of credit card acquiring and/or issuing (as defined under the banking regulations) and involves participation in a payment system that is a credit card scheme, where that payment system is designated under section 11 of the *Payment Systems (Regulation) Act 1998*. ***[Schedule 3, item 2, subsection 820-588(3)]***

3.23 Once the choice to apply the thin capitalisation rules as if the group did not contain any ADIs has been made in respect of a particular income year, it may not be revoked. ***[Schedule 3, item 2, subsection 820-588(4)]***

3.24 However, the choice is available in respect of each income year and a head company may, for example, exercise the choice in one income year and not in the next.

Example 3.1

Forco wholly-owns all of the shares in Austco 1 and Austco 2. Austco 1 and Austco 2 formed a MEC group on 1 July 2003, with Austco 1 as the provisional head company. Austco 1 owns all of the shares of Austco 3.

On 1 August 2004 Austco 3 is authorised by APRA as a specialist credit card institution. None of the other members of the MEC group are ADIs or financial entities during the income year, which begins on 1 January.

Austco 1 as the head company of the MEC group makes a choice under section 820-588 in respect of Austco 3 for the period commencing 1 August 2004 to 31 December 2004. Consequently, for the purposes of Division 820, the head company of the MEC group applies the thin capitalisation provisions as if it were an inward investment vehicle (financial) for the period 1 August 2004 to 31 December 2004.

Example 3.2

Assume the same facts as for Example 3.1, except that Austco 2 is a financial entity for the whole of the income year ended 31 December 2004.

For the purposes of Division 820, the head company of the MEC group applies the thin capitalisation provisions as if it were an inward investment vehicle (financial) for the whole of the income year ended 31 December 2004. It is not necessary to break the year into part-year periods because a choice has been made under section 820-588 to treat Austco 3 as a financial entity from the time of its authorisation by APRA as a specialist credit card institution.

Interaction of the choice mechanism with section 820-587

3.25 Section 820-587 applies the rules in Subdivision 820-D for outward investing entities (ADI) to MEC groups to which they would not otherwise apply.

3.26 An example of the intended application of section 820-587 was provided in paragraph 6.27 of the explanatory memorandum to the *New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002*, which inserted the section. The example indicated that the section would apply to a MEC group where a foreign bank has two wholly-owned Australian subsidiaries, one being a bank and the other not a bank, where the latter is not owned by the Australian bank and so does not come under APRA supervision.

3.27 If the choice under proposed section 820-588 is made by the head company of a MEC group, section 820-587 will not apply. This is because the effect of making the choice under section 820-588 is that none of the members of the group is an ADI. Therefore, the requirement in paragraph 820-587(b) that at least one member of the group is both a foreign controlled Australian entity and an ADI will not be satisfied.

Section 820-585 is not to apply where the group contains only specialist credit card institutions

3.28 Section 820-585 essentially provides that a consolidated group will not have any debt deductions denied under the thin capitalisation rules where the head company of the group, in its own right, is either a foreign-controlled Australian ADI that does not qualify as an outward investing entity (ADI), or a foreign-controlled Australian company that is a pure ADI holding company.

3.29 This provision was inserted into the law because the capital adequacy requirements of APRA were considered sufficient in relation to such head companies and it was, therefore, unnecessary to also apply thin capitalisation rules.

3.30 However, this view was formed on the basis that all ADIs were, at the time, supervised by APRA on a consolidated group basis for prudential purposes. Because groups containing specialist credit card institutions but no other type of ADI are not prudentially supervised on a consolidated group basis, the application of section 820-585 is inappropriate.

3.31 These amendments, therefore, specify that section 820-585 does not apply to the head company of a consolidated group containing one or more ADIs if, at that time, all ADIs that are members of the group are specialist credit card institutions. It should be noted that section 820-585 will not apply to such a head company regardless of whether it makes the choice under proposed section 820-588. ***[Schedule 3, item 1, subsection 820-585(3)]***

Subdivision 820-FB

3.32 Subdivision 820-FB allows:

- the head company of a consolidated or MEC group; or
- a single Australian resident company that cannot consolidate,

to treat as part of itself the Australian branch of a foreign bank or foreign financial entity. The Australian branch is referred to in the Subdivision as the ‘Australian permanent establishment’, and the foreign bank or foreign financial entity is the ‘establishment entity’.

3.33 APRA's guidelines on the establishment of specialist credit card institutions allow for the possibility that a foreign credit card bank might establish a branch in Australia that is authorised as a specialist credit card institution.

3.34 A similar choice mechanism will, therefore, apply in situations to which Subdivision 820-FB applies.

3.35 This means that:

- the head company of a consolidated or MEC group; or
- a single Australian resident company,

that treats as part of itself the Australian permanent establishments of an establishment entity, may choose to apply the thin capitalisation rules as if the head company or single company was an outward investing entity (non-ADI) or an inward investing entity (non-ADI), as the case requires if, where any of the head company, single company or establishment entity are ADIs, they are also specialist credit card institutions. ***[Schedule 3, item 5, section 820-610]***

3.36 This choice has effect despite sections 820-85 and 820-185 (which define 'outward investing entity (non-ADI)' and 'inward investing entity (non-ADI)' respectively), and section 820-609 (which deals with the classification of a head company or single company that chooses to treat as part of itself the Australian permanent establishments of an establishment entity). ***[Schedule 3, item 5, subsection 820-610(4)]***

3.37 To make clear that section 820-609 is subject to the choice mechanism in section 820-610, subsection 820-609(7) is amended to specifically refer to section 820-610. This amendment is required because subsection 820-609(7) currently provides that section 820-609 applies despite any other provision of Division 820, other than Subdivision 820-EA. ***[Schedule 3, item 4]***

3.38 A consequential amendment is made to paragraph 820-609(2)(a). This amendment does not change the effect of the paragraph, but ensures it operates appropriately given the amendment to section 820-585 in item 1 of the Schedule. ***[Schedule 3, item 3]***

3.39 Consequential amendments are also made to various definitions in subsection 995-1(1) as a result of the insertion of proposed sections 820-588 and 820-610. ***[Schedule 3, items 6 to 10]***

Application and transitional provisions

3.40 These amendments will apply to income years beginning on or after 1 January 2004. This is because the ADIs that the amendments are relevant to (ie, specialist credit card institutions) were first authorised as

ADIs by APRA in 2004. This retrospective application of the amendments will benefit taxpayers. ***[Schedule 3, item 11]***

Chapter 4
Capital gains tax marriage breakdown roll-over for small superannuation funds

Outline of chapter

4.1 Schedule 4 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to extend the capital gains tax (CGT) marriage breakdown roll-over to in specie transfers of personal superannuation interests from a small superannuation fund to another complying superannuation fund under specific conditions.

Context of amendments

4.2 Subdivision 126-D of the ITAA 1997 currently provides a CGT roll-over on legal marriage breakdown for transfers of CGT assets between small superannuation funds where there has been a 'payment split' pursuant to a court order or agreement under Part VIIIB of the *Family Law Act 1975*.

4.3 The existing CGT marriage breakdown roll-over is only available where a CGT asset reflecting the interest subject to a payment splitting order or agreement is transferred between small superannuation funds.

4.4 Consequently the CGT roll-over is unavailable if:

- any asset reflecting the personal superannuation interest of the spouse whose interest has been split is transferred to another superannuation fund;
- any asset reflecting the existing personal interest of the other spouse is transferred to another superannuation fund;
- any asset reflecting the personal superannuation interest of one of the spouses is transferred to another superannuation fund where there has been no payment split; or
- any asset is transferred to a complying superannuation fund that is not a small superannuation fund.

4.5 For de facto spouses, the current CGT marriage breakdown roll-over is only available for transfers of non-superannuation assets because of a court order under a state, territory or foreign law relating to

de facto marriage breakdowns or an agreement which is binding under a state, territory or foreign law relating to de facto marriage breakdowns.

4.6 These amendments will ensure that CGT need not be an impediment to separating spouses achieving a 'clean break' from each other in terms of their superannuation arrangements.

Summary of new law

4.7 Subdivision 126-D of the ITAA 1997 is amended to provide a CGT roll-over on marriage breakdown for a transfer of any CGT asset reflecting the personal interest of either spouse (but not both) in a small superannuation fund to another complying superannuation fund if that transfer satisfies specific conditions.

4.8 Related amendments are made to:

- the existing CGT marriage breakdown roll-over between small superannuation funds to extend it to transfers from a small superannuation fund to another complying superannuation fund; and
- the CGT marriage breakdown roll-over for transfers of non-superannuation assets to ensure that it applies to transfers pursuant to written agreements made under Western Australian, Tasmanian, Queensland or Northern Territory laws relating to de facto marriage breakdown.

Comparison of key features of new law and current law

New law	*Current law*
A CGT roll-over will be available on marriage breakdown for: • a transfer of any asset reflecting the personal interest of either spouse in a small superannuation fund to another complying superannuation fund; and/or • a transfer of any asset reflecting a spouse's entitlement under a payment splitting order or agreement to another complying superannuation fund.	The CGT roll-over is only available for a transfer of any asset reflecting a spouse's entitlement under a payment splitting order or agreement to another small superannuation fund.
A CGT roll-over will be available on	The CGT roll-over may not apply to

New law	*Current law*
marriage breakdown for a transfer of a non-superannuation asset pursuant to a written agreement equivalent to a binding financial agreement under the *Family Law Act 1975*.	transfers pursuant to written agreements made under the Western Australian, Tasmanian, Queensland or Northern Territory laws relating to de facto marriage breakdowns, which are equivalent to binding financial agreements under the *Family Law Act 1975*.

Detailed explanation of new law

CGT marriage breakdown roll-over

4.9 These amendments provide a CGT roll-over on marriage breakdown to defer the making of a capital gain or capital loss from a transfer of any asset reflecting the personal interest of one of the spouses from a small superannuation fund to another complying superannuation fund for the benefit of the transferor spouse ***[Schedule 4, item 6, paragraph 126-140(2A)(c)]***. The accrued capital gain or capital loss is deferred until a subsequent CGT event happens to an asset which has been transferred.

4.10 Under section 995-1 of the ITAA 1997, ***spouse*** includes a person who, although not legally married to the person, lives with the person on a genuine domestic basis as the person's husband or wife.

4.11 A ***small superannuation fund*** is defined under section 995-1 of the ITAA 1997 as a complying superannuation fund with four or fewer members. A ***complying superannuation fund*** is defined under the same section as a complying superannuation fund within the meaning of section 45 of the *Superannuation Industry (Supervision) Act 1993* and includes most mainstream superannuation funds.

4.12 The CGT marriage breakdown roll-over will be available to the trustee of the small superannuation fund who made the transfer of the superannuation interest.

Awards, orders and agreements

4.13 To be eligible for the CGT roll-over, the transfer must be in accordance with:

- an award made in the arbitration of property settlement proceedings under the *Family Law Act 1975* between an individual and their spouse or former spouse or of a matter in respect of which such proceedings might be taken, or a corresponding award made under a corresponding state,

territory or foreign law ***[Schedule 4, item 6, paragraphs 126-140(2A)(d) and (2B)(a)]***;

- a court order made under the *Family Law Act 1975* altering property interests of an individual or their spouse or former spouse, or a court order in proceedings under that Act binding some other person (eg, the corporate trustee of a small superannuation fund) to effect a division of property between an individual and their spouse or former spouse ***[Schedule 4, item 6, paragraphs 126-140(2A)(d) and (2B)(b)]***;
- a court order made under a state, territory or foreign law relating to de facto marriage breakdowns that corresponds to an abovementioned court order made under the *Family Law Act 1975* ***[Schedule 4, item 6, paragraphs 126-140(2A)(d) and (2B)(c)]***;
- a binding financial agreement under the *Family Law Act 1975* or a corresponding written agreement that is binding because of a corresponding foreign law ***[Schedule 4, item 6, paragraphs 126-140(2A)(d) and (2B)(d)]***; or
- a written agreement that is binding under a state, territory or foreign law relating to de facto marriage breakdowns that, because of such a law, prevents a court making an order about matters to which the agreement applies or that is inconsistent with the terms of the agreement in relation to those matters, unless the agreement, or one or more of its terms, is varied or set aside ***[Schedule 4, item 6, paragraphs 126-140(2A)(d) and (2B)(e)]***.

Genuine marriage breakdown

4.14 The CGT roll-over will only apply where a marriage or de facto marriage has genuinely broken down (see paragraph 4.16).

4.15 There may be instances where a transfer occurs because of reasons not directly connected with the breakdown of a relationship. For example, this may be the case where the spouses had an agreement before the breakdown of the marriage or de facto marriage that the particular property was to be transferred between them for reasons not directly related to the marriage breakdown. The CGT roll-over will not be available in these circumstances.

4.16 These amendments will require that for transfers arising from an agreement:

- the spouses involved are separated with no reasonable likelihood of cohabitation being resumed; and
- the transfers happened because of reasons directly connected with the breakdown of the marriage or de facto marriage.

[Schedule 4, item 6, paragraph 126-140(2A)(h) and subsection 126-140(2C)]

4.17 The question of whether the spouses have separated is to be determined in the same way as it is for the purposes of section 48 of the *Family Law Act 1975*, as affected by sections 49 and 50 of that Act. ***[Schedule 4, item 6, subsection 126-140(2D)]***

4.18 The mere fact that two separated people live in the same home (ie, they are genuinely separated but living under one roof) does not amount to 'cohabitation' for this purpose.

4.19 These requirements will not apply to transfers arising out of a court order or arbitral award because it would be reasonable to assume that such transfers would directly relate to a marriage or de facto marriage breakdown.

'Clean break'

4.20 These new provisions provide spouses in a small superannuation fund with an opportunity to completely separate their superannuation arrangements on marriage breakdown so as to achieve a 'clean break'. To be eligible for the CGT roll-over, the trustee must transfer *all* of the assets reflecting the personal superannuation interest of the transferor spouse ***[Schedule 4, item 6, paragraphs 126-140(2A)(e) and (f)]***. If a number of assets are to be transferred in accordance with an abovementioned award, order or agreement, the transfers may take place separately ***[Schedule 4, item 6, paragraph 126-140(2A)(e)]***.

Either spouse (but not both)

4.21 These new provisions enable a trustee of a small superannuation fund to access the CGT roll-over on behalf of either spouse on marriage breakdown. However, once the trustee has obtained a CGT roll-over for the benefit of either spouse, the roll-over is no longer available for a transfer of any asset reflecting the personal superannuation interest of the other spouse (which arises out of the same marriage breakdown). Only one spouse needs to move their personal superannuation interest for a 'clean break' to be achieved.

4.22 A future entitlement to benefits from the fund as a result of a payment splitting order or agreement does not constitute an 'interest' for this purpose.

Roll-over where each spouse has a personal interest in a small superannuation fund and there has been no payment split

4.23 Where each spouse has a separate personal interest in a small superannuation fund and there has been no payment split of one spouse's interest in favour of the other spouse, the CGT roll-over will apply to a transfer of any asset reflecting the personal interest of either spouse. The award, order or agreement in accordance with which the transfer or

transfers are made will determine which spouse moves their interest and hence benefits from the CGT roll-over. Once any such transfer has been made, the trustee can no longer obtain a CGT roll-over for any transfer for the benefit of the other spouse. ***[Schedule 4, item 6, paragraphs 126-140(2A)(a), (b) and (g)]***

Example 4.1

Amy and David each have a personal interest in a small superannuation fund and there has not been any payment split. They reach a binding financial agreement on marriage breakdown which provides that the trustee transfer all of the assets reflecting David's personal interest to another complying superannuation fund. The assets reflecting David's personal interest consist of a parcel of shares and a rental property. The transfer of the parcel of shares is completed first.

A CGT roll-over will apply to the transfer. Consequently no roll-over will then be available to the trustee for any transfer made for the benefit of Amy. When the trustee subsequently transfers the rental property, a CGT roll-over will also apply to that transfer.

Roll-over where each spouse has a personal interest in a small superannuation fund and there has been a payment split

4.24 If a payment split of one spouse's interest in a small superannuation fund in favour of the other spouse has been discharged by the creation of a new interest in the same fund for that other spouse, then effectively each spouse now has a separate personal interest in that fund. Therefore the rule in paragraph 4.23 applies. The same rule also applies where a payment split has not been discharged at all (ie, where the spouse benefiting from a payment split still has an entitlement to future benefits from the small superannuation fund as a result of the payment split).

Example 4.2

In addition to the facts in Example 4.1, Amy acquired either a part or all of her personal interest as a result of a previous payment splitting order in her favour.

A CGT roll-over will still apply to the transfer made for the benefit of David under the binding financial agreement. No roll-over will be available to the trustee for any transfer made for the benefit of Amy.

Example 4.3

Andrew and Tracy each have a personal interest in a small superannuation fund. Tracy's interest is subject to a payment splitting agreement which entitles Andrew to future benefits from the fund. The agreement also stipulates that the trustee transfer all of the assets reflecting Andrew's personal interest to another complying superannuation fund.

A CGT roll-over will apply to the transfer. No roll-over will then be available to the trustee for any transfer made for the benefit of Tracy.

If the trustee subsequently transfers any asset reflecting Andrew's entitlement under the payment splitting agreement to his new superannuation fund, the existing marriage breakdown roll-over will apply to that transfer.

4.25 If a payment split has resulted in a transfer of an asset to another complying superannuation fund to which the existing CGT marriage breakdown roll-over applies, then only the spouse benefiting from the payment split can move their personal superannuation interest with CGT roll-over under these new provisions ***[Schedule 4, item 6, paragraphs 126-140(2A)(a), (b) and (g)]***. The reason for this restriction is that by transferring an asset reflecting their entitlement under the payment splitting order or agreement, that spouse has initiated the process of separating the couple's superannuation arrangements and should be allowed to complete that process.

Example 4.4

Matt and Karen each have a personal interest in a small superannuation fund. The trustee has previously obtained a CGT roll-over (under the existing marriage breakdown roll-over provisions) for the transfer of 5,000 shares from the fund to another small superannuation fund because of a payment splitting order in Karen's favour.

As Karen has already started removing her superannuation from the fund, the trustee can no longer obtain a CGT roll-over for any transfer made for the benefit of Matt.

If the trustee subsequently transfers all of the assets reflecting Karen's personal interest in accordance with any award, order or agreement specified in these new provisions, a CGT roll-over will apply to that transfer.

Related amendments

Roll-over of assets as a result of a payment split

4.26 This Schedule also amends the existing CGT marriage breakdown roll-over — which currently applies to transfers of assets between small superannuation funds — by extending it to transfers from a small superannuation fund to another complying superannuation fund. ***[Schedule 4, items 4 and 5, paragraphs 126-140(1)(c) and (2)(b)]***

Roll-over of non-superannuation assets

4.27 In December 2006, Schedule 1 to the *Tax Laws Amendment (2006 Measures No. 4) Act 2006* amended Subdivision 126-A of the ITAA 1997 to extend the CGT marriage breakdown roll-over to the transfer of an asset to a spouse or former spouse pursuant to:

- a binding financial agreement under the *Family Law Act 1975*; and

- a written agreement under a state, territory or foreign law relating to de facto marriage breakdowns.

4.28 The extension to transfers pursuant to a written agreement under a law relating to de facto marriage breakdowns was intended to extend the CGT roll-over to transfers pursuant to any written agreement equivalent to a binding financial agreement under the *Family Law Act 1975*.

4.29 In relation to assets transferred under Australian law, all states and territories (except Victoria) have laws under which parties to a de facto marriage can make a written agreement equivalent to a binding financial agreement under the *Family Law Act 1975*. The amendments made to Subdivision 126-A of the ITAA 1997 in December 2006 were intended to extend the CGT roll-over to the transfer of an asset to a former de facto spouse pursuant to such an agreement made under any of those laws.

4.30 However, subparagraphs 126-5(1)(f)(ii) and 126-15(1)(f)(ii) of the ITAA 1997 may be construed to exclude transfers pursuant to written agreements made under Western Australian, Tasmanian, Queensland or Northern Territory laws which are equivalent to binding financial agreements under the *Family Law Act 1975*.

4.31 Currently, a financial agreement made under the *Family Court Act 1997* (Western Australia) prevents courts in that State from making an order about matters to which the agreement applies, unless the agreement is set aside. In the other Australian states and territories, a written agreement that is equivalent to a binding financial agreement under the *Family Law Act 1975* prevents courts from making an order that is inconsistent with the terms of the agreement, unless the agreement, or one or more of its terms, is varied or set aside.

4.32 Proposed subparagraphs 126-5(1)(f)(ii) and 126-15(1)(f)(ii) will provide for the identification of the state, territory or foreign laws under which parties to a de facto marriage can make a written agreement equivalent to a binding financial agreement under the *Family Law Act 1975* in those terms. ***[Schedule 4, items 2 and 3, subparagraphs 126-5(1)(f)(ii) and 126-15(1)(f)(ii)]***

Application and transitional provisions

4.33 These amendments will apply to CGT events that happen on or after 1 July 2007, regardless of when the award, order or agreement is made.

Consequential amendment

4.34 A consequential amendment is made to item 7 in the table in section 112-150 of the ITAA 1997 to reflect the availability of the CGT roll-over where a CGT asset is transferred from a small superannuation fund to another complying superannuation fund because of a marriage breakdown. ***[Schedule 4, item 1]***

Chapter 5
Income tax treatment of the Prime Minister's Prize for Australian History and the Prime Minister's Prize for Science

Outline of chapter

5.1 Schedule 5 to this Bill amends the *Income Tax Assessment Act 1997* to exempt from income tax the Prime Minister's Prize for Australian History and the Prime Minister's Prize for Science, to the extent that the prizes would otherwise be assessable income.

Context of amendments

5.2 On 20 June 2007 the Prime Minister announced that the Prime Minister's Prize for Australian History would be tax exempt.

5.3 These amendments ensure that no tax is payable on the Prime Minister's Prize for Australian History and the Prime Minister's Prize for Science.

Summary of new law

5.4 From 1 July 2006, the Prime Minister's Prize for Australian History and the Prime Minister's Prize for Science will be exempt from income tax to the extent that the prizes would otherwise be assessable income.

Detailed explanation of new law

5.5 Whether a prize is taxable income depends on consideration of the circumstances and the nature of the prize and the recipient.

5.6 Given that the treatment of the prizes depends on the nature of the prize and the recipient, these amendments ensure that the Prime Minister's prizes are exempt only where the amounts would otherwise be assessable income. ***[Schedule 5, item 2, section 51-60]***

Application provision

5.7 These amendments apply to assessments for the 2006-07 income year and later income years. ***[Schedule 5, item 3]***

Chapter 6
Removal of the same business test cap

Outline of chapter

6.1 Schedule 6 to this Bill amends the company loss recoupment rules in the *Income Tax Assessment Act 1997* (ITAA 1997) to remove the $100 million total income cap on the same business test.

Context of amendments

6.2 Under the company loss recoupment rules, a company (including the head company of a consolidated group or multiple entry consolidated group) is able to claim deductions for prior year losses only if it satisfies the continuity of ownership test or the same business test.

6.3 The continuity of ownership test broadly requires that the shares carrying more than 50 per cent of all voting, dividend and capital rights be beneficially owned by the same persons at all times during the ownership test period (ie, the period from the start of the loss year to the end of the income year in which the loss is to be deducted).

6.4 The same business test requires the company to carry on the same business in the income year the loss is claimed as a deduction and the 'test time' (which is either the point in time the continuity of ownership test is no longer satisfied, or the start of the income year when the loss is incurred where it is not practicable for the company to show that it has satisfied the continuity of ownership test). Companies with total income for an income year in excess of $100 million are denied access to the same business test for losses incurred on or after 1 July 2005.

6.5 In response to concerns raised by business and professional groups, the Government has reviewed the operation of the same business test. As a result of this review, the $100 million total income cap on the same business test will be removed.

Summary of new law

6.6 These amendments will improve the operation of the company loss recoupment rules by removing the $100 million total income cap on the same business test.

Comparison of key features of new law and current law

New law	*Current law*
A company will be able to deduct prior year losses that are incurred on or after 1 July 2005 in an income year if: • the company satisfies the continuity of ownership test; or • the company satisfies the same business test.	A company can deduct prior year losses that are incurred on or after 1 July 2005 in an income year if: • the company satisfies the continuity of ownership test; or • the company's total income for the income year is $100 million or less and it satisfies the same business test.

Detailed explanation of new law

6.7 The company loss recoupment rules will be modified to remove the $100 million total income cap on the same business test. ***[Schedule 6, items 1 and 2, sections 165-212A, 165-212B, 165-212C and 716-805]***

6.8 Therefore, a company will be able to deduct prior year losses that are incurred on or after 1 July 2005 in an income year if:

- the company satisfies the continuity of ownership test; or
- the company satisfies the same business test.

6.9 Consequential amendments will remove various cross-references and notes that refer to the $100 million total income cap on the same business test. ***[Schedule 6, items 3 to 67, sections 165-5, 165-10, 165-13, 165-15, 165-23, 165-30, 165-35, 165-40, 165-45, 165-93, 165-99, 165-115, 165-115B, 165-115BA, 165-117, 165-120, 165-126, 165-129, 165-132, 165-210, 166-5, 166-20, 166-40, 175-5, 175-40, 175-80, 701-30, 707-120, 707-125, 707-135, 707-210, 715-15, 715-50, 715-55, 715-60, 715-70, 715-95, 715-355, 715-360, 716-850, 719-260, 719-285 and the definition of 'total income' in subsection 995-1(1) of the ITAA 1997]***

Application and transitional provisions

6.10 These amendments will apply to:

- any tax loss that is incurred in an income year commencing on or after 1 July 2005;
- any net capital loss that is made in an income year commencing on or after 1 July 2005; and
- any deduction in respect of a bad debt that is incurred in an income year commencing on or after 1 July 2005.

[Schedule 6, item 68]

6.11 These amendments are beneficial to taxpayers as they will make it easier for companies to deduct prior year losses. The amendments apply from 1 July 2005 so that:

- companies with total income in excess of $100 million that satisfy the same business test are not denied access to losses incurred since 1 July 2005; and
- companies do not incur additional compliance costs by having to separately keep track of losses incurred since 1 July 2005.

Chapter 7
Partial capital gains tax roll-over for statutory licences

Outline of chapter

7.1 Schedule 7 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to extend the existing statutory licence capital gains tax (CGT) roll-over under Subdivision 124-C to provide for roll-over where one or more new licences are issued in consequence of the ending of one or more licences and to provide for a partial roll-over. A partial roll-over applies where one or more statutory licences end and are replaced by one or more new licences and the licensee also received non-licence capital proceeds such as money.

Context of amendments

7.2 Subdivision 124-C provides a CGT roll-over if a statutory licence expires or is surrendered and a new licence is issued which renews or extends the original licence. The current roll-over is therefore limited to specific types of replacement licences.

7.3 It is appropriate to provide roll-over in a broader range of circumstances where a statutory licence is effectively replaced by another statutory licence. Accordingly, the amended provision focuses on the activity permitted by the licence rather than the way in which the licence comes to an end.

7.4 A licence or licences may be issued to take the place of one or more original licences. These amendments will provide roll-over of capital gains or losses in these cases.

Summary of new law

7.5 These amendments extend the existing statutory licence CGT roll-over in Subdivision 124-C. The roll-over will apply when a statutory licence ends, CGT event C2 happens, and one or more new licences are issued which authorise substantially similar activity to the activity authorised by the original licence or licences. These amendments also provide a partial roll-over where a statutory licence ends and is replaced by a new licence or licences and non-licence capital proceeds are also received.

Comparison of key features of new law and current law

New law	*Current law*
Subdivision 124-C provides an automatic CGT roll-over where CGT event C2 happens on the ending of a statutory licence and a new licence or licences are issued for the original licence.	Subdivision 124-C provides an automatic CGT roll-over if an original statutory licence expires or is surrendered and the licence holder obtains a new licence by renewing or extending the original licence.
A partial roll-over under Subdivision 124-C will apply where non-licence proceeds are also received for the ending of the original licence or licences.	The roll-over under Subdivision 124-C does not apply if a licence holder also receives non-licence capital proceeds such as cash.
Where there is more than one replacement licence or non-licence capital proceeds, the cost base of the original licence or licences will be allocated on a reasonably attributable basis between the licences and non-licence capital proceeds.	No equivalent.
Subparagraph 116-30(2)(b)(ii) of the ITAA 1997 will not apply where non-licence capital proceeds are received.	If the capital proceeds are more or less than the market value of the original licence, the capital proceeds are replaced with the market value of the licence under subparagraph 116-30(2)(b)(ii) of the ITAA 1997.
The *Income Tax (Transitional Provisions) Act 1997* provides for the allocation of cost bases for Achieving Sustainable Groundwater Entitlement payments.	No equivalent.

Detailed explanation of new law

Ending of a statutory licence by reference to CGT event C2

7.6 A capital gain or loss made on the ending of a statutory licence will be disregarded in a broader range of circumstances.

7.7 Currently CGT roll-over is subject to the ownership of a statutory licence ending by expiry or surrender. A broader range of endings such as cancellation will be included under these amendments. This is achieved by amending Subdivision 124-C to provide roll-over

where the ending of a statutory licence results in CGT event C2 happening. ***[Schedule 7, item 2, paragraph 124-140(1)(a)]***

The substantially similar activity test

Single licence roll-over

7.8 In the simplest case, roll-over will be available when a licence ends and, as a result, a new licence is issued which authorises substantially similar activity as the original licence.

7.9 The new licence must be issued because of the ending of the original licence and so a relationship must exist between the two. The new licence must be received because of the ending of the original licence. ***[Schedule 7, item 2, paragraph 124-140(1)(b)]***

7.10 Further, the new licence must authorise activity which is substantially similar to the activity authorised by the original licence. This requires an analysis of the activity permitted or authorised by the original licence and a comparison with the activity permitted or authorised by the new licence. The test requires that the activities be substantially similar in nature, recognising that the cancellation and issue of a new licence may be required because of changes in the industry, changes in the business practices of the licence owner, or changes in the technology supporting the licence. In determining whether a new licence authorises substantially similar activity it is appropriate to consider whether the skills or infrastructure required to utilise or exploit the rights granted by the original licence are also required to utilise or exploit the rights granted by the new licence. ***[Schedule 7, item 2, paragraph 124-140(1)(c)]***

7.11 The substantially similar activity test accommodates changes between the features of the old and new licences. Therefore, the fact that the new licence may:

- authorise a use for a longer period of time than the original licence;
- be granted in perpetuity while the original licence applied for a limited time, or vice versa;
- authorise changes in volume or quantity available for use;
- authorise changes in areas or physical locations; or
- allow non-licence capital proceeds such as cash to be received as part of issuing the new licence,

does not necessarily mean that the activities fail the substantially similar test.

Example 7.1

Caughtya Pty Ltd has a licence (the original licence) to fish for a particular species of fish in the protected waters of Moreton Bay in Southeast Queensland. It is determined by the issuing authority, a government agency, that fishing for that species is not sustainable and so those licences are cancelled. As a result of the cancellation the government agency issues to each affected licence holder a licence to catch a different species of fish in the open waters off Central Queensland. The boats and equipment used for the original licence can not be used in the open waters off Central Queensland. Caughtya Pty Ltd will be required to invest in a bigger boat.

Caughtya Pty Ltd's ownership of the original licence has ended. As a result of that ending it was issued with a new licence for the original licence. While Caughtya was required to purchase a new boat and other equipment, it continues to operate in the fishing industry and to use skills relating to commercial fishing that were used with the original licence. The substantially similar activity test is satisfied.

Multiple licences roll-over

7.12 The more complex cases occur where multiple original or new licences are involved. A reorganisation of an industry can involve the collapsing of original licences into fewer new licences, or the splitting of licences to recognise different aspects of the authorised activity (eg, to permit trading of one part of the original licence).

7.13 Where multiple licences are involved, the roll-over requires that all of the original licences that end, and for which the licensee is issued a new licence or licences, must end as part of a single arrangement. The new licence or licences must be issued as part of that arrangement.
[Schedule 7, item 2, paragraph 124-140(1)(a)]

Example 7.2

William owns a farm on two land titles which are dealt with separately by the water authority. On each title William has several bores which are separately operated under their own licences. The water authority intends to cancel the original licences and replace the bore licences with one access licence on each land title. As the original and new licences relate to the extraction of water, the original licences on each title will be the subject of a separate roll-over that recognises that all the licences on each title are replaced with an access licence.

Example 7.3

As William will receive two new access licences, each new licence must satisfy the substantially similar activity test. In William's case the original bore licences all had different volume limits and, as part of a restructure of entitlements in the aquifer on which his property sits, each bore licence is being reduced according to a formula. The new access licence will allow William greater security of a lesser quantity of water and will allow him to sell some or all of his water entitlement.

William meets the test for roll-over for each access licence as the activity permitted by the new licence (ie, the extraction of water) is substantially similar to the activity authorised by the new access licence.

Example 7.4

Maurie owns a property on which he grows tobacco, as have the previous three generations of his family. He holds a tobacco licence, which he acquired before September 1985, that permits him to operate in the tobacco industry.

Due to global restructuring in the industry, tobacco will no longer be purchased from this region and his licence, and those of other producers in the region, will be cancelled.

Under this industry restructure, Maurie will receive a payment for the cancelled licence from the relevant licensing authority.

Due to concerns about the economic impact on the region, the state government is keen to assist affected tobacco growers to move into other industries. It plans to establish aquaculture in the region and tobacco growers who have had their tobacco licences cancelled will be offered aquaculture licences, which can be acquired with the proceeds of the cancelled tobacco licences. They will also be provided with assistance with the costs of redeveloping their properties to undertake aquaculture activities.

Roll-over is not available in these circumstances because the aquaculture licence is not issued for the ending of the tobacco licence, even though the proceeds of the cancelled tobacco licence are used to purchase the new licence. In any event, the aquaculture licence does not authorise substantially similar activity to that authorised by the tobacco licence.

7.14 The roll-over applies in a variety of combinations of issues of multiple new licences and the ending of multiple original licences. The consequences of the roll-over are set out in sections 124-145, 124-150, 124-155, 124-160 and 124-165.

Consequences of roll-over

7.15 If the conditions for roll-over are satisfied, any capital gain or loss arising from the ending of the statutory licence is disregarded. ***[Schedule 7, item 3, section 124-145]***

Where all original licences were post-CGT

7.16 A post-CGT licence is a licence that was acquired on or after 20 September 1985. Where one new licence results from the ending of an original post-CGT licence, the cost base of the original licence becomes the first element of the cost base of the new post-CGT licence. ***[Schedule 7, item 3, section 124-155]***

7.17 For the purposes of claiming the CGT discount, the new licence is taken to have been acquired when the original licence was acquired as specified in section 115-30 of the ITAA 1997.

