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Mr Paul McMahon
Committee Secretary
Standing Committee on Industry, Science and Resources
House of Representatives
PARLIAMENT HOUSE
CANBERRA ACT 2600

Dear Mr McMahon

Please find enclosed, at Attachment A, the Australian Taxation Office's responses to the general questions asked by committee members during the public hearing of the committee held on Thursday 5 April 2001.

Yours sincerely,

Geoffrey Miller

Geoff Miller
Assistant Commissioner

TAXES – Building a better Australia

Attachment A

HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON INDUSTRY, SCIENCE AND RESOURCES

Public Hearing Thursday 5 April 2001

Answers to Questions

Hansard Pages 357 to 373

Question 1:

What are the tax consequences when a company develops a plant which does not work and writes it off where:

(a) there are R&D activities involved in developing the plant; or

(b) there are no R&D activities involved in developing the plant?

If the company then spends more money to make the plant work, is the additional expenditure tax deductible?

Answer :

(a) Where a plant is developed as the object of carrying out a program of eligible R&D activities, as defined in sub-section 73(1) of the *Income Tax Assessment Act 1936* (ITAA), and part of that program of activities involves the usage of the plant in trials or for testing, the expenditure on the plant may be eligible for a concessional treatment under section 73B. This will be the case if the plant was constructed for use exclusively in carrying on R&D activities[1], and is actually used exclusively for carrying on those activities. The maximum deduction[2] that can be obtained for plant that meets these tests is a full write off of the plant (spread over three years), multiplied by 1.25. If qualifying use is less than a 3 year period, normal depreciation deductions may then become available. A deduction for a loss on a failed plant which so qualified for concessional treatment will only be allowed at the 125% rate if the plant is lost, destroyed or disposed of, after the use in R&D activities. As this is not the case in the question posed, given that further work is carried out on the plant, a full write-off of the undeducted portion of the plant will not be available under the tax concession at that point.

(b). A plant which is used by a taxpayer, or installed ready for use for the purpose of producing assessable income, is eligible for deductions for depreciation, based upon its effective life (Division 42 of the *ITAA*). A write-off of any undepreciated amount is available where the plant is disposed of, lost or destroyed. As this is not the case in the

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[1] Note that pursuant to a government announcement of 26 April 2001, this test is to be retrospectively changed so that it requires that the plant be for use exclusively in R&D activities '*for an initial period of time*'.

[2] Applies where plant is used exclusively in R&D activities for a 3 year period.

question posed, given that further work is carried out on the plant, no write-off of the undeducted portion of the plant is available under Division 42.

The costs of the additional expenditure on the plant may be eligible for the tax concession, if the further activities being conducted are eligible *research and development activities*, as defined in section 73B(1).

- If the additional costs are expenditure on the item of plant, the same tests of eligibility of *plant expenditure* referred to under (a) will need to be met, for the expenditure to be eligible for concessional treatment.

- If the expenditure qualifies as plant expenditure, and the plant is used exclusively for carrying on R&D activities, the additional costs will be eligible for the one third write-off for up to three years at the 125% rate.

Note that these answers apply the law which existed up until 29 January 2001. In the Government's *Backing Australia's Ability* statement on that date, the R&D plant expenditure rules were replaced. Under the new law, plant that is acquired or constructed after 29 January 2001 will no longer be subject to the 'exclusive use' intention test described above. Plant which is used in carrying on R&D activities will be eligible for an effective life depreciation deduction at the 125% rate, instead of a three year write-off. Where plant is used for purposes other than R&D purposes, a pro-rata depreciation deduction will be allowable.

Question 2:

More generally, what processes does the ATO follow when companies, in particular those involved in oil drilling and exploration, claim large tax write offs for expenditure on failed projects?

Answer:

It is common within the resources sector for large write offs of capital expenditure. By its very nature the industry is involved in high risk ventures, such as exploration, where there can be a lack of success resulting in losses including the destruction or termination of plant. Certain tax provisions allow deductions for expenditure on exploration and also determine the treatment of capital expenditure including plant. In some instances, there is also a high element of risk associated with new production processes being trialed or where plant is set up in frontier areas e.g. deep water oil/gas extraction etc.

The ATO has various processes which address issues such as these. It may provide advice to clients as part of the private binding ruling process and/or public rulings program. In addition, ATO has had major input to the development of tax reform measures in respect of capital allowances which deal with the tax treatment of capital expenditure on items such as plant or exploration.

