TREASURER

NO. 62

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

1996-97 BUDGET REVENUE MEASURES: THE GOVERNMENT MEETING ITS TAXATION COMMITMENTS

With the release of 1996-97 Budget, the Government has implemented all of the taxation measures announced in *Meeting our Commitments* which provide direct relief to families and small business.

Press releases I have issued tonight provide details of the implementation of the following taxation election commitments announced by the Coalition during the election campaign:

- Family Tax Initiative;
- Capital Gains Tax Rollover Relief for Small Business;
- Capital Gains Tax: Extending the Principal Residence Exemption;
- Capital Gains Tax: Exemption on Retirement;
- Capital Gains Tax: Equity Investments in SMEs;
- Income Tax Rebate for Low Income Aged Persons;
- Employee Share Schemes;
- Fringe Benefits Tax Exemption for Remote Area Housing in the Primary Production Sector;
- Taxation of Alcohol; and
- Gift Deductibility for Community Medical Scholarship Schemes.

A separate press release *Superannuation Reform* details commitments relating to CGT exemption on retirement and income tax rebates for low income aged persons.

The Minister for Health has issued a separate press release detailing implementation of the Government's taxation incentives to encourage the take up of private health insurance.

These commitments provide direct assistance to families and business of $5.9 billion over the next four years. This is in addition to other taxation election commitments which the Government has already implemented, or is in the process of implementing, including:

- the reduction in the provisional tax uplift factor from Labor's 8 per cent to 6 per cent;
- an increase in the Fringe Benefits Tax minor benefits threshold to $100; and
- the Small Business Deregulation Taskforce, which includes in its terms of reference examination of taxation compliance with particular reference to the administration of FBT and a range of other taxes.

As announced during the election campaign, the government will give consideration to its other FBT election commitments after the Task Force has reported; including entertainment, car parking and the issue of aligning the FBT and income tax years.

In another boost to small business, the Government has announced that it will not be proceeding with amendments to the PAYE provisions of the tax law proposed by the previous Government.

Other press releases outline the implementation of anti-avoidance measures detailed in *Meeting our Commitments* which were foreshadowed by the previous Government during the election campaign:

- Thin Capitalisation;
- Foreign Companies Claiming Australian Residence;
- Measures to Address Tax Avoidance Through Tax Exempt Entities Distributing Funds Offshore; and
- High Wealth Individuals

Other measures I am announcing tonight deal with a range of issues addressing taxation compliance, avoidance and anomalies. These are contained in press releases relating to:

- Withholding Tax Avoidance;
- Deductions Allowable to a Co-operative Company for the Repayment of Government Loans;
- Exemption of Income Derived By Bona Fide Prospectors;
- Income tax: Trust and Company Losses;
- Capital Gains Tax and Company Revenue Provisions;
- Capital Gains Tax: Liquidation of a Group Company;
- Capital Gains Tax: Modified Application of Section 160ZZS;
- Luxury Car Leasing; and
- Tax Evasion on Computer Equipment.

The Minister for Industry, Science and Tourism, John Moore, and I have also jointly announced tonight a major new funding initiative for research and development (R&D). This measure is being announced in conjunction with a reduction in the premium rate of tax deduction for research and development expenditure from 150 per cent to 125 per cent. The package of R&D measures announced in the Budget will ensure that total Commonwealth Government budget support for R&D in 1996-97 remains in excess of $3.5 billion dollars.

This announcement is detailed in the press release 'Research and Development Tax Concession: Reduction in the Premium Rate of Deduction to a Maximum of 125 per cent— *Start*: A Major New Research and Development Funding Initiative.'

CANBERRA
20 August 1996

TREASURER

NO. 63

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

ELECTION COMMITMENT: FAMILY TAX INITIATIVE

The Government has met its election commitment to reduce the tax burden on families with children, and to provide additional tax assistance where a parent is at home caring for young children. The Family Tax Initiative will provide assistance to almost 2 million families, at an expected cost of more than $1 billion in a full year.

Family Tax Assistance will be delivered by:

- a $1000 income tax free threshold increase for one member of a couple or for a sole parent, for each dependent child up to the age of 16 or secondary student up to the age of 18 years, where family taxable income is less than $70000 (with this income threshold increased by $3000 for each additional child after the first child); and

- a $2500 tax free threshold increase for single income families (including sole parents) where at least one child is under the age of 5 years and the breadwinner's taxable income is less than $65000 (with this income threshold increased by $3000 per child after the first child) and, for couples, the annual income of the other partner (excluding government payments) is less than the income cut off for basic Parenting Allowance (currently $4535 per annum).

Eligible families will receive assistance of around $7.70 per fortnight for each eligible child. In addition to this, single income families with young children will receive a further $19.20 a fortnight.

A single income family with two children (one under 5 years of age) can have tax reduced by around $34.60 a fortnight. If the family is also claiming the full rate of the new incentives for private health insurance (available from 1 July 1997) the total assistance will be more than $50 a fortnight.

Further details on assistance available is provided in the attached table.

Family Tax Assistance will be available to taxpayers from 1 January 1997 (on the basis of half the above threshold increases applying for the 1996-97 income year). The assistance will be available through the PAYE and provisional tax systems, or alternatively a taxpayer may choose to claim the assistance only on assessment.

Family Tax Assistance will be available to all families with sufficient taxable income to benefit. Low income families will also have the alternative of fortnightly cash assistance (Family Tax Payment). The fortnightly cash assistance will be available where a family's income would qualify them for the higher rate of Family Payment and will be provided through the Department of Social Security.

20 August 1996
CANBERRA

ATTACHMENT

FAMILY TAX INITIATIVE

From 1 January 1997, a family with eligible dependent children and family taxable income less than the relevant threshold for Part A will be eligible for the following Part A assistance.

No. of dependent children	Family Income Threshold	Value of Part A (per year)	Value of Part A (per fortnight)
1	$70 000	$200	$7.70
2	$73 000	$400	$15.40
3	$76 000	$600	$23.10
4	$79 000	$800	$30.80

A family with a child under the age of five, with taxable income of the breadwinner less than the Part B income threshold and (for couples) the other partner's income is less than the income cut-off for basic Parenting Allowance (currently $4535), will be eligible for Part B assistance **in addition to Part A**.

No. of dependent children	Breadwinner Income Threshold	Value of Part B (per year)	Value of Part B (per fortnight)
1	$65 000	$500	$19.20
2	$68 000	$500	$19.20
3	$71 000	$500	$19.20
4	$74 000	$500	$19.20

A family which meets both Part A and Part B eligibility criteria will receive the following total assistance:

No. of dependent children	Total Value of Part A and Part B (per year)	Total Value of Part A and Part B (per fortnight)
1	$700	$26.90
2	$900	$34.60
3	$1100	$42.30
4	$1300	$50.00

Fortnightly amounts are rounded in these tables.

TREASURER

NO. 64

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

ELECTION COMMITMENT: CAPITAL GAINS TAX ROLLOVER RELIEF FOR SMALL BUSINESS

The Government has announced in the 1996-97 Budget broad design details of its commitment to provide capital gains tax (CGT) rollover relief to small business. The measure will apply to capital gains tax otherwise payable on asset disposals on or after 1 July 1997.

The implementation of this election promise demonstrates the Government's commitment to all small business operators. The Government is committed to ensuring that a lack of capital does not constrain the growth and development of these enterprises.

The provision of CGT rollover relief will provide small business with a boost of $150 million per year, encouraging further expansion in this vital sector of the economy.

The broad design details for CGT rollover relief for small businesses are:

- rollover relief will apply to the disposal and acquisition of some or all assets for use in the same or another 'like kind' business;
  - to benefit from rollover relief, the proceeds (including the gain) from disposal must be reinvested within 12 months in assets of the same or a 'like kind' business;
  - the 'like kind' test for businesses will be: Would a reasonable person be satisfied that the newly acquired asset is to be used in a business which is substantially the same as the taxpayer's current business?
- a 'like kind' test will not generally apply asset by asset;
- rollover relief will only apply where a direct interest in a business is sold and not where indirect interests in the business (for example, shares) are sold;
- rollover relief will only be available for the disposal and acquisition of active assets;
  - in the case of assets which have both 'active' and 'passive' characteristics, an apportionment test will apply, whereby the realised capital gain is apportioned between the active and passive elements of the asset. Only the 'active portion' of the capital gain will qualify for rollover relief;
- consistent with the election policy that rollover relief would be available to 'trading businesses', rollover relief will be available to businesses not wholly engaged in passive investment;

- to be eligible for rollover relief a taxpayer's total net business assets, including both passive and active assets, must not exceed $5 million;
  - the $5 million threshold will apply to both the aggregate business interests of the taxpayer and the business in which the interest is being sold. In determining whether the threshold is satisfied a modified 'common ownership' test will be applied;
- where a replacement asset which has benefited from rollover relief later becomes a passive asset, it will be subject to CGT at that time;
- taxpayers will be required to net off any capital losses against capital gains before they can claim rollover relief, including those losses realised within a 12 month period from the relevant disposal date;
- in determining the cost base of the newly acquired asset the deferred capital gain will be deducted from the cost base of the newly acquired asset (the adjusted cost base);
- only the capital gain on goodwill can be rolled over to reduce the cost base of newly acquired goodwill;
- taxpayers may benefit from either the existing goodwill exemption or rollover relief, but not both;
- taxpayers will be eligible for rollover relief up to the value of the newly acquired qualifying asset or assets, and any surplus will be subject to CGT;
- the pre-CGT status of existing assets will not be transferable to newly acquired assets; and
- taxpayers will only be eligible to claim rollover relief once every five years.
  - That is, if a replacement asset is sold within five years, then the gain (with reference to the adjusted cost base) on that replacement asset cannot itself be rolled over and is therefore brought fully to tax.

