Chapter 3

Issues in relation to Schedules 1, 2, 3 and 7

Schedule 1—Effective life provisions for mining rights

3.1 The committee received a submission from the Minerals Council of Australia (MCA) relating to Schedule 1 of the bill. The MCA's submission claimed a continuing 'level of uncertainty' in the determination of the period over which mining rights are depreciated under the *A New Tax System (Capital Allowances) Act 2001* and 2003 amendments to section 40 of the *Income Tax Assessment Act (ITAA) 1997*. The submission also noted the Council's complaints to the Australian Taxation Office (ATO) and the Australian Government concerning the 2006 draft ruling on the treatment of mining rights under section 40-95(7) of the ITAA. Mr Anthony Portas, MCA's Head of Taxation, Asia Pacific, told the committee:

> Our main concerns were, firstly, that the proposed methodology to determine the life of a mine was inaccurate and inconsistent with industry practice, and, secondly, that there was a suggestion that taxpayers had to assess the effective life of the mining right each year, which is actually not the case for other depreciating assets.[1]

3.2 The MCA 'welcomed' Treasurer the Hon. Peter Costello's announcement in May 2006 that the government would provide legislative amendments to restore the intent of the draft ruling.[2] Mr Portas told the committee that all members of the Minerals Council tax committee are 'comfortable' with the proposed legislation.[3]

3.3 The MCA's submission provided several grounds of support for Schedule 1 of the bill. It noted that it:

- clarifies in statute the policy intent in relation to how mining rights should be depreciated under the UCA (uniform capital allowance) regime;
- is consistent with Government's intent…and current industry practice;
- is highly consistent with broader UCA principles and approaches;
- is a 'point in time' calculation which promotes certainty and clarity (in terms of likely tax benefits) so as to encourage investment in new mines;
- has been exhaustively debated by all key stakeholders over an extended six year time period; and

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1 Mr Anthony Portas, *Committee Hansard*, 23 April 2007, p. 3.

2 Minerals Council of Australia, *Submission 4*, p. 1.

3 Mr Anthony Portas, *Committee Hansard*, 23 April 2007, p. 3.

- is administratively simple and equitable in terms of taxation treatment.[4]

Schedule 2—Taxation of boating activities

3.4 As Chapter 2 mentioned, Schedule 2 of the bill relates to the deduction of expenses for persons operating a private boat and receiving an income from this activity, but who are not considered to be operating a business. The current law denies any deductions despite compelling these persons to include all income they generate from these activities for tax purposes. The new law will allow deductions from the year of income following the year of income in which these amendments receive Royal Assent and later years.

3.5 The committee received a submission from Ernst & Young which broadly supports the amendments in Schedule 2. The submission states that the proposed change is 'an appropriate rectification' of the current situation where tax is paid in situations where private boat owners are operating at a commercial loss. Ernst & Young supported the provisions of the bill, which protect these private boat owners by ensuring they cannot be taxed on income received while making a commercial loss.[5]

3.6 Ernst & Young's submission also commended the bill for correcting the situation where private boat owners believe they are operating a business—deriving assessable income—only to have the ATO rule otherwise. Under the new law, if the operation is not classified as a 'business', losses can be offset against the income derived in future years from letting the boat.[6]

Retrospectivity

3.7 Ernst & Young argued that the changes should be made retrospective. Its submission notes that following a 2002 ruling, the ATO has audited many private boat operators. The ATO audits have disputed these operators' business plans and 'recast these in a way that produces a loss'. According to Ernst & Young, the ATO concludes that the taxpayer is not conducting a business. The boat owner is required to return all income without any deductions to offset against the income.

3.8 Ernst & Young's submission proposes that, at a minimum, the ATO should allow retrospective deductions equivalent to the income that has been taxed. It states:

> …we submit that this new legislation should be retrospective in order to ensure taxpayers are not unfairly taxed on amounts that reflect something that in the ordinary course, the Australian tax law should never sought [sic] to tax.[7]

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4 Minerals Council of Australia, *Submission 4*, p. 2.

