Chapter 2

Provisions of the Tax Laws Amendment (2007 Measures No. 2) Bill 2007

2.1 This bill is an omnibus bill that will implement changes to the Australian taxation system in the following areas:

- depreciation treatment of mining rights;
- taxation of boating activities;
- certain expenditure on research and development activities;
- donation of listed shares to deductible gift recipients (DGRs);
- deductions for contributions relating to fund-raising events; and
- venture capital regime.

2.2 An outline of the provisions of the bill's eight Schedules follows.

Schedule 1—Effective life provisions of mining rights

2.3 Schedule 1 amends Division 40 of the *Income Tax Assessment Act 1997* to align more closely the decline in value deductions for mining, quarrying and prospecting rights with other depreciating assets. The change clarifies the law on the uniform capital allowance system, which was introduced on 1 July 2001. It has no financial impact.

2.4 The uniform capital allowance system has two components. First, there are general rules applying to asset depreciation, based either on the Commissioner of Taxation's determination or a self-determination. A self-determination may calculate an asset's effective life using either the 'prime cost' method or 'diminishing value' method. Second, there are intangible depreciating assets—listed in a table in subsection 40-95(7) of the Act—which do not use these rules and must use the 'prime cost' method to calculate their decline in value.

2.5 Mining rights are listed in the table in subsection 40-95(7) of the Act but, under the terms of subsection 40-70(2), can use the 'diminishing value' method to determine the effective life of an asset. However, the inclusion of mining rights in subsection 40-95(7) meant that mining rights were treated differently from depreciating assets not included in the subsection and other intangible assets in the table. The Explanatory Memorandum (EM) noted that:

> …there was a possible interpretation that including mining rights in…[subsection 95(7) that] led, in cases where taxpayers chose the diminishing value method of working out the decline in value of their

> mining right, to the effective life of a mining right being based on the *whole* rather than the *remaining* life of the existing or proposed mine…[1]

2.6 The EM also noted that under the current law 'there was an interpretation that holders of mining rights were required to assess the life of the right annually' which led to outcomes that were 'inconsistent with that for other depreciating assets under the uniform capital allowance system'.[2]

2.7 The bill will remove mining rights from a table of depreciating assets in subsection 40-95(7) of the Income Tax Assessment Act (ITAA 1997). They will be included under two new subsections, 40-95(10) and 40-95(11). If the bill is passed, a taxpayer acquiring a mining right from a prior holder will be able to estimate the remaining period until the end of the life of the mine irrespective of whether the taxpayer chooses the prime cost or diminishing value method of value depreciation. The proposed legislation will also mean there will be no requirement for a taxpayer to undertake a yearly assessment of the value of their mining right.

2.8 The EM explains how the effective life of a mining right will be calculated under the new legislation. Under subsection 40-95(10), taxpayers must themselves estimate the period until the end of the life of the mine—that is, the period over which reserves are expected to be extracted from the mine. There is also an additional subsection, 40-110(3B), which permits the recalculation of the effective life of a mining right if it is no longer accurate because of a mine's changed circumstances.[3]

2.9 In his Media Release of 9 May 2006, the Minister for Revenue, the Hon. Peter Dutton, noted that all holders of mining, petroleum and quarrying rights will benefit from the measure, 'particularly those who acquire them from a former holder'. The Minister's statement explained that instead of requiring the holder to write-off a right over the whole life of the mine, the new law will allow them to write-off their right over the remaining life of the mine.[4]

Schedule 2—Taxation of boating activities

2.10 Schedule 2 of the bill relates to taxation of boating activities. Under the current law, tax deductions on income earning activities associated with using boats are only permissible from certain business activities. The intent is that the tax system does not subsidise the use of private boats. The bill will enable taxpayers to deduct amounts related to using boats up to the level of their boating income for that income year. The intent of the bill is to ensure that taxpayers are not unfairly treated by taxing

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1 Explanatory Memorandum, *Tax Laws Amendment (2007 Measures No. 2) Bill 2007*, p. 11.

2 Explanatory Memorandum, p. 11.

3 Explanatory Memorandum, p. 15.

4 The Hon. Peter Dutton, Minister for Revenue, 'Effective lives of mining, petroleum and quarrying rights', *Media Release*, 9 May 2006.

their income from boating but denying them deductions for related expenses, while maintaining restrictions on using the tax system to subsidise the private use of boats.[5]

2.11 Under the new law, deductions relating to using or holding boats will be capped at the level of income earned from boating activities. Any excess deductions will be quarantined and deferred to later years. The EM explains that if income from boating activities ceases 'for a year or number of years, the quarantined amount will be carried forward repeatedly and become deductible in the income year when assessable income is next earned from boating activities'.[6] It adds that advertising, signage and other promotional expenditure will continue to be deductible under the quarantining rule. However, there will be exceptions to the quarantine rule if the activities require the boat as a central part of the business. If the taxpayer is carrying on these boating activities—listed in subsection 26-50(5) of the ITAA 1997—the related deductions can be offset against *any* assessable income. If they are outside these activities, the deductions are subject to the quarantine rule.