Legislation implementing the measure will be prepared in consultation with the representatives of professional bodies on the CGT Sub-Committee of the Commissioner of Taxation's National Tax Liaison Group.

The attachment sets out a simplified presentation of taxpayer eligibility for rollover relief.

20 August 1996
CANBERRA

Contact: ATO CGT Hotline
Phone: 1800 244 601

ATTACHMENT

Eligible for Rollover Relief

Unless

- **Your business is not a trading business**
- **The total net assets of your business and any associated business, including both passive and active assets, are worth more than $5m**
- **The asset you are selling is shares in a company, an interest in a trust or any other passive asset**
- **You have claimed rollover relief in the last 5 years**
- **The asset you are buying is not a qualifying active CGT asset**
- **The new asset will be used in a business which is not 'like' your current business**
- **The new asset has been acquired more than 12 months after the disposal of the old asset**

TREASURER

NO. 65

EMBARGO: Budget. Not for release before 7.30 PM EST, 20 August 1996.

ELECTION COMMITMENT: CAPITAL GAINS TAX - EXTENDING THE PRINCIPAL RESIDENCE EXEMPTION

The Government will be implementing its election commitment to extend the qualifying period for a CGT exemption on disposal of an inherited house and help to reduce the compliance cost burden of CGT on taxpayers.

The commitment will be implemented through amendments to the operation of the capital gains tax (CGT) principal residence exemption — section 160ZZQ of the *Income Tax Assessment Act 1936*.

The amendments to the principal residence exemption will:

(i) extend the qualifying period from 12 months to 24 months for a CGT exemption on disposal after 7.30 pm EST 20 August 1996 of an inherited dwelling as long as at least part of the dwelling was a principal residence of the deceased;

(ii) extend the same qualifying period to the disposal after 7.30 pm EST 20 August 1996 by a trustee of a deceased estate of a dwelling satisfying the same requirement;

(iii) where a principal residence is first used for income producing purposes after 7.30 pm EST 20 August 1996, require the use of market value as the cost base of the dwelling in calculating any taxable gain or loss;

(iv) deem a beneficiary or trustee who acquires a dwelling as a result of a death, after 7.30 pm EST 20 August 1996, to have acquired the dwelling at its market value on the date of death if the dwelling was, or was deemed to be, wholly the principal residence of the deceased at that date;

(v) provide a beneficiary who disposes of a dwelling after 7.30 pm EST 20 August 1996 with a partial CGT exemption where the deceased never used the house as a principal residence but it became the principal residence of the beneficiary; and

(vi) require the exemption provided under (v) above be pro-rated, on the basis of the time and extent the dwelling was used as a principal residence of the beneficiary, over the time the dwelling was owned by the deceased and the beneficiary.

These amendments will have significant benefits for affected taxpayers.

- Taxpayers eligible to claim a CGT exemption on disposal of an inherited dwelling will have an additional 12 months to arrange an orderly sale.

- The introduction of the extended qualifying period is being brought forward from 1 July 1997 (as promised prior to the election) to 7.30 pm EST 20 August 1996.

- Eligible taxpayers in receipt of a dwelling from 20 August 1994 onwards will be able to make use of the extended qualifying period - ie. from before the date of the pre-election commitment.

- The three amendments outlined in paragraphs (iii) to (v) above will reduce CGT compliance costs associated with the principal residence exemption. They will improve the operation of the law, at only a slight cost to revenue.

  – These amendments recognise that taxpayers often experience record keeping and compliance problems when disposing of a dwelling that has been used for income producing purposes either for part of the period of ownership or during a period prior to inheritance. The amendments will reduce these problems.

    : First, where a principal residence is first used for income producing purposes after 7.30 pm EST 20 August 1996, taxpayers will use market value as the cost base of the dwelling in calculating any taxable gain or loss. As a result taxpayers will not need to keep records of costs incurred before a dwelling is used for income producing purposes, but must keep records of any costs subsequently incurred.

    : Second, a beneficiary or trustee who acquires a dwelling after 7.30 pm EST 20 August 1996 as a result of a death will be deemed to have acquired the dwelling at its market value on the date of death if the dwelling was the principal residence of the deceased at that date. As a result taxpayers will only need to keep records of costs incurred after the death of the deceased. This will simplify the tax treatment in the majority of cases.

    : Third, a beneficiary who disposes of an inherited dwelling after 7.30 pm EST 20 August 1996 will be eligible for a partial CGT exemption, where the deceased never used the house as a principal residence but it becomes the principal residence of the beneficiary.

20 August 1996
CANBERRA

Contact: ATO CGT Hotline
Phone: 1800 244 601

TREASURER

NO. 66

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

ELECTION COMMITMENT: CAPITAL GAINS TAX — EQUITY INVESTMENTS IN SMEs

The Government has decided to amend the *Income Tax Assessment Act 1936* so that equity investments in small or medium sized enterprises (SMEs) made by lending institutions from 1 July 1996 may be taxed under the capital gains provisions. This measure was included in *Meeting our Commitments*.

This concession will apply to a lending institution's equity investment where:

- the SME has total assets of $50 million or less;
- the investment consists of newly issued ordinary shares which do not constitute trading stock of the lending institution; and
- the lending institution holds at least 10% of the SME's paid up capital once the investment is made.

Under current tax law, equity investments (other than by a share trading business) by banks, other financial intermediaries and other taxpayers who provide equity finance as part of their finance business are taxed on revenue account.

At the time an equity investment is made by such taxpayers, there is no deduction for the expenditure. When income from sale of the equity investment is realised, the net profit is taxed, or the net loss is deductible.

This is different from the treatment received by individual taxpayers who make equity investments (other than in the business of buying and selling shares). Such taxpayers are taxed under the capital gains tax (CGT). Under CGT, real capital gains are taxed upon realisation of the income — that is, capital gains are indexed against inflation.

By allowing lending institutions to benefit from CGT treatment when investing in SMEs, the Government will be providing an incentive for these organisations to make long-term investments in the small business sector.

Small and medium sized business is the engine room of jobs and growth in the economy. The Government is committed to ensuring that a lack of financial options do not constrain the growth and development of these enterprises. These changes will encourage banks and other lending institutions to become equity partners in SMEs and help alleviate the debt-financing problems suffered by many of these businesses.

20 August 1996
CANBERRA

Contact: Geoff Miller (ATO)
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TREASURER

NO. 67

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

ELECTION COMMITMENT: EMPLOYEE SHARE SCHEMES

The Government will be meeting its election commitment to provide more generous tax treatment for employee share schemes.

These changes recognise that employee share schemes contribute to strengthening employee participation in Australian business and to encouraging voluntary saving.

The employee share scheme provisions of Division 13A of the *Income Tax Assessment Act 1936* are to be amended, with effect from 1 July 1996, to provide for:

- an increase to the value of shares or rights that can be tax exempt under a qualifying employee share scheme, from $500 to $1000 a year, per employee (with a matching increase in the available deduction for employers); and
- an easing of employee participation conditions for a qualifying employee share scheme, from three quarters to two thirds of permanent employees for shares under the tax deferral concession and for shares and rights under the exemption concession.

The Government also intends to amend section 26AAC of the *Income Tax Assessment Act 1936* which applies generally where Division 13A does not. Under the proposed amendments, section 26AAC will not apply to shares or rights purchased for an amount equal to or greater than market value. As this exclusion also applies under Division 13A, once a taxpayer determines that the shares or rights have been acquired at or above market value, no further consideration of the employee share scheme taxation provisions will be necessary. This amendment will apply to acquisitions of shares or rights after the date of Royal Assent.

As the result of a recent court decision, many elections lodged by taxpayers under subsection 26AAC(15A) will not be valid. The Government will amend the law to entitle taxpayers to make an election under subsection 26AAC(15A) when shares with restrictions are issued to a trust to be held on behalf of a taxpayer. This amendment will validate the action of taxpayers who believed they were making valid elections under subsection 26AAC(15A). It will not allow a taxpayer to make an election where he or she did not do so within the required time. This amendment will apply from 24 June 1986 which is the date from which subsection 26AAC(15A) applies.