5 Ernst & Young, *Submission 6*, p. 1.

6 Ernst & Young, *Submission 6*, pp. 1–2.

7 *Submission 6*, p. 2.

3.9 Mr Craig Jackson, Partner at Ernst & Young, told the committee that he believed there would not be 'large numbers' seeking retrospective deductions:

> I would not think in terms of the retrospectivity that there would be thousands but, depending on how many other taxpayers have had a dispute with the tax office, there may be 50 or 100 would be a guess, but purely a guess.[8]

3.10 Mr Gregory Pinder, Senior Adviser with the Treasury, told the committee that the issue of retrospectivity is:

> …a matter for government. When you want the measure to start is really a policy decision. There are some issues that you would want to take into account. Essentially, this existing law has applied for over 30 years—from 1974—so there would be a question of how far back you want to go. You want to take into account the administration costs and compliance costs involved in amending assessments back that far. Some people may have entered into settlements with the tax office and there would be a question about whether you would want to undo settlements that have been entered into.[9]

3.11 Mr Pinder told the committee that Treasury had had no direct discussions with Ernst & Young on the matter. He also noted that the revenue cost 'would probably be in the order of $4 million to $5 million a year for each year that you went back'.[10]

Schedule 3—Expenditure on research and development activities

3.12 Under current legislation, a company must have increased its R&D expenditure for the income year above its three year rolling average to access the premium incremental concession of 175 per cent (Sections 73P to 73Z of the ITAA). A company that is part of an R&D group must *also* have at least one member of the group whose expenditure for the year is greater than its R&D expenditure in the prior income year to access the premium. The bill eliminates this additional criterion for a member of an R&D group.

Retrospectivity

3.13 The committee received submissions from PwC (PwC hereafter) and KPMG on this issue. The PwC submission highlighted Items 19 and 20 of Schedule 3. Item 19 repeals Subsection 73X(1) of the ITAA 1997 and substitutes:

> (1) The premium amount is distributed between each group member (the increasing members) that increased its incremental expenditure incurred during its group membership period for the Y0 year of income over the average of its incremental expenditure incurred during its group membership period for the Y-1, Y-2 and Y-3 years of income.

8 Mr Craig Jackson, *Committee Hansard*, 23 April 2007, p. 16.

9 Mr Gregory Pinder, *Committee Hansard*, 23 April 2007, p. 17.

10 Mr Gregory Pinder, *Committee Hansard*, 23 April 2007, p. 17.

3.14 Item 20 states that the amendments made by Item 19 apply ‘to assessments for the year of income following the year of income in which this Act receives the Royal Assent and later years’. PwC argues that applying these changes to section 73X only to prospective income years 'is unfair and…the changes should operate retrospectively as they are aimed at correcting an acknowledged technical drafting error in the original legislation'.[11]

3.15 PwC argues that the bill must compensate those companies that have been entitled to, but unable to claim, the premium under the original legislation. It pursues this claim on the argument that the purpose of the bill’s amendments is to rectify two errors with the original legislation. First, it was not clear whether a single company that had increased its R&D spend above its three year average but not above its spend for the previous year would be entitled to the premium incremental concession. Second, PwC argued that in the case of group companies, there are ‘severe adverse effects’ when the largest company had increased its R&D spend above its three year average but not above the previous year. The PwC submission concludes:

> It is our view that when a provision is acknowledged as being flawed, amendments to that provision should apply retrospectively to ensure that the original intent of the legislature is given effect from the original time that the provision was introduced.[12]

3.16 Ms Sandra Mason, Partner at PwC, elaborated on the company's position at the public hearing. She told the committee that in most cases, the total group deductions under the 175 per cent concession will remain the same but will be shared differently between the group members. Ms Mason identified a potential compliance burden if all group 175 per cent claimants were required to reassess their entitlements and tax deductions back to July 2001, and deductions were reallocated among members in their group. Accordingly, she suggested that Item 20 of the Act be amended to ensure that retrospectivity applies only:

> …if requested in writing by the 175 per cent claimants in a particular group detailing the additional tax deductions the group would receive under the new legislation's retrospective action.[13]

3.17 Mr Matthew Flavel, Manager of Treasury's Industry Tax Policy Unit, told the committee that Budget Paper No. 2 classified the amendment to the eligibility of the 175 per cent premium as an improvement, not an oversight or an error in the 2001 legislation.[14] As an improvement to the law, the expectation is that it should only apply prospectively.