7.18 Where more than one licence ends, or more than one new licence is received, the cost base of each new licence must be determined on a reasonable basis. This allocation of the original cost base or cost bases is by reference to the number, market value and character of the original and new licences. ***[Schedule 7, item 3, section 124-155]***

7.19 Character can refer to volume entitlements or other inherent features of the licence or licences by which meaningful comparisons can be made between various licences. From these inherent features market values can be derived which could also be used as a reasonable basis of apportionment if, for example, the same characteristics appear across all licences. The reference to market value does not require a professional valuation to be obtained but is included as a factor to be considered when selecting a particular characteristic on which to allocate cost bases to achieve the required reasonable allocation of cost bases.

Example 7.5

> Modifying Example 7.3, William actually received two new licences on one of the titles, one for high security access and one for low security access. In applying the CGT roll-over, William needs to allocate the cost bases of his two original licences to the two new licences on a reasonable basis.
>
> In doing so William would need to take into account the number of new licences received and the market value and character of each of the new licences and the original licences. A common feature of all the licences is a volume entitlement. William can use this entitlement to allocate cost bases provided the market values for each megalitre of water under each of the original and new licences are not considerably different. In this case they are. The tradable high security water has a much higher market value per megalitre.
>
> William allocates the total of the cost bases of his original licences across his two new licences by using the market values of the new licences.

Where all original licences were pre-CGT

7.20 Where the original licence or licences were all acquired before 20 September 1985 (pre-CGT licences) and a new licence or licences are issued for the original licence or licences, the new licence or licences are taken to have been also acquired before 20 September 1985. ***[Schedule 7, item 3, section 124-160]***

7.21 If any ineligible proceeds result from the disposal of part of a pre-CGT licence, any capital gain or capital loss on the ineligible proceeds will be disregarded (ineligible proceeds are explained in paragraph 7.24).

Where original licences were pre-CGT and post-CGT licences

7.22 Where pre-CGT and post-CGT licences end and a new licence or licences are issued, each new licence is taken to be two separate assets. One of these assets is treated as having been acquired before 20 September 1985, and the other is treated as having been acquired on or after 20 September 1985. ***[Schedule 7, item 3, subsections 124-165(1) and (2)]***

7.23 The cost base of each of those assets is determined by allocating the total of the cost bases of the original post-CGT licences between the new licences in proportion to their market values. The market values are determined when the original licences end. ***[Schedule 7, item 3, subsection 124-165(3)]***

Example 7.6

Edward has three water licences. One was acquired before 20 September 1985 (pre-CGT) and the other two were acquired after 19 September 1985 (post-CGT). The pre-CGT licence has a market value of $100,000. One post-CGT licence has a cost base of $110,000 and a market value of $180,000 and the other post-CGT licence has a cost base of $90,000 and market value of $120,000.

Edward's three water licences are cancelled by the relevant authority, which issues Edward with two new water licences one with a market value of $150,000 and the other with a market value of $250,000.

As the original licences are a mix of pre-CGT and post-CGT licences, each new licence is effectively split into a pre-CGT and post-CGT component with each component being treated as a separate CGT asset.

Edward needs to determine the cost base of each of the post-CGT components of his two new licences. He does this by allocating the total cost bases for his original post-CGT licences to the two new post-CGT assets that he is taken to have acquired.

The total of the market values of all the new licences is:

$$\$150{,}000 + \$250{,}000 = \$400{,}000$$

The total of the cost bases of the original post-CGT licences is:

$$\$110{,}000 + \$90{,}000 = \$200{,}000$$

The cost base of the post-CGT component of the new licence with a market value of $150,000 is:

$$\$200{,}000 \times \frac{\$150{,}000}{\$400{,}000} = \$75{,}000$$

The cost base of the post-CGT component of the new licence with a market value of $250,000 is:

$$\$200{,}000 \times \frac{\$250{,}000}{\$400{,}000} = \$125{,}000$$

When Edward disposes of one of the new licences he will have to work out the pre-CGT and post-CGT components of that licence on a reasonable attribution basis as specified in subsection 116-40(1) of the ITAA 1997.

Partial roll-over

7.24 Roll-over does not apply to the extent to which a statutory licence ends and the licence holder receives non-licence proceeds for the ending of the licence. These non-licence proceeds may include other assets, including cash (the ineligible proceeds). It is therefore necessary to determine the capital gain or loss on the ending of the original licence that relates to the ineligible proceeds (ie, for what part of the original licence is the ineligible proceeds received). The capital gain or loss on the ineligible proceeds cannot be rolled over. ***[Schedule 7, item 3, subsection 124-150(1)]***

7.25 Before apportioning the cost base of the original licence or licences to the new licence or licences the cost base of the original licence or licences is reduced by the amount that is attributable to any ineligible proceeds. The amount of the cost base of each licence attributable to ineligible proceeds is calculated on a reasonable basis. ***[Schedule 7, item 3, subsections 124-150(2) to (4)]***

7.26 Where ineligible proceeds relate to a particular licence the cost base of those ineligible proceeds will be part of the cost base of that licence. Where the ineligible proceeds relate to more than one licence the cost base of the ineligible proceeds will be a part of each of the original licences. The cost base of each of these original licences will be reduced to the extent of the cost base of the ineligible proceeds before being allocated to new licences. ***[Schedule 7, item 3, subsection 124-150(4)]***

7.27 As there is no roll-over for the capital gain or loss relating to the ineligible proceeds, and the total capital proceeds may be more or less than the market value of the original licence, the market substitution rule for capital proceeds does not apply. ***[Schedule 7, item 7, subsection 116-30(2A)]***

Example 7.7

Joe has been running a closed narrowcasting television service in his local area for 10 years by means of a low powered radio spectrum licence. The service provides information to local residents about local events and has subscribers who meet the costs of narrowcasting. All content is local and live.

The subscription fee also provides a small return on the costs of the spectrum licence Joe purchased to facilitate his dream of having his own TV station. The licensing authority has compulsorily withdrawn Joe's spectrum licence for the frequency he has been using because another service needs the frequency, and as part of the arrangement the authority has reallocated a licence for another low power frequency.

Since the new frequency will require additional power to transmit, the authority has also provided an additional payment to Joe so that he can continue operating without having to increase his subscription fees to his local subscribers. Roll-over applies to the extent of the receipt of the new licence. Any capital gain arising as a result of the payment of cash will continue to be assessable.

Example 7.8

Bob has two post-CGT land titles and multiple bores on each title. Under a restructure of the water licences, Bob receives a cash payment and a new access licence that replaces all of his original licences on one of the land titles. CGT roll-over will apply to roll-over any capital gain that Bob might make from the ending of his original licences and he will need to determine the capital gain or loss arising from the cash payment.

The effect of the new licence is to restrict his water access by 40 per cent compared to the volume permitted by all of his original licences on the affected land title. On a reasonable apportionment basis Bob can take 40 per cent of the cost base of all of the original licences and reasonably attribute that amount to the cost base of the ineligible proceeds (the cash).

The cost base of the new access licence is then the sum of the remaining cost bases of the original licences (ie, as reduced by the 40 per cent of each cost base attributed to the cash).

Example 7.9

Modifying Example 7.8, Bob has two original licences on the one title, one permitting access to 100 megalitres of water and the other to 500 megalitres of water. Both licences are replaced with one water access licence that gives him access to 200 megalitres of water. The water authority advises Bob that the basis of the allocation of the new licence is that the water entitlements reflect a reduction in volume of 80 per cent of the first licence, and 64 per cent of the second licence. Bob receives a cash payment that fully reflects the loss of water entitlements as well as the new access licence for the cancellation of his original licences.

In determining the cost base of the cash payment, Bob considers the nature of the rights that he had under the original licences, and also the nature of his entitlements under the new licence, and concludes that those entitlements are the same but for the reduction in the volumes of water he is permitted to take. He therefore decides to allocate 80 per cent of the cost base of his first original licence and 64 per cent of the cost base of his second original licence to the cash payment.

Example 7.10

Again modifying Example 7.8, from the calculations provided by the issuer of the licence, Bob is also able to work out how the cash payment was calculated. Bob receives a cash payment and new access licence for the two bore licences (bore 1 and bore 2) on the land title.

The payment was made for the reduction by 30 per cent of Bob's access to water on the licence entitlement on bore 1. Bob receives $10,000, which fully reflects the loss of water entitlements, as part of the package of reforms.

The cost base of the licence of bore 1 is $8,000.

The cost base of the licence of bore 2 is $3,000.

On a reasonable allocation basis Bob can allocate 30 per cent of the cost base of the licence on bore 1 ($2,400) to the cost base of the ineligible proceeds.

The capital gain on the ineligible proceeds will be:

$10,000 – $2,400 = $7,600

Bob has to reduce the cost base of the bore 1 licence by the amount of the cost base of the ineligible proceeds. In calculating the cost base of the new access licence, the adjusted cost base of the licence of bore 1 ($8,000 – $2,400 = $5,600) is added to the cost base of the licence of bore 2 ($3,000).

The cost base of the new access licence is $8,600.

Foreign residents — taxable Australian property

7.28 Where a statutory licence owned by a foreign resident is used in carrying on a business through a permanent establishment in Australia (taxable Australian property) and the new licence or licences are also used in that business, roll-over will be available. ***[Schedule 7, item 2, subsections 124-140(1A) and (1B)]***

Application and transitional provisions

7.29 These amendments will commence on Royal Assent. The amendments will apply to CGT events that happen in the 2006-07 income year and later years.

7.30 The Achieving Sustainable Groundwater Entitlements programme was announced in 2005 to ensure the six major groundwater systems in NSW are sustainable in the longer term.

7.31 Under the Achieving Sustainable Groundwater Entitlements programme, bore licences will be replaced by an aquifer access licence, combined water supply works and use approval and, in some cases, a supplementary licence. The new access licence is granted in perpetuity and is tradable. The supplementary licence is an access licence for a declining amount of water over a period of years and is not tradable. Eligible bore licence holders may also be offered a cash payment based on their former entitlements to water and their history of extraction of water.

7.32 Where Achieving Sustainable Groundwater Entitlements cash payments are received the transitional provisions provide for the use of

the 2002 values, which were used to calculate the amounts of the cash payments, in determining the capital gain or loss arising in relation to the cash payment (the ineligible proceeds). These provisions permit the use of readily available values which affected taxpayers have been provided with as part of the adjustment process required under the Achieving Sustainable Groundwater Entitlements programme. These provisions also affect the allocation of the cost base of the original licence between the new aquifer access licence, the combined water supply works and use approval, the supplementary water licence and the ineligible proceeds. ***[Schedule 7, item 4, sections 124-140, 124-141 and 124-142 of the Income Tax (Transitional Provisions) Act 1997]***

7.33 No part of the cost base of the original licence is allocated to a supplementary licence where one is received. The 2002 value ascribed to the new aquifer access licence and the cash payment are treated as the total capital proceeds for the original licence (ie, the supplementary licence and combined approval are effectively ignored). The cost base of the original licence is allocated between the new aquifer access licence and the cash payment. ***[Schedule 7, item 4, subsections 124-141(1), (3) and 124-142(2) of the Income Tax (Transitional Provisions) Act 1997]***

7.34 A supplementary licence is received where the new aquifer access licence is for a lesser amount of water than the historical extraction. It allows for a gradual reduction from the existing extraction levels to the new allocation entitlement amount. While a discount factor is applied against the active water lost to reflect the supplementary water available, this discount is used to calculate the cash payment rather than a valuation of the water available under the supplementary licence. For these reasons the supplementary licence is allocated a nil cost base. The combined water supply works and use approval is also given a nil cost base because it can be obtained from the relevant NSW Government authority at a minimal cost. ***[Schedule 7, item 4, section 124-142 of the Income Tax (Transitional Provisions) Act 1997]***

Example 7.11

McDillon is in the Namoi water basin and subject to the Achieving Sustainable Groundwater Entitlements programme. McDillon acquired a bore licence with the acquisition of her property in October 1985. The property's bore licence, with an entitlement of 163 megalitres per year, has ended and McDillon has been issued a new aquifer access licence, a supplementary licence and combined works and use approval. The new aquifer access licence allows for 52 megalitres per year, which is less than McDillon's history of extraction of 102 megalitres per year.

McDillon also receives a cash payment of $37,000 based on her original entitlement of 163 megalitres per year and the reduction in available water over 10 years from her old extraction rate.

The 2002 value ascribed to the new aquifer access licence is $57,200 (being the new aquifer access licence entitlement of 52 megalitres per year *times* post plan tradable value of water of $1,100 a megalitre).

The cost base of McDillon's original licence is $20,000, being an appropriate portion of the total cost of acquiring the property, which included the bore licence.

The cost base allocated to the ineligible proceeds (the cash payment) will be $7,856, that is:

$$\$20{,}000 \times \frac{\$37{,}000}{\$37{,}000 + \$57{,}200}$$

The capital gain on the ineligible part will be $29,144, that is:

$$\$37{,}000 - \$7{,}856$$

The cost base of the new aquifer access licence is $12,144, that is:

$$\$20{,}000 - \$7{,}856$$

The cost bases of the supplementary licence and combined works and use approval are nil.

7.35 There may be other programmes where statutory licences end and the licence holders are issued new licences and receive ineligible proceeds such as cash. If the amount of the cash payment is calculated with respect to prescribed values rather than market values, licences issued under such programmes will be considered for listing under the regulations. This listing will mean licence holders receiving cash payments under such programmes will be treated in a similar way to Achieving Sustainable Groundwater Entitlements licence holders. ***[Schedule 7, item 4, paragraphs 124-140(2)(b) and (3)(b), 124-141(1)(b) and subsection 124-141(2) of the Income Tax (Transitional Provisions) Act 1997]***

Consequential amendments

7.36 There are also amendments tidying up tables, notes and examples that need to be inserted or changed because of the wider application of the roll-over. ***[Schedule 7, items 5, 6 and 8 to 12]***

7.37 A regulation-making power is inserted into the *Income Tax (Transitional Provisions) Act 1997*. ***[Schedule 7, item 13]***

Chapter 8
Australian property trusts and stapled securities

Outline of chapter

8.1 Schedule 8 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to provide holders of ownership interests in stapled entities with a capital gains tax (CGT) roll-over when a public unit trust is interposed between those holders and the stapled entities.

8.2 This Schedule also amends the *Income Tax Assessment Act 1936* (ITAA 1936) to ensure that such restructures do not result in the interposed head trust being taxed as if it were a company. In addition, public unit trusts will be able to acquire controlling interests in, or control, foreign entities whose business consists primarily of investing in land outside Australia for the purpose, or primarily for the purpose, of deriving rent.

Context of amendments

CGT context

8.3 Stapled groups often consist of several different entities, such as unit trusts and companies, whose equity interests are stapled together. Every holder of interests in the entities in the stapled group must own proportionate equity interests in each of the entities whose equity is stapled. Issue of further equity by any of the entities is correspondingly limited so that each entity can issue equity only in association with proportionate issues of equity by the other entities. Trading in, or disposal of, equity is correspondingly limited too.

8.4 Over the last five years, tax advantaged real estate investment vehicles in the rest of the world (and particularly Asia) have grown significantly. In the United States of America (US), a tax preferred vehicle for property investment is called a Real Estate Investment Trust. A US Real Estate Investment Trust may be a trust or a company, but is taxed in the US only as a company. Its tax preferred feature is that, while it meets detailed prescriptive rules about its activities and its distribution policies, it can pay tax deductible dividends to its equity holders. Therefore a US Real Estate Investment Trust can avoid the effect of ‘classical taxation’ in the US, that is, taxation at company level and

taxation again on distribution to equity holders, without credit for the tax paid at company level.

8.5 To enable Australian Listed Property Trusts to acquire overseas vehicles in exchange for their own equity, it is often necessary for the acquirer to issue only its own equity. For example, it is only where equity in a US Real Estate Investment Trust is exchanged for equity in the acquirer that the holders of the Real Estate Investment Trust are able to obtain a tax deferral in the US. In this respect, a stapled Australian Listed Property Trust is at a competitive disadvantage to a single entity seeking to acquire US Real Estate Investment Trusts. This is because the interest holders of the target Real Estate Investment Trust would be entitled to a CGT roll-over in the US if the acquirer was offering only its own equity but not if the acquirer was offering a combination of its own equity with other equity. An Australian Listed Property Trust equity which is stapled can only offer proportionate equity in each of the stapled entities and so cannot offer as much tax deferral as an acquirer offering only its own equity.

8.6 Subdivision 124-G of the ITAA 1997 provides a CGT roll-over for the holders of shares in an existing company under a scheme for reorganising the company's affairs. Subdivision 124-H of the ITAA 1997 provides similar relief where a new company is interposed between an existing unit trust and its unit holders.

8.7 Under the current CGT provisions, stapled entities are unable to establish a head trust and rearrange their corporate structure with a CGT roll-over for their interest holders.

8.8 These amendments will provide a CGT roll-over to allow for the reorganisation of stapled groups, and in particular Australian Listed Property Trusts. This will enable Australian Listed Property Trusts to rearrange their stapled structures and allow them to interpose a head trust so that they are treated as a single entity for the purposes of overseas acquisitions.

Divisions 6B and 6C context

8.9 Both Division 6B and 6C of Part III of the ITAA 1936 deal with taxing certain public unit trusts as companies.

8.10 Division 6B taxes public unit trusts like companies and their unit holders like shareholders (essentially when company assets or company business become assets or business of the unit trust as part of an arrangement by which shareholders in the company get units in the trust).

8.11 Division 6C of the ITAA 1936 also acts to protect the corporate tax base by taxing as a company the trustee of a public unit trust where the trust is carrying on a trading business, or 'controls' another entity carrying on a trading business. It is an all-or-nothing, year-by-year provision such

that any active business activity conducted or controlled by a public unit trust in a year of income means that the trust is taxed like a company for that year in relation to all its income and activities. Its equity holders are taxed like shareholders for that year too.

8.12 Division 6C taxes public unit trusts in a similar manner to companies unless they are confined to certain traditional passive investment activities. A public unit trust is, broadly, a unit trust where any of the units are listed on a stock exchange or are offered to the public or the units in the unit trust are held by not fewer than 50 persons (section 102P of the ITAA 1936).

8.13 A unit trust is a 'trading trust' if it carries on a trading business or controls or is able to control, directly or indirectly, a trading business carried on by another person (section 102N of the ITAA 1936). A 'trading business' is any business that does not consist wholly of 'eligible investment business', that is, of certain traditional passive activities.

8.14 Company treatment does not extend to public unit trusts that carry on only 'eligible investment business' which consists only of investing in land or an interest in land primarily for rental purposes, or of investing or trading in certain equities or instruments, or a combination of any of these activities (section 102M of the ITAA 1936).

8.15 When a trust such as a newly interposed head trust owns or controls a trading business after a restructure, the trust (as a public unit trust) will be subject to taxation as if it were a company under the public trading trust rules in Division 6C.

8.16 The interposed head trust would then not only control subsidiary trusts producing passive income, but also any subsidiary companies or trusts producing active income. The result would be that the interposed head trust would be taxed as if it were a company, were it not for these amendments.

8.17 These proposed amendments will facilitate Australian public unit trusts acquiring property and property-holding entities offshore.

Summary of new law

8.18 This Schedule amends Division 124 of the ITAA 1997 by inserting Subdivision 124-Q. This Subdivision will provide a CGT roll-over for members of a stapled group:

- where there has been an interposition of a public unit trust between the holders of ownership interests in the entities of the stapled group and the stapled entities; or

- where there is a destapling of the stapled entities and a public unit trust that was one of the stapled entities, is interposed between the holders of ownership interests in the entities in the stapled group and the remaining formerly stapled entities.

8.19 This Schedule also amends Division 6C of the ITAA 1936 so that the imposition of such a head trust after a restructure will not lead to the trust being treated as a public trading trust (and therefore taxed as a company) provided certain other conditions are met.

8.20 Division 6C is also amended to allow a public unit trust to acquire a controlling interest in or control a foreign entity (such as a US Real Estate Investment Trust) whose business consists primarily of investing in land outside Australia for the purpose, or primarily for the purpose, of deriving rent, without the acquisition leading to the trust being taxed as if it were a company.

Comparison of key features of new law and current law

New law	*Current law*
A CGT roll-over will be provided for holders of ownership interests of the stapled entities where, under a scheme for reorganising the stapled entities' affairs, they dispose of their ownership interests in the stapled entities in exchange for a proportionate number of ownership interests in an interposed public unit trust.	No equivalent.
A public unit trust will not be treated as a public trading trust where: • it is a trust interposed between the entities in the stapled group and their equity holders; and • through its holding of a previously stapled company or a previously stapled trust (that was taxed as a company), the trust controls a 'trading business' as defined in section 102M of Division 6C of the ITAA 1936.	If a public unit trust carries on a trading business or controls another entity that carries on a trading business, the public unit trust will be treated as a public trading trust and taxed as if it were a company in the relevant year of income.
Public unit trusts can acquire a controlling interest in or control a foreign entity whose business	The acquisition of a controlling interest would lead to the trust being taxed as a company, if the foreign

New law	*Current law*
consists primarily of investing in land outside Australia for the purpose, or primarily for the purpose, of deriving rent.	entity carried on a 'trading business'.

Detailed explanation of new law

8.21 ***Stapled entities*** are a group of entities that may consist of two or more trusts, or one or more companies and one or more trusts, whose ownership interests are stapled together to form stapled securities. 'Ownership interests' are defined according to subsection 125-60(1) of the ITAA 1997, and cover shares, trust interests, and options or the like, giving an entitlement to acquire a share or trust interest. ***[Schedule 8, item 6, subsection 124-1045(1)]***

8.22 A stapled security is created when two or more different things are contractually bound together so that they cannot be sold separately. Many different types of securities can be stapled together, for example, many property trusts have their units stapled to the shares of companies with which they are closely associated (often because the property trust owns rental property and the associated company manages that property).

8.23 A ***stapled entity*** is an entity in relation to stapled securities if ownership interests in the entity form part of the stapled securities. ***[Schedule 8, item 6, subsection 124-1045(2)]***

Exchange of the stapled securities

8.24 CGT roll-over applies when a public unit trust is interposed between holders of interests in the entities in a stapled group and the entities in the stapled group. ***[Schedule 8, item 6, subsection 124-1045(1)]***

8.25 In the stapling arrangement, at least one of the trusts is a trust whose trustee is not assessed and liable to pay tax under Division 6B or 6C of Part III of the ITAA 1936, and if no company is involved at least one of the trusts is a trust whose trustee is assessed and liable to pay tax under Division 6B or 6C. The roll-over will only be available where the stapled entities include at least one entity that is taxed like a company and at least one entity that is not so taxed. ***[Schedule 8, item 6, paragraphs 124-1045(1)(b) and (c)]***

8.26 The 'new trust case*'* is when the public unit trust interposed between the members and the stapled entities is a new unit trust (see Diagram 8.2).

8.27 The 'existing trust case' is when one of the stapled entities becomes the public unit trust interposed between the members and the other stapled entities (see Diagram 8.3).

8.28 The roll-over only applies if holders of interests in the entities in the stapled group (the 'exchanging members') who own the ownership interests in the stapled entities will, under a scheme for reorganising the affairs of the relevant stapled entities:

- for a new trust case — no longer be the owner of those ownership interests and acquire ownership interests in a new unit trust (the 'interposed trust') and nothing else; or
- for an existing trust case — retain their ownership interests in one of those trusts (also the 'interposed trust'), no longer be the owner of the remaining ownership interests that form the stapled securities and receive nothing other than ownership interests in the interposed trust or an increase in the value of their existing ownership interests in the interposed trust or both.

[Schedule 8, item 6, subparagraphs 124-1045(1)(d)(i) and (ii)]

8.29 In certain circumstances certain foreign holders are excluded from this requirement in the new trust case (see paragraphs 8.50 to 8.57).

8.30 The interposed trust must become the owner of:

- for a new trust case — all of the ownership interests in the stapled entities; or
- for an existing trust case — all of the ownership interests in the other stapled entities.

[Schedule 8, item 6, subparagraphs 124-1045(1)(e)(i) and (ii)]

8.31 It is not unusual in a stapled structure for one stapled entity to hold an ownership interest in another stapled entity in the structure. For example, the structure's trading company may own a non-controlling interest in the Division 6C public unit trust. If the public unit trust was interposed and was required to acquire shares in the company, it would be acquiring an indirect interest in itself, which may raise issues relating to the *Corporations Act 2001*. Because of this, the requirements of the CGT roll-over will not be satisfied as the ownership interests in the trust owned by the company (unstapled securities) will not be exchanged for ownership interests in the interposed trust. Therefore ownership interests which one of the stapled entities may hold in another stapled entity within the stapled group are excluded from the operation of Subdivision 124-Q. This is however limited to any unstapled securities that have been issued up until the legislation is introduced in Parliament. ***[Schedule 8, item 6, subsection 124-1045(3)]***

Conditions for the roll-over

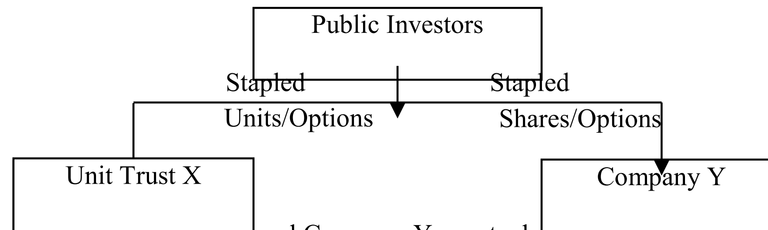
8.32 Each exchanging member must own a percentage of the ownership interests in the interposed trust that reasonably equates to the

percentage of the ownership interests the member owned in the stapled entities just after the scheme is completed (the ‘completion time’). ***[Schedule 8, item 6, subsection 124-1050(1), paragraph 124-1045(1)(f)]***

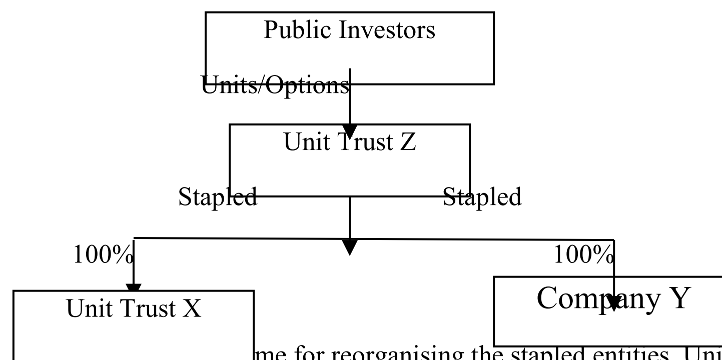
8.33 A scheme for reorganising the affairs of the relevant stapled entities would be any arrangement or any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise. When the scheme is completed will be a factual matter, that is, when all the steps of the scheme have been done.

8.34 As Example 8.1 shows, the percentage of ownership interests before the completion time is the same as the percentage of ownership interests after the completion time.

Example 8.1



Unit Trust X and Company Y are stapled entities. Unit Trust X has 4,000 units and options to acquire a further 1,000 units on issue. Company Y has 4,000 ordinary shares and options to acquire a further 1,000 ordinary shares on issue. There are no other ownership interests in either entity.



[illegible]me for reorganising the stapled entities, Unit Trust Z is interposed between the stapled entities and the owners of the interests in those entities. Unit Trust Z (the interposed trust) becomes the owner of all of the ownership interests (including the options) in both of the stapled entities. Exchanging members who owned units and shares in the stapled entities receive one unit in the interposed trust for every stapled security that they owned. The trustee of the interposed trust has advised that he considers one Unit Trust X option and one Company Y option represent approximately one tenth of an ownership interest in a stapled security just before the reorganisation. Therefore, for every 10 options that an exchanging member owns over units and shares in the stapled entities, they receive one unit in the interposed trust.

Geoff owned 400 units in Unit Trust X with options to acquire a further 200 units, and 400 shares in Company Y with options to acquire a further 200 shares. The shares were stapled to the units, and the options were correspondingly stapled. He receives 420 units in the interposed trust — 400 for his 800 ownership interests in the stapled entities and 20 for his 400 options to acquire ownership interests. Geoff's percentage of the ownership interests in the interposed trust just after the completion time reasonably equates to his percentage of ownership interests in the stapled entities just before that time.

8.35 Just after the completion time, each exchanging member must have the same, or as nearly as practicably the same, proportionate market value of ownership interests in the interposed trust as the member had in the stapled entities before the completion time. This means that changes in the relative proportions of different kinds of ownership interests before the completion time are the same as the ownership interests after the completion time. ***[Schedule 8, item 6, subsection 124-1050(2)]***

8.36 An anticipated reasonable approximation of the market value of ownership interests after the completion time is sufficient in working out whether an exchanging member complies with subsection 124-1050(2). ***[Schedule 8, item 6, subsection 124-1050(3)]***

8.37 An anticipated reasonable approximation of market values of ownership interests may include valuations provided to exchanging members in scheme documents. ***[Schedule 8, item 6, subsection 124-1050(3)]***

8.38 The member must be an Australian resident or a foreign resident at the completion time. If the member is a foreign resident:

- some or all of their ownership interests in the stapled entities must have been taxable Australian property just before the completion time; and
- their ownership interests in the interposed trust must be taxable Australian property just after the completion time.

[Schedule 8, item 6, subsection 124-1050(4)]

8.39 'Taxable Australian property' is defined in section 855-20 of the ITAA 1997. This provision ensures that assets cannot be rolled out of the Australian tax system.

Consequences of the roll-over for the exchanging members

8.40 If a member with post-CGT interests obtains the roll-over then the CGT consequences are as follows:

- a capital gain or capital loss that a member makes from each of their ownership interests is disregarded ***[Schedule 8, item 6, subsection 124-1055(1)]***; and
- the first element of the cost base and reduced cost base of each of the member's ownership interests in the interposed trust is an amount that is reasonably attributable having regard to ***[Schedule 8, item 6, subsection 124-1055(2)]***:
  - the total of the cost bases of all of their ownership interests in the stapled entities; and
  - the number, market value and character of their ownership interests in the interposed trust.

8.41 In some circumstances, the cost base of a member's ownership interests in the stapled entities would consist of a substituted market value cost base.

Example 8.2

> To continue from Example 8.1, the total cost base for all of Geoff's ownership interest in the stapled entities was $2,310:
>
> 400 Unit Trust X units — $3 each
>
> 200 Unit Trust X options — $1 each
>
> 400 Company Y shares — $2 each
>
> 200 Company Y options — $0.55 each
>
> All of his ownership interests were acquired after 19 September 1985. It is reasonable to aggregate the cost bases and allocate a cost base of $5.50 to each of his 420 units in the interposed trust that he receives under the reorganisation, that is $5.50 × 420 = $2,310.

8.42 If a member acquired all of their ownership interests in the stapled entities pre-CGT (ie, before 20 September 1985), they are taken to have acquired all of their ownership interests in the interposed trust pre-CGT. ***[Schedule 8, item 6, subsection 124-1055(3)]***

8.43 If the member has both pre- and post-CGT interests in the stapled entities, the member is taken to have acquired some of their ownership interests in the interposed trust pre-CGT.

8.44 In determining the number of interests that are taken to have been acquired pre-CGT, the member should have regard to:

- the number, market value and character of their ownership interests in the stapled entities; and
- the number, market value and character of their ownership interests in the interposed trust.

[Schedule 8, item 6, subsection 124-1055(4)]

Example 8.3

> Shares in Company P and units in Unit Trust Q are stapled together. Under a scheme for reorganising its affairs, a new trust, Unit Trust R will be interposed between the stapled structure and its members whereby the members exchange a share in Company P and a unit in Unit Trust Q together for a unit in Unit Trust R.
>
> Richard holds 1,000 shares in Company P and 1,000 units in Unit Trust Q. Under this scheme he will exchange his interests for 1,000 units in Unit Trust R.
>
> 150 of Richard's interests in Unit Trust Q are pre-CGT.
>
> At the time of the scheme each share in Company P has a market value of $1 and each unit in Unit Trust Q has a market value of $4.50.

The value of Richard's pre-CGT interests is $675 (ie, 150 units *multiplied* by a market value of $4.50).

The value of his total interest in Company P and Unit Trust Q is $5,500 (ie, 1,000 units *multiplied* by a market value of $4.50 *plus* 1,000 units *multiplied* by a market value of $1).

The proportion of Richard's total holdings which is pre-CGT is 0.1227 (ie, $675 *divided* by $5,500).

As Richard receives 1,000 units in Unit Trust R, it would be reasonable for 122.7 of those units to be taken to be pre-CGT.

As part of a unit cannot be pre-CGT and the remainder of the unit post-CGT, it would be reasonable for 123 of Richard's units in Unit Trust R to be taken to be pre-CGT interests.

Alternatively, had the proportion of Richard's total investment which is pre-CGT been 0.1224, it would be reasonable for 122 of Richard's units in Unit Trust R to be taken to be pre-CGT interests.

8.45 The first element of the cost base and reduced cost base of each of the member's post-CGT ownership interests in the interposed trust is an amount that is reasonable having regard to:

- the total of the cost bases of their post-CGT ownership interests in the stapled entities; and
- the number, market value and character of their post-CGT ownership interests.

[Schedule 8, item 6, subsection 124-1055(5)]

Example 8.4

Shares in Company D and units in Unit Trust E are stapled together. Under a scheme for reorganising its affairs, a new trust, Unit Trust F will be interposed between the stapled structure and its members whereby the members exchange a share in Company D and a unit in Unit Trust E together for a unit in Unit Trust F.

Kaye holds 100 shares in Company D and 100 units in Unit Trust E. Under this scheme she will exchange her interests for 100 units in Unit Trust F.

The current market value of Company D's shares is $1.50 and the current market value of Unit Trust E's units is $7.

The cost base of Kaye's shares in Company D is as follows: 50 shares have a cost base of $1.30, 20 shares have a cost base of $1.35 and 30 shares have a cost base of $1.40.

The cost base of Kaye's units in Unit Trust E is as follows: 50 units have a cost base of $3.50, 20 units have a cost base of $5.10 and 30 units have a cost base of $5.50.