The Government will also make some minor technical amendments to Division 13A, including an amendment to subsection 139CD(5) to ensure the participation requirement applies to permanent employees only.

20 August 1996
CANBERRA

Contact: Geoff Miller (ATO)
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TREASURER

NO. 68

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

ELECTION COMMITMENT: FRINGE BENEFITS TAX EXEMPTION FOR REMOTE AREA HOUSING IN THE PRIMARY PRODUCTION SECTOR

The Government will be implementing its election commitment to provide a fringe benefits tax (FBT) exemption for remote area housing provided by employers in the primary production sector (as defined in the *Income Tax Assessment Act 1936*).

The exemption will be provided in recognition of the special circumstances of primary industry in remote areas and will be available from the FBT year commencing 1 April 1997.

The exemption will have the same geographical coverage as the existing 50 per cent FBT housing concession for remote area employers. That is, an area is remote if it is at least 40 kilometres from a population centre of 14,000 or more and at least 100 kilometres from a centre of 130,000 or more and outside the areas of Australia described in the income tax law as Zone A and Zone B. In the specified Zone A and Zone B areas, a remote area is one that is at least 40 kilometres from a population centre of 28,000 or more and at least 100 kilometres from a centre of 130,000 or more.

Other conditions that apply to the existing remote area housing concession will also apply, including that it is necessary for an employer to provide residential accommodation to an employee.

The Government has already acted to implement other FBT election commitments.

On 27 June, the Government introduced legislation implementing its commitment to provide an FBT exemption for minor benefits of less than $100 (where the benefits also meet the other conditions under the law). This amendment will help to reduce compliance costs for employers who provide minor benefits to employees and will ensure that employers who only provide irregular minor benefits of less than $100 avoid paying FBT altogether.

In relation to other FBT matters, the Prime Minister announced the establishment of the Small Business Deregulation Task Force on 2 May this year, which is to report back to the Government on revenue neutral measures to reduce the burden of paper work and compliance costs on small business. The Task Force's terms of reference include the examination of taxation compliance with particular reference to the administration of FBT and a range of other taxes. The Government will give consideration to other FBT election commitments after the Task Force has reported; including entertainment, car parking and the issue of aligning the FBT and income tax years.

Implementation of these election commitments is proof of the importance the Government places on addressing employer concerns with FBT compliance costs.

20 August 1996
CANBERRA

TREASURER

NO. 69

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

ELECTION COMMITMENT: TAXATION OF ALCOHOL

The Government will be implementing its election commitment to maintain the current taxation of wine, non-grape fruit wines and wine cocktails (such as cider, mead, vermouth and marsala).

The Government will therefore not proceed with the previous Government's decision to extend excise to certain alcoholic beverages from 1 January 1997.

This decision will end the uncertainty created by a succession of inconsistent announcements by the previous Government as to the taxation status of alcoholic beverages currently exempt from excise arrangements.

20 August 1996
CANBERRA

Contact: Howard Garnier (Australian Customs Service)
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TREASURER

NO. 70

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

ELECTION COMMITMENT: GIFT DEDUCTIBILITY FOR COMMUNITY MEDICAL SCHOLARSHIP SCHEMES

The Government will implement its election commitment to provide gift deductibility for donations to a limited number of Community Medical Scholarship Schemes as part of its strategy for improving access to quality health services for people living in rural and remote areas. These schemes are designed to assist young persons from rural areas to undertake medical study, with the aim that such persons will return to rural communities to work as doctors.

Tax deductibility will be provided to individual schemes after the Government has considered their applications for admission to the gift provisions. Schemes will need to meet the usual public fund requirements.

The Government has announced a number of other initiatives in the 1996-97 Budget to improve rural health service provision. These include funding to rural hospitals and medical schools for projects to provide support for doctors to work in rural areas, the establishment of six university departments of rural health, and the provision of up to 150 John Flynn Scholarships each year to medical students to enable them to spend time training in rural areas.

20 August 1996
CANBERRA

Contact: John Lamerton (ATO)
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TREASURER

NO. 71

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

GOVERNMENT DECIDES NOT TO PROCEED WITH LABOR'S PROPOSED PAYE AMENDMENTS

The Government has decided not to proceed with proposed amendments to the pay-as-you-earn (PAYE) provisions of the income tax law and similar provisions in related laws announced by the former Government.

These 1995-96 Budget amendments were included in *Taxation Laws Amendment Bill (No. 5) 1995*, which lapsed with the calling of the election.

The Government has received representations on the proposed amendments expressing concern that they could, in some circumstances, result in unintended consequences by bringing payments to independent contractors within the PAYE provisions and similar provisions in related laws.

The Commissioner of Taxation has indicated that he will continue to take all appropriate steps to safeguard the intended operation of these areas of the law including, where necessary, testing the law in the courts.

This announcement follows a series of election commitments already delivered by the Government to reduce the administrative burden of the tax system and regulation on small business. These decisions include the establishment of the Small Business Deregulation Task Force; the reduction in the provisional tax uplift factor to 6 per cent; and providing an FBT exemption for minor benefits of less than $100.

In last year's Budget, the former Government also foreshadowed the release of a discussion paper relating to the derivation of personal services income through interposed entities (such as companies). The Government has also decided not to proceed with this proposal.

In this regard, the Government has asked the Commissioner of Taxation to ensure that he continues to apply the existing provisions of the tax law, including the general anti-avoidance provisions, so that tax payable on personal services income is not avoided through the use of interposed entities. Longstanding income tax rulings issued by the Commissioner of Taxation deal in some detail with this issue.

20 August 1996
CANBERRA

TREASURER

NO. 72

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

ELECTION COMMITMENT: THIN CAPITALISATION

The Government is announcing a number of measures relating to thin capitalisation rules as foreshadowed by the previous government and included in *Meeting our Commitments*.

The thin capitalisation measures place a limit on the amount of interest expense payable on related party foreign debt that can be deducted for domestic tax purposes. The ratio assists in ensuring that an appropriate amount of profit is derived in Australia, and in protecting Australia's revenue base.

The general ratio for related party debt to equity will be reduced from 3:1 to 2:1. This new ratio for non-financial institutions is more consistent with average commercial gearing ratios.

The ratio for financial institutions will remain unchanged at 6:1 to avoid any reduction in the efficiency of capital markets.

To complement the new limitation on gearing, the definition of foreign debt for companies that are not financial institutions will be extended to foreign debt for which a legally enforceable guarantee has been provided by foreign controllers or their non-resident associates, as well as foreign debt secured against the assets of foreign controllers or their non-resident associates.

The definition of foreign equity for fixed trusts will be calculated on the basis of their foreign controllers' interests in the capital or income of the trust. For partnerships, the foreign equity will be based on the interest that the foreign partners have in the partnership capital.

The foreign equity of a discretionary trust cannot be calculated in a meaningful way since entitlements depend on the exercise of the trustee's discretion. Therefore, discretionary trusts will be denied an income tax deduction for interest paid to offshore parties who are in a position to control the trust (referred to in the existing legislation as 'foreign controllers' and who are usually beneficiaries) and their non-resident associates. The latter change will also counter some avoidance arrangements.

To further counter avoidance, the asset revaluation rules for trusts and partnerships will limit any revaluations so that they cannot exceed the market value of the assets and require the revaluations to take place before the commencement of a year of income. This will bring the asset revaluation rules for trusts and partnerships into line with those currently applying to companies.

The thin capitalisation anti-avoidance rules will also be strengthened. The provisions dealing with back to back loans, whereby loans to an Australian enterprise from related overseas parties are given the appearance of a transaction between arm's length parties, will be extended to all arrangements that have the effect that the foreign controller has provided funding that flows through one or more unrelated intermediaries (whether as debt, equity or otherwise) in a way that results in interest

expense being incurred in Australia. Under this anti-avoidance measure, any funds provided by a foreign controller or its associates to an unrelated intermediary on the basis that the intermediary will provide funds to the foreign controller's Australian enterprise will be treated as foreign debt.

The thin capitalisation provision which treats loans by an Australian enterprise to its foreign controller or non-resident associates through unrelated intermediaries as reductions in its equity will be extended. The Australian enterprise's foreign equity will be reduced where it provides funding in any form (including redeemable preference shares) under such arrangements to its foreign controller or non-resident associates.

A technical deficiency will be corrected in an anti-avoidance provision applying to trusts and partnerships which treats trust and partnership equity contributions that are funded by borrowings from offshore associates as foreign debt of the trust or partnership. The operative provision which disallows a deduction for interest on foreign debt that exceeds the trust's or partnership's gearing ratio fails to take into account the interest deductions on the borrowings from the offshore associate.

These measures will apply from the 1997-98 year of income.