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11 *Submission 1*, p. 1.

12 *Submission 1*, p. 3.

13 Ms Sandra Mason, *Committee Hansard*, 23 April 2007, p. 6.

14 Mr Matthew Flavel, *Committee Hansard*, 23 April 2007, p. 10.

3.18 Moreover, Mr Flavel told the committee that retrospectivity in applying the law was something that Treasury tried to avoid. He noted two concerns with the PwC proposal. First:

> We have a particular concern about the idea of allowing an opting in or elective basis to apply retrospectively. If it were to be applied retrospectively, we could not see why it would not apply to all circumstances rather than just simply allowing an election when it may be beneficial to particular taxpayers.

And second:

> …there would be circumstances in which firms within a group would have different shareholders, and therefore the retrospective application would mean that there would be some firms which would potentially have a reallocation to another firm within the group. That could obviously impact on shareholders or owners of those particular firms.[15]

3.19 Mr Garry Waugh, Lead Partner of National R&D at PwC, told the committee that 'there are some circumstances where it is not simply a reallocation of the premium within between parties within a group'. Specifically, he highlighted single companies in groups that are not consolidated for tax purposes as being disadvantaged by the proposed change to Item 19 in that they miss out on the 175 per cent premium.[16] Mr Flavel noted that even in circumstances where a large company and a small company are grouped together, 'if they were separate firms they may not always be…eligible for the 175 per cent concession'.[17]

3.20 KPMG also argued that the amendment to Section 73X(1) of the ITAA 1936 should be made retrospective. Its submission noted:

> the deferral of the date of application of the intended amendment until the year of income following the year of income in which this amendment receives Royal Assent defeats the spirit of the policy objective of rectifying this legislative anomaly…As these measures are a concession, they should be retrospective to 1 July 2001 to reflect the policy intent outlined in the Backing Australia's Ability innovation measures.[18]

3.21 KPMG's submission adds that if this recommendation is not accepted, 'at a minimum, the amendment should apply to years of income ending on or after 9 May 2006, i.e. the date of the announcement of this amendment'.[19]

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15 Mr Matthew Flavel, *Committee Hansard*, 23 April 2007, p. 11.

16 Mr Garry Waugh, *Committee Hansard*, 23 April 2007, p. 12.

17 Mr Matthew Flavel, *Committee Hansard*, 23 April 2007, p. 12.

18 *Submission 5*, p. 1.

19 *Submission 5*, p. 3.

3.22 Treasury was strongly opposed to this suggestion. Mr Flavel explained to the committee:

> Choosing a date like the date of the budget provides a number of issues, including the fact that it is part way through an income year. It is also something that as only really been used when there has been a decision which the government has wanted to apply specifically from that date so that there is no adverse behaviour.[20]

Costing of retrospective changes

3.23 Ms Mason told the committee that PwC had not costed the impact of its proposed retrospective deductions. She did note that Treasury's estimated financial impact in the EM was $2.5 million per year and added, 'we presume…that the impact would be in line with that'.[21] Mr Waugh told the committee that:

> The assumption could be that the cost to the revenue in respect of earlier years is likely to be less than the current year because of the four-year history requirement…plus the lower uptake that I mentioned in earlier years.[22]

The consultative process for the bill's amendment to the 175 per cent premium

3.24 Ms Mason told the committee that the bill's changes to the 175 per cent concession had been raised at a consultative forum with AusIndustry and the Australian Taxation Office (among others) prior to the May 2006 federal budget. Treasury told the committee it had only received direct notification of the issue by the ATO.[23]

3.25 Mr Flavel emphasised to the committee that the majority of the bill's amendments are technical amendments aimed at improving the ability of firms to access R&D tax concessions.[24] He noted that Treasury was 'aware that given they [the amendments] were all improvements it was going to be highly unlikely that these were going to be contentious ', other than the issue of retrospectivity.