2.12 The EM notes that the financial impact of the measure will be $5 million in 2007–08, $6 million in 2008–09 and $6 million in 2009–2010.

Schedule 3—Expenditure on research and development activities

2.13 Schedule 3 of the bill makes several technical amendments to the research and development (R&D) provisions of the *Income Tax Assessment Act 1936* (ITAA 1936). These changes, announced in the May 2006 federal budget, relate to the premium incremental concession and the refundable R&D tax offset. These two elements have applied from the income year starting after 30 June 2001.

2.14 The premium incremental tax concession allows companies to deduct 175 per cent of additional expenditure incurred on certain types of R&D activities. To claim this concession, companies must have increased their expenditure for the year, above a base level which is determined by their average R&D expenditure over the previous three years. Companies must have a three year history of R&D expenditure to register and claim for the basic R&D tax concession of 125 per cent.[7]

2.15 The refundable R&D tax offset allows companies with an annual group turnover of under $5 million to obtain a tax offset equivalent to their R&D tax concession entitlements. These entitlements are the basic concession of 125 per cent of R&D expenditure and 175 per cent of additional R&D expenditure for the income

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5 Explanatory Memorandum, p. 19.

6 Explanatory Memorandum, p. 21.

7 Australian Government, AusIndustry, 'Tax Concession for Research & Development', Overview, April 2006, pp. 2–3.

year above the base level.[8] The tax offset is paid as an upfront rebate for these companies' R&D expenditure.

2.16 The bill proposes several amendments to the ITAA. First, companies will be allowed to object to written notices from the Commissioner of Taxation if they are dissatisfied with the amount allowed under the R&D tax offset. The current law states that companies can only appeal the Commissioner's decision if they have an income tax assessment. The bill thereby broadens appeal and review rights. This provision applies to years of income commencing on or after 1 July 2001.

2.17 Second, the bill enables companies to choose the R&D tax offset by writing to the Commissioner within the normal time for amendment of income tax assessments. Currently, companies must choose the R&D tax offset in the year in which they are entitled to it.

2.18 Third, the bill will extend the current rule that limits eligibility for the R&D tax concession to expenditures over $20 000 unless a company incurs contracted expenditure to a Registered Research Agency. From the day of Royal Assent, companies can claim the tax offset for the amount of contracted expenditure.

2.19 Fourth, the bill broadens the expenditure threshold for R&D tax offset eligibility from all 'persons' to all 'taxpayers'. This will ensure that all companies in a group are covered by the offset provisions. The provision will apply from the first year of income after 9 May 2006.

2.20 Fifth, the bill makes a correction to Section 73H by changing the reference from section 72L to section 73L.

2.21 Sixth, the bill will ensure that the premium incremental concession will be distributed amongst all companies that have increased their R&D expenditure over the average of their past three years' expenditure. Under the current law, this is not always the case. A group of companies can be eligible for the premium concession where their collective expenditure is greater than the rolling three year average of the group. However, it is possible that no company in this group has increased its expenditure from the previous year and is therefore not eligible for the distribution of the premium concession. This amendment applies from the year of income following the year of income in which these amendments receive Royal Assent and later years. Objections to this timing are discussed in Chapter 3.

2.22 Seventh, the bill tightens current arrangements by referring to the company's group membership period for eligibility for the premium incremental concession. Under the current law, a new company entering the group can qualify the group for the concession through its R&D expenditures prior to joining the group. The new law will ensure that if a company is unable to take its R&D expenditure history to the new

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8 Australian Government, AusIndustry, 'Tax Concession for Research & Development', Overview, April 2006, pp. 2–3.

group, it is unable to establish eligibility for the group to the concession based on R&D expenditure when the company was not a member of the group. This amendment applies from the year of income following the year of income in which these amendments receive Royal Assent and later years.

2.23 Eighth, the bill will amend the current legislation to reflect the introduction of the 'Commercial Ready program'. Companies' payment under this program establishes eligibility for the premium incremental concession. The Commercial Ready program replaced the R&D Start program on 6 May 2004.

2.24 Ninth, the bill corrects the current situation where the aggregate R&D expenditure of the company or group of companies can be less than the average of the previous three years of R&D expenditure. In these cases, there is a negative incremental amount. Given that the purpose of the concession is to provide a benefit for the company or group of companies, the bill takes a negative incremental amount as zero. This provision will apply to years of income commencing on or after 1 July 2001.