The sum of Kaye's cost bases is as follows:

(50 × \$1.30) + (20 × \$1.35) + (30 × \$1.40) + (50 × \$3.50) + (20 × \$5.10) + (30 × \$5.50) = \$576

As Kaye receives 100 units in Unit Trust F it will be reasonable for each interest to have a cost base of \$5.76 (ie, \$576 *divided* by 100 units).

Consequences of the roll-over for the interposed trust

8.46 The CGT consequences for the interposed trust in relation to the ownership interests in each of the stapled entities that the trustee of the interposed trust acquires under the scheme are as follows:

- the trustee is taken to have acquired some ownership interests pre-CGT if some of the stapled entity's assets at the completion time were acquired pre-CGT; and
- the number of ownership interests (worked out at the completion time) is the greatest possible (expressed as a percentage of all the ownership interests in the stapled entity acquired by the trustee) that does not exceed:
  - the market value of the stapled entity's assets it acquired pre-CGT; *less*
  - its liabilities,

expressed as a percentage of the market value of the stapled entity's assets *less* its liabilities. The amounts are to be worked out at the completion time. ***[Schedule 8, item 6, subsections 124-1060(1) to (3)]***

8.47 The first element of the cost base and reduced cost base of each of the trustee's ownership interests in the stapled entity that is not treated by subsection 124-1060(3) as having been acquired pre-CGT, is a reasonable proportion of the total cost bases (as at the completion time) of the stapled entity's assets acquired post-CGT *less* its liabilities. ***[Schedule 8, item 6, subsection 124-1060(4)]***

8.48 The cost base and the reduced cost base of ownership interests of the trustee of the interposed trust in respect of its ownership interests in each stapled entity will be established by applying section 124-1060. In applying section 124-1060, treat a liability that does not relate to any specific asset of a stapled entity as a liability in respect of all of the assets of the stapled entity. Further, if a liability relates to two or more of those assets, allocate the liability between those assets on a reasonable basis having regard to the market value of those assets. ***[Schedule 8, item 6, subsection 124-1060(5)]***

8.49 An amount reflecting a membership interest of a unit holder in a trust is not a liability. Liabilities are to be determined at the completion time and not at the time of acquisition of assets.

Certain foreign holders are disregarded

8.50 It is a requirement of the roll-over, in the new trust case, that all the holders of ownership interests in the stapled entities acquire ownership interests in the new interposed trust.

8.51 However, issuing new ownership interests in Australian entities to foreign holders could in some cases contravene the laws of the foreign countries. This is normally dealt with by arranging for the new ownership interests to be issued to a sale agent, who then disposes of them, on behalf of the former foreign holders, and remits the net proceeds. For company restructures, such an arrangement is commonly known as a 'foreign share sale facility'. Similar arrangements are likely to be used for reorganisations of stapled entities, referred to here as a 'foreign sale facility'.

8.52 To ensure that holders of ownership interests in the stapled entities who receive ownership interests in the new interposed trust can obtain the CGT roll-over when a foreign sale facility is used, Subdivision 124-Q has the effect as if certain foreign holders are not exchanging members. ***[Schedule 8, item 6, subsection 124-1065(2)]***

8.53 A ***foreign holder***, as defined by section 9 of the *Corporations Act 2001*, is a holder of securities whose address, as shown in the register which records the details of their holding, is a place outside Australia and the external Territories.

8.54 A foreign holder will be taken not to be an exchanging member if they own ownership interests in the stapled entities and:

- the ownership interests are either disposed of to the interposed trust or cancelled;
- an agent or nominee, appointed on behalf of the foreign holder, acquires new units and/or options, rights or similar interests in the interposed trust; and
- the agent or nominee subsequently:
  - disposes of those ownership interests; and
  - gives the foreign holder an amount equal to the capital proceeds of the disposal *less* expenses.

[Schedule 8, item 6, subsection 124-1065(1)]

8.55 In some circumstances the agent or nominee may dispose of these interests on a pooled basis. That is, the agent or nominee may dispose of the interests together with other ownership interests that the agent or nominee acquired under the foreign sale facility.

8.56 In these circumstances the agent or nominee will be required to give the foreign holder of the ownership interests in the stapled entities an amount equal to their proportion of the capital proceeds (*less* expenses). ***[Schedule 8, item 6, subparagraph 124-1065(1)(f)(ii)]***

8.57 A foreign holder's proportion of the capital proceeds would be determined by reference to their ownership interests in the stapled entities relative to the total ownership interests of all the foreign holders in the stapled entities who receive capital proceeds from the agent or nominee.

Example 8.5

The Stapled Co Ltd (Stapled) and the Attached Unit Trust (Attached) are two entities stapled together. Stapled has 10,000 shares issued and Attached has 10,000 units. These are the only ownership interests.

There are three foreign holders of ownership interests in the stapled entities:

- Debbie holds 1,000 shares in Stapled and 1,000 units in Attached (10 per cent of the total ownership interests);
- Kishma holds 1,500 shares in Stapled and 1,500 units in Attached (15 per cent of the total ownership interests); and
- Lyn holds 500 shares in Stapled and 500 units in Attached (5 per cent of the total ownership interests).

Stapled and Attached propose to interpose a new unit trust — the Fastened Unit Trust (Fasten) — between themselves and the holders of ownership interests under an arrangement where its holders exchange one share in Stapled and one unit in Attached together for one unit in Fasten. However, as Debbie, Kishma and Lyn are unable to receive new units in Fasten a foreign sale facility is established with Jason as their agent.

Fasten is interposed and the holders of ownership interests in the stapled entities exchange their ownership interests in Stapled and Attached for ownership interests in Fasten. Jason then acquires ownership interests in Fasten, on behalf of Debbie, Kishma and Lyn, and subsequently disposes of them on a pooled basis.

Debbie's proportion of the capital proceeds would be determined by reference to her ownership interests in Stapled and Attached relative to the total holdings of Kishma, Lyn and herself (ie, the foreign holders who will receive capital proceeds from Jason).

As the total holdings of Debbie, Kishma and Lyn totalled 30 per cent of Stapled and Attached, and Debbie held 10 per cent, she would be entitled to receive 33.33 per cent of the net capital proceeds from Jason (ie, 10/30).

Similarly, Kishma would receive 50 per cent and Lyn would receive 16.67 per cent of the net capital proceeds.

Certain interposed trusts are not trading trusts

8.58 Without these amendments to Division 6C of the ITAA 1936, an interposed head trust that is a public unit trust would be a public trading trust, because it would be controlling an active trading business through its ownership of the subordinate company (or trust taxed as a company) which was formerly a part of the stapled group.

8.59 Under these amendments a public unit trust that is an interposed trust will not be a trading trust in relation to an income year if:

- the trust is an interposed trust in relation to a scheme for reorganising the affairs of stapled entities (as referred to in the capital gains roll-over amendments in this measure) in relation to the year of income or an earlier year of income;
- a roll-over was obtained by any entity under the roll-over amendments in this measure in relation to the scheme for the year of income or that earlier year of income; and
- the trustee of the trust does not, at any time during the year of income carry on a trading business; or control, or be able to control, directly or indirectly, the affairs or operations of another entity that carries on a trading business, other than:
  - a company that was, before the scheme was completed, one of the formerly stapled entities;
  - a subsidiary of that company or an entity controlled or able to be controlled, directly or indirectly, by that formerly stapled company;
  - a trust whose trustee was, before the scheme for reorganisation was completed, assessed and liable to pay tax under Division 6B or 6C of the ITAA 1936 (ie, a trust taxed like a company) and that was, before the scheme was completed, one of the formerly stapled entities; or
  - an entity that is controlled or able to be controlled, directly or indirectly, by a formerly stapled trust that was taxed like a company.

[Schedule 8, item 4, section 102NA of the ITAA 1936]

8.60 Essentially, under these amendments a previously stapled company or a public unit trust that was taxed like a company (under Division 6B or 6C respectively), that is owned or controlled by the interposed trust, will be able to continue to operate as it had before the restructure, without the interposed trust being taxed as a company. The interposed trust will be able to own, or control, any previously stapled public unit trusts on the basis that they are not carrying on a trading business. ***[Schedule 8, item 4, section 102NA of the ITAA 1936]***

8.61 Under a scheme for reorganising the affairs of the relevant stapled entities, the investors will exchange their ownership interests for ownership interests in the newly interposed trust, which may be a new trust or may be a trust that was formerly a stapled entity, but is now the interposed trust after the restructure. ***[Schedule 8, item 6, Subdivision 124-Q of the ITAA 1997]***

8.62 As a result of the restructure, the interposed trust becomes the owner of the ownership interests in the stapled securities; or in the case where an existing trust becomes the interposed trust, it becomes the owner of the ownership interests in the other stapled entities.

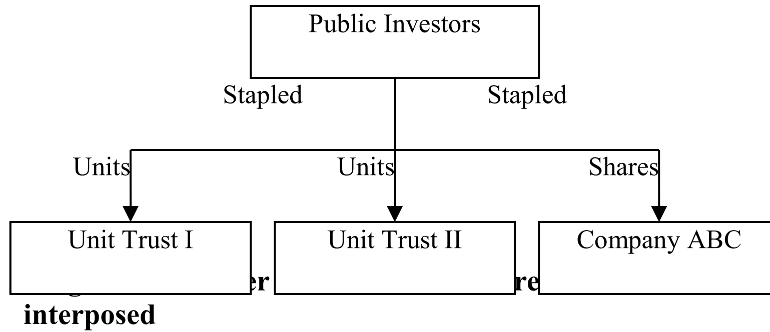
8.63 This is demonstrated in Example 8.6.

Example 8.6

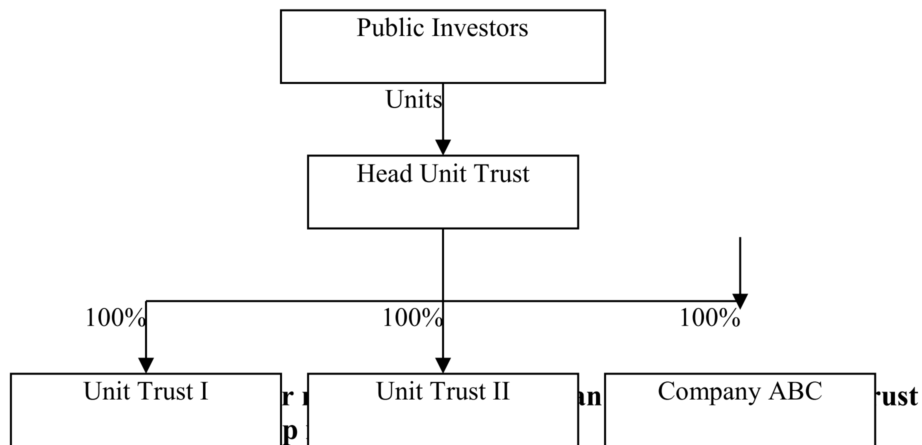
A group of stapled entities (Diagram 8.1) which consists of two trusts and a company choose to interpose a head trust such that the group's structure is now rearranged to provide investors with a single unit in the new head trust as opposed to holding a stapled security consisting of one unit in each of the two trusts and a share in the company (Diagram 8.2).

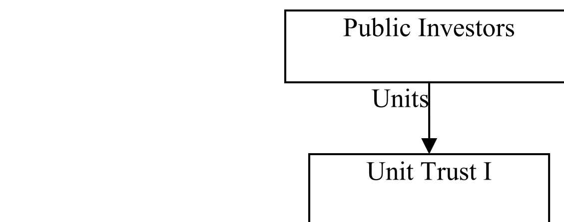
Alternatively, the group of stapled entities may restructure, such that an existing public unit trust within the group assumes the head trust position (Diagram 8.3). This trust would then own the other trusts (if any) and also own the company that was part of the stapled group of entities before the restructure.

Diagram 8.1: Before restructure



interposed





8.64 In addition, to facilitate the international competitiveness of Australian property trusts more generally, an amendment is made to Division 6C of the ITAA 1936 to allow the trustee of a public unit trust to acquire ownership interests in, or control, a foreign entity whose business consists primarily of investing in land outside Australia for the purpose, or primarily for the purpose, of deriving rent. *[Schedule 8, item 3, subsection 102N(2) of the ITAA 1936]*

8.65 In effect, these amendments will not cause a public unit trust to be a trading trust only because it has acquired ownership interests (including a controlling interest) in, or controls:

- a foreign entity whose business (when considered together with the businesses of entities that the foreign entity controls or is able to control, directly or indirectly) consists primarily of investing in land outside Australia for the purpose, or primarily for the purpose, of deriving rent; or
- a foreign entity controlled, or able to be controlled, directly or indirectly, by an entity covered by the dot point above.

This means that if a public unit trust acquires a US Real Estate Investment Trust whose business consists primarily of investing in land outside Australia for the purpose, or primarily for the purpose, of deriving rent, and the US Real Estate Investment Trust has a subsidiary that carries on a trading business, the public unit trust, while it may be taken to control the subsidiary, will not breach Division 6C. ***[Schedule 8, item 3, subsection 102N(2) of the ITAA 1936]***

8.66 An amendment is also made to address the concern that a foreign entity that is a unit trust that is covered under this new provision is not again subject to the Division 6C rules because of the operation of subsection 102P(10). Subsection 102P(10) will not apply to a unit trust that is a foreign entity referred to in paragraph 8.65. ***[Schedule 8, item 5, subsection 102P(10) of the ITAA 1936]***

8.67 This extension aids acquisitions of foreign landholding entities which might include some things other than 'eligible investment business', because foreign tax requirements and those of Division 6C may be different. For example, the tax rules in the US for a company to qualify as a US Real Estate Investment Trust allows some trading business, that is not allowed under the Division 6C rules (were it not for these amendments).

8.68 Because there is some doubt about whether Division 6B (which deals with corporate unit trusts) applies to a reorganisation of the kind contained in this measure, an amendment is made to section 102F to ensure that ownership interests in a unit trust or a company that is part of a scheme for reorganising the affairs of stapled entities referred to in this measure, are not property for the purposes of applying subsections 102F(1) and (2). Therefore, the shares in a previously stapled company which are given up for a unit in an interposed unit trust will not, by itself, be taken to trigger Division 6B of the ITAA 1936. ***[Schedule 8, item 1, subsection 102F(4) of the ITAA 1936]***

Application and transitional provisions

8.69 The CGT roll-over amendments will apply in relation to CGT events that happen on or after 1 July 2006.

8.70 The other amendments apply to the 2006-07 year of income and later years of income.

Consequential amendments

8.71 Consequential amendments will also be made to Parts 3-1 and 3-3 of the ITAA 1997 to reflect the availability of this roll-over:

- References to this roll-over will be added to Subdivision 112-B. Subdivision 112-B lists situations when the general cost base and reduced cost base rules may be modified ***[Schedule 8, items 7 and 8]***.
- Reference to this roll-over will be added to Subdivision 115-D. Subdivision 115-D provides tax relief for shareholders in listed investment companies ***[Schedule 8, item 9]***.
- A reference to Subdivision 124-Q will be added to the guide material of Division 124 ***[Schedule 8, item 10]***.
- A reference to this roll-over will be added to the note in subsection 124-5(2) ***[Schedule 8, item 11]***.

8.72 Subsection 995-1(1) defines 'stapled entity' as having the meaning given by section 124-1045. ***[Schedule 8, item 12]***

Chapter 9
Deductible gift recipients

Outline of chapter

9.1 Schedule 9 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to update the list of deductible gift recipients (DGRs) to include nine new entities and to extend the time period of DGR status for one entity.

Context of amendments

9.2 The income tax law allows taxpayers who make gifts of $2 or more to DGRs to claim income tax deductions. To be a DGR, an organisation must fall within a category of organisations set out in Division 30 of the ITAA 1997, or be listed by name under that Division.

9.3 DGR status assists relevant funds and organisations to attract public support for their activities.

Summary of new law

9.4 These amendments add nine organisations to the list of specifically listed DGRs and extend the time period for which deductions are allowed for gifts to the Shrine of Remembrance Restoration and Development Trust. Gifts of $2 or more, made to these entities within each entity's eligible time period, are tax deductible.

Detailed explanation of new law

9.5 Schedule 9 lists the organisations in Table 9.1 as DGRs. *[Schedule 9, items 1, 4 to 6]*

Table 9.1

Name of fund	*Date of effect*	*Special conditions*
The Bathurst War Memorial Carillon Public Fund Trust	3 August 2007	The gift must be made after 2 August 2007 and before 3 August 2009
Kidsafe ACT (Inc.)	3 August 2007	
Kidsafe New South Wales (Inc.)	3 August 2007	
Kidsafe QLD (Inc.)	3 August 2007	
Kidsafe Vic (Inc.)	3 August 2007	
Kidsafe SA Incorporated	3 August 2007	
Kidsafe Western Australia (Inc)	3 August 2007	
Kidsafe NT (Inc.)	3 August 2007	
Kidsafe Tasmania (Inc)	3 August 2007	

9.6 The Bathurst War Memorial Carillon Public Fund Trust was established to raise funds to rebuild the Bathurst War Memorial Carillon to its original plans following damage caused by lightning in 2001. The Carillon was built in 1933 as a memorial to the men of Bathurst and district who served during the First World War, and in all conflicts since. *[Schedule 9, items 4 to 5]*

9.7 Kidsafe is a non-government, not-for-profit charitable organisation dedicated to preventing unintended injuries and reducing resulting deaths to children associated with childhood accidents. The national body, Child Accident Prevention Foundation of Australia is listed as a DGR. As the result of a restructure of the foundation, the individual state and territory associations will now be listed to better serve the community. *[Schedule 9, items 1 and 6]*

Extending periods for which gifts are deductible

9.8 Schedule 9 extends the period for which deductions are allowed for gifts to the organisation listed in Table 9.2. *[Schedule 9, item 2]*

Table 9.2

Name of fund	*New special conditions*	*Current special conditions*
Shrine of Remembrance	The gift must be made before 1 July 2009.	The gift must be made before 1 July 2007.

Name of fund	*New special conditions*	*Current special conditions*
Restoration and Development Trust		

9.9 The Shrine of Remembrance in Melbourne, built between 1928 and 1934, is Victoria's largest war memorial to the men and women who served Australia in armed conflicts and in peacekeeping operations throughout our nation's history. The Shrine of Remembrance Restoration and Development Trust was established to raise funds for the restoration and development of the Shrine of Remembrance. ***[Schedule 9, item 2]***

Application and transitional provisions

9.10 The amendments to list the organisations in Table 9.1 and Table 9.2 apply from the dates of effect shown in those tables. ***[Schedule 9, items 1 to 6]***

Chapter 10
Film production offsets

Outline of chapter

10.1 Schedule 10 to this Bill reforms the taxation treatment of the Australian screen media industry by:

- introducing a refundable tax offset for Australian expenditure in making Australian films (the producer offset);
- enhancing the existing refundable film tax offset for Australian production expenditure (the location offset);
- introducing a refundable film tax offset for 'post, digital and visual effects production' in Australia (the PDV offset); and
- phasing out the existing tax incentives provided to investors in Australian films.

Context of amendments

10.2 In the 2007-08 Budget, the Government announced a package of measures to reform and strengthen the Australian screen media industry. The package is designed to support the industry at a time when it is striving to meet the challenges of a changing global environment. The package seeks to encourage greater private sector investment in the industry and improve the market responsiveness of the industry.

10.3 Taxation incentives for the film industry are currently provided to both investors in, and producers of, films in Australia. Investors may claim deductions for capital expenditure on Australian films under either Division 10B or Division 10BA of the *Income Tax Assessment Act 1936* (ITAA 1936). Film production companies incurring expenditure on larger budget productions in Australia may be eligible for a refundable film tax offset under Division 376 of the *Income Tax Assessment Act 1997* (ITAA 1997).

10.4 The current investor tax incentives in Divisions 10B and 10BA of the ITAA 1936 have had limited effectiveness in recent years and will be phased out in favour of shifting towards incentives for producers of films.

10.5 The introduction of the producer offset represents a major new support mechanism for film producers and it will assist the industry to be more competitive and responsive to audiences. It provides a real opportunity for producers to retain substantial equity in their productions and build stable and sustainable production companies, and aims to increase private investor interest in the industry.

10.6 Division 376 of the ITAA 1997 provides a tax offset for certain Australian production expenditure incurred by a production company in making a film where a minimum level of expenditure has been incurred. The offset can be claimed in the income tax return for the income year in which the film is completed.

Summary of new law

10.7 The taxation treatment of the Australian screen media industry is reformed by:

- introducing a refundable tax offset for producers of Australian films (the producer offset) where:
  - the offset is 40 per cent of qualifying Australian production expenditure incurred on a feature film;
  - the offset is 20 per cent of qualifying Australian production expenditure incurred on films that are not feature films; and
  - the offset is available in relation to qualifying Australian production expenditure incurred on or after 1 July 2007;
- enhancing the existing refundable film tax offset for Australian production expenditure (the location offset) where:
  - the offset is increased from 12.5 per cent to 15 per cent of qualifying Australian production expenditure; and
  - the increased offset is available to films commencing principal photography or production of the animated image on or after 8 May 2007;
- introducing a refundable tax offset for post, digital and visual effects production in Australia (the PDV offset) where:

  - the offset is 15 per cent of certain Australian expenditure that is incurred in relation to post, digital and visual effects production for a film; and
  - the offset is available to a film that commences post, digital or visual effects production on or after 1 July 2007; and
- phasing out the existing tax incentives provided to investors in Australian films in the following ways:
  - applications for certificates under Divisions 10B and 10BA of the ITAA 1936 will not be accepted after the date of Royal Assent of this Bill; and
  - the first deduction available under Division 10B will only be available up until 30 June 2009, and a deduction under Division 10BA is not allowable in relation to the 2009-10 year of income or a later year of income.

Comparison of key features of new law and current law

New law	*Current law*
Producer offset	
Providing a refundable tax offset of 40 per cent for feature films and 20 per cent for films that are not feature films.	No equivalent.
Location offset	
Providing a refundable tax offset of 15 per cent.	The offset is currently 12.5 per cent.
PDV offset	
Providing a refundable tax offset of 15 per cent.	No equivalent.

New law	*Current law*
Phasing out existing tax incentives for investors	
Not accepting applications for certificates under Divisions 10B and 10BA of the ITAA 1936 after the date of Royal Assent of this Bill. The first deduction available under Division 10B will only be available up until 30 June 2009. A deduction under Division 10BA is not allowable in relation to the 2009-10 year of income or a later year of income.	Division 10B of the ITAA 1936 provides a deduction over two years to Australian residents. The deduction is for foreign residents for capital expenditure incurred in acquiring the copyright of an Australian film which is used to produce assessable income. Division 10BA of the ITAA 1936 provides a deduction to Australian residents when capital expenditure is incurred in the production of an Australian film that results in the acquisition of an interest in the initial copyright of that film.

Detailed explanation of new law

10.8 Division 376 of the ITAA 1997 is being repealed and replaced by a new Division 376, incorporating the new producer offset, the PDV offset and the enhancements to the existing offset. It should be noted that, unless otherwise indicated in this chapter, the concepts that are used in the existing Division 376 continue to have the same meaning and intent in the new Division 376 of the ITAA 1997.

10.9 Companies may be entitled to one of three refundable tax offsets in relation to Australian expenditure incurred in making films. The offsets are designed to support and develop the Australian screen media industry by providing concessional tax treatment for Australian expenditure.

10.10 Subdivision 376-A provides a guide to Division 376 by outlining the key features of the tax offsets and the structure of the Division. ***[Schedule 10, item 1, Subdivision 376-A]***

Part 1 — The producer offset

10.11 The producer offset is a new financial incentive offered to producers of Australian films and is designed to encourage support for the Australian screen media industry. The structure of the producer offset is similar to that of the refundable film tax offset available under the existing Division 376 of the ITAA 1997, with some variations.

Eligibility for the producer offset

10.12 The producer offset is available to a company for the making of an Australian film when the following conditions are met:

- the film was completed in the income year;
- a certificate has been issued for the film by the film authority;
- the offset is claimed in the income tax return for the year by the company; and
- the company is either an Australian resident or a foreign resident that has a permanent establishment in Australia and has an Australian Business Number (ABN).

[Schedule 10, item 1, subsection 376-55(1) of the ITAA 1997]

10.13 A film is ***completed***:

- for a film that is not a series — when it is first in a state where it could reasonably be regarded as ready to be distributed or exhibited to the general public; and
- for a series (whether or not comprised of seasons) — at the earlier of:
  - the time when the 65th episode is first in a state where it could reasonably be regarded as ready to be distributed, broadcast or exhibited to the general public; and
  - the time when the series is in such a state.

[Schedule 10, item 1, subsection 376-55(2), definition of 'completed' in subsection 995-1(1) of the ITAA 1997]

10.14 The point of completion is generally accepted to be at a stage that includes post-production and editing as well as the shooting of the film. It does not have to be distributed or exhibited, just be in a state where either could reasonably happen if desired.

10.15 The administering authority for the producer offset is the ***film authority***, which is defined as the Film Finance Corporation Australia Limited. ***[Schedule 10, item 1, subsection 376-55(3), definition of 'film authority' in subsection 995-1(1) of the ITAA 1997]***

10.16 A company is not entitled to the offset if:

- a company or someone else claims a deduction in relation to a unit of industrial property that relates to copyright in the film under Division 10B of Part III of the ITAA 1936;
- a final certificate for the film has been issued at any time under Division 10BA of Part III of the ITAA 1936;

- a certificate has been issued at any time under the location offset for the film;
- a certificate for the film has been issued at any time under the PDV offset;
- the company or someone else has deducted money paid for shares in a film licensed investment company under Subdivision 375-H and the company has invested in the film; or
- production assistance (other than development assistance) for the film has been received by the company or anyone else before 1 July 2007 from any of the following bodies:
  - the Film Finance Corporation Australia Limited;
  - Film Australia Limited;
  - the Australian Film Commission; or
  - the Australian Film, Television and Radio School.

[Schedule 10, item 1, subsection 376-55(4) of the ITAA 1997]

10.17 Production assistance is intended to mean money paid by the above Australian Government bodies to assist in the production of the film itself. It is not intended to include, for example, grants paid to assist with a film's marketing or for a film's producer to attend film markets or festivals, or production investment of other government agencies.

10.18 The receipt of development assistance in relation to a film, prior to 1 July 2007, does not preclude the company from eligibility for the offset. ***Development assistance*** for a film means financial assistance provided to assist with meeting the development costs for the film and includes assistance to the extent to which it is provided in relation to any of the following:

- expenditure on location surveys or otherwise identifying or assessing possible locations;
- storyboarding and scriptwriting;
- research for the film;
- casting actors;
- developing a budget; and
- developing a shooting schedule for the film.

[Schedule 10, item 1, subsection 376-55(5), definition of 'development assistance' in subsection 995-1(1) of the ITAA 1997]

Details of the offset

10.19 A company is entitled to the offset for an income year only if it claims the offset in its income tax return for the year, and is an Australian resident company, or an Australian permanent establishment of a non-resident company and where it has an ABN, both when it lodges the income tax return and when the tax offset is due to be credited. ***[Schedule 10, item 1, subsection 376-55(1) of the ITAA 1997]***

10.20 The requirement that the company be either an Australian resident or a permanent establishment is consistent both with the non-binding obligation in the Australia-United States of America double tax treaty to avoid discrimination, and with the more general model non-discrimination clause in the Organisation for Economic Co-operation and Development model treaty. There is no discrimination between production companies that have the same tax presence in Australia, wherever resident or wherever incorporated.

10.21 Further, it simplifies the administration of these amendments and ensures that the offset is given to producers with a uniform income tax rate and treatment.

10.22 Subsection 960-100(4) of the ITAA 1997 provides that a reference to a particular kind of entity (in this case a company) in a provision, refers only to the entity in that particular capacity and not in any other capacity. The example in the subsection illustrates that a reference to a company does not include the company acting in the capacity as trustee.

10.23 The amount of the offset is:

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

of the total of the company's qualifying Australian production expenditure on the film. ***[Schedule 10, item 1, section 376-60]***

10.24 The total of the company's qualifying Australian production expenditure on the film is determined by the film authority under section 376-75 (see paragraph 10.136).

10.25 The offset must be claimed by the company in its income tax return for the income year in which the film is completed. Once lodged, there is no opportunity for that claimant to change the claim from one tax offset to another. The claim made at the time of lodging the return is irrevocable. ***[Schedule 10, item 1, reference at the end of subsection 376-55(1) to paragraph (c)]***

10.26 A refund of tax offsets will occur where the total of those offsets exceeds the amount of income tax and other tax liabilities that the company would have had to pay if it had not received those tax offsets (but had received all its other tax offsets), by operation of section 67-30 of

the ITAA 1997. Any amount of offset applied against tax liabilities or refunded to a company would not be assessable income for income tax purposes. However, given its untaxed nature at the company level, where a refunded offset amount is distributed to shareholders, those distributions will be unfranked dividends.

Eligible genres

10.27 A film will be eligible for the producer offset if it is one of the following:

- a feature film;
- a single episode programme;
- a series;
- a season of a series; or
- a short-form animation.

[Schedule 10, item 1, paragraph 376-65(2)(c)]

10.28 A documentary may qualify as a feature film, series or a season of a series, or a single episode programme.

10.29 A film is not:

- a film for exhibition as an advertising programme or a commercial;
- a film for exhibition as a discussion programme, a quiz programme, a panel programme, a variety programme or a programme of a like nature;
- a film of a public event (other than a documentary);
- a training film;
- a computer game (within the meaning of the *Classification (Publication, Films and Computer Games) Act 1995*);
- a news or current affairs programme; or
- a reality programme (other than a documentary).

[Schedule 10, item 1, paragraph 376-65(2)(d)]

Feature film

10.30 A feature film is the only format which receives a 40 per cent offset. The term feature film is intended to mean a film of at least one hour in length that is screened as the main attraction in commercial cinemas. Where a feature film is designed for release in a large-format cinema, such as IMAX, it is intended that the film be at least 45 minutes in length. For the purposes of the producer offset, it is expected that a feature film would need to show evidence of its release or proposed

release in an Australian cinema (see paragraph 10.130). A feature film may be an animated feature film and may be a documentary.

Single episode programme

10.31 If a film does not receive a cinema release, but is a stand-alone programme of at least one commercial hour in length that is exhibited on another medium, it may qualify as a 'single episode programme'. This category of film includes telemovies or movies-of-the-week, films released direct to DVD or films released on the Internet, video on demand or a mobile phone delivery platform. ***[Schedule 10, item 1, subsection 376-65(3)]***

10.32 The concept of *commercial hour* recognises that programmes are made of varying length and they may be transmitted to the public in different ways. For instance, a programme of 52 minutes duration may be shown without interruption by one broadcaster, but be shown in a 60 minute programming slot by a commercial broadcaster. Such a programme would be regarded as being of one 'commercial hour' in length.

10.33 A project may commence as a feature film, seeking an offset of 40 per cent, but not be picked up for Australian cinema distribution. In such a case, providing the film can achieve distribution on another platform, it may be considered to be a single episode programme.

10.34 A single episode programme may be an animated film and may be a documentary. If the programme is a documentary, it must be at least one half of a commercial hour in duration. ***[Schedule 10, item 1, paragraph 376-65(3)(d)]***

Short-form animation

10.35 A short-form animation is a programme of one episode or a collection of episodes, predominantly utilising cell, stop motion, digital and/or other animation, of not less than one quarter commercial television hour in total duration. This means, for example, that a collection of six five-minute animated episodes (30 commercial minutes) would be regarded as a short-form animation, as the film will be at least one quarter of a commercial hour. ***[Schedule 10, item 1, subsection 376-65(4)]***

10.36 The provision requires an animation to be a drama, which may include a comedy and/or children's animation. ***[Schedule 10, item 1, subsection 376-65(4)]***

10.37 Where it is a collection of episodes, a short-form animation must have a common theme or themes and be produced wholly or principally for exhibition together, for a national market or national markets under a single title. This requirement does not mean that the animation must be broadcast in Australia, just that the collection is a bona fide collection (eg, a series or an anthology). ***[Schedule 10, item 1, paragraph 376-65(4)(a)]***

Series

10.38 A series or season of a series is a multiple-episode film that does not receive a cinema release, but is exhibited on another medium. A series or season of a series must be at least two episodes and no more than 65 episodes. Each episode must be at least one commercial half-hour in length. ***[Schedule 10, item 1, paragraph 376-65(5)(a), subparagraph 376-55(2)(b)(i)]***

10.39 The 65-episode limit is a cumulative cap on the support the producer offset will provide to a series. It recognises that once a series has been in production for such a number of episodes, it should be capable of being made without Australian Government support and effectively become self-sufficient.

10.40 When the 65-episode limit has been reached, that season will be deemed completed and only qualifying Australian production expenditure on the episodes up to and including the 65th episode are eligible for the producer offset. Further episodes or seasons of the series would be ineligible for the producer offset. ***[Schedule 10, item 1, paragraph 376-170(4)(c)]***

10.41 Where an applicant series has episodes that were made prior to 1 July 2007, those episodes are counted towards the 65-episode limit. ***[Schedule 10, item 1, subsection 376-170(5)]***

10.42 There may be cases where a new series emerges from an existing series, such as where a series is a 'spin-off' or where a series is a remake of a series made a long time in the past. Where there is doubt as to whether an applicant season of a series is in actuality a season of a existing series, the film authority will be expected to satisfy itself that the applicant season involves a new creative concept in order for it to be considered a season of a new series. In such cases, the episodes of the previous series will not be counted towards the 65-episode limit. The film authority must have regard to the title of the series, as well as whether the series has substantially different characters, settings, production locations and individuals involved in the making of the series compared to any other series. The film authority must also have regard to any other matters that it considers to be relevant. It is expected that such matters could include whether there had been a significant lapse in time since the completion of any other series which could be considered to have a similar creative concept to the applicant series. It is also intended that the film authority consider the creative concept of the applicant series compared only to other series, not, for example, to feature films, books or plays with a similar creative concept. ***[Schedule 10, item 1, subsection 376-70(2)]***

10.43 A series or season of a series may be an animated film and may be a documentary.

Seasons of series

10.44 A season of a series is a multiple-episode film that does not receive a cinema release, but is exhibited on another medium. A season of a series is intended to represent a group of episodes that continue a

series, but are made separately to previous seasons of the series. Each season of a series must be at least two episodes and the total number of episodes of all seasons of the series can be no more than 65 episodes. Each episode must be at least one commercial half-hour in length. ***[Schedule 1, item 1, paragraph 376-65(5)(b), subparagraph 376-55(2)(c)(i)]***

10.45 Where an application is made for a season of a series, the film authority will take the total number of episodes of all previously certified seasons of that series into account when calculating whether the maximum 65 episodes has been reached.