3.26 Mr Waugh was asked why it had taken five years for the bill's proposed changes to the 175 per cent concession to be publicly raised. He responded that major groups had found it difficult to 'work their way through the complex provisions' and that some of the problems 'have taken some time to come to light'.[25]

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20 Mr Matthew Flavel, *Committee Hansard*, 23 April 2007, p. 11.

21 Ms Sandra Mason, *Committee Hansard*, 23 April 2007, p. 7.

22 Mr Garry Waugh, *Committee Hansard*, 23 April 2007, p. 11.

23 Mr Matthew Flavel, *Committee Hansard*, 23 April 2007, p. 11.

24 Mr Matthew Flavel, *Committee Hansard*, 23 April 2007, p. 5.

25 Mr Garry Waugh, *Committee Hansard*, 23 April 2007, p. 9.

Schedule 7—Technical amendments and corrections

3.27 The committee received submissions from the Sydney Opera House and the Powerhouse Museum supporting Schedule 7 of the bill enabling cultural institutions that are linked to Government to receive gifts from ancillary funds. The Acting Chief Executive of the Sydney Opera House, Mr David Antaw, wrote in his submission:

> The amendments contained in the Tax Bill are the last step in what has been a long process for entities such as the Sydney Opera House, the Powerhouse Museum, the National Gallery of Victoria and many others, in creating an environment where philanthropic gifts can be received from ancillary funds and prescribed private funds (PPFs).[26]

3.28 Mr Antaw noted that amendments had been passed to New South Wales and Victorian Charities law in late 2006 to deem gifts to cultural entities to be charitable. However, he argued that the ATO must also recognise that these gifts will not adversely affect the ancillary fund or PPF's charitable status. Accordingly, Mr Antaw urged that the Bill 'be approved and legislated in the near future'.[27] The Director of the Powerhouse Museum, Dr Kevin Fewster, also endorsed the proposed amendments in Schedule 7 noting that the current law disadvantages the Museum.[28]

Committee comments

3.29 The committee supports the amendments in all seven Schedules of the bill. It highlights the particular support received for the proposed changes to depreciation of mining rights (Schedule 1) and receipt of gifts by cultural institutions from ancillary funds (Schedule 7). The committee received no evidence on Schedules 4, 5, 6 and 8 and on this basis, it appears that these measures are uncontentious.

3.30 The committee notes that the main issues of contention with the bill concern the timing of the proposed amendments in Schedules 2 and 3. On the issue of tax deductibility for private boat operators and holders, the committee highlights Treasury's evidence that retrospective claims may date back more than 30 years and may therefore involve high administration and compliance costs. This may also affect various settlements that have been made with the ATO.[29]

3.31 On the issue of whether to give retrospective payments to companies within a group that have been unable to claim the 175 per cent premium, the committee acknowledges the proposals put by PwC and KPMG, however, it notes the concerns with the situation post July 2001 do not appear to have been raised until prior to the May 2006 Budget. Treasury has explained that as the amendment to eligibility for the

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26 *Submission 2*, p. 1.

27 *Submission 2*, p. 2.

28 *Submission 3.*

29 Mr Gregory Pinder, *Committee Hansard*, 23 April 2007, p. 18.

premium is an improvement—rather than correction—to the 2001 legislation, it should not apply retrospectively. The committee also notes Treasury's concerns that retrospective payments would reallocate funds to other firms within the group, thereby impacting on shareholders or owners of those firms. On principle and on administrative grounds, therefore, the committee supports the timing of the amendments in Schedule 3.

Recommendation 1

3.32 The committee recommends that the Senate pass the bill.

Senator the Hon Michael Ronaldson
Chair