20 August 1996
CANBERRA

Contact: Jillian Saint (ATO)
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TREASURER

NO. 73

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

ELECTION COMMITMENT: FOREIGN COMPANIES CLAIMING AUSTRALIAN RESIDENCE

The 1996-97 Budget contains measures which will deem certain companies and similar entities that are dual residents to be non-residents for the purposes of a number of tax provisions. The measures, which will apply on and from 1 July 1997, will reduce the scope for company residence status to facilitate tax avoidance. This measure was foreshadowed by the previous government and included in *Meeting our Commitments*.

Australia generally taxes resident companies on their world-wide income, but its taxing rights over the Australian source income of non-residents are limited by double taxation agreements (DTAs). It is possible for companies to be concurrently resident under Australian law (which qualifies them for various tax concessions and exemption from various anti-avoidance measures) and non-resident under a DTA (which limits Australia's taxing rights over Australian source income and generally denies a taxing right over foreign source income). Such companies thereby qualify for certain domestic taxation benefits, without being fully subject to Australian tax.

To address this anomaly, such companies, if they are non-residents solely for the purposes of a DTA, will be deemed to be non-residents for the purposes of the group loss transfer, capital gains rollover and intercorporate dividend rebate provisions and certain anti-avoidance provisions of the *Income Tax Assessment Act 1936*. Those measures are Division 16F on thin capitalisation; Division 16G on debt creation; section 159GT(6), which denies deductions for accrued liabilities on securities held by offshore associates; and section 221YRA, which denies deductions for interest and royalties paid to non-residents until withholding tax has been paid.

It is also possible for a company to be a resident of Australia solely under the 'central management and control' test in Australian law and, at the same time, resident of another jurisdiction. These companies will be deemed to be non-residents for the purposes of the group loss transfer, capital gains rollover and intercorporate dividend rebate provisions and the anti-avoidance measures listed above. This amendment will apply only to cases where residence has to be determined solely under the central management and control test. Thus, a company will maintain its Australian resident status for the purposes of the provisions outlined above if it is also a resident of Australia under the incorporation or voting power tests.

These measures will also apply to other non-individual entities that are treated as companies such as public unit trusts and corporate limited partnerships.

20 August 1996
CANBERRA

Contact: Ken Allen (ATO)
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TREASURER

NO. 74

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

ELECTION COMMITMENT: MEASURES TO ADDRESS TAX AVOIDANCE THROUGH TAX EXEMPT ENTITIES DISTRIBUTING FUNDS OFFSHORE

The Government intends to introduce legislation to counter tax avoidance through the use of tax exempt bodies distributing funds offshore.

Charitable trusts - restriction on distributions to overseas organisations

The 1996-97 Budget contains measures to amend the income tax law to address tax avoidance schemes that exploit the charitable trust exemption and circumvent the gift provisions. The Government has decided that it will maintain the current tax exemption for genuine charities, but will introduce legislative amendments foreshadowed by the previous government to counter tax avoidance. This measure was included in *Meeting our Commitments*.

Two Parliamentary inquiries have identified a tax avoidance arrangement which exploits the charitable trust exemption and circumvents the gift provisions. The House of Representatives Standing Committee on Finance and Public Administration's report of March 1991, The Final Report on an Efficiency Audit of the Australian Taxation Office: International Profit Shifting, *'Follow the Yellow Brick Road'*, examined this arrangement. The second inquiry was a report by the Joint Committee of Public Accounts in November 1993 entitled Report No 326, '*An Assessment of Tax*'.

The operation of section 23(j)(ii) of the *Income Tax Assessment Act 1936* will be amended so that a charitable trust will only be allowed to distribute its funds, without losing its income tax exemption, to any charity in Australia (whether or not the charity has tax deductibility under section 78, but including Overseas Aid Funds operating under section 78). In addition, the charitable trust will be allowed to use its funds for charitable purposes undertaken directly by the trust in Australia in accordance with its trust deed. Charitable trusts established by will before 7.30 pm EST 20 August 1996 will not be affected by the measure.

Domestic charities that are exempt from Australian income tax under section 23 (for example, charitable or religious institutions under section 23(e)) will retain that exemption, and consequently there will be no tax liability on distributions by charitable trusts to these organisations.

Transitional arrangements will be provided to enable charitable trusts with trust deeds which permit other distributions (for example, to overseas organisations) to change their trust deeds before 1 July 1998 and retain their income tax exemption, provided they do not make non-approved distributions in that time.

This measure will take effect after the commencement of charitable trusts' 1996-97 year of income.

Removal of tax exemption for certain overseas organisations earning income in Australia

Certain organisations located overseas are exempt from income tax on their Australian sourced income. This exemption can result in the transfer of revenue from Australia to a foreign treasury and can facilitate tax avoidance through the use of tax exempt entities to distribute funds offshore. Furthermore, some overseas organisations are also exempt from Australian withholding tax under certain conditions.

To complement the measure to restrict distributions by charitable trusts to overseas organisations, the *Income Tax Assessment Act 1936* will be amended to remove the tax exempt status for certain organisations located overseas, irrespective of whether they are subject to tax in their home country. The measure will not impact on any entity which is a resident for Australian tax purposes. Furthermore, the section 128B(3) exemption for these overseas organisations from withholding tax (in cases where the non-resident is exempt from income tax in the foreign country) will also be removed.

The affected organisations currently rely upon the following exemptions: religious, scientific, charitable or public educational institutions (section 23(e) of the *Income Tax Assessment Act 1936*); public or non-profit hospitals (section 23(ea)); trade unions or employer associations (section 23(f)); non-profit cultural, sporting and friendly societies (section 23(g)); and public charitable and research funds (section 23(j)).

This measure will apply from 7.30 pm EST 20 August 1996.

The Government will release an exposure draft of the legislation for all the above measures as a priority, and will undertake consultations before introducing the legislation into the Parliament to ensure that *bona fide* charitable organisations are not detrimentally affected.

20 August 1996
CANBERRA

Contact: Dave Walker (ATO)
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TREASURER

NO. 75

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

ELECTION COMMITMENT: HIGH WEALTH INDIVIDUALS

The Government has decided to provide the Australian Taxation Office (ATO) with additional funds of $9.7 million in 1996-97 and $9.5 million 1997-98 to enable a special taskforce investigation into the tax minimisation practices of some high wealth individuals in order to improve high wealth individuals' compliance with the tax laws and to develop administrative responses and recommendations for legislative change on a progressive and ongoing basis.

Enhanced investigation activity and analysis will allow a greater understanding of the very complex and extensive tax planning arrangements used by some high wealth individuals, thereby facilitating the progressive development of administrative and legislative proposals for Government consideration.

The revenue at risk from aggressive tax planning and minimisation arrangements used by some high wealth individuals has been estimated at $800 million a year. Treasury and the ATO caution that this estimate is subject to uncertainties about wealth data, remedial measures, utilisation of losses and behavioural responses by affected taxpayers. This figure should be seen as an order of magnitude estimate of the 'revenue potentially at risk' rather than as the 'sum of gains from particular measures'.

Taskforce investigation will first identify the nature of the problem and mechanisms used, then design counter measures expected to generate revenue beyond 1997-98. However, as a result of the investigations, early improvements in compliance, both voluntary and through enforcement of existing law are expected, which will generate revenue in 1997-98 in the order of $100 million.

20 August 1996
CANBERRA

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TREASURER

NO. 76

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

WITHHOLDING TAX AVOIDANCE

The 1996-97 Budget contains measures to protect the non-resident withholding tax base from emerging tax avoidance arrangements.

The general anti-avoidance provisions of the *Income Tax Assessment Act 1936* (the Act) — Part IVA — will apply to non-resident interest, dividend and royalty withholding tax in order to provide a mechanism within the Act to effectively counter withholding tax avoidance schemes in a comprehensive way.

Other amendments to the withholding tax provisions will further assist in preventing abuse. The definition of 'interest' will be amended to address arrangements which attempt to convert an interest income stream into a form which it is argued is not 'interest' or 'in the nature of interest'.

Amendments will also ensure that withholding tax is payable where:

- royalties are derived by a resident in similar circumstances to those by which interest is subjected to withholding tax under subsection 128B(2A) of the Act;
- tax exempt bodies are interposed between an Australian resident payer and a non-resident recipient; or
- dividends consist of bonus shares issued from asset revaluation reserves.

These measures do not signal any change in the Government's policy on withholding taxes, but are intended to give effect to existing policy by addressing tax avoidance. All measures will apply from 7.30 pm EST, 20 August 1996.

20 August 1996
CANBERRA

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TREASURER

NO. 77

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

DEDUCTIONS ALLOWABLE TO A CO-OPERATIVE COMPANY FOR THE REPAYMENT OF GOVERNMENT LOANS

The Government has decided to repeal paragraph 120(1)(c) of the *Income Tax Assessment Act 1936* with application to government loans to co-operatives entered into after 7.30 pm EST 20 August 1996, and to existing loans only where their terms are altered after this time.