10.46 Where an applicant season of a series is part of a series that has included seasons made prior to the commencement of the producer offset or without producer offset support, the episodes of the previous seasons made before 1 July 2007 count towards the 65-episode cap. ***[Schedule 10, item 1, subsection 376-170(5)]***

10.47 When the 65-episode limit has been reached, even if the 65th episode falls before completion of a season of the series, only qualifying Australian production expenditure on the episodes up to and including the 65th are eligible for the producer offset. Further episodes or seasons of the series will be ineligible for the producer offset. ***[Schedule 10, item 1, paragraph 376-170(4)(c)]***

10.48 A series of which the season is a part must contain a new creative concept. In assessing the new creative concept, the same rules apply as for series (see paragraph 10.42). ***[Schedule 10, item 1, subsection 376-70(2)]***

10.49 A season of a series may be an animated film and may be a documentary.

What are the qualifying expenditure thresholds?

10.50 One of the aims of the producer offset is to encourage growth of the Australian screen production industry. As a result, tax offsets are only available to projects that spend above a minimum amount on production. The minimum expenditure thresholds differ depending on the format of the project.

10.51 The expenditure thresholds are based on the qualifying Australian production expenditure of the project (see Subdivision 376-C for an explanation of how to calculate qualifying Australian production expenditure) and have two forms:

- most formats require an overall minimum expenditure threshold to be met in order to qualify for the producer offset; and
- some formats require a minimum average qualifying Australian production expenditure to be spent per hour of the film.

10.52 The average qualifying Australian production expenditure to be spent per hour is worked out by using the formula in subsection 376-65(7). This formula requires that the total qualifying Australian production expenditure for the film be divided by the total length of the series measured in hours. Parts of hours may be considered in applying this formula, so that, for instance, a 90 minute film would be regarded as 1.5 hours for the purposes of calculating qualifying Australian production expenditure per hour. ***[Schedule 10, item 1, subsection 376-65(7)]***

10.53 The length of the film in this context does not refer to commercial hours, it refers to the actual length in hours of the finished film. For example, a series of eight, 30 commercial minute episodes, where each episode is of 22 minutes in actual duration, would equate to a film of 2.93 hours in length.

10.54 As this is an average requirement, there is no need for each episode of a series or documentary to meet the average qualifying Australian production expenditure threshold.

10.55 Where an application is for a season of a series, it is assessed as a production on its own and the season must meet the relevant expenditure thresholds itself.

10.56 A documentary may be a feature film, a series or a season of a series, or a single episode programme. If a documentary is a feature film, it must meet the expenditure thresholds for a feature film in order to qualify for the 40 per cent offset. However, documentaries that are single episode programmes, or series or seasons of a series need only meet expenditure thresholds for documentaries, rather than the expenditure thresholds for other projects of those formats.

10.57 A documentary will take its ordinary meaning. It is intended that it will mean a creative interpretation of actuality, other than a news, current affairs, sports coverage, magazine, infotainment or light entertainment programme.

10.58 A reality television programme is not a documentary. It is intended that the term ‘reality programme’ be applied to programmes in which contestants or participants are usually placed in contrived situations, where the primary purpose is to provide a vehicle within which their characters can be observed and assessed by the viewer. The primary purpose of such a reality programme would not be to explore and interpret an idea. Where there is a competitive element in the programme between participants it is intended the programme would generally be considered a reality programme.

10.59 By contrast, a programme is more likely to be classed as a documentary when, even though it may be based around a contrived situation, the contrivance will serve to explore a creative idea, concept or theme. Observations about the character of a participant will tend to

illustrate the idea, rather than serve as the primary purpose. Such programmes may contain a strong information component within which the idea is explored. There will often be critical commentary which interprets or provides context for the activity depicted.

10.60 The expenditure thresholds for each format are outlined in Table 10.1. ***[Schedule 10, item 1, subsection 376-65(6)]***

Table 10.1

Type of film...	***Total of the company's qualifying Australian production expenditure on the film (as determined by the film authority under section 376-75) is at least...***	***Amount for the film worked out under subsection (7) is at least...***
A feature film	$1m	not applicable
A single episode programme other than a documentary	$1m	$800,000
A single episode programme that is a documentary	not applicable	$250,000
A short form animation that is not a feature film, a single episode programme or a series	$250,000	$1m
A film where the application for the certificate is for a series and not for a season of that series, and the series is not a documentary	$1m	$500,000
A film where the application for the certificate is for a series and not for a season of that series, and the series is a documentary	not applicable	$250,000
A film where the application for the certificate is for a season of a series, and the series is not a documentary	$1m	$500,000
A film where the application for the certificate is for a season of a series, and the series	not applicable	$250,000

Type of film...	*Total of the company's qualifying Australian production expenditure on the film (as determined by the film authority under section 376-75) is at least...*	*Amount for the film worked out under subsection (7) is at least...*
is a documentary		

10.61 For the purposes of the expenditure thresholds, official co-productions (ie, films made under a co-production treaty or a Memorandum of Understanding between the Australian Government and the Government of another country) may count expenditure that is in the other co-producing country or countries and that would have been qualifying Australian production expenditure if it had been incurred in Australia as qualifying Australian production expenditure. This is intended to include expenditure incurred by co-producing partners that are approved by the competent authorities in accordance with the relevant treaty or Memorandum of Understanding. ***[Schedule 10, item 1, subsection 376-170(1)]***

10.62 This only applies to the expenditure thresholds and only applies to official co-productions made under a co-production treaty or Memorandum of Understanding between the Australian Government and the Government of another country. For the purposes of calculating a co-production's offset amount, only qualifying Australian production expenditure that meets the tests in Subdivision 376-C will be counted.

Production expenditure

General test

10.63 There is a general test for what constitutes production expenditure. ***Production expenditure*** of a film is so much of a company's expenditure as it incurs in, or in relation to, the making of the film; or as is reasonably attributable to the use of equipment or other facilities for the making of the film or to activities undertaken in making the film. ***[Schedule 10, item 1, subsection 376-125(1), definition of 'production expenditure' in subsection 995-1(1) of the ITAA 1997)]***

10.64 The making of a film means the doing of the things necessary for the production of the first copy of the film. ***[Schedule 10, item 1, subsection 376-125(2), definition of 'make' in relation to film in subsection 995-1(1) of the ITAA 1997]***

10.65 A company makes a film by completing the various activities that bring the film to the point where it could reasonably be regarded as ready for exhibition or distribution (by broadcast, satellite or cable, or by video distribution on tapes or DVDs or otherwise), for which it is being

produced. This is the time when the film is completed (see paragraph 10.13). Those activities include pre-production activities in relation to the film, and post-production activities in relation to the film. These take their ordinary meanings within the film industry in Australia. ***[Schedule 10, item 1, subsection 376-125(3]***

10.66 For the purposes of the offset, developing the proposal for the making of the film is not part of making the film, nor is arranging or obtaining finance for the film, which includes 'pitching' the film. Similarly, the distribution of the film and its promotion are not part of actually making the film for the purposes of the offset. Some costs of promotional material are included in both qualifying Australian production expenditure, and production expenditure; so some promotional activities can be occurring while a film is being carried out (see paragraph 10.93). However, these activities are nevertheless not part of making the film for the purposes of the offset. ***[Schedule 10, item 1, subsection 376-125(4); item 7, definition of 'make' in relation to film in subsection 995-1(1 of the ITAA 1997)]***

10.67 The definition of production expenditure is designed to allow expenditure to be apportioned between the film production project and any other purpose for which it has been incurred. For example, this allows the costs of facilities used in the making of a number of films to be apportioned between films. Expenditure will count as long as it has been incurred. The company does not have to actually discharge its liability to pay. This will allow expenditure to count on an accruals basis. This is consistent with commercial practice in the film industry. Some of these expenditures, and some part of the payments by the commissioning studio, could be unpaid at the time of completion of the film and at the time the offset is claimed.

10.68 Production expenditure may have been incurred in the income year for which the offset is claimed — that is, the year in which the film is completed. It may have also been incurred in earlier years. Films are not presumed to necessarily be made within a single year. Production expenditure will generally be of a revenue nature, but may also be of a capital nature, and this is expressly acknowledged in the law. Production expenditure may be expenditure that gives rise to an income tax deduction. ***[Schedule 10, item 1, subsection 376-125(5)]***

Specific inclusions

10.69 Production expenditure for a film will also include some specific expenditure incurred by the company which may not meet the general test of what is production expenditure.

10.70 All qualifying Australian production expenditure is included in production expenditure, even if it would not otherwise come within the scope of production expenditure (see paragraph 10.88). ***[Schedule 10, item 1, section 376-130]***

10.71 Where a company holds a depreciating asset and uses it in making a film, the company's production expenditure on the film includes an amount equal to the decline in the value of the asset to the extent to which that decline is reasonably attributable to the use of the asset in the making of the film. 'Depreciating asset' and 'decline in value' are terms from the capital allowances regime. The capital allowances regime in Division 40 of the ITAA 1997, is designed to allow deductions for the cost of depreciating assets based on their effective life. This is their decline in value for tax purposes. ***[Schedule 1, item 1, subsection 376-125(6)]***

10.72 The capital allowances regime also reconciles this assumed loss of value to the actual change in value worked out when a balancing adjustment event occurs. When a balancing adjustment event occurs for the asset before the film is completed:

- if the asset's termination value is more than its adjustable value just before the event occurred — the production expenditure of the company on the film is reduced by the film proportion of the difference; or
- if the asset's termination value is less than its adjustable value just before the event occurred — the production expenditure of the company on the film includes the film proportion of the difference.

This will ensure that the real economic cost of using the asset in the production of the film is taken into account in working out the offset. 'Balancing adjustment event', 'termination value' and 'adjustable value' are terms used in the capital allowances regime. ***[Schedule 1, item 1, subsection 376-125(7)***

10.73 The cost of the depreciating asset is excluded from production expenditure. This provision gives a company the benefit of an appropriate allowance for the cost of depreciating assets it uses on a production, even if those assets were acquired originally for another project or before any particular film project began. A company may well have assets of this kind, and the cost of making a film should take proper account of their cost, whether they are acquired for the particular film, at the time of the particular film, or otherwise. ***[Schedule 1, item 1, subsection 376-135; item 10]***

Specific exclusions

10.74 There are a number of specific exclusions that will not be eligible to be included as production expenditure.

10.75 Expenditure incurred by way of, or in relation to, the financing of a film is not production expenditure. This will specifically include interest, or other returns, on amounts invested in the film and costs connected with raising and servicing finance for the film. ***[Schedule 10, item 1, section 376-135, item 1 in the table]***

10.76 Insurance policies are incurred by way of, or in relation to, the financing of a film when the risk they insure is a risk to the financing of the film production. Insurance policies such as: film producer's indemnity; negative film; faulty stock, camera and processing; and weather are mainly entered into for the purpose of ensuring that money or capital in excess of the film's budget (or to replace wasted production expenditure) will be available to complete the film if the budget is exceeded (or past production expenditure wasted) as the result of an occurrence of an insurable event. Completion bonds or guarantee policies cover the additional cost of production at least where an insured event leads to that extra cost. The primary purpose for entering into any insurance policy of this kind is to ensure that sufficient capital will be available to complete the film (or repeat a wasted step in the production of the film) if an insurable event occurs, or to pay out the financier if the film is not completed. These insurances demonstrate the relationship between the loss insured against the film's budget and finance. Expenditure for such insurance cover is either incurred by way of, or in relation to, financing the film.

10.77 Insurance premiums for comprehensive insurance policies will need to be apportioned to the extent that they relate to non-qualifying events such as the financing of a film.

10.78 Development expenditure for the film is not production expenditure, except so far as it is qualifying Australian production expenditure. ***[Schedule 10, item 1, section 376-135, item 2 in the table]***

10.79 ***Development expenditure*** is a defined term in subsection 995-1(1) of the ITAA 1997. It is expenditure incurred in meeting the development costs for a film and includes expenditure:

- on location surveys or otherwise identifying or assessing possible locations;
- storyboarding and scriptwriting;
- research for the film;
- casting actors;
- developing a budget; and
- developing a shooting schedule for the film.

10.80 Another exclusion to production expenditure is expenditure that is incurred in acquiring copyright, or a licence in relation to copyright, in a pre-existing work for use in the film, except so far as this is qualifying Australian production expenditure, essentially because the pre-existing work is Australian. The cost of copyright, or of a copyright licence, to allow the film to use an existing work is generally not an expenditure in making the film so much as it is a cost of being in a position to make the film, and so is preliminary to production expenditure. However, the cost

for pre-existing Australian copyright is included, essentially to increase the share of qualifying Australian production expenditure. This measure reflects and supports broader Australian cultural policy. ***[Schedule 10, item 1, section 376-135, item 3 in the table]***

10.81 Another exclusion is general business overheads of the company that are not incurred in, or in relation to, the making of the film and are not reasonably attributable to activities, or the use of equipment or facilities, in making the film. In effect, no part of general business overheads can be attributed to making the film. However, if a part of those overheads is qualifying Australian production expenditure under the specific inclusion criteria, then that part of general overheads is not excluded from production expenditure. ***[Schedule 10, item 1, section 376-135, item 4 in the table]***

10.82 Expenditure that relates to publicising or otherwise promoting the film (press expenses, still photography, promotion, videotapes, public relations and other similar expenses) is excluded from production expenditure, even if it is incurred during production, unless it is qualifying Australian production expenditure. ***[Schedule 10, item 1, section 376-135, item 5 in the table]***

10.83 Another specific exclusion will be expenditure incurred by way of:

- amounts that are payable out of the receipts, earnings or profits from a film;
- amounts that depend on the receipts, earnings or profits from a film; and
- amounts that are otherwise dependent on the commercial performance of the film.

In practice, some work in making the film is done not for a set cost but for an interest in the film's performance. The production expenditure for a film, on which the offset is paid, is meant to be limited to those expenditures which are independent of the film's commercial performance and its earnings. ***[Schedule 10, item 1, section 376-135, items 6 and 7 in the table]***

10.84 An amount payable in satisfaction of a residual payment right to a member of the cast cannot count as production expenditure except to the extent to which the amount is actually paid before the film is completed. ***[Schedule 10, item 1, section 376-135, item 8 in the table]***

10.85 The exclusion of expenditure by way of profit share, or for residual payments, would be ineffective if production expenditure included amounts liable to be repaid because of the economic performance of the film or because residual payments proved not to be required. Therefore, all advances against profit share, against economic performance of the film or its receipts, or against residual payments, are

excluded from production expenditure unless the advances are non-recoverable from the payee. ***[Schedule 10, item 1, section 376-135, item 9 in the table]***

10.86 Any expenditure that goes into the cost of a depreciating asset, whether one for which deductions are calculated under Division 40 of the ITAA 1997 or one for which deductions are calculated under Division 43 of the ITAA 1997, is not production expenditure. This includes both original cost and further depreciable costs of such items. However, the decline in value of a depreciating asset (other than those buildings, structures and improvements to which Division 43 of the ITAA 1997 applies) is itself expressly included in production expenditure. The exclusions ensure that the total production expenditure on a film, and its qualifying Australian production expenditure, are not skewed by the inclusion of substantial capital costs for depreciating assets that actually relate to many films, and not only the particular film. ***[Schedule 10, item 1, section 376-135, item 10 in the table]***

10.87 Regulations may specify other costs to be excluded from production expenditure. Such regulations would be subject to the procedural rules applicable to Australian regulations and so would require registration, and would be required to be tabled in both Houses of Parliament where they would be subject to disallowance in the Parliamentary process. ***[Schedule 10, item 1, section 376-135, item 11 in the table]***

Qualifying Australian production expenditure

General test

10.88 ***Qualifying Australian production expenditure*** for a film is the production expenditure for the film to the extent to which it is incurred for, or is reasonably attributable to:

- goods and services that are provided in Australia;
- the use of land located in Australia; or
- the use of goods that are located in Australia at the time they are used in the making of the film.

This broad test connects particular items of production expenditure to Australia. It is meant to ensure opportunities for Australian taxpayers and for the Australian film industry, which is a major purpose of the offset. However, there are exclusions from that general connection (see paragraphs 10.97 to 10.100), which further support this intention. ***[Schedule 10, item 1, section 376-145, definition of 'qualifying Australian production expenditure' in subsection 995-1(1) of the ITAA 1997]***

Specific inclusions

10.89 There are a number of specific inclusions provided for in the legislation ***[Schedule 10, item 1, subsection 376-150(1)]***. All of these are therefore also production expenditure. A number of them are items which

are not otherwise production expenditure which increase not only the total production expenditure but also the share of production expenditure which will be qualifying Australian production expenditure. This means that these inclusions can operate to bring films within the eligibility for the offset if certain expenditures happen in Australia, not only by connecting production expenditure to Australia, but also by connecting to Australia some kinds of expenditure which would fall outside the definition of 'production expenditure' but which support Australian cultural objectives.

10.90 Development expenditure is generally not production expenditure, as discussed in paragraphs 10.78 and 10.79. However, so far as development expenditure is for goods and services provided in Australia, the use of Australian land, or the use of goods located in Australia when they are used in making the film (eg, hiring equipment or props for use in Australia on a shoot), development expenditure is production expenditure. The benefit of counting this as production expenditure and as qualifying Australian production expenditure is that it encourages development expenditure to be carried out in Australia and adds support for Australian film projects, which are likely to have lower budgets and so have more difficulty with both the expenditure and the percentage thresholds for eligibility. ***[Schedule 10, item 1, subsection 376-150(1), item 1 in the table]***

10.91 However, qualifying Australian production expenditure will not include legal expenses except those which relate to writers' contracts or to copyright issues, including chain of title. This is to ensure that substantial expenditures likely to be connected more to the financing and structuring of the project than to film development are not considered to be production expenditure. ***[Schedule 10, item 1, subsection 376-150(2)]***

10.92 Expenditure incurred to acquire copyright, or a licence in relation to copyright, in a pre-existing work for use in the film will be qualifying Australian production expenditure. Therefore it is production expenditure if the copyright is held by an Australian resident, whether that be an Australian resident company or person. This encourages the use of copyrights held in Australia, and so, indirectly, the use in film projects of material that is under Australian creative control. ***[Schedule 1, item 1, subsection 376-150(1), item 2 in the table]***

10.93 Publicity for a film is not part of making it. However, where publicity material, for use in publicising or otherwise promoting the film, is copyright held by an Australian citizen, an Australian protected person or a person resident in Australia, and the expenditure on the material was incurred by the company before completion of the film, that expenditure is part of qualifying Australian production expenditure. This encourages the use of Australians in publicity undertaken during production. ***[Schedule 10, item 1, subsection 376-150(1), item 3 in the table]***

10.94 Expenditure which is not incurred during the 'making of the film', as it is not directly attributable to the production of the first copy of

the film, is not normally qualifying Australian production expenditure. However, under this provision, it is intended that such expenditure may be included as qualifying Australian production expenditure where it is incurred in producing additional content for a subsequent release of the film and is incurred in Australia prior to the completion of the film. This means that, for example, footage for special features for a DVD release if shot in Australia during a film's production could be counted as qualifying Australian production expenditure of the film. Such expenditure would also be considered part of the film's production expenditure and, for the producer offset, total film expenditure. ***Schedule 10, item 1, subsection 376-150(1), item 4 in the table]***

10.95 This provision also acts as an exception to the general exclusion on publicity and promotion expenditure from production expenditure (item 5 in the table in section 376-135). For example, if a trailer to promote the film during production is shot in Australia and is intended to be released with the film in some form, this may be considered qualifying Australian production expenditure.

10.96 Regulations may prescribe additional items of expenditure as qualifying Australian production expenditure. ***[Schedule 10, item 1, subsection 376-150(1), item 5 in the table]***

Specific exclusions

10.97 If expenditure has been incurred when the company is neither an Australian resident nor has both a permanent establishment in Australia and an ABN, that expenditure is not eligible as qualifying Australian production expenditure. Therefore, if a company starts a production as a non-resident without a permanent establishment in Australia this will reduce both its qualifying Australian production expenditure and the share of total production expenditure that it represents. ***[Schedule 10, item 1, section 376-155]***

10.98 Where a person is not a member of the cast and enters Australia to work on the film for less than two consecutive calendar weeks, expenditure in relation to the remuneration and other benefits for this person for services regarding the film, and expenditure on the person's travel and other costs, are not qualifying Australian production expenditure. This applies to each trip made individually. The objective of this provision is to encourage opportunities for the Australian film industry without creating special labour rules restricting the benefit of the offset. ***[Schedule 10, item 1, section 376-155]***

10.99 Regulations may prescribe other exclusions from what would otherwise be qualifying Australian production expenditure. ***[Schedule 10, item 1, section 376-155]***

10.100 If a company enters into what is essentially a service contract, the test of whether expenditure under the contract is qualifying Australian production expenditure does not depend only on where goods embodying

the result are delivered. If services will be embodied in goods that are delivered to the company and those services were predominantly performed outside Australia, for the purposes of determining qualifying Australian production expenditure this service is not provided in Australia. This rule is intended to have the effect that, what would not be qualifying Australian production expenditure if it were incurred on activities the company carries out for itself, does not become qualifying Australian production expenditure by engaging someone else. For example, the cost of animation or special effects work carried out outside Australia is not qualifying Australian production expenditure. If a company is contracted for the animation or effects work to be delivered as stock or computer media in Australia, the animation or special effects work would have to be carried out in Australia for the expenditure on contracting out this work to be qualifying Australian production expenditure. ***[Schedule 10, item 1, section 376-160]***

Special rules — producer offset

10.101 It is intended that all business overheads that meet the general test for qualifying Australian production expenditure are considered qualifying Australian production expenditure. The legislation recognises that while some expenditure on a production company's general business overheads will not be directly related to a film's production, it is reasonable for a proportion of these costs to be attributed to the production. Therefore, where general business overheads are not incurred in relation to the making of the film, but are still expended in Australia, a reasonable apportionment of these overheads can be claimed as qualifying Australian production expenditure. ***[Schedule 10, item 1, subsection 376-170(2), item 1 in the table]***

10.102 This apportionment is capped at either 5 per cent of the production's total film expenditure (which is outlined in paragraph 10.110) or $500,000, whichever is the lesser. This encourages production companies to be located in Australia even if they make projects that do not qualify for the offset as well as projects that do, because a share of general overheads will only qualify for the offset if they are located in Australia. ***[Schedule 10, item 1, subsection 376-170(3)]***

10.103 For the producer offset, a person's travel to and within Australia may be qualifying Australian production expenditure where they are travelling to Australia to undertake activities for the making of the film. This provision is subject to the rule that non-cast members must work on the film in Australia for at least two weeks before expenditure on those non-cast members can be considered qualifying Australian production expenditure (this is explained in paragraph 10.88). ***[Schedule 10, item 1, subsection 376-170(2), item 2 in the table]***

10.104 The producer offset also allows travel from or outside Australia to count as qualifying Australian production expenditure in certain situations. Where a person's travel is to, or within, any other country

other than Australia and the travel is to undertake activities in relation to the making of the film during principal photography, expenditure on that travel may be qualifying Australian production expenditure where an Australian resident's remuneration is qualifying Australian production expenditure because of the extra-territorial expenditure provision in item 4 in the table in subsection 376-170(2). For example, if an Australian-resident cinematographer travels to France to undertake location shooting for a documentary about Australian military involvement in World War I, that person's travel costs may be qualifying Australian production expenditure. ***[Schedule 10, item 1, subsection 376-170(2), item 2 in the table]***

10.105 For the producer offset, expenditure made on the freighting of any goods to be used in the making of the film is qualifying Australian production expenditure. This is regardless of whether the freight is within or between Australia and other countries. ***[Schedule 10, item 1, subsection 376-170(2), item 3 in the table]***

10.106 Some documentaries, iconic films on Australian events overseas and co-productions may need to shoot outside Australia. For example, a film on Gallipoli may want to film on location in Turkey or an Australian documentary on the bird of paradise may need to shoot in Papua New Guinea. Where expenditure is on goods or services provided by Australian residents for the making of the film during principal photography in a location outside of Australia, and the subject matter of the film reasonably requires the location to be used, the expenditure will be qualifying Australian production expenditure. This also means that, for example, if a film involves an overseas location, but the use of that location is not possible and achieving the impression of that location reasonably necessitates the use of another overseas location, expenditure at that other location may also be qualifying Australian production expenditure. ***[Schedule 10, item 1, subsection 376-170(2), item 4 in the table]***

10.107 While receiving assistance in developing a film from an Australian Government agency does not preclude eligibility for the producer offset, it would provide unjustifiable additional assistance if the offset was then received on expenditure made with that assistance. Therefore, where development assistance (explained in paragraph 10.18) received from the Film Finance Corporation Australia Limited, Film Australia Limited, the Australian Film Commission or the Australian Film Television and Radio School is not repaid, any expenditure made with that funding is to be deducted from the qualifying Australian production expenditure. Where such assistance is repaid, the qualifying Australian production expenditure is not affected. ***[Schedule 10, item 1, paragraph 376-170(4)(a)]***

10.108 The amount of expenditure that can be claimed as qualifying Australian production expenditure by a company in regard to development, remuneration for the principal director, the producers and

producers' unit and principal cast, is limited. These expenditures are intended to represent the stated 'above the line' costs of a company. The qualifying Australian production expenditure that can be claimed on these costs is only up to a maximum of 20 per cent of a film's production budget — represented by the concept of 'total film expenditure' which is outlined in paragraph 10.110. This does not mean that further expenditure on 'above the line' costs cannot be made, nor does it mean that expenditure that exceeds the cap will mean that the production cannot qualify for the producer offset. Rather, it means that any expenditure on 'above the line' costs that is greater than 20 per cent of the film's total film expenditure will not be considered as qualifying Australian production expenditure and will therefore not be counted towards the expenditure threshold or the rebate amount for the production. ***[Schedule 10, item 1, paragraph 376-170(4)(b)]***

10.109 The cap on 'above the line' costs and the allowance for general business overheads, are based on a concept of total film expenditure, which is intended to equate to the concept of a film's budget as understood by the Australian screen production industry. ***[Schedule 10, item 1, paragraph 376-170(4)(b)]***

10.110 ***Total film expenditure*** is defined as the sum of:

- 'production expenditure' as defined in section 376-125;
- matters specifically included as production expenditure by section 376-130 and outlined in sections 376-150 and 376-170; and
- expenditures excluded from the definition of 'production expenditure' by section 376-135, to the extent that these are not covered above.

[Schedule 10, item 1, subsection 376-170(6), definition of 'total film expenditure' in subsection 995-1(1) of the ITAA 1997]

10.111 This is not intended to mean that some types of expenditure can be counted twice, nor does it mean that expenditure that cannot be quantified (such as profit participation) can be included. This provision is intended to represent the total amount of a film's production company's production budget, including development and financing, but excluding a distributor's expenditure on marketing, promotion and distribution. The relevant film authority will have the ability to outline how a company's total film expenditure should be reported in the rules for the producer offset.

Expenditure generally

10.112 The general expenditure tests below apply to all three offsets under Division 376.

Expenditure to be worked out on an arm's length basis

10.113 Where the company incurs expenditure under an arrangement and any parties to the arrangement did not deal with each other at arm's length and the amount of the expenditure would be more than it would be if they dealt with each other at arm's length, then the amount of expenditure is taken to be the amount that would have been incurred if the parties had been dealing with each other at arm's length. This rule applies not only to the actual arrangement under which the company incurs expenditure, but also to any act or transaction directly or indirectly connected with the expenditure the company incurs. So, for instance, arrangements which require a company to obtain certain goods or services from a particular source can be tested and, if not at arm's length, the expenditure on those goods or services will be limited to an arm's length amount. This will be so even if the company itself was dealing at arm's length to obtain the goods and services since a non-arm's length deal between others could otherwise inflate the cost. ***[Schedule 10, item 1, section 376-175]***

10.114 This provision does not automatically raise expenditure to arm's length rates if the expenditure is lower. However, if expenditure has been lowered to qualify for the offset (eg, by reducing production expenditure in total so as to increase the percentage of qualifying Australian production expenditure), general anti-avoidance rules may apply.

Expenditure incurred by prior production companies

10.115 Generally, a company carries out, or arranges the carrying out of, all the activities (or all the activities in Australia) necessary for making a film. Even when the production makes use of elements from a previous production, this is still usually the case. However, in some cases, a company has taken over the making of the film from another company (which may itself have taken over the making of the film from another company, and so on). In those cases, each company making the film is taken to have incurred the production expenditure of the previous companies. Its production expenditure excludes, then, any expenditure incurred to enable it to take over the making of the film (taking over is not part of actually making the film, in the same way that proposing, financing, promoting and distributing the film are not part of making the film). ***[Schedule 10, item 1, subsection 376-180(1)]***

10.116 In those cases, eligibility for the offset extends to the company that completes the production (or the Australian production) of the film. That company does not actually carry out, or arrange the carrying out, of all the activities (or all Australian activities) necessary for making the film but it is taken to do so, because it has taken over the making of the film from the previous company or companies, in the same way that it is taken to have incurred the production expenditure of those companies. So the

company that completes the activities is taken to have carried out, or arranged the carrying out of, those activities that were necessary for making the film, that were actually carried out, or arranged to be carried out, by the previous company or companies. ***[Schedule 10, item 1, subsection 376-180(2)***

Currency conversion

10.117 All production expenditure and qualifying Australian production expenditure must be worked out in Australian dollars. This means that expenditure made in a foreign currency must be converted to Australian dollars. For the purposes of meeting expenditure thresholds for the offsets, the rate of exchange is the rate of exchange on the date on which principal photography or the production of the animated imaging commenced. ***[Schedule 10, item 16, subsection 960-50(6), items 9 and 9A in the table]***

10.118 For the purposes of calculating the amount refunded under the offsets, the exchange rate used is the average rate of exchange for the period during which qualifying Australian production expenditure is incurred. For the PDV offset, this is the period during which qualifying Australian production expenditure in relation to post, digital and visual effects production is incurred. ***[Schedule 10, item 16, subsection 960-50(6), item 9B in the table]***

Transfer pricing

10.119 An Australian film production company may be providing film production services under an agreement with a foreign parent or other associate. Australia's transfer pricing rules in Division 13 of Part III of the ITAA 1936 and the Associated Enterprises article of a relevant double tax agreement permit the Commissioner of Taxation (Commissioner) to adjust the amount the Australian film production company charges for its services, to the amount that would be charged between independent parties dealing at arm's length with each other in comparable circumstances.

10.120 In performing the comparability analysis required to apply an appropriate arm's length pricing method, a tax offset under Division 376 should be taken into account. The tax offset should be treated as a condition of the market for film production services in Australia, and taken into account in evaluating a taxpayer's transfer price in that market. This is consistent with paragraph 2.104 of Taxation Ruling TR 97/20, which accords with paragraph 1.55 of the Organisation for Economic Co-operation and Development's 1995 *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.*

Certification

10.121 The certification process is generally the same for all three offsets under Division 376. The producer offset will be administered by

the film authority, whilst the location offset and PDV offset will be administered by the Arts Minister.

10.122 The ***Arts Minister*** is defined in subsection 995-1(1) of the ITAA 1997 as the Minister administering the *Film Licensed Investment Company Act 2005*.

Requirements for certification

10.123 Once a film is completed, the eligible production company may apply to the film authority for a certificate of eligibility for the producer offset. A certificate of eligibility guarantees that the applicant will receive the producer offset on the film's qualifying Australian production expenditure. ***[Schedule 10, item 1, subsection 376-230(3)]***

10.124 Certification requires that the film authority is satisfied of a number of requirements. The film authority must be satisfied that the film has been completed, and that the film has a significant Australian content or has been made under an agreement between the Australian government or an authority of the Australian government and a foreign country or an authority of the foreign country (ie, is an official co-production). ***[Schedule 10, item 1, subsection 376-65(1)]***

10.125 In determining whether a film has significant Australian content, the film authority must have regard to the following:

- the subject matter of the film;
- the place where the film was made;
- the nationalities and places of residence of the persons who took part in the making of the film (including authors, composers, actors, scriptwriters, editors, producers, directors and technicians);
- the details of the production expenditure incurred in respect of the film; and
- any other matters that the film authority considers to be relevant.

[Schedule 10, item 1, subsection 376-70(1)]

10.126 This test is the same as the test previously applied to applicants for certification under Division 10BA of the ITAA 1936, with the exception that the film does not have to be wholly or substantially made in Australia and the following two matters are no longer specified as matters to which regard must automatically be had:

- the holder of intellectual copyright in the film; and
- the source of finance for the film.

10.127 While these two matters are not specific factors requiring consideration, it is intended that they may still be able to be considered as particular factors in the certification test, especially where consideration of other matters does not result in strong grounds for or against certification.

10.128 Subject to these changes, the matters detailed in the test are intended to be interpreted in the same way as the Division 10BA test, which was previously under the authority of the Arts Minister, and delegated to the Department of Communications, Information Technology and the Arts.

10.129 The film authority must also be satisfied that the film was produced for cinema release (in the case of a feature film), for public broadcast, including by satellite or by cable, or for public video release on tapes, DVDs or otherwise (in the case of other formats). In essence, therefore, the film must be produced for public release or distribution in some form. ***[Schedule 10, item 1, paragraph 376-65(2)(b)]***

10.130 To be satisfied that a film is a feature film, the film authority will require evidence of an Australian commercial agreement that provides a feature film with a theatrical release in a commercial cinema. Such an agreement would be expected to be a bona fide arrangement for the theatrical release of the film, and would not be justified by a contrived arrangement, for instance for release on one, or a very small number of screens.

10.131 For formats other than a feature film, evidence of Australian distribution will be required. Examples include television broadcast agreements, or the commercial delivery of a production via a new media platform (such as online or mobile content) where access to the content is available to Australians. This may be through bona fide self-distribution or arm's length distribution.

10.132 Arm's length distribution may include:

- distribution advances or guarantees from a distributor or sales agent for Australian territory in terms of direct to DVD/VHS release, television broadcast, mobile phone or online;
- an agreement guaranteeing commercial delivery of a production via a mobile content platform or online or through retail sales for direct to DVD/VHS release in Australia; or
- development of an online service that would provide a commercial delivery of the production to Australians.

10.133 The key concept is that distribution must be on a commercial basis. Distribution guarantees or similar must be provided to the film authority in order for a film to be certified for the producer offset.

