Chapter 2

The bill

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

- small business capital gains tax concessions;
- exemptions from interest withholding tax;
- integrity arrangements and compliance requirements for deductible gift recipients ;
- extensions to certain deductible gift recipients;
- effective life of tractors and harvesters;
- farm management deposits; and
- capital protected borrowings.

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

Schedule 1—Small business capital gains tax provisions

2.3 The small business capital gains tax (CGT) provisions in Schedule 1 of the bill arise in part from the recommendations of the Board of Taxation[1] that were accepted by the Government.

2.4 Schedule 1 is intended to reduce the compliance costs for small business and increase the availability of the small business CGT concessions. It makes changes to the following:

- the maximum net asset value test;
- the active asset test;
- the 15-year exemption;
- the retirement exemption;
- the small business roll-over; and
- the application of concessions to partners in a partnership and deceased estates.

2.5 Amendments also replace the controlling individual 50 per cent test with a significant individual 20 per cent test that can be satisfied either directly or indirectly through one or more interposed entities. The objective is to make the controlling

---

1 Board of Taxation, *A Post-implementation Review of the Quality and Effectiveness of the Small Business Capital Gains Tax Concessions in Division 152 of the Income Tax Assessment Act 1997*, at: http://www.taxboard.gov.au/content/small_business_CGT/CGT_Report.asp

individual test less onerous so that the small business CGT concessions can be accessed by a broader range of small business taxpayers.

Standing Committee for the Scrutiny of Bills comment

2.6 In its Alert Digest No. 1 of 2007, the Scrutiny of Bills Committee raised the issue of retrospective application in relation to Schedule 1, item 67. However, the Committee made no further comment on the provision because the Explanatory Memorandum states that the relevant amendment is beneficial to some taxpayers because it increases the availability of the small business capital gains tax concession.

Schedule 2—Interest withholding tax exemptions

2.7 Subject to a number of exemptions, interest payments to non-residents are levied under Division 11A of the *Income Tax Assessment Act 1936* (the ITAA) with 10 per cent withholding tax. Exemptions for certain publicly offered debentures or debt interests are contained in sections 128F and 128FA of the Act. These exemptions for certain types of offshore borrowings are intended to ensure that Australian business does not face a higher cost of capital as a consequence of the imposition of interest withholding tax. The exemptions are targeted at arm's-length arrangements such as structured capital raisings for business activities and exclude related party transactions and individually negotiated loans.

2.8 The bill amends sections 128F (exemption on certain publicly offered **company** debentures or debt interests) and 128FA (exemption on certain publicly offered **unit trust** debentures or debt interests) to clarify the withholding tax exemptions.

2.9 Significantly, the bill also introduces a regulation making power to the sections to allow the Minister to specify which instruments will qualify for the exemptions and which will not qualify.

Background

2.10 Before 2005, the exemptions from interest withholding tax (IWT) in the ITAA were limited to interest paid by a company or unit trust to non-residents for debentures that satisfied the public offer test and certain other conditions. However, in 2005, legislative amendments[2] extended the exemptions from interest on a debenture to interest on a debenture or a non-debenture debt interest. The extensions were made to reflect changes to Australia's 2001 debt/equity rules that arose from the development of innovative financing arrangements. The changes replaced legal form tests for characterising financing arrangements as debt or equity with tests of substance rather than form. These changes were made in response to the use in financial markets of

2 These amendments were contained in the *New International Tax Arrangements (Managed Funds and Other Measures) Act 2005*.

instruments that were legally equity, but actually debt, or legally debt, but actually equity (this development is explained more completely in paragraph 2.15).

2.11 The 2005 amendments to section 128F of the ITAA enabled interest on debt interests under the new debt/equity rules to be eligible for the IWT exemptions, provided they also satisfied the other eligibility requirements and, in particular the public offer test (details of which can be found on pages 51-52 of the Explanatory Memorandum). For example, the 2005 changes enabled interest on close substitutes for debentures in capital raisings by companies, such as redeemable preference shares, to be eligible for the IWT exemption.

2.12 In a similar way to section 128F, section 128FA provides for exemption from IWT for interest payments to non-residents. Prior to the 2005 amendments, section 128FA provided for interest withholding tax exemption only for interest paid on debentures issued by the trustee of an eligible unit trust. The 2005 amendments to section 128FA were also driven by the 2001 debt/equity rule changes, and extended IWT exemptions to interest on debt interests that also satisfied the other eligibility requirements.

2.13 The ASFA online dictionary defines debentures as a type of interest-bearing security issued by companies.[3] Money invested in debentures is a secured loan. There is usually no specific security, but the debenture is supported by a charge over the assets of the company. Debentures generally raise money for the medium to long term — two to five years.