Paragraph 120(1)(c) allows eligible co-operatives double deductions for the cost of assets. They receive a tax deduction for repayment of money lent to the co-operative by a government, in addition to normal deductions for interest on the money lent, providing the loan is used by the company to acquire assets from that government which are required for the purpose of carrying on the business or to pay the government for assets which the company has taken over from that government. They also receive normal tax deductions for depreciation in relation to the cost of the assets.

The net effect of paragraph 120(1)(c) is that if the asset and the loan are obtained from a government, an eligible marketing co-operative can claim an effective 200 per cent tax deduction for capital expenditure — full write-off of the cost of an asset and deductions for capital repayments.

Repeal of the paragraph is consistent with competitive neutrality principles and the Government's policy of removing anomalies from the tax system. The provision gives preference to co-operatives over other companies. It also prefers borrowers, as the effective double deduction is only available to the extent that assets are paid for from borrowings. The Government is also concerned by evidence that the provision is being exploited by some government-owned financial institutions to gain a commercial advantage over other lenders.

20 August 1996
CANBERRA

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TREASURER

NO. 78

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

EXEMPTION OF INCOME DERIVED BY BONA FIDE PROSPECTORS

The Government has decided to repeal paragraph 23(pa) of the *Income Tax Assessment Act 1936*. The tax exemption provided by this provision will not be available in respect of income derived under contracts entered into after 7.30 pm EST 20 August 1996.

Paragraph 23(pa) exempts income derived from the sale, transfer or assignment of rights to mine for gold or for any prescribed metal or mineral. The list of prescribed metals and minerals is attached. The exemption only applies to sales undertaken by a 'bona fide' prospector, one who meets several complex factual tests.

The exemption was enacted as an incentive to prospectors to search for prescribed metals and minerals, which they do not necessarily have the means to mine themselves, with the knowledge that the income they received from transferring rights to mine would not be reduced by taxation.

The list reflects concerns in the 1940s and 1950s that known resources of certain metals and minerals were inadequate for Australia's present and prospective domestic consumption. These concerns are no longer justified in the light of Australia's current reserves and the globalised trading environment.

The exemption is unequal in its application and effect. Not all prospectors are eligible to claim the exemption. Not all metals and minerals attract the exemption.

In practice paragraph 23(pa) has proved costly to administer and the law difficult to interpret.

20 August 1996
CANBERRA

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ATTACHMENT

PRESCRIBED METALS AND MINERALS

Asbestos
Bauxite
Chromite
Emery
Fluorspar
Graphite
Ilmenite
Kyanite
Manganese
Manganese oxides
Mica
Monazite
Pyrite
Quartz Crystals
(piezo-electric
quality)
Radio-active Ores
Rutile
Sillimanite
Vermiculite
Zircon

Ores of
- Antimony
- Arsenic
- Beryllium
- Bismuth
- Cobalt
- Columbium
- Copper
- Lithium
- Mercury
- Molybdenum
- Nickel
- Osmiridium
- Platinum
- Selenium
- Strontium
- Tantalum
- Tellurium
- Tin
- Tungsten
- Vanadium

TREASURER

NO. 79

EMBARGO: Budget. Not for release before 7.30pm EST, 20 August 1996.

INCOME TAX: TRUST AND COMPANY LOSSES

Measures to prevent transfers of the benefit of trust losses

I am announcing today the Government's intentions with regard to the previous Government's proposals to deal with the recoupment of current year and carry forward losses of trusts.

The previous Government announced in the 1995-96 Budget that measures would be introduced to restrict the recoupment of current year and carry forward losses of trusts with effect from 7.30pm EST on 9 May 1995. The measures were subsequently drafted and introduced into the Parliament in September 1995 as part of the *Taxation Laws Amendment Bill (No. 4) 1995.*

The trust loss measures are aimed at preventing an erosion of the tax base through transfers of the benefit of trust losses. This occurs when a person who did not bear the economic effect of the loss when it was incurred by the trust obtains a benefit as a result of the trust's ability to deduct the loss.

The Senate referred the measures to the Senate Economics Legislation Committee for inquiry and report. The inquiry was delayed by the proroguing of Parliament.

The Government is committed to introducing amendments to the income tax law to prevent transfers of the benefit of trust losses. However, the Government is concerned that the measures proposed by Labor went too far and that not enough time was given for community and Parliamentary debate on the proposals.

The Government therefore intends to make a significant number of changes to the previous Government's provisions having regard to representations received by the Government, Treasury and the Australian Taxation Office (ATO). These changes are outlined in Attachment A to this release.

The Government is committed to consulting widely with the professional tax and accounting bodies and taxpayers in drafting new and modified provisions to deal with transfers of the benefit of trust losses.

The legislation will continue to take effect from 7.30pm EST on 9 May 1995. However, the date before which, for the purposes of the measures, trusts can elect to be treated as family trusts at all times from 9 May 1995 will be extended to 1 July 1997.

The re-drafted measures will be released shortly as an exposure draft for public comment prior to their introduction into the Parliament.

Deductibility of losses of a company owned by a discretionary trust

In recent months tax professionals and taxpayers have expressed concern over whether losses can be deducted by companies whose shares are held by the trustee of a discretionary trust. The Government recognises this concern and will amend the income tax law to deal with the problem.

The company loss provisions of the income tax law will be amended to apply special rules for companies whose shares are held by the trustee of a discretionary trust. The amendments willallow companies to operate under some of the special rules contained in the proposed trust loss measures so that:

(i) where the relevant interests in a company are held by a family trust, the trustee of the family trust will be taken to beneficially own the interests as an individual; and

(ii) where 50 per cent or more of the relevant interests in a company are held by a discretionary trust that is not a family trust, losses can be deducted by the company provided certain conditions are met.

These changes will apply to losses, and bad debts, incurred in the 1996-97 or later years of income. Details of the proposed rules are set out in Attachment B to this press release.

20 August 1996
CANBERRA

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ATTACHMENT A

CHANGES TO THE PREVIOUS GOVERNMENT'S TRUST LOSS MEASURES

Family trusts

Family trusts, as defined for the purposes of the trust loss measures, receive concessional treatment as compared to other trusts. However, the previous Government's measures would have required almost all those trusts wishing to benefit from the concession to alter their trust deeds. This would have been a costly exercise because of stamp duty and legal and accounting fees. This Government is committed to reducing, as far as possible, the costs taxpayers need to incur to benefit from the family trust concession.

The definition of family trust will be altered so that a trust will be a family trust if it elects to make actual distributions of income and capital only to family members, to funds, authorities or institutions mentioned in any of the tables in subsection 78(4) or covered by paragraph 78(5)(a) of the *Income Tax Assessment Act 1936* or to family entities that make a similar election. Where the election is made, any future distributions (broadly defined) of income or capital in breach of the election will be taxed to the trustee (or interposed family entity) at the top marginal rate plus medicare levy. This will remove the need for trust deeds to be altered and thus will remove the need for taxpayers to incur unnecessary costs for the family trust concession to apply.

The transitional provision proposed by Labor (allowing trusts to convert to family trusts) requiring that the majority of distributions be received by family members will be replaced by a requirement that the trust be controlled by a family member or members in the transitional period. This will reduce the compliance costs involved in tracing distributions made by trusts wishing to be treated as family trusts. Also, the date before which a trust can elect to be treated as a family trust at all times from the 1995-96 Budget time will be extended to 1 July 1997.

Fixed trusts owned by non-fixed trusts

Labor's proposed measures originally did not permit a fixed trust owned 50 per cent or more by discretionary trusts to deduct prior or current year losses. This Government recognises that this structure is one frequently employed in ordinary commercial or family operations. Labor proposed a transitional rule in the Senate to overcome taxpayer concerns but this only applied to allow deductibility of pre-1995-96 Budget losses. In our view, this did not go far enough.

The previous Government's transitional rule proposed in the Senate to allow fixed trusts owned by non-fixed trusts to deduct pre-1995-96 Budget losses in some circumstances will be extended to apply to all losses, both pre and post 1995-96 Budget.

Income injection test

Taxpayers expressed concern that the second limb of the income injection test (draft subsection 270-10(2)) went too far. The Government recognises this concern. Accordingly, the second limb of the income injection test will be removed and necessary changes made to the first limb to ensure that an injection of assessable income into a loss trust by an outsider will be the provision of a benefit to the trust.

In addition, the benefits that are taken into account under the test will be clarified by ensuring that distributions of, or entitlements to, income (including dividends) and capital will be treated as a benefit.

Labor's measures provided that the whole of a loss or other deduction would be disallowed if the income injection test was failed, even if the deduction exceeded the income injected into the loss trust under an income injection scheme. In the Government's view, this approach is unfair. As a result, the test will be modified to provide that the deduction will not be allowable from income that has been injected into a trust under a scheme.