10.134 The film authority must be satisfied that:

- the film is a feature film, a single-episode programme, a series, a season of a series, or a short-form animation;
- the film is not a film of a public event, a training film, an advertisement or commercial, a discussion, quiz, panel, variety or like programme, a news or current affairs programme, a computer game or a reality TV programme;
- the applicant company carried out, or made the arrangements for, all the activities that are necessary for the making of a film, and that the applicant company is the only company that satisfied this requirement; and
- the company's qualifying Australian production expenditure on the film meets the expenditure thresholds outlined above at paragraph 10.60.

[Schedule 10, item 1, paragraphs 376-65(1)(a), (2)(c) and (2)(d), subsection 376-65(6)]

10.135 As certification requires the film authority to be satisfied of these things, the claim for the producer offset in the tax return is based only on the existence of the certificate and on the level of qualifying Australian production expenditure specified in the certificate. If the certificate is revoked because of fraud or serious misrepresentation in obtaining the film authority's satisfaction of those issues, then the certificate will be taken never to have been issued, and the offset can not be claimed or, if claimed, will be the subject of amendment of the assessment to deny the offset. ***[Schedule 10, item 1, section 376-270, subsections 376-245(3) to (5)]***

Issuing of a certificate

10.136 For a company to be entitled to the producer offset for a film, the film authority must have issued a certificate for the film ***[Schedule 10, item 1, subsection 376-65(1)]***. Further, the film authority will determine the level of qualifying Australian production expenditure of a certified production ***[Schedule 10, item 1, section 376-75]***. Allowing the film authority to determine qualifying Australian production expenditure will provide certainty to applicants as to the amount that a certified production will receive. A determination of qualifying Australian production expenditure is not a Legislative Instrument within the meaning of the *Legislative Instruments Act 2003*.

Requirements of the certificate

10.137 Any certificate that the film authority issues is expected to be in writing, to state the company's ABN and the date of issue of the certificate, that the film is eligible for the offset, and the qualifying Australian production expenditure for the film as determined by the film authority. The film authority must notify the Commissioner of the issue

of the certificate within 30 days, and will give the company's name and address, the qualifying Australian production expenditure determined by the film authority, and such other information as the film authority and the Commissioner agree. ***[Schedule 10, item 1, subsection 376-240(1)]***

Revocation and refusal of certificates

10.138 The film authority will have the power to revoke the certificate if the issue of the certificate was obtained by fraud or by serious misrepresentation. Revocation will have the effect of requiring full repayment of any offset given through a tax return process. ***[Schedule 10, item 1, subsection 376-245(3)]***

10.139 Where a certificate is revoked, the film authority must give written notice to the company to which the certificate was issued, including reasons for the decision. ***[Schedule 10, item 1, subsection 376-245(4)]***

10.140 If the film authority decides not to issue a certificate, the company seeking the certificate must receive written notice of that decision. ***[Schedule 10, item 1, subsection 376-235(2)]***

10.141 The decision not to issue a certificate, and a decision to revoke a certificate, will be reviewable in the Administrative Appeals Tribunal (AAT) on application by the company the interests of which have been affected. A determination of qualifying Australian production expenditure by the film authority is also a matter which can be reviewed by the AAT. ***[Schedule 10, item 1, section 376-255]***

10.142 The notice of refusing to issue a certificate or to revoke a certificate need not set out the findings on material questions of fact, refer to the evidence and other material on which the findings were based or the reasons for the decision. The notice must, however, include advice that an application can be made to the AAT and that a statement outlining the above matters (unless the reasons have already been supplied) may be requested. A failure by the film authority to comply with these obligations will not, however, affect the validity of the decision to refuse to issue a certificate or to revoke a certificate. ***[Schedule 10, item 1, section 376-250]***

10.143 Where a certificate issued to a company has been revoked under section 376-245, the income tax assessment of the company will need to be amended to deny the offset. ***[Schedule 10, item 1, section 376-270]***

10.144 The relevant period in which the Commissioner may amend assessments will be during a period of four years starting immediately after the revocation of the certificate. ***[Schedule 10, item 1, section 376-270]***

Rule-making powers

10.145 The film authority may make rules by legislative instrument deciding on administrative requirements for applications for certificates for the producer offset, including:

- the application form;
- the type of information to be provided;
- methods of verification of that information (such as requesting reports by auditors); and
- procedures around the provision of supplementary or additional information that the film authority may request.

[Schedule 10, item 1, subsection 376-265(2)]

10.146 The film authority may also make rules that will outline the processes and requirements for applications for provisional certificates for the producer offset. Provisional certificates will provide a guide to producers who are aiming to take advantage of the scheme. They will enable a producer to receive an indication from the film authority that a proposed production will be eligible for the producer offset if it is made in accordance with the details on which the authority relied in issuing the provisional certificate. ***[Schedule 10, item 1, subsection 376-265(1)]***

Part 2 — The location offset

10.147 The location offset is the existing refundable film tax offset with enhancements. It is designed to encourage large scale film productions to locate in Australia, and is aimed at providing greater economic, employment and skill development opportunities.

How much is the offset?

10.148 The offset is 15 per cent of the total of the company's qualifying Australian production expenditure on the film. Consistent with the other offsets, the offset amount is credited to the applicant company through the company's income tax return. ***[Schedule 10, item 1, section 376-15]***

When is the offset available?

10.149 The offset will apply to films which commence principal photography or production of the animated image on or after 8 May 2007. ***[Schedule 10, Part 4, subitem 91(1)]***

10.150 A film which commenced principal photography prior to 8 May 2007 may apply for the 12.5 per cent refundable film tax offset under the existing terms of Division 376 prior to the amendments made by this Bill. The *Refundable Film Tax Offset Rules 2002* also continue to operate in relation to such productions. ***[Schedule 10, Part 4, subitem 92(1)]***

10.151 An applicant company is entitled to the offset if:

- if the total of the company's qualifying Australian production expenditure on the film is less than $50 million — the company's production expenditure on the film ceased being incurred in the income year;
- if the total of the company's qualifying Australian production expenditure on the film is at least $50 million — the company's qualifying Australian production expenditure on the film ceased being incurred in the income year;
- the Arts Minister has granted a certificate to the applicant company;
- the offset is claimed by the company in its income tax return for the income year in which post, digital and visual effects production work ceased; and
- the company is either an Australian resident company or a foreign resident company with a permanent establishment and an ABN. This must be the case both when the tax return is lodged and the offset is paid. While it is not strictly a requirement that the company be an eligible company when it makes its application to the Minister for a certificate, it is expected that companies will meet this criterion when they make their application.

[Schedule 10, item 1, subsection 376-10(1)]

10.152 A company may apply to the Arts Minister for a certificate of eligibility for the location offset when:

- for films with qualifying Australian production expenditure of more than $50 million — once the company's qualifying Australian production expenditure has ceased being incurred; or
- for films with qualifying Australian production expenditure of at least $15 million and less than $50 million — once the company's production expenditure has ceased being incurred.

[Schedule 10, item 1, subsection 376-10(1)]

10.153 This provision recognises that for large budget films, production may continue for some time after the production leaves Australia. It provides the company with the opportunity to access the offset when the film finishes work in Australia, rather than needing to wait for the film's completion.

10.154 An applicant company is not entitled to the offset where:

- a deduction has been claimed in relation to intellectual property in the film under Division 10B of the ITAA 1936;

- the film has been issued with a final certificate under Division 10BA of the ITAA 1936 (including concessional capital investment support under the Film Licensed Investment Company scheme and equity funding by the Film Finance Corporation Australia Limited); or
- the film has been granted a final certificate for either the producer offset or the location offset.

[Schedule 10, item 1, subsection 376-10(2)]

Expenditure thresholds

10.155 As is the case for the producer offset, a film must meet certain expenditure thresholds to be eligible for the location offset. These are unchanged from the refundable film tax offset. The total of the company's qualifying Australian production expenditure, as determined by the Arts Minister, must be either:

- at least $50 million of qualifying Australian production expenditure; or
- at least $15 million and less than $50 million where qualifying Australian production expenditure is at least 70 per cent of the company's production expenditure.

[Schedule 10, item 1, subsection 376-20(5)]

10.156 For each category of expenditure, there is an equivalent required level of responsibility which the company must have for the film's production. These are unchanged from the refundable film tax offset:

- for films with qualifying Australian production expenditure of more than $50 million — the company either carried out, or made the arrangements for carrying out, all the arrangements for the making of the film in Australia; or
- for films with qualifying Australian production expenditure of at least $15 million and less than $50 million — the company must have either carried out, or made the arrangements for carrying out, all the arrangements for the making of the film.

[Schedule 10, item 1, subsection 376-20(5)]

Eligible genres

10.157 A film will be eligible for the location offset if it is one of the following:

- a feature film or a film of a like nature;
- a mini-series of television drama; or
- a television series not otherwise covered.

[Schedule 10, item 1, paragraph 376-20(2)(b)]

10.158 A television series will not be excluded from certification for access to the offset if it is of a documentary-like nature.

10.159 A production will be ineligible for the location offset or the PDV offset if it is a documentary (other than a television series), an advertisement or a commercial. Discussion programmes, quiz programmes, panel programmes, variety programmes, and all other programmes of that kind are ineligible. Similarly a production is not eligible if it is a film of a public event, a training film or a film forming part of a drama programme series that is, or is intended to be, of a continuing nature and is not a television series. ***[Schedule 10, item 1, paragraph 376-20(2)(c)]***

Television series

10.160 There are timeframes for the completion of a television series production. Where a television series is predominantly a digital animation or other animation it must be made within a period of 36 months. This period commences once production expenditure begins to be incurred. The commencement of the 36-month period is not triggered by either pre-production or pilot production activities. Effectively, the 36-month period excludes pre-production activities as mentioned in paragraph 376-125(3)(a), as well as activities associated with the production of a pilot (if there is one). Due to the nature of digital or other animation series, they are given a longer timeframe for completion. ***[Schedule 10, item 1, subparagraph 376-20(3)(b)(i)]***

10.161 A television series other than a series which is predominantly a digital animation or other animation is subject to a different timeframe for completion. Such a series, most likely a 'live action' series, must complete all principal photography within a period of 12 months. This period again excludes activities associated with the production of a pilot episode (if there is one). Principal photography does not include second unit photography. ***[Schedule 10, item 1, subparagraph 376-20(3)(b)(ii)]***

10.162 Where the film is a television series and it is applying for the location offset, it must meet an additional expenditure threshold specific to television series. A television series will be required to have a minimum average of at least $1 million of qualifying Australian production expenditure per hour. The intent of this threshold is to ensure low-value series and series which would have been produced in Australia regardless of the extension of the offset, are excluded. The amount of qualifying Australian production expenditure per hour for a television series is worked out by using the formula in subsection 376-20(6). This formula requires that the total qualifying Australian production expenditure for the television series be divided by the total length of the series measured in hours. The calculation is the same as that explained in

relation to the producer offset in paragraphs 10.52 to 10.54. ***[Schedule 10, item 1, paragraph 376-20(3)(c)]***

10.163 For the location offset, a television series must be a film made up of two or more episodes that:

- are produced wholly or principally for exhibition to the public on television under a single title;
- contain a common theme or themes;
- contain dramatic elements that form a narrative structure; and
- are produced wholly or principally for exhibition together, for a national market or national markets.

[Schedule 10, item 1, paragraph 376-20(3)(a)]

10.164 The requirement that all of the episodes must be produced wholly or principally for exhibition together for a national market or national markets is designed to prevent the bundling of episodes that were not designed to be exhibited together, such as different television series produced in different languages for different markets.

10.165 Unlike the producer offset, it is intended that reality television (as referred to in paragraph 10.58) is eligible for the location and PDV offsets, but only as television series. To this end, the amendments specify that a film will be considered to contain dramatic elements that form a narrative structure (without limiting the operation of the provision) if:

- the sole or dominant purpose of the film is to depict actual events, people or situations; and
- the film depicts those events, people or situations in a dramatic or entertaining way, with a heavy emphasis on dramatic impact or entertainment value.

[Schedule 10, item 1, subsection 376-20(4)]

Production expenditure

10.166 The general test for production expenditure for the location offset is the same as that for the producer offset, including specific inclusions and exclusions and rules related to expenditure generally. There are a few special rules which apply to the location offset.

Special rules — location offset

10.167 For the location offset, a company can choose to disregard the remuneration of one person from the company's production expenditure. Remuneration includes all benefits provided for the person's services in the making of the film, and it includes the travel and other costs associated with those services, such as the costs of bringing the person to and from Australia. These costs will then be disregarded for all purposes.

They will not be taken into account as part of production expenditure, or as part of qualifying Australian production expenditure. The offset will not be given for those expenditures either. ***[Schedule 10, item 1, section 376-25]***

10.168 The reason for choosing to disregard one person's remuneration would generally be that the remuneration would add to production expenditure but not qualifying Australian production expenditure, and so could exclude a film from eligibility for the offset where total qualifying Australian production expenditure is below $50 million by making that expenditure less than 70 per cent of production expenditure. The company must nominate the person whose remuneration is to be disregarded in its application for a certificate from the Arts Minister on completion of the film. ***[Schedule 10, item 1, section 376-25]***

10.169 In relation to a pilot to a television series, expenditure on a pilot that is not qualifying Australian production expenditure is excluded from production expenditure. In effect, if a pilot is produced overseas and the series is subsequently produced as an eligible television series in Australia, then all expenditure reasonably attributable to the production of that pilot episode is to be excluded from the calculation of total production expenditure for the purposes of the offset. The intent of this provision is to encourage series that have already shot a pilot overseas to consider relocating to Australia. This provision enhances Australia's attractiveness as a location, as the exclusion of overseas pilot expenditure lessens the impact of the 70 per cent criterion applicable to the entire series (for series with qualifying Australian production expenditure between $15 million and $50 million). ***[Schedule 10, item 1, section 376-140]***

10.170 In relation to a pilot to a television series produced in Australia, the provisions operate such that pilots shot in Australia will have relevant expenditure counted towards qualifying Australian production expenditure for the purposes of the offset if, and only if, the television series is an eligible series. In other words, the location offset will not be available on the pilot alone. It is intended that this will encourage the production of pilots in Australia.

Qualifying Australian production expenditure

10.171 The general test for qualifying Australian production expenditure for the location offset is the same as that for the producer offset, including specific inclusions and exclusions and rules related to expenditure generally. There are a few special rules which apply to location offset and the PDV offset.

Special rules — location offset and the PDV offset

10.172 For the location offset and the PDV offset, where a production company's general business overheads are not incurred in relation to the making of the film, but are still expended in Australia, a reasonable apportionment of these overheads can be claimed as qualifying Australian

production expenditure. This apportionment is limited to either 2 per cent of the film's production expenditure or $500 000, whichever is the lesser. Expenditure included as qualifying Australian production expenditure by this provision is also to be included as production expenditure. This provision encourages foreign production companies to be located in Australia even if they make projects that do not qualify for the offset as well as projects that do, because a share of general overheads will only qualify for the offset if they are located in Australia. ***[Schedule 10, item 1, subsection 376-165(1), item 1 in the table]***

10.173 Qualifying Australian production expenditure also includes a company's expenditure in relation to a person's travel to Australia to undertake activities in relation to the making of the film if the remuneration paid to that person for those activities is qualifying Australian production expenditure of the company. This provision is subject to the rule that non-cast members must work on the film in Australia for at least two weeks before expenditure on those non-cast members can be considered qualifying Australian production expenditure. ***[Schedule 10, item 1, subsection 376-165(1), item 2 in the table]***

10.174 It is intended that a person's travel from Australia is not considered to be for the making of the film so is therefore neither production expenditure nor qualifying Australian production expenditure. Where expenditure on a person's travel is made by purchasing a return airfare, qualifying Australian production expenditure and production expenditure may include 50 per cent of the cost of the return ticket.

10.175 For the location offset, qualifying Australian production expenditure also includes a company's expenditure incurred in freighting an item to Australia to be used in the making of the film. It is intended that freighting an item from Australia is not considered to be production expenditure and is therefore not qualifying Australian production expenditure either. ***[Schedule 10, item 1, subsection 376-165(1), item 3 in the table]***

Certification for the location and PDV offsets

10.176 The certification process for both the location offset and PDV offset are similar to that for the refundable film tax offset. The key exception is that, consistent with the producer offset, the Arts Minister must determine a company's qualifying Australian production expenditure.

Requirements for certification

10.177 A certificate of eligibility guarantees that the applicant will receive the location or PDV offset on the film's qualifying Australian production expenditure.

10.178 Certification requires that the Arts Minister is satisfied of a number of requirements. The Minister must be satisfied that the film was produced for exhibition in cinemas (in the case of a feature film), for

public broadcast, including by satellite or by cable, or for public video release on tapes, DVDs or otherwise (in the case of other formats). In essence, therefore, the film must be produced for public release or distribution in some form. ***[Schedule 10, item 1, paragraphs 376-20(2)(a) and 376-45(2)(a)]***

10.179 The Arts Minister must also be satisfied that the film is an eligible genre, meets the expenditure thresholds and meets the requisite level of company responsibility as outlined above for the location offset, and below for the PDV offset. ***[Schedule 10, item 1, paragraphs 376-20(2)(b) and 376-45(2)(b)]***

10.180 During the certification process, the Arts Minister will determine the level of qualifying Australian production expenditure of a certified production. Providing the Arts Minister with the authority to determine qualifying Australian production expenditure will provide certainty to applicants as to the amount that a certified production will receive. A determination of qualifying Australian production expenditure is not a legislative instrument within the meaning of the *Legislative Instruments Act 2003*. ***[Schedule 10, item 1, sections 376-30 and 376-50]***

10.181 The claim for the location offset or the PDV offset in the company's tax return is based only on the existence of the certificate and on the level of qualifying Australian production expenditure determined in the certificate. If the certificate is revoked, then the certificate will be taken never to have been issued, and the offset can not be claimed or, if claimed, will be the subject of amendment of the assessment to deny the offset. ***[Schedule 10, item 1, subsection 376-245(5)]***

10.182 In practice, it is expected that the Arts Minister will act on the advice of the Film Certification Advisory Board when considering applications.

Requirements of the certificate

10.183 Any certificate that the Arts Minister issues is expected to be in writing, to state the company's ABN and the date of issue of the certificate, that the film is eligible for the relevant offset, and the qualifying Australian production expenditure for the film as determined by the Arts Minister. The Arts Minister must notify the Commissioner of the issue of the certificate within 30 days, and will give the company's name and address, the qualifying Australian production expenditure determined by the film authority, and such other information as the Arts Minister and the Commissioner agree. ***[Schedule 10, item 1, section 376-240]***

Revocation and refusal of certificates

10.184 The Arts Minister will have the power to revoke the certificate if the issue of the certificate was obtained by fraud or by serious misrepresentation. Revocation will have the effect of requiring full

repayment of any offset given through a tax return process. ***[Schedule 10, item 1, paragraph 376-245(1)(a)]***

10.185 The Arts Minister may also revoke a certificate if a certified applicant does not provide the Minister with a copy of the film within 30 days after the film's completion. This provision is to provide the Arts Minister with certainty that a film which has been certified and has claimed an offset is, in fact, completed and released. Without limiting the Minister's authority, it is expected that the Minister would consult with a certified applicant prior to invoking this authority. ***[Schedule 10, item 1, paragraph 376-245(1)(b)]***

10.186 Where a certificate is revoked, the Arts Minister must give written notice to the company to which the certificate was issued, including reasons for the decision. ***[Schedule 10, item 1, subsection 376-250(1)]***

10.187 If the Arts Minister decides not to issue a certificate, the company seeking the certificate must receive written notice of that decision. ***[Schedule 10, item 1, subsection 376-250(1)]***

10.188 The decision not to issue a certificate, and a decision to revoke a certificate, will be reviewable in the AAT on application by the company whose interests have been affected. A determination of qualifying Australian production expenditure by the Arts Minister is also a matter which can be reviewed by the AAT. ***[Schedule 10, item 1, section 376-255]***

10.189 The notice of refusing to issue a certificate or to revoke a certificate need not set out the findings on material questions of fact, refer to the evidence and other material on which the findings were based or the reasons for the decision. The notice must, however, include advice that an application can be made to the AAT and that a statement outlining the above matters (unless the reasons have already been supplied) may be requested. A failure by the Arts Minister to comply with these obligations will not, however, affect the validity of the decision to refuse to issue a certificate or to revoke a certificate. ***[Schedule 10, item 1, subsection 376-250(3)]***

10.190 Where a certificate issued to a company has been revoked under section 376-245, the income tax assessment of the company will need to be amended to deny the offset. ***[Schedule 10, item 1, section 376-270]***

10.191 The relevant period in which the Commissioner may amend assessments will be during a period of four years starting immediately after the revocation of the certificate. ***[Schedule 10, item 1, section 376-270]***

Rule-making powers

10.192 The Arts Minister is empowered to make rules in relation to the location and PDV offsets. Such rules are legislative instruments within the meaning of section 5 of the *Legislative Instruments Act 2003*.

10.193 The Arts Minister may by rules establish a Film Certification Advisory Board to consider applications for eligibility for the offset and

advise the Minister on whether to issue certificates of eligibility. The Arts Minister may decide on other activities and duties in relation to the offset for the Board to undertake. The Arts Minister may specify the membership of the Board and the terms and conditions of its appointment, and may specify the procedures of the Board. ***[Schedule 10, item 1, subsection 376-260(1)]***

10.194 The Arts Minister may also make rules deciding on administrative requirements for applications for certificates for the location offset and the PDV offset, including:

- the application form;
- the type of information to be provided;
- methods of verification of that information (such as requesting reports by auditors); and
- procedures around the provision of supplementary or additional information that the film authority may request.

[Schedule 10, item 1, subsection 376-260(3)]

10.195 The Arts Minister may also make rules that will outline the processes and requirements for applications for provisional certificates for the location offset or the PDV offset. It is anticipated that provisional certificates will be issued by the Film Certification Advisory Board and will provide a guide to producers who are aiming to take advantage of the scheme. They will enable a producer to receive an indication from the Film Certification Advisory Board that a proposed production will be eligible for the location offset or the PDV offset if it is made in accordance with the details on which the Board relied in issuing the provisional certificate. ***[Schedule 10, item 1, subsection 376-260(2)]***

Part 3 — The PDV offset

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

How much is the offset?

10.197 The offset is 15 per cent of the company's qualifying Australian production expenditure to the extent that the qualifying Australian production expenditure relates to the post, digital and visual effects production of a film. Consistent with the other offsets, the offset amount is credited to the applicant company through the company's income tax return. ***[Schedule 10, item 1, section 376-40]***

When is the offset available?

10.198 The offset will be available for post, digital and visual effects production work that commences on or after 1 July 2007. The date on

which production commences on the film for which the post, digital and visual effects production work is being undertaken has no effect on whether the offset can be accessed. ***[Schedule 10, Part 4, subitem 91(2)]***

10.199 An applicant company is entitled to the offset where:

- all eligible expenditure post, digital and visual effects production-related expenditure (see below) has ceased being incurred;
- the Arts Minister has granted a certificate to the applicant company, which requires a company to have incurred at least $5 million of qualifying Australian production expenditure on post, digital and visual effects production work;
- the offset is claimed by the company in its income tax return for the income year in which post, digital and visual effects production work ceased; and
- the company is either an Australian resident company or a foreign resident company with a permanent establishment and an ABN. This must be the case both when the tax return is lodged and the offset is paid. While it is not strictly a requirement that the company be an eligible company when it makes its application to the Arts Minister for a certificate, it is expected that companies will meet this criterion when they make their application.

[Schedule 10, item 1, subsection 376-35(1)]

10.200 An applicant company is not entitled to the offset where:

- a deduction has been claimed in relation to intellectual property in the film under Division 10B of the ITAA 1936;
- the film has been issued with a final certificate under Division 10BA of the ITAA 1936 for the film (including concessional capital investment support under the Film Licensed Investment Company scheme and equity funding by the Film Finance Corporation Australia Limited); or
- the film has been granted a final certificate for either the producer offset or the location offset.

[Schedule 10, item 1, subsection 376-35(3)]

Criteria for certification

10.201 Before the Arts Minister grants a certificate to an applicant company, he or she must be satisfied that the film for which the post, digital and visual effects production work is being undertaken is an eligible format for the location offset. This means that the film must be, for example, a feature film (for distribution on any medium), telemovie,

television series or miniseries. The film itself need not meet timing or expenditure criteria. ***[Schedule 10, item 1, paragraph 376-45(2)(b)]***

10.202 The Arts Minister must be satisfied that the applicant company is the sole company responsible for all post, digital and visual effects production activities involved in making the film in Australia. Depending on the structure of the production, this could be, for example:

- an Australian company set up to manage Australian post, digital and visual effects production companies' work on the film;
- the 'lead' Australian post, digital and visual effects production company which subcontracts some post, digital and visual effects production work to other Australian companies; or
- an Australian production company or production services company.

[Schedule 10, item 1, paragraph 376-45(5)(b)]

10.203 The Arts Minister must also be satisfied that the application meets the expenditure threshold below, and that all eligible expenditure for the post, digital and visual effects production offset has ceased being incurred. ***[Schedule 10, item 1, paragraph 376-45(5)(a)]***

10.204 Information about the process for certification and the rules about certificates are outlined above in relation to the location offset.

Eligible expenditure

10.205 Expenditure is eligible if it is:

- qualifying Australian production expenditure; and
- incurred in relation to post, digital and visual effects production.

10.206 Eligible expenditure for the post, digital and visual effects production offset is a subset of what would be considered qualifying Australian production expenditure for the location offset. Therefore, such expenditure must be production expenditure incurred on, or reasonably attributable to, goods and services provided in Australia, the use of land in Australia, or the use of goods located in Australia at the time they are used in the making of the film. However, eligible expenditure must be spent on, or incurred in relation to, post, digital and visual effects production for the film.

10.207 ***Post, digital and visual effects production*** is defined as:

- the creation of audio or visual elements (other than principal photography, pick ups or the creation of physical elements such as sets, props or costumes) for the film;

- the manipulation of audio or visual elements (other than pick ups or physical elements such as sets, props or costumes) for the film; and
- activities that are necessarily related to the activities mentioned in the dot points above.

[Schedule 10, item 21, definition of 'post, digital and visual effects production' in subsection 995-1(1) of the ITAA 1997]

10.208 Post, digital and visual effects production includes post-production, all digital production and all visual effects production on the film. It does not however, include principal photography, whether that footage is shot on film or digitally.

10.209 The first limb above extends to all image creation and sound creation, and includes digital creation, motion capture, animation and photography, orchestration, audio recording and sound effects recording and generation, except where that work is in fact principal photography or is the shooting of pick ups (short periods of photography to fill gaps in the film or replace footage shot during principal photography), or where the work is the making of physical items (such as sets, props and costumes). Such physical elements are not intended to encompass the construction of miniatures or models as part of post, digital and visual effects production. ***[Schedule 10, item 1, paragraph 376-35(2)(a)]***

10.210 Post, digital and visual effects production also includes all manipulation of elements, whether visual or audio elements, except where it is physical manipulation of a physical item (eg, manipulating sets). Such manipulation is not intended to encompass the manipulation of miniatures or models as part of post, digital and visual effects production. Manipulation of images of physical items, whether on film or digitally, is considered post, digital and visual effects production. This provision means that all editing, compositing, and other post-production tasks are post, digital and visual effects production. ***[Schedule 10, item 1, paragraph 376-35(2)(b)]***

10.211 The final limb in the definition above includes expenditure that is not strictly on post, digital and visual effects production tasks, but is necessary to them. This would therefore cover, for example:

- airfares, salaries and per diems for visual effects production staff sent to Australia to oversee or undertake post, digital and visual effects production work;
- salaries, equipment costs and hires, and facilities hire for use in a model or green-screen shoot;
- actor's fees, per diems etc. for working on additional dialogue recording;
- freight of prints to and from the laboratory; and

- depreciation of assets owned by the applicant (eg, computer equipment and infrastructure).

[Schedule 10, item 1, paragraph 376-35(2)(c)]

10.212 The following tasks are examples of post, digital and visual effects production: 2D and 3D animation, green-screen photography (so long as the entire film is not shot against green-screen and as a result, such photography is in fact the principal photography for the film), pre-visualisation, music composition and recording, online and offline editing, still photography, matte painting and stills manipulation, credit design, models and miniatures, foley effects, additional dialogue recording and colour-correction. The hire of stages and facilities and other expenditures that are necessarily related to the undertaking of post, digital and visual effects production are also post, digital and visual effects production, as would salaries for actors recording additional dialogue or appearing in green-screen photography and expenditure on costumes for green-screen photography.

10.213 Further, if a member of the production, such as director, art director or visual effects producer, travels to Australia to oversee elements of post, digital and visual effects production, that person's salary, per diems and fringes will also be post, digital and visual effects production for the period that they are working on post, digital and visual effects production in Australia. However, non-cast members must remain in Australia and work on the film for at least two weeks in order for their costs to count as qualifying Australian production expenditure. If a non-cast member enters Australia to work on the film for more than two weeks, only the proportion of their costs that relate to post, digital and visual effects production work are eligible. ***[Schedule 10, item 1, paragraph 376-155(b)]***

10.214 In considering an application for certification, the Arts Minister must determine the amount of qualifying Australian production expenditure that is incurred in relation to post, digital and visual effects production (ie, eligible expenditure for the post, digital and visual effects production offset). The Arts Minister must do so in writing as soon as practicable after receiving the application. Subsection 376-50(4) specifies that such a determination is not a legislative instrument. This provision is intended to assist readers by making it clear to them that the determination of qualifying Australian production expenditure is not a legislative instrument within the meaning of section 5 of the *Legislative Instruments Act 2003*. ***[Schedule 10, item 1, section 376-50]***

What are the qualifying expenditure thresholds?

10.215 In order to qualify, the company must incur at least $5 million of qualifying Australian production expenditure as defined above. ***[Schedule 10, item 1, subsection 376-45(5)]***

Production expenditure and qualifying Australian production expenditure

10.216 The rules for production expenditure and qualifying Australian production expenditure for the PDV offset are the same as those for the location offset, including specific inclusions and exclusions, currency exchange and rules related to expenditure generally.

Part 4 — Phasing out tax incentives for investors

10.217 The current investor tax incentives in Divisions 10B and 10BA of the ITAA 1936 have had limited effectiveness in recent years and will be phased out.

10.218 Divisions 10B and 10BA will be repealed effective from 1 July 2010.

10.219 Section 8 of the *Acts Interpretation Act 1901* will ensure that the repeal of Divisions 10B and 10BA of the ITAA 1936 will not affect the previous operation of the Divisions or affect any right, privilege, obligation or liability acquired, accrued or incurred under the Divisions.

Division 10B

10.220 These amendments will provide that no applications for a certificate can be made after Royal Assent of the amending legislation. ***[Schedule 10, Part 2, item 2]***

10.221 The first deduction available under Division 10B will only be available up until 30 June 2009. The effect of this will be to ensure that the film is producing assessable income by 30 June 2009. If a taxpayer claims a deduction in respect of a film under this Division in relation to the 2008-09 year of income, the taxpayer can also claim a deduction in respect of the film in relation to the 2009-10 year of income. ***[Schedule 10, Part 2, item 2]***

Division 10BA

10.222 These amendments will provide that an application for a provisional certificate under Division 10BA must be made before the day on which the amending legislation receives Royal Assent. ***[Schedule 10, Part 2, item 3]***

10.223 Division 10BA does not require an applicant to hold a valid provisional certificate in order to apply for a final certificate. From the date of Royal Assent of the amending legislation, an applicant cannot apply for a final certificate in respect of a film unless a valid provisional certificate has been issued. This will ensure that the concessions under this Division will be phased out as per the policy intent without allowing applicants to bypass the provisional certificate process. ***[Schedule 10, Part 2, item 5]***

10.224 A deduction under Division 10BA is not allowable in relation to the 2009-10 year of income or a later year of income. ***[Schedule 10, Part 2, item 6]***

Part 5 — Technical amendment

10.225 Division 67 of the ITAA 1997 lists tax offsets that are subject to the refundable tax offset rules. The theme statement in the guide material to Division 67 is replaced to provide a clear statement of the operation of the Division. ***[Schedule 10, Part 2, items 7 to 9, and 11 to 15, section 67-10 of the ITAA 1997]***

10.226 As a result of the introduction of the producer offset, an amendment is required to the capital allowances regime in Division 40 of the ITAA 1997. The capital allowances regime allows a taxpayer to deduct an amount equal to the decline in value of a depreciating asset over its effective life. Generally, the value of the depreciating asset is its cost. However, certain assets are excluded from the operation of Division 40 by section 40-45.

10.227 Copyright in a film is a depreciating asset. Section 40-45 currently excludes copyright in a film from the application of Division 40 where a deduction is available in relation to the asset under Division 10B or 10BA of the ITAA 1936. The cost of copyright in a film is broadly the expenses incurred in producing the film, and hence creating the copyright in the film, or the acquisition cost of the copyright. Some of these expenses are also qualifying Australian production expenditure for the purposes of the offset. To ensure that the taxpayer is only entitled to one tax benefit in relation to the Australian expenditure, the cost of the depreciating asset (the copyright in the film) is to be reduced by the amount of the producer offset to which the taxpayer is entitled. ***[Schedule 10, Part 2, item 10, subsection 40-45(6) of the ITAA 1997]***

Application and transitional provisions

10.228 The amendments to enhance the existing refundable film tax offset (the location offset) will apply to films that commence principal photography or production of the animated image on or after 8 May 2007. ***[Schedule 10, Part 4, subitem 91(1)]***

10.229 The amendments made to introduce the PDV offset will apply to a film that commences post, digital and visual effects production on or after 1 July 2007. ***[Schedule 10, Part 4, subitem 91(2)]***

10.230 The amendments made to introduce the producer offset apply to qualifying Australian production expenditure incurred:

- on or after 1 July 2007; and
- before 1 July 2007, to the extent that such expenditure is attributable to goods or services provided on or after 1 July 2007.

[Schedule 10, Part 4, subitem 91(3)]

10.231 In respect of productions which are underway on 1 July 2007, it is intended that expenditure incurred will apply to services provided, or goods acquired, on or after 1 July 2007. This is regardless of when the contractual obligation to provide the services was undertaken. This means that in the case of any film in production on 1 July 2007, where contracts have been entered into prior to that date, applicants may make a reasonable apportionment of expenses (eg, crew expenses) for services provided and goods used on or after 1 July 2007.

