Chapter 2

Schedule 1—Tax preferred entities (Asset financing)

2.1 Schedule 1 to the bill amends the income tax law to modify the taxation treatment of financing arrangements between public private partnerships (PPPs). The changes are intended to simplify the tax treatment of leasing and similar arrangements between taxpayers and the tax exempt sector for financing and providing infrastructure and other assets.[1] They 'will effectively remove a complex aspect of the current arrangements, and bring two different provisions of the 1936 Tax Act into one consolidated provision in the new law.'[2]

2.2 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).[3] The objective of the measure in Schedule 1 is to provide a more coherent and neutral tax treatment that reflects the economic substance of the arrangement.

2.3 Schedule 1 adds Division 250 to the *Income Tax Assessment Act 1997* (ITAA 1997). The aim of Division 250 is to encourage private sector investment in pubic–private partnerships (PPPs) by reducing compliance costs, providing tax benefits and giving greater certainty to private builders of major infrastructure. The legislation can therefore be viewed as a stimulus to PPP activity in Australia. The measure will apply if, broadly:

- the tax exempt entity (the public agency)[4] directly or indirectly uses, or effectively controls the use of the asset; and
- the taxpayer (the private investor) does not have the predominant economic interest in the asset.[5]

2.4 The Division will deny or reduce capital allowance deductions if the asset is put to a tax preferred use and the taxpayer has insufficient economic interest in the asset. (Schedule 1 of the bill defines and introduces into the ITAA 1997 various terms

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1 The Hon. Mal Brough, MP, Minister for Revenue and the Assistant Treasurer, 'Tax Exempt Asset Financing Reforms', Press Release No. 081, 13 September 2005.

2 The Hon. Mal Brough, MP, Minister for Revenue and the Assistant Treasurer, 'Tax Exempt Asset Financing Reforms', Press Release No. 081, 13 September 2005.

3 EM, p. 105.

4 'Tax exempt entities' refers to federal, state and local governments, as well as charitable and other institutions such as hospitals and religious bodies. Tax preferred entities includes tax exempt entities as well as non-residents.

5 The Hon. Peter Dutton MP, Minister for Revenue, 'Continuing to Improve Australia's tax system', Media Release No. 100, 16 August 2007. See also, EM, pp 13 and 15.

relating to tax preferred use of an asset.[6]) Where deductions are denied or reduced, Division 250 treats the arrangement as a deemed loan that is taxed as a financial arrangement on a compounding accruals basis. The effect of such treatment is to allow deductions for interest payments which are spread over the period of the arrangement rather than over the period of the effective life of the asset.[7] Depending on the particular arrangement, this can spread deductions over a longer period.[8] This differs from existing treatment under the *Income Tax Assessment Act 1936* (ITAA 1936) where deductions are denied and all the proceeds from the arrangement are assessable (section 51AD) or capital allowance deductions are denied and the arrangement is treated as a deemed loan that is taxed on a cash receivables basis (Division 16D).[9]

2.5 Division 250 also contains various exclusions such as certain short-term and low value arrangements. Additionally, it does not apply to arrangements that operate for less than 12 months, where the taxpayer is a small business entity or where the financial benefits provided by the tax preferred sector do not exceed $5 million.[10]

2.6 The provisions of Schedule 1 offer more flexibility and incentives for public-private investment than current arrangements.

Background and existing arrangements[11]

2.7 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.

2.8 Stakeholders in public private partnerships developed arrangements to circumvent this principle[12] and so section 51AD and Division 16D of Part III of the ITAA 1936 were enacted in the 1984-85 income year to prevent the mischief. 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.

2.9 Currently, section 51AD prevents a tax-exempt body—typically a government agency—from accessing tax benefits from an asset that is financed by highly leveraged non-recourse debt. Where this section applies, the taxpayer is assessed on

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6 See items 2 to 24 of Schedule 1 of the bill.

7 Mr Anthony Regan, Manager, Company Tax Unit, Business Tax Division, Department of the Treasury, *Proof Committee Hansard*, 28 August 2007, p. 6.

8 Mr Regan, *Proof Committee Hansard*, 28 August 2007, p. 7.

9 EM, p. 17.

10 EM, pp 25–26 and pp. 43–50.

11 EM, pp 13–15.

12 See the EM at p. 14 for a description of these arrangements.

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).

2.10 Division 16D denies capital allowance deductions for the cost of, or capital expenditure on, property which a tax-exempt body uses under a finance lease or similar arrangement.[13] This division 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.