The Government is committed to ensuring that all persons, including high wealth individuals, pay their fair share of tax. As part of achieving this aim, the definition of outsider for the purposes of the income injection test will be modified so that an outsider includes a family member in relation to the trust unless that family member is the trustee of the trust or has a fixed entitlement in the trust. To avoid retrospectivity, this modification of the income injection test will only have effect from the 1996-97 Budget time (7.30pm EST, 20 August 1996).

Trusts used as joint vehicles

Labor's trust loss measures failed to recognise that fixed trusts can be used as vehicles whereby two persons or families jointly operate a business or undertaking. If one partner in this situation disposed of their interest, the losses of the trust would have been disallowed. The Government will remedy this inequitable outcome in relation to existing joint vehicle structures.

A transitional rule will be adopted to enable a fixed trust to deduct a loss where the trust is owned by two parties in equal shares. This would be to allow joint structures in place immediately before the 1996-97 Budget time (7.30pm EST, 20 August 1996) or which existed at some time between the 1995-96 Budget time and the 1996-97 Budget time to deduct a loss if:

- two individuals hold the fixed entitlements, directly or indirectly, to both the income and capital of the trust in equal shares; and
- one of those individuals disposes of all of their fixed entitlements in the trust.

For this purpose, the trustee of a family trust (as defined - see paragraph 2 above) is treated as an individual.

Control test

Labor's control test for non-fixed trusts did not recognise that control of a trust may pass, in the normal course of events, on the death or retirement of the controller. The Government will modify the control test which applies to non-fixed trusts so that the test is not failed solely because of the death of a controller. Also, the Commissioner will be given a discretion to treat the control test as not being failed where it is reasonable to do so. Both these provisions will apply only where those who can benefit from the relevant trust have not changed.

Pattern of distributions test

Labor's rules did not provide the circumstances in which trust distributions could be traced for the purposes of the pattern of distributions test which applies to non-fixed trusts. Taxpayers have expressed concern at the uncertainty that this created.

The pattern of distributions test will be modified to provide specific rules so that distributions of income or capital of a trust can be traced to relevant individuals or be deemed to have been received by relevant individuals. These rules will apply where distributions are made by a loss trust to an

interposed entity and then not on-distributed to individuals or where there is constructive receipt of a distribution by an individual. This means that:

- where no individuals hold fixed entitlements in the interposed entity (e.g. it is a discretionary trust), no individuals will be taken to receive the distribution;
- where individuals hold fixed entitlements to income or capital of the interposed entity, the distribution will be taken to be received by the individuals who directly or indirectly hold the fixed entitlements to income or capital, as the case may be, in proportion to the fixed entitlements held; and
- where an amount of a distribution is applied for the benefit of a person, that person will be taken to have received the distribution.

Consistent with the way the measures were originally drafted, actual distributions through interposed entities will continue to be able to be traced through those entities, regardless of their nature.

The Government will also modify the pattern of distributions test to alleviate the impact of the trust loss measures in the transitional stages. Where distributions made prior to the 1995-96 Budget time have to be taken into account in applying the pattern of distributions test, all distributions received by members of the same family prior to and after the 1995-96 Budget time will be treated as having been received by the same individual.

Tracing fixed entitlements

Labor proposed special tracing rules for mutual companies and superannuation funds to overcome tracing difficulties where these entities are interposed between a loss trust and the ultimate owners of the trust. However, these rules did not go far enough and did not reduce compliance costs as much as they could have. The Government will remove these proposed rules and substitute the following:

- The kinds of companies prescribed by the regulations will be taken to be an individual holding the relevant interest in the loss trust for their own benefit if the company has more than 50 members. This provision will be along similar lines to that which applies to family trusts under draft subsection 271-20(2). For companies prescribed in the regulations with 50 or less members, each member will be taken to have an equal fixed entitlement to income or capital of the company.
- Pending the making of regulations under this proposal, mutual insurance companies, mutual affiliate companies, trade unions and non-profit sporting clubs will get the benefit of these tracing rules. Superannuation funds will also be treated in the same way. Amendments will also be made to the definition of 'widely held unit trust' to ensure these special tracing rules do not jeopardise the status of a loss trust as a widely held unit trust.
- A rule will also be inserted to alleviate the practical tracing difficulties that arise where a public company or widely held unit trust is interposed between a loss trust and the ultimate owners of the trust. The Commissioner will be given the power to assume that a fixed entitlement in a loss trust held directly or indirectly by a public company or widely held unit trust is held by the same natural persons where it is reasonable to do so, having regard to all information which is available in relation to the direct and indirect ownership and control of the public company and widely held unit trust.

Amendments proposed by the previous Government

Several of the amendments proposed by the previous Government in the Senate will be taken up. They are as set out below.

- Special treatment will be provided for unlisted very widely held trusts during their start-up phase so that they will not be unfairly disadvantaged. Also, a modification will be made to the definition of 'unlisted very widely held trust' so that its units need not be redeemable at any time.
- The pattern of distributions test will be modified to prevent unreasonable outcomes where there is a death or divorce of a beneficiary of a trust.
- The family trust definition will allow distributions at any time to certain charitable and benevolent institutions listed in the gift provisions of the income tax law (see paragraph 2 above).
- The definition of 'excepted trust' will be amended so that it will include a fixed unit trust if all of the direct and indirect fixed entitlements to income and capital of the trust are held by bodies exempt from tax under section 23 of the *Income Tax Assessment Act 1936*.

Other amendments

Various technical corrections will be made to the previous draft of the proposed measures. The proposed provisions will also include, with effect from the 1996-97 Budget time (7.30pm EST, 20 August 1996), bad debt provisions along the lines of those that apply to companies under the existing income tax law.

ATTACHMENT B

DETAILS OF THE PROPOSED COMPANY LOSS CHANGES

The prior and current year loss and bad debt rules for companies in the income tax law will be amended, with respect to losses incurred in the 1996-97 or later years of income, to allow companies to operate under some of the special rules contained in the proposed trust loss measures.

The first of these rules will apply where the relevant interests in a company are held, directly or indirectly, by a family trust (as defined for the purposes of the trust loss measures). In these circumstances, the trustee of the family trust will be taken to beneficially own the interests as an individual for the purposes of the continuity of beneficial ownership test.

The other special rule relates to the situation where individuals do not, directly or indirectly, beneficially own, or have rights to, more than 50 per cent of the relevant interests in a company because 50 per cent or more of the relevant interests in the company are held by non-fixed trusts that are not family trusts. In this case, the continuity of beneficial ownership test will be taken to be satisfied if:

- there is no change in the persons holding the interests in the company or the percentage of their interests; and
- every non-fixed trust that is not a family trust and which holds relevant interests, directly or indirectly, in the company satisfies the loss deductibility tests that apply to non-family discretionary trusts under the proposed trust loss measures.

For the purposes of this second point, the tests that need to be satisfied are a control test and a pattern of distributions test (also a 50 per cent stake test may be applicable to some non-fixed trusts).

For losses incurred in the 1995-96 or earlier years of income, the Commissioner has advised the Government that he will interpret the existing continuity of beneficial ownership test consistently with the broad principles that have been adopted in relation to section 160ZZS of the *Income Tax Assessment Act 1936*. That is, where, in the context of a family discretionary trust, the trustee continues to administer the trust for the benefit of members of a particular family, the ATO will accept that, for all practical purposes, there has been a continuity of beneficial ownership for the purposes of the Act. If there are non-family trust arrangements which fall outside this interpretation, the Commissioner will look at the arrangements on a case by case basis to see whether the continuity of beneficial ownership test can be satisfied.

TREASURER

NO. 80

EMBARGO: Budget. Not for release before 7.30pm EST, 20 August 1996.

CAPITAL GAINS TAX AND COMPANY REVENUE PROVISIONS

The Government is tonight announcing amendments to remove anomalies in the capital gains tax (CGT) provisions dealing with the recoupment, carry forward and transfer of capital losses by companies. Amendments will also be made to remove anomalies in the revenue loss and bad debt write-off provisions in relation to their interaction with the CGT provisions.

Prior year capital losses

The income tax law will be amended to ensure that the mechanism by which capital losses are carried forward to subsequent years does not allow those losses to be reincurred (or refreshed) in each subsequent year. Capital losses will attach to the year of income in which they are incurred and they must be recouped in order of the year in which they are incurred.

The amendment will apply for the 1996-97 year of income and subsequent years. As the provisions to be amended operate on an annual basis the amendment will apply from the commencement of the 1996-97 year of income.

The amendment will affect provisions which apply to taxpayers other than companies, but the amendment will only have practical effect for companies.

Current year capital losses

The income tax law will be amended to ensure that companies can utilise capital losses to offset capital gains realised in the same year in similar circumstances as revenue losses can be offset against revenue for the same year. The same business test for current year capital losses will therefore be modified accordingly. Capital losses will still only be able to be offset against capital gains.

The amendment will apply from the commencement of the 1996-97 year of income.