10.232 Despite the repeal and substitution of Division 376 of the ITAA 1997, that Division continues to apply, in relation to films that commenced principal photography or production of the animated image before 8 May 2007, as if the repeal and substitution had not happened. ***[Schedule 10, Part 4, subitem 92(1)]***

10.233 Further, despite the repeal and substitution of Division 376, legislative instruments that:

- were made under section 376-105 of the ITAA 1997; and
- were in force immediately before the commencement of the repeal and substitution of Division 376,

continue to have effect, and may be dealt with in relation to films that commenced principal photography or production of the animated image before 8 May 2007, as if the amendment had never happened. ***[Schedule 10, Part 4, subitem 92(2)]***

Consequential amendments

10.234 As a consequence of the repeal of Division 10BA of the ITAA 1936, Subdivision 375-G of the ITAA 1997 is also repealed. The effect of Subdivision 375-G is to quarantine losses arising where film deductions (broadly those deductions allowable under Division 10BA) exceed film income. Subdivision 375-G will not be required once deductions are no longer available under Division 10BA. However, a number of the concepts used in Subdivision 375-G are used elsewhere in the tax law.

10.235 There are many consequential amendments as a result of the repeal of Divisions 10B and 10BA of the ITAA 1936, and Division 375 of

the ITAA 1997. ***[Schedule 10, Part 3, items 26 to 62, 64 to 75, 77, 78, 81, 82, 84, 85, and 88 to 90]***

10.236 These concepts are:

- assessable film income;
- exempt film income;
- film component;
- film deductions;
- film loss; and
- net assessable film income.

10.237 These terms are currently defined in subsection 995-1(1) of the ITAA 1997 with references to Subdivision 375-G. These defined terms are amended to remove the references to Subdivision 375-G and replace them with their respective meanings. ***[Schedule 10, Part 3, items 63, 76, 79, 80, 83, 86 and 87, subsection 36-40(3), definitions of 'assessable film income', 'exempt film income', 'film component', 'film deductions', 'film loss' and 'net assessable film income' in subsection 995-1(1) of the ITAA 1997]***

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

Outline of chapter

11.1 Schedule 11 to this Bill amends the *Income Tax Assessment Act 1936* (ITAA 1936) to extend the premium 175 per cent research and development (R&D) tax concession to companies belonging to a multinational enterprise group for additional R&D expenditure on behalf of a grouped foreign company above a rolling three-year average of expenditure. Companies will also receive a specific base deduction for all expenditure that contributes to a company's calculation of additional R&D expenditure in that income year.

Context of amendments

11.2 The ITAA 1936 allows a tax concession for companies that incur expenditure on R&D activities. For a claimant to receive the R&D tax concession that R&D must be undertaken on behalf of the company, not have guaranteed financial returns to the company and be exploited for Australian benefit. These rules currently disqualify Australian companies who conduct R&D on behalf of a foreign company, from claiming the R&D tax concession.

11.3 The R&D tax concession comprises three main elements:

- a base R&D tax concession that provides a higher rate of deduction of 125 per cent for all eligible expenditure on R&D activities;
- a refundable R&D tax offset that provides a cash refund to the value of the deduction for small companies in a tax loss situation; and
- a premium R&D tax concession that provides an additional deduction of 50 per cent to a total deduction for that

expenditure of 175 per cent for all additional expenditure above the average of the three previous years of expenditure.

11.4 On 1 May 2007, the Prime Minister and the Minister for Industry, Tourism and Resources jointly announced that the Government would extend the premium 175 per cent R&D tax concession to multinational subsidiaries that choose to hold resulting intellectual property offshore and are currently unable to claim the R&D tax concession.

11.5 The extension of the premium 175 per cent R&D tax concession is intended to encourage additional R&D expenditure in Australia by multinational enterprise subsidiaries. An immediate 100 per cent deduction for expenditure on eligible R&D activities and an additional 75 per cent immediate tax deduction on expenditure above the average of the previous three years of expenditure on R&D, will be provided.

11.6 The amendments to the provisions for the premium 175 per cent R&D tax concession are intended to have minimal changes to the eligibility or entitlements of current claimants for the premium 175 per cent R&D tax concession under the existing rules if they do not conduct any R&D on behalf of a grouped foreign company. The three main exceptions for companies that conduct only Australian-owned R&D that may affect their entitlement to an additional deduction under the premium 175 per cent R&D tax concession are:

- Clarification of the definition of 'incremental expenditure'.
- The group for the calculation of the premium 175 per cent R&D tax concession will be expanded to include companies who deduct under the new base 100 per cent specific deduction.
- The expenditure counted in the premium 175 per cent R&D tax concession will be reduced by an amount equal to twice the value of grants received.

11.7 This measure was included in the 2007-08 Budget and the Australian Government's *Industry Statement* of 1 May 2007.

Summary of new law

11.8 The extension of the premium 175 per cent R&D tax concession will include amendments to the existing R&D tax concession provisions of the ITAA 1936 to allow for an additional 75 per cent deduction for additional expenditure on foreign-owned R&D activities. A base 100 per cent specific deduction will be allowed for all R&D expenditure contributing to the calculation of the premium 175 per cent R&D tax concession.

11.9 Amendments will also be made to the *Industry Research and Development Act 1986* (IR&D Act) to deliver the policy intent of this measure. These amendments will give the Industry Research and Development Board (IR&D Board) additional functions and powers relating to foreign-owned R&D activities.

11.10 The new law will include some key design features to deliver the policy intent of providing a higher rate of deduction at the rate of 175 per cent for additional R&D expenditure in Australia where the beneficial ownership of the results resides with a foreign company grouped with the eligible company. These are as follows:

- The current definition of 'incremental expenditure' will be amended to specifically exclude expenditure that fails a deductibility test for a base R&D tax concession.
- A new treatment for grants will be applied to both the foreign-owned and Australian-owned components of the premium 175 per cent R&D tax concession. An amount equalling twice the amount of any R&D grant will be removed from the calculation of the premium 175 per cent R&D tax concession. The existing grant clawback for the 125 per cent R&D tax concession will be unchanged.
- Companies will be eligible for the extension of the premium 175 per cent R&D tax concession for expenditure incurred on behalf of a foreign company if at all times the eligible company is in a 'group', as defined by section 73L of the ITAA 1936. A foreign company is a body corporate incorporated under the law of a foreign country and which is a resident of a foreign country for the purposes of a double taxation agreement relating to that country to which Australia is a party.
- To allow for immediate access to the premium R&D tax concession, companies who belong to a group that has had a presence in Australia will be deemed to have made deductions in previous years based upon their expenditure in their first full income year commencing after 30 June 2007 and before 1 July 2008.
- Companies in groups that have not had a presence in Australia prior to the commencement of this measure will have immediate access to the new additional deduction for foreign-owned R&D expenditure component of the premium 175 per cent R&D tax concession with a zero rolling average.
- The calculation of the premium 175 per cent R&D tax concession will pool foreign-owned and Australian-owned R&D expenditure such that increases to one type of

expenditure will be reduced by any decrease to the other type of expenditure.

Comparison of key features of new law and current law

New law	*Current law*
An extended premium R&D tax concession with an accelerated deduction at the rate of 175 per cent will encourage additional R&D activities by subsidiaries of multinational enterprises.	Beneficial ownership provisions in the ITAA 1936 and the IR&D Act currently prevent companies who effectively own and exploit the results of R&D activities offshore from accessing the R&D tax concession.
A specific deduction at the rate of 100 per cent for all foreign-owned expenditure contributing to the calculation of an eligible company's additional 75 per cent deduction.	R&D expenditure which does not satisfy the beneficial ownership provisions may or may not be deductible under other provisions in the income tax law.

Detailed explanation of new law

11.11 The object provision for the R&D tax concession will reflect the intention to encourage companies to conduct additional R&D activities in Australia. Currently, the object provision for the R&D tax concession only explicitly refers to making companies more internationally competitive. ***[Schedule 11, item 1, item 50]***

11.12 Headings will be inserted into the R&D provisions to assist readers with the navigation and understanding of the law.

Australian-centred research and development activities

11.13 The existing definition of 'Australian research and development activities' in subsection 73B(1) of the ITAA 1936 forms the basis of a new definition of 'Australian-centred research and development activities'. This definition restricts the activities that are deductible as foreign-owned R&D to those that are conducted in Australia. This means that any expenditure incurred on activities conducted overseas will not be deductible. ***[Schedule 11, item 2]***

11.14 The base 100 per cent specific deduction will only be allowed for directly related activities if they have a sole or dominant purpose of supporting a core R&D activity conducted in Australia. A core R&D activity is one that meets the criteria of systematic, investigative and experimental. The newly inserted definition of 'Australian-centred research and development activities' provides clarity by only including

directly related activities if they are related to a core activity conducted in Australia as eligible for the deductions for foreign-owned R&D. ***[Schedule 11, item 2]***

Foreign companies based in double tax agreement countries

11.15 Eligibility will be restricted to companies that conduct R&D on behalf of a foreign company that is a body corporate in a country with which Australia has a double tax agreement. The foreign company must be a resident of that foreign country as determined by the double tax agreement. This requirement is important for the effective administration of the concession as the information regarding the beneficial ownership of R&D results by the foreign company can be obtained through the double tax agreement. ***[Schedule 11, item 4]***

On own behalf

11.16 The current law requires that expenditure is incurred on R&D activities carried on by, or on behalf of, an eligible company and not for the purpose of carrying on R&D activities on behalf of any other person. The rule in relation to foreign-owned expenditure is that the expenditure must be incurred by the eligible company for the purpose of carrying on Australian-centred R&D activities, and those activities must be carried on wholly or primarily on behalf of the foreign company. ***[Schedule 11, items 6 and 7]***

Minimum expenditure of $20,000

11.17 The current law allows an exception to the minimum aggregate expenditure threshold of $20,000 for contracted expenditure incurred to a registered research agency. A similar exception for foreign-owned expenditure will not be available. Contracted expenditure is targeted at small Australian companies with constraints on their ability to conduct R&D and as such it is not applicable to multinational enterprises. ***[Schedule 11, item 5]***

Base 100 per cent specific deduction for contributing R&D expenditure

11.18 A company will be eligible for the base 100 per cent specific deduction for foreign-owned R&D if they satisfy all of the following conditions:

- Expenditure must be incurred at a time when the eligible company is grouped with the foreign company (under section 73L). By satisfying this provision it does not necessarily mean the expenditure is incurred in the eligible company's group membership period. This is determined under section 73R of the ITAA 1936. This means that expenditure incurred for the purpose of activities conducted on behalf of a foreign company at a time when the eligible company is not a group member of that foreign company will not be deductible.

- Expenditure must be incurred by the eligible company for the purpose of carrying on Australia-centred R&D activities.
- The activities must be carried on wholly or primarily on behalf of the foreign company.
- The activities must be carried out under a written agreement between the eligible company and the foreign company for the performance of the R&D activities. The agreement must be directly between the eligible company and foreign company and no other parties. The activities themselves can be performed by the eligible company or can be performed by another person under an agreement to which the eligible company is party.
- Expenditure will not be eligible for the base 100 per cent specific deduction if it is incurred by an eligible company (first eligible company) in connection with an agreement between it and another eligible company who is a group member under section 73L of the ITAA 1936 when the expenditure is incurred; and the agreement is for the activities to be performed by the first eligible company or by a third party under a separate agreement between the first eligible company and that third party.
- Expenditure on foreign-owned R&D by the eligible company must be greater than $20,000.
- All Australian-centred R&D activities to which a group incurred expenditure in the income year, regardless of whether they were covered by an R&D plan or not, must be registered by the eligible company and all of its group members with the IR&D Board. Registration for the activity is necessary if the company incurred expenditure in relation to it in the income year. If this is not satisfied the company will be ineligible for the base 100 per cent specific deduction and the additional deduction for all of its foreign-owned R&D expenditure. ***[Schedule 11, item 8]***

11.19 The requirement for a written agreement between the foreign company and the eligible company is based on the existing definition of 'agreement' in the ITAA 1936. The forms of agreement covered are tightened by requiring them to be in a written form. The agreement must also be a direct agreement between the eligible company and the foreign company with no other parties to the agreement, and as such it will not allow for broad agreements between the foreign company and a number of eligible companies. This will identify the one appropriate eligible company which will be entitled to deduct. The definition of 'agreement' for the new concession would include, for example, a written

company policy that all intellectual property resulting from R&D will be directly owned by the foreign company. It would also cover a contract covering the performance of a combination of services including certain R&D activities. The agreement does not need to explicitly provide the funding or include specific information regarding the carrying on of the activities in order to meet this condition. The agreement must, however, require the performance of R&D activities to meet the condition. The type of agreement that exists will also be an indicator that the Australian-centred R&D activities are carried out on behalf of the foreign company, which is a separate condition that the eligible company must satisfy to claim the deduction. ***[Schedule 11, item 8]***

11.20 Foreign-owned R&D expenditure may be incurred under further subcontract agreements with other parties, and still be expenditure incurred directly or indirectly under the agreement between the eligible company and the foreign company. This is not intended to be restricted to agreements explicitly referred to in the primary agreement between the eligible company and the foreign company. This allows the eligible company to select subcontractors without being confined to those companies mentioned under the agreement or being restricted to undertaking the activities itself if no subcontracting was mentioned under that agreement at all. Parties who are contracted by the eligible company will not be separately eligible for the new concession. ***[Schedule 11, item 8]***

11.21 Expenditure on foreign-owned R&D must be in relation to activities carried on wholly or primarily on behalf of a foreign company. As it is a requirement of the 125 per cent R&D tax concession that expenditure is incurred on R&D activities carried on by, or on behalf of, an eligible company and not for the purpose of carrying on R&D activities on behalf of any other person, any expenditure that is deductible under the new base 100 per cent specific deduction will not be eligible for a deduction under the existing 125 per cent R&D tax concession. ***[Schedule 11, item 8]***

11.22 The new law also prevents subcontracted eligible companies from claiming the deduction, as the R&D will be performed under an agreement between the two eligible companies. In this way, two deductions under the new concession for the same expenditure will be prevented. ***[Schedule 11, item 8]***

11.23 Whether activities are carried on wholly or primarily on behalf of the foreign company is determined by reference to the written agreement between the eligible company and that foreign company. This agreement should make it explicit that the R&D to be performed is to be wholly or primarily on behalf of the foreign company. ***[Schedule 11, item 8]***

11.24 The requirement for the registration of all R&D activities by the eligible company and its group members means that if companies conduct R&D on behalf of a foreign company, they must include it in the

calculation of the company's increase in foreign-owned R&D. This prevents groups artificially manipulating their history of R&D expenditure to increase their allowable additional deductions under the premium 175 per cent R&D tax concession in later income years. Registration of R&D activities that do not have an R&D plan is also required in the current income year to ensure that they will be included in the notional expenditure on foreign-owned R&D in section 73RB. ***[Schedule 11, item 8]***

Example 11.1

> Company Alpha is an Australian R&D company. It is conducting a $1 million project on behalf of company Beta that is a body corporate incorporated in the United States of America (US) and is a foreign resident for the purposes of the double taxation agreement between Australia and the US. Company Beta wholly-owns company Alpha and will directly own the intellectual property and exploitation rights of the R&D project under contract. Company Alpha incurs expenditure of $600,000 to an ungrouped and unrelated Australian subcontractor, company Sigma, and also incurs expenditure itself of $400,000. Company Alpha will be able to deduct the full $1 million.
>
> If company Alpha was owned by another US incorporated company, company Omega, when it had incurred expenditure to company Sigma on behalf of company Beta then that $600,000 will not be deductible.
>
> If company Alpha itself incurs a further $400,000 in expenditure in completing the R&D project on behalf of company Beta after being acquired by company Beta and under the company's agreement, this will be deductible under the new base 100 per cent specific deduction for foreign-owned R&D.

11.25 The base 100 per cent specific deduction will apply to all foreign-owned R&D expenditure that contributes to the calculation for the purposes of the additional deduction under the premium 175 per cent R&D tax concession for expenditure on foreign-owned R&D. ***[Schedule 11, item 8]***

11.26 The method for determining a company's deduction at the base 100 per cent level is based on the new definition of 'incremental expenditure'. The company must then exclude expenditure which is not Australian-centred R&D activities. The company should then also exclude expenditure which does not meet the requirements of paragraph (b) of the proposed subsection 73B(14C). Any total group mark-up that is determined under subsection 73B(14AB) of the ITAA 1936 is also excluded from the deduction. Noting that the definition of 'incremental expenditure', where the company commences this method of working out their base 100 per cent specific deduction, should already exclude core technology, interest and feedstock expenditure. ***[Schedule 11, item 8]***

Non-arm's length acquisition or construction

11.27 Subsection 73B(31) of the ITAA 1936 will be extended to cover expenditure that is incurred on behalf of a foreign company and deductible under this measure. ***[Schedule 11, item 9]***

Certificates are binding on the Commissioner

11.28 Where the IR&D Board issues certificates in relation to foreign-owned R&D expenditure this will be binding on the Commissioner of Taxation (Commissioner) when determining a company's assessment. This is consistent with the current law under which certificates issued for the existing R&D tax concession are binding on the Commissioner. ***[Schedule 11, item 10]***

11.29 Certificates will separate R&D activities into foreign-owned and Australian-owned and also indicate if certain activities without an R&D plan would meet the definition of 'research and development activities' if an R&D plan existed for them. This will be binding on the Commissioner in respect of the R&D activities. ***[Schedule 11, item 10]***

Entities joining a consolidated group

11.30 With the new law removing initial clawback amounts from the calculation of incremental expenditure used for the premium 175 per cent R&D tax concession it is necessary in the case of consolidated groups to treat any grants received by joining entities' as having been received by the group. As the joining entity's history of R&D expenditure is assumed by the consolidated group, it is appropriate that initial clawback amounts relating to the joining entity be removed from the calculation of the premium 175 per cent R&D tax concession. ***[Schedule 11, items 12 and 13]***

Guaranteed returns to investors

11.31 Section 73CA of the ITAA 1936 will not apply to foreign-owned incremental expenditure incurred that contributes to the calculation of the premium 175 per cent R&D tax concession and will receive the base 100 per cent specific deduction.

Refundable R&D tax offset

11.32 The refundable R&D tax offset will not be available for deductions for either the base 100 per cent specific deduction or the additional 75 per cent deduction for foreign-owned R&D expenditure. ***[Schedule 11, items 16 to 23]***

Incremental expenditure

11.33 The current law defines 'incremental expenditure' as R&D expenditure excluding plant items. The new law amends the definition to clarify that expenditure must first meet all the deductibility tests under the base R&D tax concession before being counted in the calculations of the eligible company's additional deductions. This applies to both

Australian-owned and foreign-owned R&D expenditure. ***[Schedule 11, item 27]***

11.34 The new definition will operate from 1 July 2007 onwards to incremental expenditure counted in the calculations for both the current premium 175 per cent R&D tax concession and the new 175 per cent concession for foreign-owned R&D. Adjustments to previous income year tax returns will not be required. The R&D expenditure history used by claimants after 1 July 2007 will have to reflect this new definition of incremental expenditure. ***[Schedule 11, item 27]***

R&D spend

11.35 The definition of 'R&D spend' is used as the basis for calculating an eligible company and its group members' adjustment balance in the section 73V of the ITAA 1936. This definition has been amended to encompass the same amounts that are taken into account in the calculations in sections 73RA to 73RE. Initial clawback amounts will reduce the amounts that are taken into account when calculating the adjustment balance. ***[Schedule 11, item 29]***

Eligibility for the premium 175 per cent R&D tax concession

11.36 Eligibility for the additional deduction for the increase in expenditure on Australian-owned R&D in the premium 175 per cent R&D tax concession will be unchanged. Eligibility for the foreign-owned component will not establish eligibility for the Australian-owned R&D component and vice versa. ***[Schedule 11, item 34]***

11.37 Companies will be eligible for the additional deduction for the increase in expenditure on foreign-owned R&D in the premium 175 per cent R&D tax concession if they could deduct, or an eligible group member could deduct, under the base 100 per cent specific deduction in the current claim year and each of the previous three R&D expenditure history years. Transitional arrangements will deem companies to have deducted under the base 100 per cent specific deduction in each of the three income years prior to the particular company's first full income year commencing after 1 July 2007. This does not preclude a company from qualifying with three previous nil expenditure years. ***[Schedule 11, item 34]***

Immediate access with a zero rolling average

11.38 Foreign companies that establish a new presence in Australia after the commencement of this measure will have immediate access to the premium 175 per cent R&D tax concession for the additional expenditure on foreign-owned R&D expenditure with a nil expenditure year for each of the prior three years. Therefore, in the first income year all R&D expenditure will attract an additional deduction under the extended premium 175 per cent R&D tax concession. ***[Schedule 11, item 34]***

11.39 The nil expenditure year will only be available if neither the eligible company nor any grouped eligible companies existed in that year or the 10 preceding years. Also, none of the following carried on business in Australia in the nil expenditure year or the 10 preceding years:

- a foreign company grouped under section 73L with the eligible company at any time during the Y0, Y –1, Y –2, or Y –3[1] years of income;
- a foreign company grouped under section 73L with any section 73R group member of the eligible company; or
- a person who was grouped under section 73L with the relevant foreign company.

[Schedule 11, item 34]

11.40 It is possible for a newly established company to have three nil expenditure years and qualify for the extended premium 175 per cent R&D tax concession on this basis for foreign-owned R&D expenditure. However, if in the next income year the newly established company becomes grouped with an Australian company that did exist in the nil expenditure year, or at some point in the previous 10 years, it will not qualify for the same nil expenditure year. In that subsequent year the company will be ineligible. ***[Schedule 11, item 34]***

Example 11.2

Widget Pty Ltd is incorporated in Australia on 1 July 2007. Widget is wholly-owned up to and including 30 June 2008, by foreign company, Acme Pty Ltd, incorporated on 1 July 2007 in the US. Acme Pty Ltd has no other group members and has not experienced any change in control since incorporation. Widget Pty Ltd conducts Australian-centred R&D activities on Acme Pty Ltd's behalf and has incurred expenditure for the purpose of carrying on those activities during the year ending 30 June 2008 for which it can claim a deduction under subsection 73B(14C) for the 2007-08 income year. On 1 March 2008, Widget Pty Ltd acquires Oz Pty Ltd, a company incorporated in Australia on 1 July 1985. On 1 June 2008, Widget Pty Ltd sells Oz Pty Ltd to an unrelated third party. During the period that it was controlled by Widget Pty Ltd, Oz Pty Ltd incurred expenditure on R&D activities for which it could claim a deduction under subsection 73B(14).

To be eligible for the extra deduction for an increase in expenditure on foreign-owned R&D, Widget Pty Ltd must meet the conditions in subsection 73QB(2) for the purposes of paragraph 73QB(1)(b) in relation to each of the Y –1 (the year before the current claim year),

[1] Y0: the current claim year
Y –1: the year before the claim year
Y –2: the year two years before the claim year
Y –3: the year three years before the claim year

Y –2 (the year two years before the claim year) and Y –3 (the year three years before the claim year) years of income.

Widget Pty Ltd did not itself exist during Y –1 or any earlier years. However, it must consider whether any other group member (under section 73R) existed at any time during Y –1 (or other nil expenditure year) or 10 immediately preceding years. Widget Pty Ltd must determine its group members in accordance with section 73R.

Step 1

As at the last day of the Y0 year of income Acme Pty Ltd is grouped with the eligible company. Therefore Acme Pty Ltd and Widget Pty Ltd are primary group members.

Step 2

Widget Pty Ltd and Acme Pty Ltd both have a group membership period of 1 July 2007 to 30 June 2008.

Step 3

Oz Pty Ltd is grouped with a primary group member during its group membership period (both Widget Pty Ltd and Acme Pty Ltd) and is therefore a secondary group member.

Step 4 and Step 5

Oz Pty Ltd has a group membership period of 1 March 2008 to 30 May 2008. Oz Pty Ltd is a group member of Widget Pty Ltd (under section 73R) because Oz Pty Ltd could deduct an amount under subsection 73B(14). As Oz Pty Ltd existed during each of the Y –1, Y –2 and Y –3 years of income (the nil expenditure years), Widget Pty Ltd will not meet the conditions of paragraph 73QB(2)(a).

11.41 The qualification of carrying on a business is intended to prevent those foreign companies that have not incorporated a company in Australia from receiving an advantage by the mere fact they did not incorporate a company. The nil expenditure years are intended to exclude those companies who did conduct R&D or had held any presence in Australia previously. ***[Schedule 11, item 34]***

11.42 A year in which the eligible company existed at any time, including the year in which the company was incorporated, cannot be a nil expenditure year of the eligible company. This means that the year of incorporation of the eligible company and later years cannot be nil expenditure years. Therefore it will be impossible for companies to have a nil expenditure year in relation to an income year after which they made, or were able to make, a deduction for foreign-owned R&D expenditure. ***[Schedule 11, item 34]***

11.43 In the income year following the establishment of a new presence in Australia the company will have a history of the amount spent in the prior year and two nil expenditure years. Therefore, the rolling three-year average in this income year would be the expenditure in the

prior year *divided* by three. In subsequent years, nil expenditure years will be replaced with the actual expenditure by a company in the previous claim year. ***[Schedule 11, item 34]***

Group membership

11.44 The amendments to subsection 73R(1) maintain the status quo for companies conducting Australian-owned R&D. They are group members under the same circumstances. ***[Schedule 11, item 35]***

11.45 That is, for Australian-owned R&D a company is a group member if it deducted or received a commercial ready grant or start grant in any of the relevant years that are the current claim year and the three prior income years. ***[Schedule 11, item 35]***

11.46 Companies that conduct R&D on behalf of a foreign company under the extended premium R&D tax concession may now be group members for the purposes of calculating the premium R&D tax concession. All companies in the group who incur foreign-owned R&D expenditure must register in order for eligible companies in the group to be eligible to deduct any amount under the base 100 per cent specific deduction. ***[Schedule 11, item 35]***

11.47 The fact that a company is not eligible for an additional deduction because they did not claim any deductions in the current year does not mean the expenditure of that company in its group membership period is not counted in the calculation of the premium 175 per cent R&D tax concession. The expenditure incurred by that company in its group membership period will count in the group calculations even though the company does not qualify for an additional deduction. ***[Schedule 11, items 35 and 37]***

Example 11.3

Company ABC conducts R&D activities. In relation to these activities, company ABC has incurred expenditure in the current year, and each of the three immediately preceding years, that is eligible for a deduction for Australian-owned R&D. The expenditure deductible in each year was incremental expenditure and was incurred during the group membership period of company ABC.

Company ABC is grouped under section 73R with company XYZ. Company XYZ previously conducted Australian-centred R&D activities and incurred expenditure, during its group membership period, on foreign-owned R&D for which it deducted an amount under subsection 73B(14C).

Company ABC has to calculate its entitlement to the extra deduction for an increase in expenditure on Australian-owned R&D. It must include in this calculation the expenditure on foreign-owned R&D incurred by company XYZ during its group membership period.

	Current claim year = Y0	***Y –1***	***Y –2***	***Y –3***
Company ABC	$100	$80	$70	$60
Company XYZ	–	–	$30	–

The group has an increase in expenditure of $30 on Australian-owned R&D. However, the expenditure on foreign-owned R&D incurred by company XYZ must be included in the calculation of the additional deduction for the increase in expenditure on Australian-owned R&D. This is the case even though no group member has incurred expenditure on foreign-owned R&D in the current claim year. The group has a decrease of $10 in expenditure on foreign-owned R&D. Therefore, company ABC will get an extra deduction for an increase in expenditure on Australian-owned R&D at the rate of 50 per cent of $20.

The group will not be eligible for the extra deduction for an increase in expenditure on foreign-owned R&D as no group member satisfied the conditions of section 73QB.

Calculation and distribution of the premium 175 per cent R&D tax concession deduction

11.48 An eligible company must determine its entitlement to an additional deduction under the premium 175 per cent R&D tax concession by using the new method statements. The results of these method statements will form the basis for calculating the eligible company's share of the additional deduction for Australian-owned and foreign-owned R&D. ***[Schedule 11, item 37]***

11.49 A company conducting only Australian-owned R&D in the current year and the previous three years will not have to make the calculations in proposed sections 73RB and 73RD as they relate solely to foreign-owned R&D. The outcomes of these calculations can be taken to be zero where they are used in calculating the adjusted increase in R&D for the group, and calculating the eligible company's share of the Australian-owned part of the adjusted increase in expenditure on R&D, by the group. ***[Schedule 11, item 37]***

11.50 Grants reduce expenditure to the extent that they are attributable to either Australian-owned or foreign-owned incremental expenditure. This implies that if a grant is awarded wholly for a specific R&D project it is apportioned to incremental and non-incremental expenditure in the same proportion as the R&D project's proportion of incremental and non-incremental expenditure. ***[Schedule 11, item 37]***

11.51 This is only prospectively applied to grants received after the commencement of this measure. As a company's R&D expenditure

history is calculated in the current claim year this change will affect the R&D expenditure history of claimants from 1 July 2007 onwards.

11.52 For foreign-owned R&D, R&D that does not have an R&D plan will be included in the history years of the company for the purposes of calculating the increase or decrease in foreign-owned R&D expenditure. This will maintain an incentive for all companies conducting foreign-owned R&D to be covered by an R&D plan. R&D expenditure that contributes to an additional deduction in the claim year must be covered by an R&D plan. ***[Schedule 11, item 37]***

11.53 There will be no incentive for groups to shift ownership of R&D results to manipulate the premium deduction that can be obtained for either Australian-owned or foreign-owned R&D expenditure. Total R&D will be pooled in determining an eligible company's deduction. If a group increased expenditure on Australian-owned R&D by the same amount they decreased foreign-owned R&D there would be no real increase in expenditure and no additional deduction could be obtained under the premium 175 per cent R&D tax concession. ***[Schedule 11, item 37]***

Example 11.4

> Company ABC is an Australian company and is grouped with company XYZ, which is also an Australian company. In this example company ABC and company XYZ are only conducting Australian-owned R&D. Neither company is conducting foreign-owned R&D. The entitlements to the premium 175 per cent R&D tax concession will only be different to the current law if a company receives a grant in an income year starting on or after 1 July 2007.

Section 73RA: Calculating the increases in expenditures on Australian-owned R&D by eligible companies

Subsection 1: Increase in expenditure on Australian-owned R&D by the eligible company

Step 1

The incremental expenditure on Australian-owned R&D by company ABC and company XYZ for years Y0 to Y –3				
	Current claim year = Y0	***Y –1***	***Y –2***	***Y –3***
Company ABC	$100	$35	$85	$75
Company XYZ	$90	$100	$95	$90

Step 2 and Step 3

Company ABC: received a grant for Australian-owned R&D that is attributable to incremental expenditure of $5 in year Y0 (current claim year). Therefore, the R&D expenditure in Y0 is reduced to $90 (100 – (2 × 5)).

Company XYZ: did not receive any grants for Australian-owned R&D that is attributable to incremental expenditure.

Reduced expenditure on Australian-owned R&D by company ABC and company XYZ				
	Current claim year = Y0	***Y –1***	***Y –2***	***Y –3***
Company ABC	$90	$35	$85	$75
Company XYZ	$90	$100	$95	$90

Step 4 and Step 5

Company ABC: Add up the reduced expenditure on Australian-owned R&D for years Y0 to Y –3, which equals 195 ($35 + $85 + $75). Divide by 3 to get $65. This amount is company ABC's rolling three-year average for Australian-owned R&D.

Company XYZ: Add up the reduced expenditure on Australian-owned R&D for years Y0 to Y –3, which equals 285 ($100 + $95 + $90). Divide by 3 to get $95. This amount is company XYZ's rolling three-year average for Australian-owned R&D.

Step 6

Company ABC: Change in expenditure on Australian-owned R&D by the eligible company = $25 (90 – 65)

Company XYZ: Change in expenditure on Australian-owned R&D by the eligible company = –$5 (90 – 95)

Step 7

Company ABC: The increase in expenditure on Australian-owned R&D by the eligible company = $25

Company XYZ: The increase in expenditure on Australian-owned R&D by the eligible company = $0

Subsection 2: Calculating the total increase in expenditure on Australian-owned R&D by the eligible companies in the group

Step 1 and Step 2

Add together the two amounts worked out in step 7 of subsection 1.

Total increase in expenditure on Australian-owned R&D by the eligible companies in the group = $25.

Section 73RB: Calculating the increases in expenditure on foreign-owned R&D by eligible companies

Since neither company ABC nor company XYZ conduct foreign-owned R&D, this section can be treated to be $0.

Section 73RC: Calculating the net increase in expenditure on Australian-owned R&D by the group

Step 1

Take the results of step 6 of subsection 73RA(1) which is $25 for company ABC and –$5 for company XYZ.

Step 2

Add these together to get $20. This is the net increase in expenditure on Australian-owned R&D by the group.

Section 73RD: Calculating the net increase on foreign-owned R&D by the Group

Since neither company ABC nor company XYZ conduct foreign-owned R&D, this section can be treated to be $0.

Section 73RE: Calculating the adjusted increase in expenditure on R&D by the group

Step 1, Step 2 and Step 3

Add together the results of step 6 of subsection 73RA(1) for all companies, which is $20, with the results of subsection 73RB(1), which is $0, to get a total change in R&D expenditure of $20.

Step 4

The adjustment amount required for Y_0 (AA_0) is $9 (refer to section 73T of the ITAA 1936). There is no adjustment amount for Y_{-1} (AA_{-1}) therefore the total adjustment balance equals $9 (refer to section 73V of the ITAA 1936).

Subtract the adjustment balance from the total change in R&D (Step 3) to get the adjusted increase in expenditure on R&D by the group, which equals $11.

