The Institute of
Chartered Accountants
in Australia

6 November 2009

Mr John Hawkins
Committee Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear John,

Inquiry into Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to make a submission to the Senate Standing Committee on Economics (the Committee) in relation to its inquiry into certain aspects of the measures contained in Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009 (the Bill).

As the Committee will be aware, the Institute represents more than 62,000 Chartered Accountants in Australia, and its members work in diverse roles across commerce and industry; academia; government; and public practice throughout Australia and in 140 countries around the world. The depth and diversity of our membership allows the Institute to provide independent expert comment in relation to tax policy and administration issues such as those being examined as part of this inquiry.

Schedule 2 of the Bill – Non-commercial losses

Background

An exposure draft of the legislation (ED) and explanatory material (EDEM) for the amendments to the non-commercial loss rules was released for public consultation by the Government on 26 June 2009. The Institute lodged a submission with Treasury in relation to the ED on 24 July 2009.

The Institute welcomes the fact that the Bill now incorporates the our recommendation that a specific 'carve-out' for investment allowance deductions (ie. the small business and general tax break in Division 41 of the Income Tax Assessment Act 1997) be allowed in determining the quantum of losses generated from a business activity.

Another significant improvement is that the Explanatory Memorandum to the Bill (the EM) now provides more clarity in respect of the circumstances in which the Commissioner's discretion is likely be exercised. This was recommended by the Institute in our 24 July submission (although note submission point 4 below).

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Submission

There are a number of recommendations contained in the Institute's 24 July submission, as well as in the subsequent additional submission points of 6 August, that were not addressed in the current Bill that has been presented to Parliament. Those points are set out in this submission for the Committee's consideration as part of this inquiry.

1. Division 40 and Division 43 capital allowances

Where a taxpayer has incurred capital expenditure in previous years, the new limitation on the write-off in effect encompasses an element of retrospectivity, which can be dealt with by providing that excess losses should be calculated on the basis of net earnings after interest but before depreciation. Further details in relation to this issue are provided in the attached Appendix which includes an extract from the Institute's 24 July submission to Treasury.

2. Transitional rule for deferred losses pre-1 July 2009

The Institute believes that for losses that arose pre-1 July 2009 that have been deferred by reason of a failure to satisfy any of the four business tests, a transitional approach should apply. In subsequent years, when one of the four business tests is satisfied, those losses should be capable of application against other income of the taxpayer (as per the current rules) notwithstanding the taxpayer fails the net income test (ie. where adjusted taxable income equals or exceeds $250,000). The Institute consider that this transitional arrangement is vital to ensuring that the introduction of the proposed new rules does not result in a retrospective impact on taxpayers; an outcome which the Government has continually identified is undesirable in the context of (non-tax avoidance) tax policy changes.

3. Approach to savings in compliance costs

In the view of the Institute, the Committee should explore whether some compliance saving 'carve-outs' would be possible without jeopardising the underlying policy intent of the changes. The compliance concerns identified by the Institute not only impact taxpayers but also the Australian Taxation Office itself. Further details are provided in the attached Appendix to this submission.

4. Commissioner's discretion

As stated earlier, the Institute acknowledges that the updated EM which has been presented to the Parliament contains more clarity in this area than was previously the case with the EDEM. However, the Institute believes that the discretion should not be limited to industry benchmarks for yield time (or indeed any other 'industry norms'). Instead, we are of the view that provided the taxpayer can demonstrate that:

- the business is conducted on a commercial basis (in accordance with Australian industry management practices); and
- any extended yield time is caused by natural conditions beyond the taxpayer's control,

then this should be sufficient.

Our reasons for proposing that the discretion should not be confined to businesses that comply with industry benchmarks or norms arise from the likely practical problems that will arise in determining the appropriate industry benchmark or norm to apply in any given situation. If, contrary to our views, industry benchmarks or norms are to be used then the Institute considers it is vitally important that taxpayers should be able to have access to 'safe harbours' to ensure that a business which falls below the industry norm but is otherwise being operated on a completely commercial basis does not trigger application of these proposed new laws.

Should you wish to discuss any issues raised in this submission, please do not hesitate to contact me on 02 9290 5623. It is worth pointing out that the Institute is currently scheduled to appear before the Committee at its hearings in Melbourne on 9 November 2009.

Yours faithfully,

Yasser El-Ansary
Tax Counsel
The Institute of Chartered Accountants in Australia

APPENDIX

EXPOSURE DRAFT LEGISLATION: EXTRACT FROM THE INSTITUTE'S SUBMISSION OF 24 JULY 2009

Division 40 and Division 43 capital allowances

The losses attributable to the business activity in s35-10(2) affected by the new rules will also include depreciation in relation to prior year expenditure which is being claimed progressively under Division 40 or Division 43 capital allowances. It follows that where the taxpayer has incurred capital expenditure in previous years based on the then current tax law, this new limitation on the write-off amounts to an element of retrospective tightening of the rules. The money has already been spent on acquisition or construction of the asset, so to potentially defer a deduction under Division 40 or Division 43 would in our view be analogous to a change to the law that has a retrospective implication; such outcomes should be avoided in the context of tax policy changes at all times unless necessary.

The Institute submits that excess losses should be calculated on the basis of net earnings after interest but before depreciation; that is, assessable income less current year expenses (including interest) but excluding depreciation as it is a non-cash item.

We consider that the revenue impact of this modification should be minimal because neither Division 40 nor Division 43 allows 100 per cent write-offs and therefore the tax deduction for the outgoing lags the income which the asset seller or constructor would receive.

Alternatively, if a permanent Division 40 or Division 43 deduction is not allowed, then only Division 40 or Division 43 allowances on items acquired from 1 July 2009 onwards could be included in the excess loss calculation in s35-10(2).

Approaches to save compliance costs

The introduction of the non-commercial losses provisions followed a recommendation (Recommendation 7.5) in the July 1999 report of the Review of Business Taxation entitled *A Tax System Redesigned.* In making this recommendation, the report observed:

> In recent years the Australian Taxation Office has sought to minimise the loss to revenue associated with non-commercial activities. The turnover of entities and their diverse nature have meant that the number of taxpayers involved has remained about constant, with a persisting cost to revenue. **The law in relation to carrying on a business is very difficult and resource intensive to administer and must be done on a case-by-case basis. The need to apply the existing law on that basis does not permit the efficient and effective use of resources and creates uncertainty. [Emphasis added**]

On that basis, the report determined that:

> A systemic solution that better deals with losses arising from such non-commercial activities is warranted.

This solution involved a number of tests modelled on comparable provisions in other countries that were 'designed so as not to disadvantage genuine business activities'. Under the changes, these tests are not to be made available to individuals where the income requirement is not met.

Although affected taxpayers may be able to seek the exercise of the Commissioner's discretion so as to not be required to quarantine the losses, this creates additional compliance costs and brings into play the difficulties mentioned in the first quote above (albeit with a lesser number of taxpayers).

In light of this, the Institute considers that it would be worthwhile to consider whether some compliance saving carve-outs would be possible without jeopardising the policy intent of the changes. For example, imposing a minimum area (eg. greater than 50 hectares) in order to impose some sort of scale requirement for grazing and farming businesses could be considered.