The ATO's compliance program in this sector has several focus areas such as transfer pricing, aggressive tax planning and transitional business tax reform issues, however, it also includes areas of a more general tax nature. The compliance program adopts the ATO's Co-operative Compliance Model and is fundamentally based upon risk assessment processes to ensure that we direct our resources to the most appropriate risks.

The ATO will examine unusual or large tax write offs as part of its compliance program in this sector where the risks are assessed to be high. The ATO adopts a real time philosophy to its compliance work in this sector whereby we seek to respond as quickly as possible to areas of potentially high risk as they emerge.

Question 3:

Are there any tax impediments to investing in Australian resources?

Answer:

The ATO is unable to provide an answer to this question on the basis of the data available to it. It is suggested that this question may be better directed to the Treasury.

Question 4:

Is there any evidence from the Australian Taxation Office's experience that "zonal" taxation rules are either straightforward to administer or tend to create anomalies and arbitrary boundary lines?

Answer:

The Income Tax Assessment Act 1936 contains the zone rebate (section 79A of the ITAA 1936). This is the singular example of "zonal" taxation to be found in Australian income tax.

In 1980, the then Treasurer commissioned a public inquiry into the income tax zone allowances. That Inquiry reported in June 1981. The Report of the Public Inquiry into Income Tax Zone Allowances made the following observations regarding the zone rebate which relate to its administration by the ATO:

- The nature of a zonal rebate meant that regular reviews and constant monitoring would be required to ensure the zonal delineation continues to reflect the original policy intention.
- Determination of the exact boundary lines for a zonal system will always prove difficult, especially where the zonal concession is driven by a desire to compensate certain taxpayers for conditions that cannot be measured precisely
- The arbitrariness of the zonal boundaries has in the past caused taxpayer's to rely on the Commissioner of Taxation's discretion in borderline cases.

- Unlike most other personal income tax concessions, zone allowances are available irrespective of actual expenditure.
- The self-assessment system requires taxpayers to be fully informed as to the claims they may make in their income tax return.
- The Inquiry also felt that providing a tax allowance concealed the effect the allowance had on recipients, because it was obscured by other information included in a taxpayer's return.

A more detailed examination of each of these points can be found within the published Report.

Question 5:

What are the tax consequences of a profitable Australian company choosing to shift to a different tax jurisdiction (i.e., if an entity lists itself entirely on the London Stock Exchange, may it still have to pay Australian tax?)?

Answer:

The main criteria for liability to Australian tax are residence and source.

Residence

In general terms a taxpayer resident in Australia is taxable on ordinary and statutory income derived from all sources in and out of Australia. A non-resident is liable to tax on Australian sourced income and is exempt from Australian tax on foreign source income.

Under Australia's tax law a company will be a resident of Australia if:

(a) it is incorporated in Australia; or

(b) not being incorporated in Australia, it carries on business in Australia and has either:

- its central management and control in Australia; or

- its voting power controlled by shareholders who are residents of Australia.

It should be noted that Stock Exchange listing is not a criteria per se for determining residence.

In addition, Australia's double tax agreements (DTAs) also contain residency rules. The DTAs normally adopt the residency rules of the contracting countries. These may vary slightly from DTA to DTA depending on the outcome of negotiations. DTAs also often contain tie breaker rules to deem a dual resident company to be a resident of only one of the two contracting states for the purposes of that DTA. Some DTAs (eg our DTA with the US) do not contain company residence tie breakers. Australia also denies some tax advantages to certain dual resident companies.

A key element of our DTAs is that the business profits of a resident of one country are taxable only in that country. However the other country (the source country) will have the primary taxing right where a company carries on business in the source country through a permanent establishment (eg a branch) and the profits are attributable to that permanent establishment. In such cases the country of residence relieves the resultant double taxation.

Assuming that an Australian resident company becomes a resident solely of another country, then apart from the general residency and source approach outlined above, and understanding that a specific DTA may apply, there are other possible tax consequences that could arise, depending on the circumstances in which the company finds itself. Some of them are outlined below.

Withholding Tax

Unfranked dividends, interest and royalty payments paid to non-residents are generally subject to withholding tax. This is a final tax liability. For example the payment of unfranked dividends, interest and royalties from subsidiaries resident in Australia to a parent company resident in a DTA country would be subject to withholding tax, all other things being equal. The rates of withholding under our DTAs are generally a maximum of 15% of the gross for dividends, 10% for interest and 10% for royalties.