2.11 The amendments in Schedule 1 of the bill will replace section 51AD and Division 16D with Division 250 of the 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.

2.12 Because of the specific exclusions in Division 250 and its more generous safe harbour tests, it will likely have a narrower scope than section 51AD and Division 16D.[14]

2.13 On 13 September 2005, the Minister for Revenue, the Hon. Mal Brough, announced the amendments to the law 'to give greater certainty for parties involved in major infrastructure projects'. He foreshadowed that the proposed amendments will insert a ‘lease, use or control of use of the asset’ test into the *Income Tax Assessment Act 1997*. He added:

> Stakeholders are familiar with the operation of the ‘lease, use or control of use of the asset’ test in the existing law. This is an important consideration in enhancing continued investment in Australia’s infrastructure. Stakeholder concerns about the scope of arrangements affected by the reforms being broadened by the use of new risk based tests will be alleviated by this change.[15]

2.14 On 16 August 2007, the Minister for Revenue, the Hon. Peter Dutton, announced the introduction of the legislation. He noted that the measure will apply to arrangements entered into on or after 1 July 2007, while the denial of all tax

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13 EM, p. 15.

14 EM, p. 21.

15 The Hon. Mal Brough, MP, Minister for Revenue and the Assistant Treasurer, 'Tax Exempt Asset Financing Reforms', Press Release No. 081, 13 September 2005.

deductions in certain circumstances under section 51AD will cease to apply to arrangements entered into on or after 1 July 2003.[16]

Evidence received by the committee

2.15 The committee received seven submissions that commented on Schedule 1, one of which was confidential. Overall, submissions were supportive of the Schedule which is the outcome of an extensive consultation process between stakeholders and the Treasury.[17] Although there are some areas of concerns with the legislation,[18] submitters did not wish to see the passage of the bill delayed.

2.16 Broadly, submissions can be divided into three categories, as follows:

- those that welcome the amendments as a means of encouraging investment in infrastructure (Property Council of Australia, CPA Australia, Infrastructure Partnerships Australia, and Australian Chamber of Commerce and Industry);
- those that consider the amendments unfairly discriminate against Australian investors in foreign real estate – for example property trusts (Property Council of Australia); and
- the Minerals Council of Australia submission that points out that although the Australian minerals industry supplies commodity to tax exempt state owned corporations, Division 250 provisions will not apply in this context, a point of view it contends is supported by some of the examples in the Explanatory Memorandum (Examples 1.3 and 1.4).[19] Therefore the Council supports Schedule 1 of the bill on the proviso that these examples remain in their current form.

The 'limited recourse debt test'

2.17 One of the tests for applying Division 250 to a taxpayer in respect of an asset is that the taxpayer lacks a predominant economic interest in the asset. There are several tests in the division to determine whether this is the case and one of these is the 'limited recourse debt test'. Under this test the taxpayer lacks a predominant economic interest in an asset at a particular time if:

16 The Hon. Peter Dutton MP, 'Continuing to improve Australia's tax system', Media Release No. 100, 16 August 2007.

17 EM, pp 113 and 114.

18 See for example, *Submission 9*, Property Council of Australia; *Submission 15*, Infrastructure Partnerships Australia; *Submission 17*, Australian Chamber of Commerce and Industry.

19 *Submission 7*, Minerals Council of Australia, p. 1.

- where the asset is put to tax preferred use by a tax preferred end user, more than 80 per cent of the cost of acquiring or constructing the asset is financed (directly or indirectly) by limited recourse debt;[20] or
- where the asset is put to tax preferred use by an end user that is a non-resident, more than 55 per cent of the cost of acquiring or constructing the asset is financed (directly or indirectly) by limited recourse debt.

2.18 As well as applying in relation to public private partnership arrangements in Australia, the Division can also apply where Australian taxpayers invest overseas and the tax preferred end user in such an instance is a non-resident. The Property Council of Australia submitted that there is no sound public policy ground for the distinction between residents and non-residents in relation to their levels of limited recourse debt.[21] Mr Trevor Cooke, Executive Director, International and Capital Markets Division, Property Council of Australia told the committee that 'the 55 per cent test is too low and…it should be harmonised with that applying to domestic, which is 80 per cent.'[22] The Property Council submission argues that as it stands, the provision will:[23]

- generate additional foreign taxes payable by Australian investors in overseas real estate;
- put Australian investors at a disadvantage when bidding for foreign real estate assets;
- mean that Australian investors will take more risk and pay more to foreign banks for that risk; and
- penalise Australian investment.