Group loss transfers

The income tax law will be amended to ensure that a capital loss will not be available for transfer within a company group in respect of a year of income ('the year of transfer') unless the loss could have been recouped by the loss company had it derived sufficient capital gains in that year. That is, the loss company must satisfy the recoupment tests (the ownership test, the same business test and the other safeguards preventing circumvention of the ownership test) in the year of transfer.

In addition, the gain company must satisfy the same recoupment tests applying to the loss company.

An amendment will also provide that where a capital loss is transferred to a gain company and it is later found that the gain company cannot use the loss, the loss will revert to the loss company.

These amendments will only affect transfer agreements where the year of transfer is the 1996-97 year of income or a subsequent year.

Other aspects of the group loss transfer provisions remain unchanged.

Subvention payments

When a capital loss (or a revenue loss) is transferred there will often be a payment (known as a 'subvention payment') made from the gain company to the loss company as consideration for the transfer of the loss.

The income tax law will be amended to provide that subvention payments made in consideration of the transfer of a capital or revenue loss will not give rise to a capital gain or a capital loss to the payee or the payer. This is in line with the practice of the Commissioner of Taxation.

The amendment will apply from the commencement of the 1996-97 year of income.

Meaning of certain terms

The revenue loss, capital loss and bad debt write-off provisions will be amended to ensure that terms used in recoupment/deductibility tests in those provisions include capital gains tax concepts where relevant. For example, the amendment will make it clear that, where appropriate, references to 'income' include references to 'capital gain', 'net capital gain' and 'assessable income'.

The amendment will apply from the commencement of the 1996-97 year of income.

Same business test — manipulations

The same business test in the capital loss provisions will be amended to include similar safeguards as currently contained in the revenue loss provisions to prevent manipulation of a business (for example, restructuring the business prior to a change in ownership) in order to benefit from the same business test relief.

This amendment will apply to manipulations in the scope of a company's business activities that occur after 7.30pm EST 20 August 1996.

20 August 1996
CANBERRA

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ATTACHMENT A

PRIOR YEAR CAPITAL LOSSES: EXAMPLES HIGHLIGHTING HOW THE COMMENCEMENT DATE OF THE AMENDMENT WILL OPERATE

Example 1:

Alpha Ltd has a net capital loss for the 1995-96 year of income. On 1 August 1996 there was a change in the beneficial ownership of 100 per cent of the shares in Alpha Ltd. There are no further changes in the beneficial ownership of Alpha Ltd's shares up to and including the 1998-99 year of income. Alpha Ltd expects that it will have capital gains against which it will want to recoup the 1995-96 net capital loss in the 1996-97 to 1998-99 years of income. The table below compares the existing same business test position with that which Alpha Ltd will have to meet under the amended law in those years:

Year of income	Existing law	Amended law
1996-97	must pass same business test	must pass same business test
1997-98	must pass same business test	must pass same business test
1998-99	arguably no longer needs to pass the same business test	must pass same business test

As shown in the table, notwithstanding that today's announcement is effective from the commencement of the 1996-97 year of income, Alpha Ltd will not be affected by the amendment until the 1998-99 year of income.

Example 2: companies with approved substituted accounting periods

In relation to companies with approved substituted accounting periods, the affect of the commencement date will depend on whether their 1996-97 year of income has already commenced.

Alpha Sap Ltd is a company with an approved substituted accounting period ending 30 September in lieu of 30 June. Its 1996-97 year of income does not commence until 1 October 1996.

On 1 August 1996 there was a change in the beneficial ownership of 100 per cent of the shares in Alpha Sap Ltd. There are no further changes in the beneficial ownership of shares in Alpha Sap Ltd up to and including the 1997-98 year of income. In order to incur a 1995-96 net capital loss and recoup it in the 1996-97 to 1997-98 years of income, Alpha Sap Ltd will have to meet the same business test as indicated in the table below:

Year of income	Existing law	Amended law
1995-96	must pass same business test	will not apply for this year of income
1996-97	must pass same business test	must pass same business test
1997-98	arguably no longer needs to pass the same business test	must pass same business test

As shown in the table, notwithstanding that today's announcement is effective from the commencement of the 1996-97 year of income, Alpha Sap Ltd will not be affected by the amendment until the 1997-98 year of income.

ATTACHMENT B

CURRENT YEAR CAPITAL LOSSES: EXAMPLES HIGHLIGHTING EFFECTS OF THE AMENDMENT

Example 1:

In July 1996 Beta Pty Ltd had two assets, one which it sold for a capital gain and the other which it sold for a capital loss. On 1 August 1996 there was a change in beneficial ownership of 100 per cent of Beta Pty Ltd's shares causing it to fail the ownership test. In August Beta Pty Ltd also commences a new business which will cause it to fail the same business test.

No other events covered by the CGT provisions occur during the 1996-97 year of income (nor therefore are the other safeguards which apply to prevent circumvention of the ownership test triggered at any time during the 1996-97 year of income). Beta Pty Ltd derived revenue profit both in the period immediately before the change in its shareholding and in the period after the change. Beta Pty Ltd will be able to offset its capital loss against its capital gain as they both occurred under the same ownership. If the capital gain exceeds the capital loss, the excess will be combined with the revenue profits to calculate its assessable income.

Example 2

In July 1996 Gamma Ltd sold an asset incurring a capital loss. On 1 August 1996 a capital gain was injected into the company in circumstances which cause a safeguard preventing circumvention of the ownership test to apply. Gamma Ltd maintains the same business during the 1996-97 year of income. The same business test relief will not be available to allow Gamma Ltd to offset the capital loss against the capital gain in the 1996-97 year of income.

Note - as shown in Example 1 above, applying the amendments from the commencement of the 1996-97 year of income will, in the main, benefit companies. Where a company's circumstances trigger a safeguard preventing circumvention of the ownership test during the period from the commencement of the 1996-97 year to today, the company will be disadvantaged by the amendment. The safeguards preventing circumvention of the ownership test are additional measures designed to prevent loss trafficking.

ATTACHMENT C

GROUP LOSS TRANSFERS: AN EXAMPLE HIGHLIGHTING EFFECTS OF THE AMENDMENTS

Delta Ltd has a net capital loss for the 1995-96 year of income. Epsilon Ltd was a wholly owned subsidiary of Delta Ltd for the whole of the 1995-96 year. On 1 August 1996 there was a change in beneficial ownership of 100 per cent of Delta Ltd's shares and hence a change in the beneficial ownership of 100 per cent of Epsilon Ltd's shares.

For the 1996-97 year of income, Delta Ltd did not derive any capital gains or incur any capital losses, but Epsilon Ltd did derive a capital gain. As Delta Ltd does not satisfy the ownership test, in order for it to transfer its 1995-96 net capital loss to Epsilon Ltd, Delta Ltd must satisfy the same business test for the whole of the 1996-97 year. In addition, as Epsilon Ltd does not satisfy the ownership test, it must satisfy the same business test for the whole of the 1996-97 year.

The other aspects of the group loss transfer provisions, which are not changed by these amendments, will also need to be satisfied.

Note: were Delta Ltd to both incur and seek to transfer a net capital loss in the 1996-97 year of income, broadly similar conditions to those applying in the example above would apply. There will be some modification to this area of the law as a result of the amendment to the current year capital loss provisions announced today.

These amendments apply to transfer agreements where the year of transfer is the 1996-97 year of income or a subsequent year. Transfers for the 1995-96 year of income continue to be dealt with under the existing law.

TREASURER

NO. 81

EMBARGO: Budget. Not for release before 7.30pm EST, 20 August 1996.

CAPITAL GAINS TAX - LIQUIDATION OF A GROUP COMPANY

The Government has decided to remove the possibility of the duplication of gains or losses in group company reorganisations involving *in specie* distributions.

This measure is needed to remove an anomaly that only arises in the liquidation of a group company where an asset(s) is transferred *in specie* rather than being sold and the proceeds transferred as an intercorporate dividend.

Under the current law, if in the course of the liquidation of a subsidiary company, an asset is distributed *in specie* to a holding company, a capital gains tax (CGT) rollover is available in relation to the transfer of the asset. However, a capital gain may accrue to the holding company on the cancellation of its shares in the subsidiary, since the cancellation of the shares is also a disposal for CGT purposes. The consideration for the disposal of the shares will be equal to the market value of the transferred asset. No rollover is available for the disposal of the shares on cancellation. The holding company will also be liable for CGT on the eventual sale of the rolled over asset.

However, no capital gain would arise on the disposal of the shares if, prior to liquidation, the asset was sold by the subsidiary to the holding company. The profit on the sale would be distributed to the holding company as a tax free intercorporate dividend, and the subsidiary then dissolved.

The CGT provisions of the *Income Tax Assessment Act 1936* will be amended so that where

- a CGT rollover applies on the transfer of an asset between group companies, and
- as a result of the transfer a capital gain is realised on the disposal of the shares in the company being liquidated,

the CGT provisions will apply so that any capital gain (or loss) arising as a consequence of the cancellation of the shares will be reduced to the extent that a capital gain (or loss) would have arisen on the asset transfer had a rollover not been made.