Subsection 73QA(3): Calculate each company's additional deductions

The eligible company's share of the Australian-owned part of the adjusted increase in expenditure on R&D by the group can be calculated by:

$$\frac{\begin{array}{c}\text{Increase in}\\\text{expenditure on}\\\text{Australian-owned}\\\text{R\&D by the}\\\text{eligible company}\\\left[\text{ss73RA}(1)\right]\end{array}}{\begin{array}{c}\text{Total increase in}\\\text{expenditure on}\\\text{Australian-owned}\\\text{R\&D by the}\\\text{eligible companies}\\\text{in the group}\\\left[\text{ss73RA}(2)\right]\end{array}} \times \frac{\begin{array}{c}\text{Net increase in}\\\text{expenditure on}\\\text{Australian-owned}\\\text{R\&D by the group}\\(\text{s73RC})\end{array}}{\begin{array}{c}\text{Net increase}\\\text{in expenditure}\\\text{on}\\\text{Australian-owned}\\\text{R\&D}\\\text{by the group}\\(\text{s73RC})\end{array} + \begin{array}{c}\text{Net increase}\\\text{in expenditure}\\\text{on}\\\text{foreign-owned}\\\text{R\&D}\\\text{by the group}\\(\text{s73RD})\end{array}} \times \begin{array}{c}\text{Adjusted}\\\text{increase in}\\\text{expenditure}\\\text{on R\&D}\\\text{by the group}\\(\text{s73RE})\end{array}$$

Company ABC: The deduction for Australian-owned R&D is:

$$\frac{25}{25} \times \frac{20}{20 + 0} \times 11 = 11$$

Therefore, for company ABC, the increase in expenditure on Australian-owned R&D eligible for the extra 50 per cent deduction is $11.

Company XYZ: The deduction for Australian-owned R&D is:

$$\frac{0}{25} \times \frac{20}{20 + 0} \times 11 = 0$$

Therefore, for company XYZ, the increase in expenditure on Australian-owned R&D eligible for the extra 50 per cent deduction is $0.

Example 11.5

Company ABC and company XYZ belong to the same group for the purposes of the proposed subsection 73R(1). In this example, company ABC and company XYZ are conducting both

Australian-owned R&D and foreign-owned R&D. They must work out their entitlements as a group under both the international premium and the 175 per cent premium.

Section 73RA: Calculating the increases in expenditure on Australian-owned R&D by eligible companies

Subsection 1: Increase in expenditure on Australian-owned R&D by the eligible company

Step 1

The incremental expenditure on Australian-owned R&D by company ABC and company XYZ for years Y0 to Y –3				
	Current claim year = Y0	***Y –1***	***Y –2***	***Y –3***
Company ABC	$80	$100	$100	$100
Company XYZ	$100	$60	$120	$90

Step 2 and Step 3

Company ABC and company XYZ did not receive any grants for Australian-owned R&D that is attributable to incremental expenditure. Therefore, the reduced expenditure on Australian-owned R&D is as per the Table in step 1.

Step 4 and Step 5

Company ABC: Add up the reduced expenditure for Y –1, Y –2, and Y –3, which equals 300 ($100 + $100 + $100). Divide by 3 to get $100. This amount is company ABC's rolling three-year average for Australian-owned R&D.

Company XYZ: Add up the reduced expenditure for Y –1, Y –2, and Y –3, which equals 270 ($60 + $120 + $90). Divide by 3 to get $90. This amount is company XYZ's rolling three-year average for Australian-owned R&D.

Step 6

Subtract step 5 from the Y0 reduced expenditure on Australian–owned R&D by the eligible company.

Company ABC: Change in expenditure on Australian-owned R&D by the eligible company = –$20

Company XYZ: Change in expenditure on Australian-owned R&D by the eligible company = $10

Step 7

Company ABC: The increase in expenditure on Australian-owned R&D by the eligible company = $0

Company XYZ: The increase in expenditure on Australian-owned R&D by the eligible company = $10

Subsection 2: Calculating the total increase in expenditure on Australian-owned R&D by the eligible companies in the group

Add together the two amounts worked out in step 7 of subsection 1.

Total increase in expenditure on Australian-owned R&D by the eligible companies in the group = $10

Section 73RB: Calculating the increases in expenditure on foreign-owned R&D by eligible companies

Step 1

Expenditure on foreign-owned R&D				
	Current claim year = Y0	***Y –1***	***Y –2***	***Y –3***
Company ABC	**$100**	$70	$80	$60
Company XYZ	**$100**	$70	$90	$60

Step 2

Company ABC has received a grant for $5 in Y_0 for foreign-owned R&D. This amount is fully attributable to foreign-owned incremental expenditure so it is doubled ($10) and removed from the company's current year amount.

Step 3

Company ABC

	Current claim year = Y0	***Y –1***	***Y –2***	***Y –3***
Foreign-owned R&D	**$100**	$70	$80	$60
Grant for foreign-owned R&D	**$5**	$0	$0	$0
Reduced foreign-owned R&D	**$90**	$70	$80	$60

Company XYZ has not received any grants, so no adjustment to the amounts in step 1 is required.

Step 4

Company ABC had an R&D plan for all activities conducted in each history year. Its notional expenditure on foreign-owned R&D for Y -1, Y –2, and Y –3 is the same as the reduced expenditure on foreign-owned R&D.

Company XYZ had R&D expenditure not covered by an R&D plan equally $10 in each of Y –2 and Y –3. Notional expenditure on foreign-owned R&D is therefore as in the following table.

Company XYZ

	Y –1	**Y –2**	**Y –3**
Notional foreign-owned	$70	$100	$70

Step 5 and Step 6

Neither company received a grant in a previous income year so they do not reduce notional foreign-owned expenditure on R&D.

Step 7 and Step 8

Company ABC: Add up the reduced notional expenditure for Y –1, Y –2, and Y –3 on foreign-owned R&D, which equals $210 ($70 + $80 + $60). Divide by 3 to get $70. This amount is company ABC's rolling three-year average for foreign-owned R&D.

Company XYZ: Add up the reduced notional expenditure Y –1, Y –2, and Y –3 on foreign-owned R&D, which equals $240 ($70 + $100 + $70). Divide by 3 to get $80. This amount is company XYZ's rolling three-year average for foreign-owned R&D.

Step 9

Company ABC: Change in expenditure on foreign-owned R&D by the eligible company = $20

Company XYZ: Change in expenditure on foreign-owned R&D by the eligible company = $20

Step 10

For both companies the change is positive so the increase in expenditure on foreign-owned R&D by each eligible company is the same as the results in step 9.

Subsection 2: Calculating the total increase in expenditure on foreign-owned R&D by the eligible companies in the group

Total increase in expenditure on foreign-owned R&D by the eligible companies in the group = $40.

Section 73RC: Calculating the net increase in expenditure on Australian-owned R&D by the group

Step 1

Take the results of step 6 of subsection 73RA(1), which is –$20 for company ABC and $10 for company XYZ.

Step 2

Add these together to get –$10. As it is negative the net increase in expenditure on Australian-owned R&D by the group equals $0.

Section 73RD: Calculating the net increase on foreign-owned R&D by the group

Step 1

Take the results of step 9 of subsection 73RB(1) which is $20 for company ABC and $20 for company XYZ.

Step 2

The net increase in expenditure on foreign-owned R&D by the group is $40.

Section 73RE: Calculating the adjusted increase in expenditure on R&D by the group

Step 1, Step 2 and Step 3

Add together the results of step 6 of subsection 73RA(1) for all companies which is –$10, with the results of step 9 of subsection 73RB(1) which is $40, to get a total change in R&D expenditure of $30.

Step 4

The adjustment amount required for Y_0 (AA_0) is $20 (refer to section 73T of the ITAA 1936). There is no adjustment amount for Y_{-1} (AA_{-1}) therefore the total adjustment balance equals $20 (refer to section 73V of the ITAA 1936).

Subtract the adjustment balance from the total change in R&D (Step 3) to get the adjusted increase in expenditure on R&D by the group, which equals $10.

Section 73QA: Calculate the extra deduction for increase in expenditure on Australian-owned R&D

The eligible company's share of the Australian-owned part of the adjusted increase in expenditure on R&D by the group can be calculated by:

$$\frac{\text{Increase in expenditure on Australian-owned R\&D by the eligible company } [\text{ss73RA}(1)]}{\text{Total increase in expenditure on Australian-owned R\&D by the eligible companies in the group } [\text{ss73RA}(2)]} \times \frac{\text{Net increase in expenditure on Australian-owned R\&D by the group } (\text{s73RC})}{\text{Net increase in expenditure on Australian-owned R\&D by the group } (\text{s73RC}) + \text{Net increase in expenditure on foreign-owned R\&D by the group } (\text{s73RD})} \times \text{Adjusted increase in expenditure on R\&D by the group } (\text{s73RE})$$

Company ABC: The deduction for Australian-owned R&D is:

$$\frac{0}{10} \times \frac{0}{0 + 40} \times 10 = 0$$

So company ABC gets an additional deduction of 50 per cent for $0 of expenditure.

Company XYZ: The deduction for Australian-owned R&D is:

$$\frac{10}{10} \times \frac{0}{0 + 40} \times 10 = 0$$

So company XYZ gets an additional deduction of 50 per cent for $0 of expenditure.

Section 73QB: Calculate the extra deduction for increase in expenditure on foreign-owned R&D

The eligible company's share of the foreign-owned part of the adjusted increase in expenditure on R&D by the group can be calculated by:

$$\frac{\text{Increase in expenditure on Australian-owned R\&D by the eligible company } [ss73RB(1)]}{\text{Total increase in expenditure on Australian-owned R\&D by the eligible companies in the group } [ss73RB(2)]} \times \frac{\text{Net increase in expenditure on foreign-owned R\&D by the group } (s73RD)}{\text{Net increase in expenditure on Australian-owned R\&D by the group } (s73RC) + \text{Net increase in expenditure on foreign-owned R\&D by the group } (s73RD)} \times \text{Adjusted increase in expenditure on R\&D by the group } (s73RE)$$

Company ABC: The deduction for foreign-owned R&D is:

$$\frac{20}{40} \times \frac{40}{0 + 40} \times 10 = 5$$

So company ABC gets an additional deduction of 75 per cent for $5 of expenditure.

Company XYZ: The deduction for foreign-owned R&D is:

$$\frac{20}{40} \times \frac{40}{0 + 40} \times 10 = 5$$

So company XYZ gets an additional deduction of 75 per cent for $5 of expenditure.

11.54 The distribution of an additional deduction includes a number of different terms determined under sections 73RA to 73RE. If, in calculating the eligible company's share of the Australian-owned part of the adjusted increase in expenditure on R&D by the group in section 73QA, and the corresponding 'foreign-owned research and development' definition in section 73QB, the denominator of the first two terms is zero then the equation will be undefined. In this case, there is no premium deduction to be distributed to companies in the group. ***[Schedule 11, item 37]***

Adjustment amounts and adjustment balance

11.55 The current law deems the adjustment amounts and the relevant adjustment balance to be zero when the company is eligible to claim an additional deduction in Y-1 or Y-2. To reflect the original policy intent of

the adjustment balance and adjustment amounts these provisions will now refer to the eligible company being able to deduct, which will clarify that these amounts are only zero when an additional deduction was received by the eligible company in the relevant income year. ***[Schedule 11, items 39 and 41]***

11.56 The adjustment balance will reduce the total increase in R&D (both Australian-owned and foreign-owned) by the amount of the adjustment balance. The distribution of additional deductions to eligible companies will never total an amount greater than the adjusted increase in total R&D expenditure. In this way, the adjustment balance will have an effect if total R&D expenditure in any history year, or the claim year, is less than 80 per cent of the prior history year. ***[Schedule 11, items 39 and 41]***

Amendments to the *Industry Research and Development Act 1986*

For the benefit of the Australian economy

11.57 The current law describes the benefit to the Australian economy in terms of the exploitation of the R&D activities. In determining this, the IR&D Board is required to consider that profits or gains to residents of Australia accruing directly from the R&D activities are commensurate with the expenditure involved in carrying out the activity in Australia. ***[Schedule 11, item 51]***

11.58 The current law is amended so that the undertaking of R&D activities in Australia meets the criteria of being for the benefit of the Australian economy. Similarly, overseas activities undertaken by an eligible company, for which the IR&D Board has granted a provisional certificate, will be taken to be for the benefit of the Australian economy. ***[Schedule 11, item 51]***

11.59 The certificates currently issued by the IR&D Board in relation to the exploitation of results, or Australian content will now reflect that it is sufficient for R&D activities to be undertaken in Australia, rather than the more stringent requirement that the R&D be exploited for the benefit of Australia, to be for the benefit of the Australian economy. ***[Schedule 11, items 72 and 73]***

Registration

11.60 The current law requires that for an eligible company to claim the R&D tax concession, the company must register annually its R&D activities for each income year, with the IR&D Board. It is intended that this requirement will apply equally to companies undertaking foreign-owned R&D. Accordingly the existing section 39J is amended to include Australian-centred activities undertaken by an eligible Australian company. ***[Schedule 11, item 62]***

11.61 Amendments to the current law will also reflect the information required to register foreign-owned R&D. This includes information required in a registration application, the ability for companies to advance

register and the grounds on which the IR&D Board is entitled to refuse the registration of an eligible company. ***[Schedule 11, item 62]***

Certificates for Australian-centred R&D activities

11.62 The IR&D Board, under the new law, will be able to certify if activities are Australian-centred R&D activities. This certificate may be issued by the IR&D Board to the Commissioner or where it is requested, by the Commissioner from the IR&D Board. If the IR&D Board determines that the activities are not Australian-centred R&D activities it must issue a certificate to the eligible company stating the reasons. ***[Schedule 11, item 72]***

11.63 As part of this certification, the IR&D Board will determine if directly related activities have the dominant purpose of supporting systematic, investigative and experimental R&D activities conducted in Australia. ***[Schedule 11, item 72]***

11.64 Similarly, the IR&D Board will be able to certify if activities are, or were not, Australian-centred R&D activities apart from the existence of an R&D plan. Activities having the character and nature of R&D activities will be included in the calculation of a company's foreign-owned R&D expenditure history even if no R&D plan exists for the activities. ***[Schedule 11, item 72]***

Record-keeping

11.65 For the purpose of performing any of its functions, the IR&D Board has the power under section 39N to require a registered company to provide particular information relating to activities carried on by, or on behalf of, the company. Failure to provide the information to the IR&D Board may result in a notice to the Commissioner resulting in denial of a claim for the R&D tax concession in relation to the activities. ***[Schedule 11, item 66]***

11.66 Given that specific information relating to activities carried out on behalf of an overseas company may not easily be identified by the IR&D Board and may not relate to a registered company, section 39N is to be amended to avoid doubt that where the IR&D Board reasonably requires information it can identify the information by reference to any means it determines. That is, the information might be identified by reference to the particular function of the IR&D Board (eg, assessing an application) or by other criteria (eg, the IR&D Board might ask a company to provide proof, whatever documentary form that proof takes, of its eligibility. ***[Schedule 11, items 66 and 75]***

Application and transitional provisions

11.67 Deductions will apply to expenditure incurred in a company's first full income year commencing after 30 June 2007 and later income years. *[Schedule 11, item 78]*

Transitional provisions for adjustment amounts and adjustment balances

11.68 As the provisions dealing with the adjustment amounts and the adjustment balance are being amended to refer to new provisions, transitional provisions will be in place to deem deductions under the current law to be deductions as if they were made under the new law. This ensures that adjustment amounts and the adjustment balance will continue to give an appropriate outcome for previous income years. *[Schedule 11, item 79]*

Transitional deemed history

11.69 To allow immediate access to the premium 175 per cent R&D tax concession by eligible companies that had a presence in Australia before the commencement of this measure, these companies will be deemed to have deducted an amount in the three years prior to the first income year after the commencement of this measure. This deemed expenditure history is worked out in respect of an eligible company's 100 per cent specific deduction in the first full income year after the commencement of this measure. The 100 per cent specific deduction is the expenditure incurred on foreign-owned R&D prior to the removal of grant expenditure from the calculation of the premium deduction. Therefore, the deemed history as set out in Table 11.1 does not necessarily result in an additional deduction. *[Schedule 11, item 80]*

Table 11.1

Income year before the company's first full income year commencing after 30 June 2007	***Income year that is two years before the company's first full income year commencing after 30 June 2007***	***Income year that is three years before the company's first full income year commencing after 30 June 2007***
The company is treated as having deducted 90 per cent of the eligible expenditure incurred in the first income year prior to any initial clawback amount being applied.	The company is treated as having deducted 80 per cent of the eligible expenditure incurred in the first income year prior to any initial clawback amount being applied.	The company is treated as having deducted 70 per cent of the eligible expenditure incurred in the first income year prior to any initial clawback amount being applied.

Example 11.6

Company Aqua is an established Australian company owned by company Beige (company Beige is a resident of the United Kingdom of Great Britain and Northern Ireland). Company Aqua has conducted R&D on behalf of company Beige since it was established. Company Aqua has an accounting period that commences on 1 July and ends on 30 June.

In the 2007-08 income year, company Aqua was entitled to deduct $100 under new subsection 73B(14C) of the ITAA 1936 for expenditure incurred on foreign-owned R&D. Company Aqua meets the eligibility requirements in paragraph 73QB(1)(a) and so will be treated as having deducted $90, $80 and $70 in the three previous years respectively.

If company Aqua received a grant attributable to foreign-owned incremental expenditure of $5, an amount of twice the size of the grant will be removed from expenditure that can be counted towards the increase in foreign-owned R&D for the company.

Expenditure by company Aqua in 2007-08, after removing the initial clawback amount, is $90. An additional 75 per cent deduction for $10 of expenditure will be available in the 2007-08 income year.

Consequential amendments

11.70 References to amended provisions will be updated in both the IR&D Act and the income tax law. The income tax law references to the premium 175 per cent R&D tax concession will be amended to remove reference to the existing section 73Y and replacing them with sections 73QA and 73QB. References in the IR&D Act will also be updated to reflect the new income tax law provisions. ***[Schedule 11, items 38, 43 to 49, 52 to 55 and 61]***

Chapter 12
Establishment of Innovation Australia

Outline of chapter

12.1 Schedule 12 to this Bill amends the administration and oversight arrangements for the Industry portfolio's innovation and venture capital programmes as prescribed in the *Industry Research and Development Act 1986* (IR&D Act), the *Pooled Development Funds Act 1992* (PDF Act) and the *Venture Capital Act 2002* (VC Act). There are also consequential amendments to the *Income Tax Assessment Act 1936* (ITAA 1936) and the *Income Tax Assessment Act 1997* (ITAA 1997) in relation to the programmes with taxation implications.

12.2 These amendments establish a new board, Innovation Australia, combining the roles, responsibilities and functions of the Industry Research and Development Board (IR&D Board) and the Venture Capital Registration Board (VCR Board).

Context of amendments

12.3 The Government has placed high importance on promoting and encouraging investment in innovation and venture capital to build industry competitiveness. This has been demonstrated through legislative enhancements to the Government's venture capital programmes (which received Royal Assent on 21 June 2007), extension of the Innovation Investment Fund, and a range of announcements in the Government's *Industry Statement* of 1 May 2007, including a significant enhancement to the research and development (R&D) tax concession.

12.4 At present the administrative responsibility for innovation and venture capital programmes is spread between two distinct bodies, the IR&D Board and the VCR Board. While the operation of these Boards has proven to be effective, the Government considers that the administration of both innovation and venture capital programmes can be enhanced and streamlined by combining their roles and the professional expertise of their members into a single body. The establishment of Innovation Australia is the means by which this will be achieved.

Summary of new law

12.5 This measure will establish a new board to be called Innovation Australia to administer and provide advice in relation to the Government's

innovation and venture capital programmes. Innovation Australia will replace and assume the roles, responsibilities and powers of:

- the IR&D Board, which currently has responsibilities prescribed in the IR&D Act, the ITAA 1936 and the ITAA 1997; and
- the VCR Board, which currently has responsibilities prescribed in the PDF Act, the VC Act, the ITAA 1936 and the ITAA 1997.

12.6 Innovation Australia will also carry responsibility for past decisions of the IR&D Board and the VCR Board.

12.7 The amendments establishing Innovation Australia will be prescribed in the IR&D Act. A range of consequential amendments are required to the PDF Act, the VC Act, the *Industrial Research and Development Incentives Act 1976*, the ITAA 1936 and the ITAA 1997.

12.8 The responsibilities of Innovation Australia that were previously carried out by the IR&D Board will remain prescribed in the IR&D Act.

12.9 The responsibilities of Innovation Australia that were previously carried out by the VCR Board will remain prescribed in the PDF Act and the VC Act.

12.10 The membership of Innovation Australia will generally mirror the arrangements of the IR&D Board, particularly in relation to numbers of members and appointment processes. Innovation Australia will comprise a Chairperson, an ex-officio member and 13 other appointees.

Detailed explanation of new law

Part 1 — Main amendments

Definitions

12.11 As Innovation Australia is to be established within the provisions of the IR&D Act, the object of that Act contained in section 3, which currently only refers to R&D and innovation activities, is expanded to also reflect the venture capital activities that Innovation Australia will be responsible for, as prescribed in the PDF Act and the VC Act. ***[Schedule 12, item 1, section 3]***

12.12 A definition of 'Board' is contained in subsection 4(1) of the IR&D Act and used as the short reference to the IR&D Board throughout the IR&D Act. That definition has been redefined to mean Innovation Australia. A similar definition of 'Board' is contained in the PDF Act and it has also been redefined to mean Innovation Australia. ***[Schedule 12, items 1 and 54, the definition of 'Board' in subsection 4(1) of the IR&D Act and the definition of 'Board' in subsection 4(1) of the PDF Act]***

12.13 A definition of a ‘pooled development fund’ is contained in the PDF Act. A definition of ‘pooled development fund’ has been included in the IR&D Act to cater for references to pooled development funds in the amended IR&D Act. ***[Schedule 12, item 7, subsection 4(1)]***

12.14 A new provision is to be included in the IR&D Act relating to the giving of information to Innovation Australia. It determines that information is provided to Innovation Australia if it is provided to Innovation Australia itself, a member of Innovation Australia, a committee, a committee member, a member of staff, or a consultant. A similar provision in the PDF Act is to be repealed. A consequential amendment to the PDF Act is made to recognise the new provision in the IR&D Act. ***[Schedule 12, items 10, 57 and 58, section 4 of the IR&D Act, subsections 4(1) and (5) of the PDF Act)]***

12.15 Consequential amendments to the definitions of ‘appointed member’, ‘give information to the Board’, and ‘produce a document to the Board’ are made in the PDF Act to align with definitions in the IR&D Act. ***[Schedule 12, items 53, 56 and 57, subsection 4(1)]***

12.16 A definition of ‘committee’ has been included in the PDF Act to align with the committee provisions prescribed in section 22 of the IR&D Act as amended. ***[Schedule 12, item 55, subsection 4(1)]***

Administration

12.17 In general, the administration role of Innovation Australia is being modelled on the legislative prescriptions already applying to the IR&D Board in Part II of the IR&D Act. A range of amendments are necessary to some sections of the existing Part II provisions to accommodate the change to Innovation Australia, as the new administering body, and to reflect its responsibilities under the PDF Act and the VC Act.

12.18 Part 2 and Part 9 of the PDF Act, which deal with the establishment, functions, powers and administration of the VCR Board, are to be repealed and amendments included in the IR&D Act to reflect the transfer of relevant matters to Innovation Australia. ***[Schedule 12, item 59, Parts 2 and 9 of the PDF Act]***

12.19 Section 6 of the IR&D Act is the provision that established the IR&D Board — that provision is to be repealed and replaced with a provision to establish Innovation Australia. ***[Schedule 12, item 11, section 6]***

12.20 Section 7 of the IR&D Act will outline the functions of Innovation Australia. The previous responsibilities of the IR&D Board will be retained in this section and amendments have been included to recognise Innovation Australia’s responsibilities in relation to the VC Act and the PDF Act. ***[Schedule 12, item 13, paragraph 7(c) of the IR&D Act]***

12.21 Requirements have been included in section 7 of the IR&D Act that Innovation Australia:

- evaluate and advise the Minister for Industry, Tourism and Resources about the operation of the IR&D Act, the PDF Act, the VC Act, and income tax laws as they operate in relation to those Acts ***[Schedule 12, item 12, paragraph 7(aa) of the IR&D Act]***; and
- provide information obtained under Parts 2 to 4 of the VC Act to the Commissioner of Taxation ***[Schedule 12, item 14, paragraph 7(ca) of the IR&D Act]***,

to reflect requirements previously applying to the VCR Board.

12.22 Section 11 of the IR&D Act will outline the duties of the Chairperson of Innovation Australia. The existing requirement that the Chairperson inquire into applications made, or any other matter that he or she thinks necessary, is to be amended to reflect the widening of responsibilities to cover the PDF Act and VC Act as well as the IR&D Act. ***[Schedule 12, items 17 and 18, subsection 11(1) of the IR&D Act]***

12.23 Under the IR&D Act, a distinction is made between an acting Chairperson and an acting member of the IR&D Board and they are prevented from exercising some responsibilities that would ordinarily be undertaken by the Chairperson or a member, such as granting leave of absence in the case of the acting Chairperson. The PDF Act has no such distinction or restrictions in relation to acting arrangements for the VCR Board. In relation to Innovation Australia, there is also no need for any such distinction or restrictions on the powers of an acting Chairperson or acting member, and appropriate consequential amendments to the IR&D Act are to be made to reflect this. In addition, some related provisions in the IR&D Act have been repealed so that paragraph 33A(1)(e) of the *Acts Interpretation Act 1901* can be relied upon. ***[Schedule 12, items 2, 3, 5, 6, 8, 9, 15, 16, 19, 20, 21, 33 and 43, the definitions of 'acting chairperson', 'acting member', and 'chairperson' in subsection 4(1), paragraphs 4(7)(a) and (b), subsections 11(1), 16(4), 17(8), 18(8), 20(5), 21(7) and (8) and 22A(5) of the IR&D Act]***

Ministerial directions

12.24 Under the existing section 19 of the IR&D Act, the Minister can give direction to the IR&D Board that it exercise an additional function that is related to the object of the IR&D Act. Section 19 will be amended to also allow the Minister to give Innovation Australia directions for functions relating to the objects of the PDF Act and the VC Act. ***[Schedule 12, items 22 and 23, subsection 19(1) of the IR&D Act]***

12.25 A key element of the Government's desire to establish Innovation Australia, combining the expertise of the IR&D Board and the VCR Board, is for the Minister to be able to also formally call on the wealth of experience and knowledge of Innovation Australia members by requiring their advice on innovation and venture capital matters relating to their roles under the IR&D Act, the VC Act and the PDF Act. Section 9

of the PDF Act, which is to be repealed, provided for such a requirement. A provision has been included in these amendments to explicitly give the Minister the power to require such advice of Innovation Australia. To assist readers, this new provision also includes a statement that such a requirement is not a legislative instrument. ***[Schedule 12, item 24, section 19B of the IR&D Act]***

12.26 Section 20 of the IR&D Act gives the Minister the power to give directions to the IR&D Board in relation to the policies and practices to be followed in the performance of its functions, but not in relation to a particular matter. This power is to be retained and some minor amendments have been made to reflect the wider responsibilities of Innovation Australia and some drafting improvements. ***[Schedule 12, items 25 to 27, subsections 20(1) and (4) to (6) of the IR&D Act]***

Delegation

12.27 Amendments are required to section 21 of the IR&D Act dealing with the Innovation Australia's capacity to delegate.

12.28 The existing subsection 21(1) allows the IR&D Board to delegate all its powers to the Chairperson, another IR&D Board member, a committee, or a member of the staff assisting the IR&D Board. With the exception of the matters described in the following paragraphs these delegation powers will be retained and amendments have been included to also allow Innovation Australia to delegate its functions. In relation to any delegation to a member of staff, it would be expected that that staff member would be a senior officer. Provisions of the PDF Act relating to the delegation powers and acts of the VCR Board are to be repealed. ***[Schedule 12, items 28 to 32 and 34, subsections 21(1), (2), (3), (5) and (8), paragraphs 21(3(a) and (b) of the IR&D Act; item 65, sections 72 to 74 of the PDF Act]***

12.29 Under the PDF Act, the VCR Board can delegate some of its powers and responsibilities, but has been prevented from delegating certain prescribed powers, for example, registering limited partnerships as 'venture capital limited partnerships' and revoking such registrations. The VCR Board has had to make such decisions itself.

12.30 With the establishment of Innovation Australia, it is intended that much of the day-to-day decision making will be delegated to committees appointed by the Minister for Industry, Tourism and Resources. Previously, the VCR Board was prevented from delegating certain decisions to a committee. Under these amendments, Innovation Australia will be able to delegate these decisions to a committee only. The remaining delegation restrictions relating to administration of the PDF Act and the VC Act, such as to the Chairperson, a member, or a staff member, will be retained. ***[Schedule 12, item 28, subsections 21(1) and (2) of the IR&D Act]***

Committees

12.31 Section 22 of the IR&D Act gives the Minister the power to appoint committees as necessary for providing advice to the IR&D Board and exercising any powers delegated by the IR&D Board, and the power to appoint up to seven members of a committee, including a Chairperson, under section 21. These powers and other related provisions will be retained in relation to Innovation Australia and consequential amendments have been made to reflect the wider responsibilities under the PDF Act and the VC Act and amendments to section 21 of the IR&D Act. ***[Schedule 12, items 34 to 36 and 38, subsections 22(1), (1A), (2) and (7) of the IR&D Act]***

12.32 An additional provision is to be included in relation to the appointment of committee members. Under the existing IR&D Act provisions a committee member can only be appointed for two consecutive terms and this is to be retained in respect of members. The additional provision will allow a member of a committee of Innovation Australia to be appointed for an additional two terms if that member is to be appointed as the Chairperson of a committee and had not previously been the Chairperson of that committee. ***[Schedule 12, item 37, subsection 22(2BA) of the IR&D Act]***

12.33 Section 22A of the IR&D Act deals with the delegation powers of committees. These will be retained in relation to Innovation Australia with the exception of the delegation restrictions applying in relation to the PDF Act and VC Act as described above. Consequential amendments have been made to section 22A to reflect amendments to sections 21 and 22 of the IR&D Act. ***[Schedule 12, items 28, 39 to 42 and 44, subsections 22A(1), (2), (3) and (6), paragraph 22A(2)(a), subsections 21(1) and (2) of the IR&D Act]***

Annual report

12.34 Innovation Australia will be required to submit an annual report to the Minister for Industry, Tourism and Resources, as have the IR&D and VCR Boards until now. The IR&D Act and the PDF Act contain detailed prescriptions of matters to be included in the annual reports. These same matters will need to be reported by Innovation Australia and amendments to section 46 of the IR&D Act are required to accommodate this. The annual report requirement in the PDF Act is to be repealed. ***[Schedule 12, items 45 to 47, subsections 46(1) and (2), paragraph 46(2)(a) of the IR&D Act; item 65, section 75 of the PDF Act]***

Confidentiality and secrecy

12.35 Section 47 of the IR&D Act prescribes confidentiality requirements in relation to the IR&D Board, committees, staff members and consultants. These will be retained in relation to Innovation Australia. Amendments to these provisions have been made to strengthen the coverage to protected information, as defined, and more clearly define those people subject to the confidentiality requirements. ***[Schedule 12, items 48 to 52, subsections 47(1) to (3) of the IR&D Act]***

12.36 Section 71 of the PDF Act sets out confidentiality requirements of the VCR Board which are specific to the sensitivities of the information dealt with in relation to the PDF Act and the VC Act. These provisions will be retained with some consequential amendments to reflect the other amendments to the IR&D Act and the PDF Act, including the definitions of a 'person to whom the section applies', 'protected document', and 'protected information'. ***[Schedule 12, items 60 to 64, subsection 71(5) of the PDF Act]***

Part 2 — Consequential amendments

12.37 A number of consequential amendments have been made to the ITAA 1936, the ITAA 1997, the *Industrial Research and Development Incentives Act 1976* and the VC Act to replace references to the IR&D Board and the VCR Board with Innovation Australia and reflect the amendments in relation to acting Chairpersons. ***[Schedule 12, items 66 to 71, paragraph 16(4)(m), the definitions of 'Board' in subsections 73B(1), 73BD(12), 73BE(7), 73BK(12) and 73BL(7) of the ITAA 1936; items 72 to 87, sections 43-100 (heading) and 43-100, paragraph 118-425(2)(b), subsections 118-425(2), 118-425(3) (note 3), 118-425(14) (heading), 118-425(14), paragraph 118-427(3)(c), subsections 118-427(3), 118-427(4) (note 3), 118-427(15) (heading), 118-427(15), 995-1(1), the definitions of 'form approved by the Venture Capital Registration Board' and 'Venture Capital Registration Board' in subsection 995-1(1) of the ITAA 1997; items 88 to 90, the definitions of 'acting Chairperson' and 'new Board' in subsection 4(1), subsection 4(1A) of the Industrial Research and Development Incentives Act 1976; items 91 to 278, subsection 1-15(2), subsection 3(1) (note), paragraph 3-5(c), sections 3-15 (heading), 3-15, 3-20, 7-1, paragraph 9-3(4)(a), subsections 9-4(1) to (6), paragraph 9-10(1)(b), subsections 9-10(2) and (3), 11-1(1), paragraph 11-1(2)(l), subsection 11-5(1), section 11-10, subsections 11-15(1) to (4), 13-1(1), paragraph 13-1(1)(d), subsection 13-1(1A), paragraphs 13-1(1A)(c), (d) and (f), subsection 13-1(2), paragraph 13-1(2)(d), subsections 13-1(3) to (5), 13-5(1), (1A), (2), 13-15(1), (3) and (5) to (9), 13-20(1) to (3), section 15-1, paragraph 15-1(h), subsection 15-5(1), sections 15-10, 15-15, subsections 15-17(1) to (4), section 15-20, subsections 17-1(1) and (2), paragraphs 17-1(3)(a) to (c), subsections 17-1(5), 17-3(1) to (4), 17-5(1), paragraphs 17-5(2)(a) and (c), subsections 17-5(3), (4) and (6), section 17-10 (heading), subsections 17-10(1) and (2), paragraph 17-10(2)(a), sections 17-15 and 17-20, subsections 17-25(1) and (2), section 21-1, subsections 21-5(1), (2) and (4) to (6), 21-10(1) to (4), 21-20(1), section 21-25 (heading), subsections 21-25(1) to (3), paragraph 21-25(3)(a), subsections 21-30(1) and (2), Part 4 (heading), Division 25 of Part 4 (heading), sections 25-1 and 25-5 (heading), subsections 25-5(1), (1A) and (2) to (6), sections 25-10 (heading), subsections 25-10(1), (1A) and (2) to (6), section 25-15 (heading), subsections 25-15(1), (1A) and (2) to (6), section 29-1, subsections 29-5(1) and (2), 29-10(1), (2) and (4) to (6), paragraph 29-10(6)(b), subsection 29-10(8), paragraph 29-10(8)(a), subsection 29-15(1), sections 33-1, 33-5 (heading) and 33-5, paragraphs 33-5(a), (c) and (d) of the VC Act]***