Thin capitalisation

There may be thin capitalisation consequences from a move by an Australian resident company offshore. It would depend on the particular circumstances of the company and any associated companies.

Transfer Pricing

There are rules in our tax laws and our DTAs for dealing with transfer pricing. These aim to combat international profit shifting by multi-national companies.

Foreign source income measures

Where a company becomes a resident of another country and is no longer a resident of Australia for tax purposes, our foreign source income measures or similar measures of the other country (if it has such a regime) may apply, depending on the circumstances.

Capital Gains Tax

When a company stops being an Australian resident, the change of residency triggers a CGT event for those company assets which do not have the necessary connection with Australia. More generally (and apart from the issue raised in the previous sentence) a non-resident makes a capital gain or capital loss only if a CGT event happens to a CGT asset that has the necessary connection with Australia. The CGT provisions list nine categories of CGT assets having the necessary connection with Australia. For example, land or an interest in land in Australia has the necessary connection with Australia. So too does a CGT asset used at any time in carrying on a business through a permanent establishment in Australia.

Question 6:

Who determines whether a project includes activities which qualify for the R&D tax concession and who assesses whether those activities involve technical risk - ATO or DISR?

Answer:

The ATO and the Industry Research and Development Board jointly administer the tax concession. The IR&D Board has sole responsibility for determining whether an activity is eligible R&D in terms of the legislation i.e., whether activities involve innovation, technical risk etc.

If the ATO undertakes an audit of a company and has doubts as to the eligibility of an activity, the ATO must refer the question of eligibility to the IR&D Board and the ATO is then bound to accept the determination made by the IR&D Board. The ATO does not make decisions regarding the eligibility of activities.

Question 7:

Does the ATO have any papers looking at the effectiveness and the ability of the ATO to administer the previous investment allowance?

Answer:

The ATO does not possess evidence of whether previous investment allowances were either effective or difficult to administer. Most files regarding the 1976-1985 and earlier investment allowances no longer exist. Below is an overview of the types of investment allowances the ATO has administered in the past.

Former Investment Allowance

Between 1 January 1976 and 1 July 1985 the original investment allowance operated where a taxpayer incurred capital expenditure of more than $500 in the acquisition or construction of a new unit of eligible property and the property was first used or installed ready for use before 1 January 1988. This was a deduction based on a percentage of the capital cost of the property, in the year the property was first used or installed ready for use. The investment allowance was divided into three periods with the maximum concession available being 40% and the minimum being 18%. In some circumstances, an investment allowance deduction that had been claimed could be withdrawn, for example where the owner disposed of the property.

General Investment Allowance

Later, a general investment allowance was introduced to provide a tax incentive for investment in plant or articles. It applied to expenditure incurred on plant and articles on or after 9 February 1993 and before 1 July 1994 (and put to use prior to 1 July 1995) on the acquisition or construction of new plant costing not less than $3,000. The allowance was a deduction of 10% of the capital expenditure, available in the first year the property was used or installed ready for use. It was generally in addition to depreciation and the development allowance (see below).

Development Allowance

The ATO presently administers a development allowance for certain capital expenditure, incurred after 26 February 1992 and with a capital cost of $50 million or more. The allowance is intended to provide an incentive for investment in new plant used wholly and exclusively in Australia to produce assessable income. This allowance is generally in addition to depreciation and is a deduction of 10% of the capital expenditure in the first year the property is first used or installed ready for use. To be eligible for the allowance the expenditure must have pre-qualified under the criteria set out in the DAA 1992 and been approved by the Development Allowance Authority. The development allowance is not available for expenditure that attracts special treatment under other provisions, such as the R&D rules. In certain circumstances, a development allowance deduction can be lost. The development allowance adopts and modifies the previous investment allowance provisions. The development allowance is due to cease effect from 1 July 2002.

Drought Investment Allowance

The drought investment allowance was a tax incentive to encourage primary producers to prepare for future droughts by investing in certain capital assets between 23 March 1995 and 1 July 2000. Expenditure on new “drought mitigation property” must have exceeded $3,000 and be used for the purpose of producing assessable income to qualify for the 10% deduction. There was a $5,000 limit on deductions. The allowance could not be claimed if a deduction in relation to the expenditure was allowable under the R&D provisions.