2.25 Finally, the bill will include a reference to the premium incremental concession in Section 12-5 of the ITAA 1997. This section of the Act is a reference section for all deductions in the income tax law.[9]

2.26 The EM explains that these changes 'clarify the law in situations where the intended outcome did not occur'.[10] With the exception of the amendment tightening group membership eligibility for the premium incremental concession, these provisions broaden companies' appeal rights and entitlements to the 175 per cent concession and the refundable R&D tax offset. The EM notes that the measure 'is expected to lead to an additional $7 million per year in R&D tax offset payments and decreased revenue of $2.5 million per year as a result of the premium incremental concession'.[11]

Schedules 4 and 5—Deductible gift recipients (DGRs)

2.27 Australian taxpayers may claim an income tax deduction for gifts of $2 or more, or gifts of property, made to recipients known as deductible gift recipients (DGRs). DGRs are either endorsed by the Australian Taxation Office—the majority of DGRs—or listed by name in the tax law. For some DGRs, the income tax law adds extra conditions affecting the sorts of deductible gifts they can receive. For example, the gift may only be tax deductible between certain dates, or for a specific use. Schedules 4, 5 and 6 of the bill relate to DGRs.

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9 Explanatory Memorandum, pp. 30–34.

10 Explanatory Memorandum, p. 32.

11 Explanatory Memorandum, p. 4.

2.28 Schedule 4 amends the ITAA 1997 to allow a tax deduction for donations of small parcels of shares listed in public companies to eligible DGRs. Under the current Act, gifts of property to DGRs, including shares, acquired at least 12 months before making the donation, and valued at $5 000 or less, are not tax deductible. Under the new law, these gifts will be tax deductible valued at the listed value at the time of the gift. The financial cost of the measure will be $10 million in 2008–09, $11 million in 2009–10 and $11 million in 2010–11.

2.29 Schedule 5 of the bill amends the ITAA 1997 to include the American Australian Association Limited and the Bunbury Diocese Cathedral Rebuilding Fund in the list of DGRs. The EM notes that the American Australian Association Limited 'intends to establish a United States Studies Centre at an Australian university, and facilitate education scholarships and programmes, conferences and seminars, cultural events and other activities'.[12] St Patrick's Cathedral in Bunbury was destroyed by a tornado on 16 May 2005. In response, the Bunbury Diocese Cathedral Rebuilding Fund was established and given DGR specific listing under Division 30 of the ITAA 1997. This listing ends on 19 December 2008.

2.30 Schedule 5 also extends the time period for which deductions are allowed for gifts to The Finding Sydney Foundation. The Foundation was established to search for HMAS Sydney and the German auxiliary cruiser HSK Kormoran, which disappeared off the Western Australian coast in November 1941. The bill extends the period for tax deductible gifts from 27 August 2006 to 28 August 2007.

2.31 The financial cost of the measures contained in Schedule 5 is expected to be $5 million in 2007–08, $1 million in 2008–09, $0.7 million in 2009–2010, $0.6 million in 2010–11 and $0.6 million in 2011–12.

Schedule 6—Deductions to contributions relating to fund-raising events

2.32 Schedule 6 of the bill extends eligibility for tax deductions to a DGR in cases where the contributor receives a benefit. The Minister for Revenue, the Hon. Peter Dutton, noted in the Second Reading Speech:

> The improvements to the taxation deductibility provisions provide further support to encourage philanthropy in the community, and the government is very proud to support those activities.[13]

2.33 Prior to 1 July 2004, contributions to deductible gift recipients were not tax deductible if the contributor received a benefit in return. From 1 July 2004, tax deductions were allowed where a benefit is received:

> …so long as the value of the contribution is more than $250, and the minor benefit received in return is no more than $100 and 10 per cent of the value

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12 Explanatory Memorandum, p. 44.

13 The Hon. Peter Dutton, Minister for Revenue, *Second Reading Speech*, House Hansard, 29 March 2007, p. 9.

> of the contribution, whichever is the less…The deduction is limited to that part of the contribution that is in excess of the minor benefit.[14]

2.34 The EM notes that since this measure was introduced, there has been a review 'of the suitability of the thresholds' in consultation with the Prime Minister's Community Business Partnership.[15]

2.35 The new law will allow individuals to deduct contributions to DGRs if the value of their contribution is more than $150 and the minor benefits received in return is no more than $150 and no more than 20 per cent of the value of the contribution, whichever is the less. The bill therefore lowers the contribution threshold by $100 and increases the maximum benefit allowable by $50 or a further 10 per cent of the value of the contribution.

2.36 The EM provides the example of a taxpayer paying $260 to attend a golf charity day hosted by a DGR. The game costs $50. As this is less than $150 and less than 20 per cent of the contribution ($260), the taxpayer/golfer can deduct $210 ($260–$50).[16]

2.37 The financial cost of Schedule 7 of the bill will be $1.5 million in 2007–08, $6 million in 2008–09 and $6 million in 2009–10.