Part 3 — Transitional Amendments

12.38 Transitional amendments have been made to ensure that Innovation Australia will assume responsibility for decisions made by the IR&D Board and the PDF Board, including their Chairpersons and

members, and authorisations on their behalf, and other ongoing administrative responsibilities or reporting obligations that lay with the IR&D Board and the PDF Board at the time they cease to operate.
[Schedule 12, item 279 (Interpretation), item 280 (Things done to a former Board before commencement), item 281 (Things done to the Chairperson or acting Chairperson of a former Board before commencement), item 282 (Things done by a former Board before commencement), item 283 (Things done by the Chairperson or acting Chairperson of a former Board before commencement), item 284 (Things done by a member or acting member of a former Board before commencement), item 285 (Things done by a person authorised by a former Board before commencement), item 286 (References to a former Board in Instruments etc.) and item 287 (Committees)]

Index

Schedule 1: Tax preferred entities (asset financing)

Bill reference	*Paragraph number*
Item 1, section 250-5	1.19
Item 1, section 250-10	1.47
Item 1, section 250-15	1.50
Item 1, paragraph 250-15(a)	1.51
Item 1, paragraph 250-15(b)	1.58, 1.110
Item 1, paragraph 250-15(c)	1.68
Item 1, paragraph 250-15(d)	1.79
Item 1, paragraph 250-15(e)	1.80
Item 1, section 250-20	1.111
Item 1, subsection 250-25(1)	1.113
Item 1, subsection 250-25(2)	1.114
Item 1, subsection 250-30(1)	1.115
Item 1, subsection 250-30(2)	1.116
Item 1, subsections 250-35(1) and (2)	1.118
Item 1, subsection 250-35(3)	1.119
Item 1, subsection 250-35(4)	1.121
Item 1, subsection 250-35(5)	1.123
Item 1, subsection 250-35(6)	1.124
Item 1, subsections 250-35(7) and (8)	1.125
Item 1, subsection 250-40(1)	1.128
Item 1, subsection 250-40(2)	1.130
Item 1, subsection 250-40(3)	1.131
Item 1, section 250-45	1.135
Items 1 and 6, subsection 250-50(1) and definition of 'end user' in subsection 995-1(1) in the ITAA 1997	1.24
Item 1, subsection 250-50(2)	1.25
Item 1, subsection 250-50(3)	1.26
Item 1, subsection 250-50(4)	1.28

Bill reference	***Paragraph number***
Items 1 and 22, section 250-55 and definition of 'tax preferred end user' in subsection 995-1(1) in the ITAA 1997	1.42
Item 1, subsection 250-60(1)	1.53
Items 1 and 24, subsection 250-60(1) and definition of 'tax preferred use' in subsection 995-1(1) in the ITAA 1997	1.52
Item 1, subsection 250-60(2)	1.55
Items 1 and 24, subsections 250-60(2) and (3) and definition of 'tax preferred use' in subsection 995-1(1) in the ITAA 1997	1.54
Items 1 and 12, subsection 250-60(4) and the definition of 'member of the tax preferred end user group' in subsection 995-1(1) in the ITAA 1997	1.43
Items 1 and 13, subsection 250-60(4) and the definition of 'member of the tax preferred sector' in subsection 995-1(1) in the ITAA 1997	1.44
Items 1 and 2, subsection 250-65(1) and the definition of 'arrangement period' in subsection 995-1(1) in the ITAA 1997	1.59
Item 1, subsections 250-65(2) and (3)	1.60
Item 1, paragraph 250-65(4)(a)	1.61
Item 1, paragraph 250-65(4)(b)	1.62
Item 1, subsection 250-65(5)	1.63
Item 1, section 250-70	1.65
Item 1, section 250-75	1.22
Item 1, section 250-80	1.38
Items 1, 11 and 18, subsections 250-85(1) to (4), section 250-90 and the definitions of 'guaranteed residual value' and 'provided in relation to a tax preferred use of an asset' in subsection 995-1(1) in the ITAA 1997	1.69
Items 1 and 11, subsection 250-85(3) and the definition of 'guaranteed residual value' in subsection 995-1(1) in the ITAA 1997	1.97
Item 1, subsection 250-85(5)	1.70
Item 1, subsection 250-85(6)	1.72
Item 1, subsection 250-85(7)	1.73
Item 1, subsection 250-85(8)	1.74
Item 1, paragraph 250-85(9)(a)	1.75
Item 1, paragraph 250-85(9)(b)	1.76
Item 1, section 250-95	1.77
Item 1, section 250-100	1.78
Item 1, subsection 250-105(1)	1.132

Bill reference	***Paragraph number***
Item 1, subsection 250-105(2)	1.100, 1.145
Item 1, section 250-110	1.81
Item 1, subsections 250-115(1) and (3)	1.83
Item 1, subsection 250-115(2)	1.85
Item 1, subsections 250-115(4) and (5)	1.86
Item 1, subsection 250-115(6)	1.87
Item 1, subsection 250-120(1)	1.89
Item 1, subsection 250-120(2)	1.90, 1.91
Item 1, section 250-125	1.93
Items 1 and 5, section 250-130 and the definition of 'effectively non-cancellable' in subsection 995-1(1) in the ITAA 1997	1.94
Item 1, subsection 250-135(1)	1.96
Item 1, subsection 250-135(2)	1.98
Item 1, subsections 250-140(1) to (4) and (6)	1.103
Item 1, subsection 250-140(5)	1.104
Item 1, section 250-145	1.139
Item 1, subsection 250-150(1)	1.141
Item 1, subsection 250-150(2)	1.142
Items 1 and 4, subsection 250-150(3) and the definition of 'disallowed capital allowance percentage' in subsection 995-1(1) in the ITAA 1997	1.143
Item 1, subsection 250-150(4)	1.144
Item 1, subsection 250-150(5)	1.147
Item 1, subsection 250-150(6)	1.148
Item 1, subsection 250-155(1)	1.149, 1.164
Item 1, subsection 250-155(2)	1.150
Item 1, subsections 250-155(3) to (5)	1.151, 1.152
Item 1, subsection 250-155(6)	1.153
Items 1 and 3, subsection 250-155(6), paragraph 250-160(1)(c) and the definition of 'cash settlable' in subsection 995-1(1) in the ITAA 1997	1.165
Item 1, subsection 250-155(7)	1.154
Item 1, paragraph 250-155(8)(a)	1.194
Item 1, paragraphs 250-155(8)(a) to (g)	1.155
Item 1, paragraph 250-155(8)(c)	1.197
Item 1, paragraph 250-155(8)(h)	1.156, 1.246

Bill reference	***Paragraph number***
Item 1, subsection 250-155(9)	1.157
Items 1 and 21, subsection 250-160(1) and the definition of 'subject to deemed loan treatment' in subsection 995-1(1) in the ITAA 1997	1.158
Item 1, subsection 250-160(2)	1.160
Items 1 and 21, subsection 250-160(2) and the definition of 'subject to deemed loan treatment' in subsection 995-1(1) in the ITAA 1997	1.159
Item 1, subsection 250-160(3)	1.161, 1.162
Item 1, subsection 250-160(4)	1.163
Item 1, subsection 250-165(1)	1.166
Items 1 and 10, subsection 250-165(1) and the definition of 'financial arrangement' in subsection 995-1(1) in the ITAA 1997	1.167
Item 1, subsection 250-165(2)	1.168
Items 1 and 10, subsection 250-170(1) and the definition of 'financial arrangement' in subsection 995-1(1) in the ITAA 1997	1.169
Item 1, subsection 250-170(2)	1.170
Items 1 and 10, subsection 250-170(2) and the definition of 'financial arrangement' in subsection 995-1(1) in the ITAA 1997	1.171
Item 1, subsections 250-175(1) to (3)	1.172
Item 1, subsection 250-175(4)	1.173
Items 1 and 7, subsections 250-180(1) and (2) and the definition of 'end value' in subsection 995-1(1) in the ITAA 1997	1.174
Items 1 and 7, subsections 250-180(1), (3) and (4) and the definition of 'end value' in subsection 995-1(1) in the ITAA 1997	1.175
Items 1 and 7, subsections 250-180(1) and (5) and the definition of 'end value' in subsection 995-1(1) in the ITAA 1997	1.176
Items 1 and 7, subsections 250-180(1) and (6) and the definition of 'end value' in subsection 995-1(1) in the ITAA 1997	1.177
Item 1, section 250-185	1.179
Item 1, section 250-190	1.181
Item 1, section 250-195	1.182
Item 1, section 250-200	1.183
Item 1, subsection 250-205(1)	1.184
Item 1, subsection 250-205(2)	1.185
Item 1, section 250-210	1.186, 1.187
Item 1, section 250-215	1.189, 1.190
Item 1, section 250-220	1.191
Item 1, section 250-225	1.192
Item 1, section 250-230	1.193

Bill reference	***Paragraph number***
Item 1, section 250-235	1.195
Item 1, section 250-240	1.196
Item 1, subsections 250-245(1) to (3)	1.199
Item 1, subsection 250-245(4)	1.200
Item 1, subsection 250-250(1)	1.204
Item 1, subsection 250-250(2)	1.205
Item 1, subsection 250-250(3)	1.206
Item 1, subsection 250-255(1)	1.208, 1.209
Item 1, subsection 250-255(2)	1.210
Item 1, subsection 250-255(3)	1.213
Item 1, subsection 250-255(4)	1.214
Item 1, subsection 250-255(5)	1.215
Item 1, subsection 250-255(6)	1.219
Item 1, subsection 250-255(7)	1.220
Item 1, paragraphs 250-255(7)(a) and (d)	1.222
Item 1, paragraphs 250-255(7)(b) and (c)	1.223
Item 1, subsection 250-260(1)	1.225, 1.226
Item 1, subsection 250-260(2)	1.228
Item 1, subsection 250-260(3)	1.229
Item 1, subsection 250-265(1)	1.233
Item 1, subsection 250-265(2)	1.234
Item 1, section 250-270	1.235
Item 1, subsection 250-275(1)	1.239
Item 1, subsection 250-275(2)	1.241
Item 1, subsection 250-275(3)	1.242
Item 1, subsection 250-275(4)	1.243
Item 1, subsection 250-275(5)	1.244
Item 1, subsection 250-275(6)	1.245
Item 1, subsection 250-280(1)	1.247
Item 1, subsection 250-280(2)	1.248
Item 1, subsection 250-280(3)	1.249
Item 1, subsection 250-280(4)	1.250
Item 1, subsection 250-280(5)	1.252
Item 1, subsection 250-280(6)	1.253
Item 1, subsection 250-280(7)	1.254

Bill reference	***Paragraph number***
Item 1, subsection 250-285(1)	1.256, 1.257
Item 1, subsections 250-285(2) and (3)	1.258, 1.261
Item 1, subsections 250-285(2) and (6)	1.259
Item 1, subsections 250-285(3) and (6)	1.260, 1.262
Item 1, subsections 250-285(4) and (6)	1.263
Item 1, subsection 250-290(1)	1.264
Item 1, subsection 250-290(2)	1.265
Item 1, subsections 250-295(1) and (3)	1.266
Item 1, subsections 250-295(2) and (3)	1.267
Items 8, 16 and 23, definitions of 'excluded STB', 'prescribed excluded STB' and 'tax preferred entity' in subsection 995-1(1) in the ITAA 1997	1.41
Item 14 and the definition of 'money equivalent' in subsection 995-1(1) in the ITAA 1997	1.46
Item 20, definition of 'special accrual amount' in subsection 995-1(1) in the ITAA 1997	1.314
Items 25 and 26, subparagraphs 93R(b)(v) and (c)(ii) of the *Development Allowance Authority Act 1992*	1.291
Items 27 and 28, subsections 51AD(1A) to (1D) and (4) of the ITAA 1936	1.293
Items 29 to 31, subsections 73B(15AA) and 73BC(2) of the ITAA 1936	1.296
Item 32, section 82KZLA of the ITAA 1936	1.297
Items 33 and 34, subsections 159GH(1A), (1B) and (1) of the ITAA 1936	1.299
Item 35, subsection 170(10AA) of the ITAA 1936	1.301
Items 36 to 42, sections 11-55 and 12-5	1.302
Items 43 and 44, subsections 40-25(7) and (8)	1.303
Items 45 to 56, sections 40-85, 40-525, 40-630, 40-730, 40-735, 40-750, 40-755, 40-835 and 40-880	1.304
Items 57 and 58, subsection 43-140(1)	1.305
Item 59, section 112-97	1.306
Item 60, section 118-27	1.307
Items 61 and 62, subsection 396-75(2) and paragraph 396-85(1)(c)	1.309
Items 63 and 64, subsections 705-25(4A) and 705-30(3A)	1.311
Item 65, section 960-265	1.316
Items 66 and 67, paragraphs 974-130(4)(a) and (d)	1.318
Items 68 to 70, sections 45-5, 45-120 and 45-330 of the TAA 1953	1.319

Bill reference	*Paragraph number*
Subitem 71(1)	1.268
Subitem 71(2)	1.271
Subitem 71(3)	1.272
Subitem 71(4)	1.273
Subitem 71(5)	1.276
Subitems 71(6) and (10)	1.280
Subitem 71 (7)	1.281
Subitems 71 (8) and (10)	1.283
Subitem 71(9)	1.278, 1.282
Subitem 71 (11)	1.285
Subitem 71 (12)	1.288

Schedule 2: Thin capitalisation: excluded equity interests

Bill reference	*Paragraph number*
Item 1, definition of 'excluded equity interest' in subsection 820-946(2A)	2.10
Item 2	2.11

Schedule 3: Thin capitalisation: groups containing certain ADIs

Bill reference	*Paragraph number*
Item 1, subsection 820-585(3)	3.31
Item 2, subsections 820-588(1) and (2)	3.20
Item 2, subsection 820-588(1), notes 1 and 2	3.21
Item 2, subsection 820-588(3)	3.22
Item 2, subsection 820-588(4)	3.23
Item 3	3.38
Item 4	3.37
Item 5, section 820-610	3.35
Item 5, subsection 820-610(4)	3.36
Items 6 to 10	3.39
Item 11	3.40

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

Bill reference	*Paragraph number*
Item 1	4.34
Items 2 and 3, subparagraphs 126-5(1)(f)(ii) and 126-15(1)(f)(ii)	4.32
Items 4 and 5, paragraphs 126-140(1)(c) and (2)(b)	4.26
Item 6, paragraphs 126-140(2A)(a), (b) and (g)	4.23, 4.25
Item 6, paragraph 126-140(2A)(c)	4.9
Item 6, paragraphs 126-140(2A)(d) and (2B)(a) to (e)	4.13
Item 6, paragraphs 126-140(2A)(e) and (f)	4.20
Item 6, paragraph 126-140(2A)(h) and subsection 126-140(2C)	4.16
Item 6, subsection 126-140(2D)	4.17

Schedule 5: Prime Minister's Prizes

Bill reference	*Paragraph number*
Item 2, section 51-60	5.6
Item 3	5.7

Schedule 6: Removal of the same business test cap

Bill reference	*Paragraph number*
Items 1 and 2, sections 165-212A, 165-212B, 165-212C and 716-805	6.7
Items 3 to 67, sections 165-5, 165-10, 165-13, 165-15, 165-23, 165-30, 165-35, 165-40, 165-45, 165-93, 165-99, 165-115, 165-115B, 165-115BA, 165-117, 165-120, 165-126, 165-129, 165-132, 165-210, 166-5, 166-20, 166-40, 175-5, 175-40, 175-80, 701-30, 707-120, 707-125, 707-135, 707-210, 715-15, 715-50, 715-55, 715-60, 715-70, 715-95, 715-355, 715-360, 716-850, 719-260, 719-285 and the definition of 'total income' in subsection 995-1(1) in the ITAA 1997	6.9
Item 68	6.10

Schedule 7: Statutory licences

Bill reference	***Paragraph number***
Item 2, paragraph 124-140(1)(a)	7.7, 7.13
Item 2, subsections 124-140(1A) and (1B)	7.28
Item 2, paragraph 124-140(1)(b)	7.9
Item 2, paragraph 124-140(1)(c)	7.10
Item 3, section 124-145	7.15
Item 3, subsection 124-150(1)	7.24
Item 3, subsections 124-150(2) to (4)	7.25
Item 3, subsection 124-150(4)	7.26
Item 3, section 124-155	7.16, 7.18
Item 3, section 124-160	7.20
Item 3, subsections 124-165(1) and (2)	7.22
Item 3, subsection 124-165(3)	7.23
Item 4, sections 124-140, 124-141 and 124-142 of the *Income Tax (Transitional Provisions) Act 1997*	7.32
Item 4, paragraphs 124-140(2)(b) and (3)(b), 124-141(1)(b) and subsection 124-141(2) of the *Income Tax (Transitional Provisions) Act 1997*	7.35
Item 4, subsections 124-141(1), (3) and 124-142(2) of the *Income Tax (Transitional Provisions) Act 1997*	7.33
Item 4, section 124-142 of the *Income Tax (Transitional Provisions) Act 1997*	7.34
Items 5, 6 and 8 to 12	7.36
Item 7, subsection 116-30(3AA)	7.27
Item 13	7.37

Schedule 8: Australian property trusts and stapled securities

Bill reference	***Paragraph number***
Item 1, subsection 102F(4) of the ITAA 1936	8.68
Item 3, subsection 102N(2) of the ITAA 1936	8.64, 8.65
Item 4, section 102NA of the ITAA 1936	8.59, 8.60
Item 5, subsection 102P(10) of the ITAA 1936	8.66
Item 6, subsection 124-1045(1)	8.21, 8.24
Item 6, paragraphs 124-1045(1)(b) and (c)	8.25

Bill reference	***Paragraph number***
Item 6, subparagraphs 124-1045(1)(d)(i) and (ii)	8.28
Item 6, subparagraphs 124-1045(1)(e)(i) and (ii)	8.30
Item 6, subsection 124-1045(2)	8.23
Item 6, subsection 124-1045(3)	8.31
Item 6, subsection 124-1050(1), paragraph 124-1045(1)(f)	8.32
Item 6, subsection 124-1050(2)	8.35
Item 6, subsection 124-1050(3)	8.36, 8.37
Item 6, subsection 124-1050(4)	8.38
Item 6, subsections 124-1055(1), (2)	8.40
Item 6, subsection 124-1055(3)	8.42
Item 6, subsection 124-1055(4)	8.44
Item 6, subsection 124-1055(5)	8.45
Item 6, subsections 124-1060(1) to (3)	8.46
Item 6, subsection 124-1060(4)	8.47
Item 6, subsection 124-1060(5)	8.48
Item 6, subsection 124-1065(1)	8.54
Item 6, subparagraph 124-1065(1)(f)(ii)	8.56
Item 6, subsection 124-1065(2)	8.52
Item 6, Subdivision 124-Q of the ITAA 1997	8.61
Items 7 to 11	8.71
Item 12	8.72

Schedule 9: Deductible gift recipients

Bill reference	***Paragraph number***
Items 1, 4 to 6	9.5
Items 1 and 6	9.7, 9.10
Item 2	9.8, 9.9
Items 4 to 5	9.6

Schedule 10: Streamlining concessions for Australian films and Australian film production

Bill reference	*Paragraph number*
Item 1, Subdivision 376-A	10.10
Item 1, subsection 376-10(1)	10.151
Item 1, subsection 376-10(2)	10.154
Item 1, section 376-15	10.148
Item 1, paragraph 376-20(2)(b)	10.157
Item 1, paragraph 376-20(2)(c)	10.159
Item 1, paragraph 376-20(3)(a)	10.163
Item 1, subparagraph 376-20(3)(b)(i)	10.160
Item 1, subparagraph 376-20(3)(b)(ii)	10.161
Item 1, paragraph 376-20(3)(c)	10.162
Item 1, subsection 376-20(4)	10.165
Item 1, subsection 376-20(5)	10.155
Item 1, section 376-25	10.167, 10.168
Item 1, subsection 376-35(1)	10.199
Item 1, paragraph 376-35(2)(a)	10.209
Item 1, paragraph 376-35(2)(b)	10.210
Item 1, paragraph 376-35(2)(c)	10.211
Item 1, subsection 376-35(3)	10.200
Item 1, section 376-40	10.197
Item 1, paragraph 376-45(2)(b)	10.201
Item 1, subsection 376-45(5)	10.215
Item 1, paragraph 376-45(5)(a)	10.203
Item 1, paragraph 376-45(5)(b)	10.202
Item 1, section 376-50	10.214
Item 1, subsection 376-55(1) of the ITAA 1997	10.12
Item 1, subsection 376-55(1) of the ITAA 1997	10.19
Item 1, reference at the end of subsection 376-55(1) to paragraph (c)	10.25
Item 1, subsection 376-55(2), definition of 'completed' in subsection 995-1(1) of the ITAA 1997	10.13
Item 1, subparagraph 376-55(2)(b)(i)	10.38
Item 1, subsection 376-55(3), definition of 'film authority' in subsection 995-1(1) of the ITAA 1997	10.15

Bill reference	***Paragraph number***
Item 1, subsection 376-55(4) of the ITAA 1997	10.16
Item 1, subsection 376-55(5), definition of 'development assistance' in subsection 995-1(1) of the ITAA 1997	10.18
Item 1, section 376-60	10.23
Item 1, subsection 376-65(1)	10.124, 10.136
Item 1, paragraphs 376-65(1)(a), (2)(c) and (2)(d), subsection 376-65(6)	10.134
Item 1, paragraph 376-65(2)(b)	10.129
Item 1, paragraph 376-65(2)(c)	10.27
Item 1, paragraph 376-65(2)(d)	10.29
Item 1, subsection 376-65(3)	10.31
Item 1, paragraph 376-65(3)(d)	10.34
Item 1, subsection 376-65(4)	10.35, 10.36
Item 1, paragraph 376-65(4)(a)	10.37
Item 1, paragraph 376-65(5)(a)	10.38
Item 1, subsection 376-65(6)	10.60
Item 1, subsection 376-65(7)	10.52
Item 1, subsection 376-70(1)	10.125
Item 1, subsection 376-70(2)	10.42, 10.48
Item 1, section 376-75	10.136
Item 1, subsection 376-125(1), definition of 'production expenditure' in subsection 995-1(1) of the ITAA 1997	10.63
Item 1, subsection 376-125(2), definition of 'make' in relation to film in subsection 995-1(1) of the ITAA 1997	10.64
Item 1, subsection 376-125(3)	10.65
Item 1, subsection 376-125(4), item 7, definition of 'make' in relation to film in subsection 995-1(1) of the ITAA 1997	10.66
Item 1, subsection 376-125(5)	10.68
Item 1, section 376-130	10.70
Item 1, section 376-135, item 1 in the table	10.75
Item 1, section 376-135, item 2 in the table	10.78
Item 1, section 376-135, item 3 in the table	10.80
Item 1, section 376-135, item 4 in the table	10.81
Item 1, section 376-135, item 5 in the table	10.82
Item 1, section 376-135, items 6 and 7 in the table	10.83
Item 1, section 376-135, item 8 in the table	10.84

Bill reference	***Paragraph number***
Item 1, section 376-135, item 9 in the table	10.85
Item 1, section 376-135, item 10 in the table	10.86
Item 1, section 376-135, item 11 in the table	10.87
Item 1, section 376-140	10.169
Item 1, section 376-145	10.88
Item 1, subsection 376-150(1)	10.89
Item 1, subsection 376-150(1), item 1 in the table	10.90
Item 1, subsection 376-150(1), item 3 in the table	10.93
Item 1, subsection 376-150(1), item 5 in the table	10.96
Item 1, subsection 376-150(2)	10.91
Item 1, section 376-155	10.97 to 10.99
Item 1, paragraph 376-155(b)	10.213
Item 1, section 376-160	10.100
Item 1, subsection 376-165(1), item 1 in the table	10.172
Item 1, subsection 376-165(1), item 2 in the table	10.173
Item 1, subsection 376-165(1), item 3 in the table	10.175
Item 1, subsection 376-170(1)	10.61
Item 1, subsection 376-170(2), item 1 in the table	10.101
Item 1, subsection 376-170(2), item 2 in the table	10.103, 10.104
Item 1, subsection 376-170(2), item 3 in the table	10.105
Item 1, subsection 376-170(2), item 4 in the table	10.106
Item 1, subsection 376-170(3)	10.102
Item 1, paragraph 376-170(4)(a)	10.107
Item 1, paragraph 376-170(4)(b)	10.108, 10.109
Item 1, paragraph 376-170(4)(c)	10.40, 10.47
Item 1, subsection 376-170(5)	10.41, 10.46
Item 1, subsection 376-170(6)	10.110
Item 1, section 376-175	10.113
Item 1, subsection 376-180(1)	10.115
Item 1, subsection 376-180(2)	10.116
Item 1, subsection 376-230(3)	10.123
Item 1, subsection 376-235(2)	10.140
Item 1, subsection 376-240(1)	10.137
Item 1, subsection 376-245(3)	10.138
Item 1, subsection 376-245(4)	10.139

Bill reference	*Paragraph number*
Item 1, section 376-250	10.142
Item 1, section 376-255	10.141, 10.188
Item 1, subsection 376-265(1)	10.146
Item 1, subsection 376-265(2)	10.145
Item 1, section 376-270	10.143, 10.144
Item 1, section 376-270, subsections 376-245(3) to (5)	10.135
Item 1, paragraphs 376-20(2)(a) and 376-45(2)(a)	10.178
Item 1, paragraphs 376-20(2)(b) and 376-45(2)(b)	10.179
Item 1, sections 376-30 and 376-50	10.180
Item 1, subsection 376-245(5)	10.181
Item 1, section 376-240	10.183
Item 1, paragraph 376-245(1)(a)	10.184
Item 1, paragraph 376-245(1)(b)	10.185
Item 1, subsection 376-250(1)	10.186, 10.187
Item 1, subsection 376-250(3)	10.189
Item 1, subsection 376-260(1)	10.193
Item 1, subsection 376-260(2)	10.195
Item 1, subsection 376-260(3)	10.194
Item 1, section 376-270	10.190, 10.191
Item 1, definition of ‘total film expenditure’ in subsection 995-1(1) of the ITAA 1997	10.110
Item 1, definition of ‘qualifying Australian production expenditure’ in subsection 995-1(1) of the ITAA 1997	10.88
Part 2, item 2	10.220, 10.221
Part 2, item 3	10.222
Part 2, item 5	10.223
Part 2, item 6	10.224
Part 2, items 7 to 9, and 11 to 15, section 67-10 of the ITAA 1997	10.225
Part 2, item 10, subsection 40-45(6) of the ITAA 1997	10.227
Item 16, subsection 960-50(6), item 9B in the table	10.118
Item 21, definition of ‘post, digital and visual effects production’ in subsection 995-1(1)	10.207
Part 3, items 26 to 62, 64 to 75, 77, 78, 81, 82, 84, 85, and 88 to 90	10.235
Part 3, items 63, 76, 79, 80, 83, 86 and 87, subsection 36-40(3), definitions of ‘assessable film income’, ‘exempt film income’, ‘film component’, ‘film deductions’, ‘film loss’ and ‘net assessable film income’ in subsection 995-1(1) of the ITAA 1997	10.237

Bill reference	*Paragraph number*
Part 4, subitem 91(1)	10.149, 10.228, 10.150, 10.232
Part 4, subitem 91(2)	10.198, 10.229
Part 4, subitem 91(3)	10.230
Part 4, subitem 92(2)	10.233

Schedule 11: Research and development

Bill reference	*Paragraph number*
Item 1	11.11
Item 2	11.13, 11.14
Item 4	11.15
Item 5	11.17
Items 6 and 7	11.16
Item 8	11.18, 11.21 to 11.26
Item 9	11.27
Item 10	11.28, 11.29
Items 12 and 13	11.30
Items 16 to 23	11.32
Item 27	11.33, 11.34
Item 29	11.35
Item 34	11.36 to 11.39
Item 35	11.44 to 11.47
Item 37	11.47 to 11.50, 11.52 to 11.54
Item 38	11.70
Items 39 and 41	11.55, 11.56
Items 43 to 49	11.70
Item 50	11.11
Item 51	11.57, 11.58
Items 52 to 55 and 61	11.70
Item 62	11.60, 11.61
Item 66	11.65, 11.66
Item 72	11.59, 11.62 to 11.64
Item 73	11.59

Bill reference	*Paragraph number*
Item 75	11.66
Item 78	11.67
Item 79	11.68
Item 80	11.69

Schedule 12: Innovation Australia

Bill reference	*Paragraph number*
Item 1, section 3	12.11
Items 1 and 54, the definition of 'Board' in subsection 4(1) of the IR&D Act and the definition of 'Board' in subsection 4(1) of the PDF Act	12.12
Items 2, 3, 5, 6, 8, 9, 15, 16, 19, 20, 21, 33 and 43, the definitions of 'acting chairperson', 'acting member', and 'chairperson' in subsection 4(1), paragraphs 4(7)(a) and (b), subsections 11(1), 16(4), 17(8), 18(8), 20(5), 21(7) and (8) and 22A(5) of the IR&D Act	12.23
Item 7, subsection 4(1)	12.13
Items 10, 57 and 58, section 4 of the IR&D Act, subsections 4(1) and (5) of the PDF Act	12.14
Item 11, section 6	12.19
Item 12, paragraph 7(aa) of the IR&D Act	12.21
Item 13, paragraph 7(c) of the IR&D Act	12.20
Item 14, paragraph 7(ca) of the IR&D Act	12.21
Items 17 and 18, subsection 11(1) of the IR&D Act	12.22
Items 22 and 23, subsection 19(1) of the IR&D Act	12.24
Item 24, section 19B of the IR&D Act	12.25
Items 25, 26 and 27, subsections 20(1) and (4) to (6) of the IR&D Act	12.26
Item 28, subsections 21(1) and (2) of the IR&D Act	12.30
Items 28 to 32 and 34, subsections 21(1), (2), (3), (5) and (8), paragraphs 21(3(a) and (b) of the IR&D Act; item 65, sections 72 to 74 of the PDF Act	12.28
Items 28, 39 to 42 and 44, subsections 22A(1), (2), (3) and (6), paragraph 22A(2)(a), subsections 21(1) and (2) of the IR&D Act	12.33
Items 34 to 36 and 38, subsections 22(1), (1A), (2) and (7) of the IR&D Act	12.31
Item 37, subsection 22(2BA) of the IR&D Act	12.32

Bill reference	*Paragraph number*
Items 45 to 47, subsections 46(1) and (2), paragraph 46(2)(a) of the IR&D Act; item 65, section 75 of the PDF Act	12.34
Items 48 to 52, subsections 47(1) to (3) of the IR&D Act	12.35
Items 53, 56 and 57, subsection 4(1)	12.15
Item 55, subsection 4(1)	12.16
Item 59, Parts 2 and 9 of the PDF Act	12.18
Items 60 to 64, subsection 71(5) of the PDF Act	12.36
Items 66 to 71, paragraph 16(4)(m), the definitions of 'Board' in subsections 73B(1), 73BD(12), 73BE(7), 73BK(12) and 73BL(7) of the ITAA 1936; items 72 to 87, sections 43-100 (heading) and 43-100, paragraph 118-425(2)(b), subsections 118-425(2), 118-425(3) (note 3), 118-425(14) (heading), 118-425(14), paragraph 118-427(3)(c), subsections 118-427(3), 118-427(4) (note 3), 118-427(15) (heading), 118-427(15), 995-1(1), the definitions of 'form approved by the Venture Capital Registration Board' and 'Venture Capital Registration Board' in subsection 995-1(1) of the ITAA 1997; items 88 to 90, the definitions of 'acting Chairperson' and 'new Board' in subsection 4(1), subsection 4(1A) of the *Industrial Research and Development Incentives Act 1976*; items 91 to 278, subsection 1-15(2), subsection 3(1) (note), paragraph 3-5(c), sections 3-15 (heading), 3-15, 3-20, 7-1, paragraph 9-3(4)(a), subsections 9-4(1) to (6), paragraph 9-10(1)(b), subsections 9-10(2) and (3), 11-1(1), paragraph 11-1(2)(l), subsection 11-5(1), section 11-10, subsections 11-15(1) to (4), 13-1(1), paragraph 13-1(1)(d), subsection 13-1(1A), paragraphs 13-1(1A)(c), (d) and (f), subsection 13-1(2), paragraph 13-1(2)(d), subsections 13-1(3) to (5), 13-5(1), (1A), (2), 13-15(1), (3) and (5) to (9), 13-20(1) to (3), section 15-1, paragraph 15-1(h), subsection 15-5(1), sections 15-10, 15-15, subsections 15-17(1) to (4), section 15-20, subsections 17-1(1) and (2), paragraphs 17-1(3)(a) to (c), subsections 17-1(5), 17-3(1) to (4), 17-5(1), paragraphs 17-5(2)(a) and (c), subsections 17-5(3), (4) and (6), section 17-10 (heading), subsections 17-10(1) and (2), paragraph 17-10(2)(a), sections 17-15 and 17-20, subsections 17-25(1) and (2), section 21-1, subsections 21-5(1), (2) and (4) to (6), 21-10(1) to (4), 21-20(1), section 21-25 (heading), subsections 21-25(1) to (3), paragraph 21-25(3)(a), subsections 21-30(1) and (2), Part 4 (heading), Division 25 of Part 4 (heading), sections 25-1 and 25-5 (heading), subsections 25-5(1), (1A) and (2) to (6), sections 25-10 (heading), subsections 25-10(1), (1A) and (2) to (6), section 25-15 (heading), subsections 25-15(1), (1A) and (2) to (6), section 29-1, subsections 29-5(1) and (2), 29-10(1), (2) and (4) to (6), paragraph 29-10(6)(b), subsection 29-10(8), paragraph 29-10(8)(a), subsection 29-15(1), sections 33-1, 33-5 (heading) and 33-5, paragraphs 33-5(a), (c) and (d) of the VC Act	12.37

Bill reference	***Paragraph number***
Item 279 (Interpretation), item 280 (Things done to a former Board before commencement), item 281 (Things done to the Chairperson or acting Chairperson of a former Board before commencement), item 282 (Things done by a former Board before commencement), item 283 (Things done by the Chairperson or acting Chairperson of a former Board before commencement), item 284 (Things done by a member or acting member of a former Board before commencement), item 285 (Things done by a person authorised by a former Board before commencement), item 286 (References to a former Board in Instruments etc.) and item 287 (Committees)	12.38