2.14 'Debenture' is currently defined for the purposes of sections 128F and 128FA of the Act to include debenture stock, bonds, notes and any other securities of the company (whether or not constituting a charge over the assets of the company), promissory notes and bills of exchange. The Explanatory Memorandum states that although there is some uncertainty about the scope of the terms 'debenture' and 'security' with both having broad common law meanings, relevant case law suggests the following:[4]

- a debenture is a transferable document that either creates or acknowledges a debt (rather than merely evidencing it);
- while promissory notes and bills of exchange are not customarily held to be debentures under common law, they were inserted into the definition of debenture in the Act for the purposes of these provisions; and
- savings accounts, transaction or current accounts, term deposits and non-transferable certificates of deposit would **not** generally be regarded as debentures or securities.

3 Definition from the Association of Superannuation Funds of Australia Ltd (ASFA) online dictionary, at: http://www.superannuation.asn.au/Online-Dictionary/default.aspx

4 Explanatory Memorandum, p. 47.

2.15 'Debt interest' is defined by reference to Division 974 of the *Income Tax Assessment Act 1997.* It is a broad term that includes both financial instruments and financing arrangements, and embeds the concept of a non-contingent obligation to pay an amount to the holder of the debt interest, at least equal to its issue price, in the future. For the holder, this reflects receipt of a financial benefit, which need not amount to interest. It has resulted in certain financial instruments that would previously have been regarded as equity now being categorised as debt. Provided these debt interests give rise to interest, payment of that interest may attract IWT. It includes debentures and the range of standard retail and wholesale products offered by financial institutions (the Australian Taxation Office has publicly accepted as debt interests transferable certificates of deposit and syndicated loans) as well as hybrid debt/equity instruments such as non-equity shares.

2.16 The continuing requirement that debentures and debt interests meet the public offer test limits the range of debentures and debt interests qualifying for IWT exemption. However, according to the Explanatory Memorandum, on a strict legal form assessment, it is possible that certain financial instruments that have not traditionally been regarded as debentures could be interpreted as such:

> …interpretative pressure on the relevant law has the potential to substantially widen the range of debentures and debt interests that could qualify for exemption from interest withholding tax, beyond the original policy intent. This represents a threat to the integrity of the tax system.[5]

2.17 This appears to be the key driver of the changes in this Schedule.

2.18 Accordingly, the amendments in the bill are designed to restore the original purpose of the 2005 interest withholding tax amendments. The Explanatory Memorandum states that:

> The amendments clarify the range of interest payments to non-residents on non-debenture debt interests that qualify for interest withholding tax exemption, consistent with the policy intent at the time the original amendments were introduced in 2005. At that time, the Government had intended providing eligibility for hybrid financial instruments regarded as debt under Division 974 of the ITAA 1997. The most obvious example is a non-equity share, such as a redeemable preference share. The inclusion of a regulation-making power in the amendments to prescribe further eligible debt interests will enable other (possibly yet to be developed) hybrid instruments to be made eligible where they perform a similar capital raising role in similar circumstances to currently eligible debentures and debt interests. Regulations could also be made to provide transitional arrangements, as appropriate, in relation to debt interests issued since the 2005 amendments.

5 Explanatory Memorandum, p. 46.

Standing Committee for the Scrutiny of Bills comment

2.19 In its Alert Digest No. 1 of 2007, the Scrutiny of Bills Committee raised the issue of retrospective application in relation to Schedule 2, item 8. However, the Committee made no further comment on the provision because the Explanatory Memorandum states that the amendments will have no financial impact.

Schedules 3 and 4—Deductible gift recipient arrangements

2.20 Australian taxpayers may claim an income tax deduction for gifts of $2 or more, or property, to eligible gift 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.

2.21 As part of the DGR integrity arrangements, endorsed DGRs are required to maintain gifts and contributions in a separate fund. Schedule 3, in some cases, removes the requirement for DGRs to maintain gift funds; and for DGRs to maintain one gift fund rather than multiple gift funds. Further, the amendments standardise the integrity arrangements for all DGRs, so that listed DGRs can now be reviewed by the Commissioner in line with the Commissioner's current powers to review endorsed DGRs to determine if they continue to meet the conditions of their DGR status.

2.22 Schedule 4 of the bill extends the period for which deductions are allowed for gifts to four listed funds that have time limited DGR status.

Schedule 5—Effective life of tractors and harvesters

2.23 As part of the Ralph Review recommendations,[6] the Australian Taxation Office is over time reviewing the periods over which assets can be depreciated. According to the Minister's press release,[7] the ATO was required to release a discussion paper suggesting that the 'effective life' for depreciation purposes of new tractors be increased to 12 years; and to 10 to 12 years for new harvesters.

2.24 The amendments in the bill add a statutory cap of $6^2/_3$ years to the uniform capital allowances regime for tractors and harvesters used in the primary production sector, thus preserving the current $6^2/_3$ year period and ensuring that there will be no change to the income tax treatment on harvesters and tractors. The measure is intended to provide certainty to farmers in a time of drought.[8]

---

6 *Review of Business Taxation, A tax system redesigned*, July 1999.

