

24 November 2008

# **TAX LAWS AMENDMENT (2008 MEASURES NO. 5)**

## **BILL 2008**

### **Second Reading**

**Mr BRADBURY (Lindsay) (12.44 p.m.)** — I rise in support of the Tax Laws Amendment (2008 Measures No. 5) Bill 2008. I wish to comment on the schedules contained therein and, in particular, I would like to focus my comments on schedules 4 and 5, which relate to the fringe benefits tax amendments in respect of jointly held assets and the amendments in relation to managed investment trusts.

It is worth acknowledging that the first schedule to the bill is largely an integrity measure and addresses one of the shortcomings of the current operation of the goods and services tax law. In particular, it deals with the margin scheme, a very important component of the GST law that recognises the need to tax only incremental gains in relation to real property rather than imposing the added tax burden of a tax on the entire property at each stage of the disposal process along what is inevitably a chain of disposals. The schedule deals with the interaction between the margin scheme and the GST-free provisions in relation to the sale of business as a going concern and also GST-free sales of farmland. It also involves the interaction of the provisions dealing with suppliers between associated entities.

The way in which the law has operated has given rise to a situation where some taxpayers have been able to not realise a GST liability throughout the process of the development of land. Largely, that has occurred by allowing an increase in the value of the land to occur but not to be brought to account in GST terms as a result of using these GST provisions in relation to the sale of a going concern or the GST-free sale of farmland. This measure will ensure that for taxpayers in like situations, regardless of whether or not they seek to take advantage of a going concern in farmland provisions or alternatively the associated entities provisions, like treatment will be attributed as would normally be the case for any other taxpayer utilising the margin scheme. It is a measure that will yield some revenue for the government, but it is a measure that is largely one of equity and integrity to make sure that like taxpayers are treated equally.

In relation to schedule 2 and the changes proposed to the thin capitalisation regime, it is worth noting that, with the introduction of the Australian equivalent of the International Financial Reporting Standards, there were some implications that flowed through to the thin capitalisation regime. It is important for us to recognise that there is some benefit in allowing a departure from the accounting standards in order to better reflect the factors that the government believes should be taken into account when determining the extent to which the thin capitalisation regime should apply. Thin capitalisation is the means by which, in the case of excessive leveraging—excessive use of debt through investments by multinationals—the interest deductions available can be reduced, therefore ensuring that companies do not unduly and disproportionately have a greater proportion of debt rather than equity in the investments that are operating within Australia. Obviously, allowing a greater proportion of investment to be debt funded allows greater deductions for interest expenses, and that comes at a cost to revenue. These measures largely take into account changes that are precipitated by monitoring the

operation of the Australian equivalent of the International Financial Reporting Standards.

The interest withholding tax provisions seek to extend an exemption that is currently provided in respect of withholding tax on interest payments to state and territory government bonds. Contrary to what the member for Fadden may have been trying to suggest, this is in no way connected with the government's guarantee for both retail deposits and wholesale term funding. I am not really sure what argument the member was seeking to make there, but there is clearly no connection between the government's decision to introduce the guarantees and the need for this particular initiative. In fact, if we go back and have a look at the genesis of this particular proposal, it was announced by the Treasurer back in May of this year at the same time as the Treasurer announced the Commonwealth's commitment to increase Commonwealth government securities on offer. This was a measure that was undertaken well and truly in advance of any of those more recent measures. Let it be put on the record that the suggestion made by the member for Fadden that somehow this is a response to those imperatives is clearly not correct and does not stand up to more thorough examination.

That brings us to schedule 4 and the fringe benefits tax in relation to benefits jointly held. These amendments address an area of the law that has been open for exploitation and close a loophole in relation to section 138(3) of the Fringe Benefits Tax Assessment Act which deems a benefit provided jointly to an employee and one or more associates of the employee to be provided solely to the employee. There is an interaction between that provision and the 'otherwise deductible' provision which is prevalent throughout the FBT regime.

Clearly, this has given rise to a situation where some individual employees have entered into salary-sacrificing arrangements and have purchased an investment property jointly with a partner or a spouse. They have used pre-tax dollars through that salary-sacrificing arrangement to cover the costs of the interest expenses that have been incurred in relation to the borrowings on the investment property. Those interest expenses would otherwise be deductible because they are expenses incurred in the course of producing assessable income in the form of rental income derived from the investment property. In establishing that, they bring themselves within the 'otherwise deductible' rule.

That should be viewed in parallel with section 138(3), which provides that a benefit provided jointly to an employee will be for the purposes of fringe benefits tax considered to be a benefit provided solely to that employee. The effect of this is that the employee under such an arrangement is able to obtain the benefit of the salary-sacrificing arrangement so as to claim in effect a 100 per cent deduction for the interest expense that has been incurred in respect of the investment property. Clearly, in the scenario where employees have not taken advantage of this loophole, that interest expense would need to be apportioned and, in a joint tenancy arrangement, a deduction would only be available for 50 per cent of the interest expense. So this measure will go a long way towards plugging that hole. Once again, as with the other measures in this bill, it will provide for greater equity between taxpayers in relation to how in this case the fringe benefits tax impacts upon them and their taxation affairs.

I now turn to schedule 5. This is the schedule in the bill that is of greatest interest to me. This is a further instalment in the government's attempts to establish Australia as a regional financial services hub. I know it was said previously by one speaker in this debate that one can only ask why it has taken so long for these measures to be implemented. That is a valid question to ask, and one to which I have not heard a satisfactory response. Division 6C of the Income Tax Assessment Act 1936 is one area of the law

which has for a very long time needed some close attention and reform. That is why this government is committed to achieving that reform. The measures proposed in this bill are only one instalment in achieving that reform. The Board of Taxation is currently undertaking a review of division 6C. A discussion paper for the purposes of consultation has been released. I know that industry is being widely consulted to ensure that the outcome of that process achieves wide-ranging reform in relation to the impact of division 6C.