2.19 Further, the submission suggests that foreign investors are not interested in tax benefit transfers and equalising the threshold will not give an advantage to foreigners.

2.20 Mr Tony Regan, Manager, Company Tax Unit, Business Tax Division, Department of the Treasury, told the committee that the fundamental policy question is that capital allowance deductions are intended to encourage investment in Australia rather than investment offshore.[24] Under the current law, an asset that is predominantly financed by non-recourse debt triggers section 51AD. When that occurs all capital allowance and interest deductions are denied.

2.21 However, Division 250 will relax the 50 per cent test for non-residents. Mr Regan stated that this will:

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20 'Limited recourse debt' is defined in the section 243-20 of the ITAA 1997. Section 250-115 of Schedule 1 of the bill, further refines the definition as it applies to the test.

21 Property Council of Australia, *Submission 9*, p. 2.

22 *Proof Committee Hansard*, 28 August 2007, p. 2.

23 Property Council of Australia*, Submission 9*, pp 3 – 4.

24 *Proof Committee Hansard*, 28 August 2007, p. 6.

> …build some tolerance into [the test]. It will relax it to a greater extent where the asset is in Australia. But it also does not deny deductions as such. Strictly speaking, it denies capital allowance deductions but keeps the arrangement as a loan.[25]

2.22 Currently, the position is that a 50 per cent test exists for both residents and non-residents. As a result of representations received during the consultation process, the Government decided to increase those thresholds to 80 per cent for residents and 55 per cent for non-residents. Essentially, the increase to 55 per cent for non-residents was to build some tolerance into the test so that it would not be triggered it by a marginal breach of the 50 per cent test.[26]

Committee comment

2.23 The committee understands that the primary aim of the legislation is to encourage investment in Australia rather than investment offshore, so it is not persuaded about the need to equalise the proportion of non-recourse debt between residents and non-residents in this particular legislation.

2.24 The committee notes the evidence of Mr Regan that the Board of Taxation is currently reviewing the foreign income attribution rules (as part of the Board's Review of the Anti-Tax-Deferral Regimes) and depending on its findings, some future modification of the limited recourse debt test may be possible.[27]

Other issues

2.25 The Committee also received a submission from Deloitte Touche Tohmatsu Ltd which supported the bill for its removal of the 'draconian' impacts of section 51AD and the inclusion of 'many of the significant issues raised during the earlier consultation process'.[28] However, it raised some technical issues that it believed need to be corrected in three areas of the bill.

2.26 First, Deloitte expressed concern that the wording of Division 250-50 may define an 'end-user' in terms of the use or control of the property by the tax-exempt entity post transfer. This is inconsistent with the 'end user' test in section 51AD, which did not examine the use of control of the asset post the transfer. Accordingly, Deloitte recommends changing the definition of 'user end' in Division 250–50(1) to insert the words *during the arrangement period*.

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25 *Proof Committee Hansard*, 28 August 2007, p. 6.

26 Mr Regan, *Proof Committee Hansard*, 28 August 2007, p. 7.

27 Mr Regan, *Proof Committee Hansard*, 28 August 2007, p. 8.

28 Deloitte Touche Tohmatsu Ltd, *Submission 6*.

2.27 Second, Deloitte argued that Division 250 may apply inappropriately to the controlled foreign companies (CFC) regime in cases where a CFC leases property located outside Australia to another non-resident entity. Section 383 of the ITAA 1997 does not assume that the other non-resident entity is to be treated as a resident for the purpose of Division 250. Deloitte therefore suggested that Division 250 be excluded:

> …until such time that proper consultation has occurred in respect of this interaction provision. We believe that a technical correction should be made to section 389 and 557A to achieve this result.[29]

2.28 Third, Deloitte noted that the transition rule in Schedule 1, Part 3, subitem 71(11) only has application from 1 July 2007, whereas the EM (paragraph 1.287) states that the legislation will be backdated to 1 July 2003. It argued that a technical amendment was required to change the reference from 1 July 2007 to 1 July 2003 to ensure that those affected by section 51AD since July 2003 are not adversely affected.

2.29 The committee did not canvass these issues during its public hearing and can therefore make no comment on them.

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29 Deloitte Touche Tohmatsu Ltd, *Submission 6*, p. 3.