Schedule 7—Technical amendments and corrections

2.38 Schedule 7 amends the ITAA 1997 and ITAA 1936 to correct the definition of those bodies that are exempt from paying income tax. It changes the definition of 'exempt entity' in the ITAA 1997 to include *all* entities whose income is exempt by any Commonwealth law and all untaxable Commonwealth entities. The change is needed to ensure that all Commonwealth, state and territory bodies that are exempt from income tax are also classified as an 'exempt entity' under Section 50 of the ITAA 1997. Currently, some Commonwealth, state and territory bodies are exempted from paying income tax for reasons other than that captured by Section 50 of the ITAA 1997, and so are not classified as an 'exempt entity'. Similarly, the current law does not classify as an 'exempt entity' all state and territory bodies that are exempt under Division 1AB of the ITAA 1936 or Commonwealth bodies that are not liable to taxation.[17]

2.39 Schedule 7 also changes the definition of 'excepted trust' in Schedule 2F of the ITAA 1936. Excepted trusts include those where all the capital is beneficially owned by 'exempt entities'. Currently, excepted trusts are not required to satisfy tests before they can access their tax losses. However, if a trust's beneficiaries include an exempt

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14 Explanatory Memorandum, p. 47.

15 Explanatory Memorandum, p. 47.

16 Explanatory Memorandum, p. 49.

17 Explanatory Memorandum, pp. 51–52.

state or territory body, it might not be an excepted trust and may have to satisfy these tests. The new law will require all of the trust's income and capital to be owned by exempt entities.[18]

Schedule 8—Venture capital

2.40 Australia's venture capital regime was introduced through the *Venture Capital Act 2002*. The purpose of the regime is to encourage foreign investors to team with Australian industry to provide a source of equity capital for relatively high risk projects. Apart from direct funding, government assistance for venture capital projects comes from tax concessions provided under the ITAA 1936 and ITAA 1997. Foreign investors eligible under the current system of venture capital limited partnerships (VCLPs) are exempt from tax on their profits.

2.41 Schedule 8 improves the taxation incentives for foreign venture capital activities based in Australia.[19] It will enact measures that were recommended in the government commissioned *Review of Venture Capital Industry* and announced in the 2006–07 federal budget. The budget announced the introduction of an early stage venture capital limited partnership (ESVCLP) which will provide complete tax exemption for income received by domestic and foreign partners. It also announced the relaxed eligibility requirements for concessional tax treatment under the existing scheme of VCLPs. Schedule 8 details these initiatives.

2.42 The Schedule sets out certain conditions for investors operating as an ESVCLP. First, the capital of the partnership must not exceed $100 million. Second, the partnership's investment in any one entity cannot exceed 30 per cent of its total committed capital. Third, the size of the entity into which the partnership is investing must not exceed $50 million. Fourth, the partnership must not hold investments in an entity once that entity exceeds $250 million in value. Fifth, the partnership must have an investment plan that is approved by the Venture Capital Registration Board, and must report to this board on the implementation of its approved plan. The EM states that the purpose of these restrictions is 'to ensure that investments made by ESVCLPs are targeted at early stage activities'.[20]

2.43 The current law requires: investments to be acquisitions of shares or options; the company to be located in Australia for at least the first 12 months; limited partners to be residents of specified foreign countries; ongoing auditor involvement; and a minimum $20 million of committed capital for the VCLP to register.[21] The bill allows

18 Explanatory Memorandum, p. 51.

19 Schedule 8 was prepared by the Department of Industry, Tourism and Resources (DITR), the only part of the bill where the Treasury was not principally involved.

20 Explanatory Memorandum, p. 70.

21 Explanatory Memorandum, p. 62.

for more generous concessional tax treatment of foreign residents investing in VCLPs by permitting:

- investments to be acquisitions of convertible notes and units trusts;
- up to 20 per cent of investments to be in companies and unit trusts not located in Australia;
- partners to be residents of any foreign country;
- auditors to be appointed at the end of the financial year in which the investment is made; and
- the minimum partnership capital required for registration under the VC Act to be $10 million.[22]

2.44 The Treasurer noted in his Media Release of 9 May 2006 that the introduction of the ESVCLP is expected to have a cost to revenue of $15 million over the forward estimates period, with this cost increasing as capital gains are realised. The changes to the existing capital venture scheme—the VCLP—'are not expected to have a significant revenue impact'.[23] The EM noted that the changes will cost $2 million in 2008–09, $7 million in 2009–10 and $16 million in 2010–11.[24]

22 Explanatory Memorandum, p. 60.

23 The Hon. Peter Costello MP, 'Further boost to Australia's venture capital sector', *Media Release*, No. 37, 9 May 2006.

24 Explanatory Memorandum, p. 7.