Division 6C was introduced back in 1985. It was designed to ensure that public unit trusts carrying on active business activities would be taxed in the same way as a company. It was essentially a regime that was created to ensure that, rather than taxation treatment being determined purely by the legal entity involved in the economic activity, there would be closer analysis of the underlying economic realities of the business being carried on by that entity. So just because it is a trust need not mean that it should receive the beneficial tax treatment that a trust might receive in many respects over a company.

As a result of the introduction of division 6C we saw a system emerge which allowed the characterisation of certain trusts as 'public trading trusts'. If a trust were determined to be a public trading trust, the trust would then be taxed in the same way as a company, recognising the underlying economic realities that it was undertaking business activities probably in competition with other companies in the marketplace that would be taxed accordingly. Provided that it is a widely held trust—and that is an important requirement—and it is a trust that is involved in passive investments then the trust may avoid being characterised as a public trading trust and as a result will not attract the company taxation treatment that would otherwise apply to a public trading trust.

The income of a unit trust that in relation to a year of income meets the tests to become a public trading trust will be taxed at the company rate of 30 per cent. To avoid becoming a public trading trust in a year, a public trust must engage only or wholly in eligible investment business for that year. Section 102M of the act defines 'eligible investment business'. Much of the need for reform of this division relates to the definition and the provisions set out in section 102M of the act. 'Eligible investment business' is defined to mean either or both of (a) investing in land for the purpose, or primarily for the purpose, of deriving rent or (b) investing or trading in any or all of the range of securities and instruments that are set out in the act.

The first limb in relation to investing in land has been a problematic area of the law for some time. The provisions set out in this bill will go a long way towards addressing those problems. I turn to some of the commentary in the industry consultation paper released by Treasury entitled 'Potential changes to the eligible investment rules for managed funds, including property trusts'. Under the heading 'Concerns of industry', it says:

The current operation of Division 6C can create difficulties for real estate investment trusts due to inherent uncertainties and ambiguities in the law, and because the law has not kept pace with commercial developments in property trusts since the 1980s.

There is some uncertainty about what constitutes 'eligible investment business' (EIB), which consists solely of investing in land for the purpose, or primarily for the purpose, of deriving rent, or of investing or trading in a range of financial securities and instruments listed in its provisions, or any combination of these activities. Industry is concerned that the definition of EIB is not clear and is too narrowly defined.

That is certainly a legitimate concern expressed in that Treasury document on behalf of industry, but this is something that I know many people within the sector have pointed to for a long time. One piece of evidence to support that proposition is one of the interpretive decisions handed down by the Australian Taxation Office back in 2003: ATO ID 2003/73. In that particular interpretive decision, the issue in question was:

Is a resident unit trust deriving income from rent and the provision of secretarial services, a 'trading trust' for the purposes of section 102N of Division 6C of the Income Tax Assessment Act 1936 (ITAA 1936)?

The answer to that was 'Yes, it is.' In this particular case, the facts that were provided in the interpretive decision indicated that it was a resident unit trust carrying on a business which constituted leasing of premises from a third party, providing these premises as fitted out premises for rent and providing secretarial services to tenants of these premises. The trust derived its income from renting the premises and from the provision of those secretarial services to the tenants. The income derived from the provision of the secretarial services to tenants represented approximately 25 per cent of the total income derived by the trust each year.

It was on the basis of this 25 per cent of overall income figure that the commissioner, through the interpretive decision, held that the trust was carrying on a trading business and was therefore to be characterised as a public trading trust. That gave rise to considerable uncertainty within the industry and did not really clarify the position in relation to what eligible investment business was other than to suggest that secretarial services accounting for 25 per cent of overall gross income of a trust would therefore tip it over the limit and make it a public trading trust.

That begged the question: how much income of an incidental nature to the rental purpose of the particular property would be permitted? Clearly, those secretarial services were deemed to be incidental but they were of a scale that seemed to tip it over the limit. It raised the question of what an appropriate limit would be. I am very pleased to see in the proposals contained within the bill before the House that there is the introduction of a new safe-harbour limit, which goes a very long way towards addressing this particular concern.

The safe-harbour rule, which is proposed in clause 102MB(2), reads:

For the purposes of this Division, an entity's investments in land are taken to be for the purpose, or primarily for the purpose, of deriving rent during a year of income if:

- (a) each of those investments is for purposes (other than the purpose of trading) that include a purpose of deriving rent; and
- (b) at least 75% of the gross revenue from those investments for the year of income consists of rent (except excluded rent); and
- (c) none of the remaining gross revenue from those investments for the year of income is:
  - (i) excluded rent; or
  - (ii) from the carrying on of a business that is not incidental and relevant to the renting of the land.



There is this nexus with the revenue being incidental to the renting of the land, but there is also this new notion of excluded rent which has been introduced into the regime. Excluded rent is defined elsewhere in the bill to include those particular profit based formulas that might be rent in name but in form something more akin to a profit based formulation. This is very much in keeping with the philosophy of what division 6C is intending to achieve—that is, some equity between various entities, whatever their legal forms, based on a recognition of the economic realities that underpin them.

These measures will go a very long way. They are only interim measures but combined with the ongoing commitment to consultation and delivering a radically reformed division 6C, this government will be able to move one step closer towards achieving its goal of setting up Australia as a regional hub for financial services. This is something that we are well placed to do and now, with these amendments to the law, we will be even better placed to achieve.