7 *Farmers to be protected from changes to the 'effective life' of tractors and harvesters*, Minister for Revenue and the Assistant Treasurer, the Hon. Peter Dutton, MP, Press Release No. 083, 16 November 2006.

8 *Government to make further improvements to the tax system*, Minister for Revenue and the Assistant Treasurer, the Hon. Peter Dutton, MP, Press Release No. 091, 7 December 2006.

Schedule 6—Farm management deposits

2.25 Schedule 6 is another measure to support primary producers through the ongoing drought.[9] It increases the non-primary production income threshold from $50,000 to $65,000 per income year and the total amount that a primary producer can hold in a farm management deposit from $300,000 to $400,000.

2.26 Primary producers (with a limited amount of non-primary production income) can claim deductions for farm management deposits made in the year of deposit. When they withdraw a farm management deposit, the amount of the deduction previously allowed is included in assessable income in the withdrawal tax year. The scheme is designed to allow primary producers to set aside income from profitable years for subsequent 'draw-down' in low-income years, thus reducing the risk of income variability owing to factors such as drought.

2.27 Currently, an individual primary producer with taxable non-primary production income of $50,000 or less for the year of income is able to make a farm management deposit. By increasing the non-primary production income threshold from $50,000 to $65,000 the amendment will allow more primary producers to hold farm management deposits as well as allow current holders to earn a larger amount of non-primary production income each income year without becoming ineligible for the Scheme.

Schedule 7—Capital protected borrowings

2.28 The measures in Schedule 7 deal with the taxation of capital protected borrowings (CPBs). They amend the *Income Tax Amendment Act 1997* (ITAA 1997) to overcome the decision of the Full Federal Court in Firth's Case[10] where the Court ruled that the component of 'interest' applicable to the cost of capital protection feature of a capital protected borrowing (CPB) is deductible when paid. On 5 November 2002, the High Court refused special leave for the Commissioner of Taxation to appeal this decision.

Context of amendments

2.29 A typical CPB is a limited recourse loan facility which is used to fund the purchase of shares, units or stapled securities. The nature of the facility is such that the borrower has the right to satisfy the outstanding loan by transferring the shares, units in a unit trust or stapled securities back to the lender. Consequently, the borrower is protected if there is a fall in the price of the shares, units in a unit trust or stapled securities acquired under the loan facility. According to the Explanatory

---

9 *Government to make further improvements to the tax system*, Minister for Revenue and the Assistant Treasurer, the Hon. Peter Dutton, MP, Press Release No. 091, 7 December 2006.

10 *Commissioner of Taxation vs Firth* 120 FCR 450.

Memorandum, such an arrangement can be viewed as, or disaggregated into, a full recourse loan and an embedded put option.

2.30 The cost of the capital protection component is included in, and takes the form of, 'interest' payable on the loan. As a result, the total 'periodic' expense (labelled 'interest') paid by the holder of a CPB may be considerably higher than the interest payable on a borrowing facility without capital protection.

2.31 Another common type of CPB involves a full recourse loan to fund the purchase of shares, units or stapled securities and an explicit put option to hedge the value of the securities.

Firth's case

2.32 The CPB in Firth's case consisted of:

- a limited recourse loan made to acquire a beneficial interest in the underlying securities, which could be satisfied by putting the securities to the lender; and
- the borrower's beneficial interest in the underlying securities.

2.33 Interest incurred on the limited recourse loan used to purchase securities may be deductible in accordance with section 8-1 of the ITAA 1997.

2.34 Any income from the underlying securities acquired by the funding under the loan is usually subject to tax, as is any capital gain on disposal of the underlying securities. Any capital loss on disposal will be subject to the quarantine provision of the capital gains tax (CGT) provisions meaning that it could only be offset against a capital gain.

2.35 The decision in Firth's case allows a borrower to obtain an income tax deduction for what may in fact be, in substance, a capital cost.

2.36 The measure in the bill will treat capital protection under a CPB that is not provided under an explicit put option as though it is a put option that is acquired by the borrower under the CPB. It will also treat the amount incurred in respect of such capital protection as though it is a put option premium paid by the borrower under the CPB to the provider of the capital protection under the CPB. The measure will also apply to CPBs with explicit put options.

Standing Committee for the Scrutiny of Bills comment

2.37 In its Alert Digest No. 1 of 2007, the Scrutiny of Bills Committee raised the issue of retrospective application in relation to Schedule 7, item 5. The retrospectivity arises because the amendments to overcome the effect of the Firth case are to apply from the date of the Treasurer's press release, issued on 16 April 2003 which announced the Government's decision.

2.38 The Scrutiny of Bills Committee drew attention to a declaratory resolution of the Senate in 1988 to the effect that if more than six months elapses between a government announcement of a taxation proposal and the introduction or publication of a bill, the Senate will amend the bill to reduce the period of retrospectivity to the time since the introduction or publication of the bill.