This change will apply to company dissolutions occurring after 7.30 pm EST 20 August 1996.

20 August 1996
CANBERRA

Contact: ATO CGT Hotline
Phone: 1800 244 601

TREASURER

NO. 82

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

CAPITAL GAINS TAX — MODIFIED APPLICATION OF SECTION 160ZZS

The Government has decided to amend Section 160ZZS of the *Income Tax Assessment Act 1936*. This provision determines when assets owned by public entities (ie public companies, publicly traded unit trusts and mutual insurance organisations) lose their pre-CGT status as a result of a change in majority underlying ownership by natural persons.

Section 160ZZS provides that an asset acquired by a taxpayer before 20 September 1985 shall be deemed to have been acquired on or after that date unless the Commissioner of Taxation is satisfied that the majority underlying interests in the asset were acquired before the introduction of the capital gains tax (CGT). This means, in substance, that if the majority underlying interest in an economic entity (such as a company) changes on or after 20 September 1985, the assets of the entity will be subject to CGT from the time of the change in the underlying ownership, even where the assets were acquired by the entity before 20 September 1985. The Commissioner requires listed public companies (and similar trusts) to test their underlying ownership only when there is unusual trading in their shares or units. The deemed acquisition of the assets for CGT purposes, however, does not (under current law) date to the unusual trading of the assets, but backdates to the date when majority underlying ownership changed. This has resulted in taxpayers selling assets acquired before 20 September 1985 without knowing their CGT liability, and in increased compliance costs for taxpayers in determining the relevant date of change of ownership and asset cost base.

The tax law will be amended to require public entities (ie, public companies, publicly traded unit trusts and mutual insurance organisations) to test whether there has in fact been a change in a majority of underlying interests in assets of the entity since 20 September 1985 on prescribed dates - as at 20 September 1996 and every five years thereafter. The amendments will:

- retain the requirement to test when there is unusual trading in instruments of ownership. However, where unusual trading has occurred, any change of underlying ownership will be deemed to be from that time, not earlier;
- defer the date at which assets lose their pre-CGT status from the date when the majority underlying ownership changed to when the test of underlying ownership is required to be conducted; and
- where a change in ownership has been found, require entities to determine the cost base for CGT purposes of affected assets on the basis of market value at the date the test of ownership was required.

The amendments will provide the following benefits for taxpayers:

- increased tax certainty: the entity will know whether its assets have lost their pre-CGT status before disposal;

- an increase in the statutory period for which assets retain pre-CGT status; and

- reduced compliance costs: the requirement for ascertaining the relevant date in the past when assets became ungrandfathered and valuing assets from that date will be removed.

In the short-term, the measure will produce a small bring forward of tax revenue as public entities will know the status of their post-CGT assets earlier. The measure is consistent with the Government's objective of reducing compliance costs and increasing the efficiency of the capital gains tax system.

20 August 1996
CANBERRA

Contact: Ian Pittard (ATO)
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TREASURER

NO. 83

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

LUXURY CAR LEASING

The Government has decided to amend the *Income Tax Assessment Act 1936* so that lease arrangements involving luxury cars will be treated as if they were loan transactions. This measure will apply to all luxury car leases entered into after 7.30 pm EST 20 August 1996 other than genuine short-term hire arrangements.

These changes mean that for taxation purposes the lessee of a luxury car, instead of the lessor, will be treated as the owner of the car. Lease payments will be divided for tax purposes into their underlying capital component and their finance charge component. Where the car is used for the purposes of producing assessable income, the lessee will be denied deductions for the capital component of lease payments, but will be entitled to deduct depreciation based on the cost of the car — reduced according to the appropriate luxury car depreciation limit — and the finance charge component of the lease payments.

The lessor will lose entitlement to depreciation deductions, and will not be required to return the entire lease payments as assessable income. Instead, the lessor will return as assessable income the finance charge component of the lease payments.

These changes mean that for taxation purposes the lessee, and not the lessor, of a luxury car will be treated as the owner of the car. As a result, the effect of the depreciation limit on the after-tax cost of a leased car to its end user will be comparable to the effect of the limit on the after-tax cost of buying, or otherwise financing, the car.

The proposed amendments to the income tax law have become necessary because of the widespread use of luxury car leasing arrangements involving offshore lessors, tax-exempt lessors, or tax-preferred lessors — such as superannuation funds — to avoid the intended effect of the luxury car depreciation limit which has been a part of the law since 1979-80.

The attached sets out more information on the proposed legislative amendments.

20 August 1996
CANBERRA

Contact: Brendan Flattery (ATO)
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ATTACHMENT

OUTLINE OF LEGISLATIVE CHANGES

The amendments will apply to leases of new or second hand motor vehicles entered into after 7.30 pm EST 20 August 1996.

They will apply where the cost of the motor vehicle exceeds the luxury car depreciation limit that applies for the income year in which the lease commenced.

For the purpose of the amendments, a lease is any arrangement under which the owner of the vehicle grants rights to another person to use the vehicle in return for consideration for the granting of the rights. A lease would also include a sub-lease, but not arrangements under which motor vehicles are ordinarily hired out commercially on an intermittent short-term basis.

Taxation treatment of lessor

The broad effect of the changes is to tax the lessor as a financier.

Where the parties are acting at arm's length and the lease agreement specifies the cost of the car, that amount will be taken as the amount for which the lessee has purchased the car and the amount that the lessee has borrowed from the lessor.

In other cases, the amount will be equal to the amount the lessee could be expected to pay to purchase the car under an arm's length transaction, that is, the market value. That would be the case, for example, under a lease where neither a cost nor a residual value is specified and the lessee is expected to return the car at the end of the lease.

As the lender, the lessor will be assessed to tax on the finance charge component of the payments under the lease that represents a return on the funds provided to the lessee. In other words, that component represents the interest and other charges.

In practical terms over the life of the lease, the return on funds will be calculated as the difference between the cost of the car and the amounts the lessee has agreed to pay under the lease contract, including any agreed residual payment or value.

- Where a lease does not specify a residual payment or value, the termination amount that will be factored in to determine the lessor's return on funds will be the estimated market value of the car at the end of the lease.

The lessor's return on funds will be brought to account annually (the finance charge component) as assessable income over the term of the lease on a compounding accruals basis. Compounding accruals accounting applies the implicit interest rate of the lease to the principal outstanding at the beginning of each income year to determine the amount of accrued income that will be included in the assessable income of the lessor. The principles applied will be similar to those used in the operation of Division 16E of the *Income Tax Assessment Act 1936*.

The lessor will not be entitled to depreciation allowances.

On termination or expiry of the lease, it may be necessary to make an adjustment to determine the correct amount to be included in the lessor's assessable income — or allowed as a deduction — in the year of termination. Adjustment would be necessary, for example, where:

- there is an early termination of the lease without, for example, full payment of the agreed rentals and/or the residual value; or

- the lessor's return on funds had been calculated on the basis of an estimated residual value of the vehicle which was more or less than the value received on termination.

The adjustment on termination will take into account all payments and receipts under the lease, including payments on termination and the residual amount received for the vehicle, and gains or losses previously brought to account. The adjustment formula will be *a* minus *b* minus *c*, where:

a = all amounts received under the lease, including the final value of the car.

b = all of the lessor's payments under the lease, including the cost of the car.

c = the net amount previously brought to tax by the lessor.

Taxation treatment of lessee

The lessee will be taxed as a borrower and owner of the vehicle.

Where the car is used by the lessee for income producing purposes, the lessee will be entitled to:

- an annual deduction equal to the finance charge component worked out each year on a compounding accruals basis. These deductions will mirror the amount of the finance charge component included in the lessor's assessable income, but will be reduced to the extent to which the car is used for non-business purposes.

  – Any adjustment on termination of the lease would also affect the lessee's equivalent deductions under the lease; and

- taxation depreciation allowances based on the cost of the car, ascertained as above, reduced according to the luxury car depreciation cost limit applicable to the year of income, and by any non-business usage.

On termination of the lease, the lessee will be treated as having disposed of the car if it is returned to the lessor. Normal depreciation balancing charge provisions will then apply.

- For that purpose, the consideration receivable on disposal ordinarily will be the amount credited to the lessee under the terms of the lease, for example, the agreed residual value.

- If the lessor were to credit the lessee with an amount other than the agreed residual value— for example, by allowing the lessee to retain any sale proceeds that exceed the residual value — the lessee will be taken to have disposed of the car for that other amount.

I. Where the lessor’s assessable return on funds has been calculated on the basis of an estimated market value of the car at the end of the lease, consideration receivable on disposal will be the actual market value at that time.

If the lessee retains the car, the lessee would remain entitled to depreciation allowances.

Sub-leases

Where the lessee sub-leases the luxury car, these rules will apply to treat the sub-lessee as the owner eligible for income tax depreciation allowances. While neither the lessor's assessable return on investment nor the lessee's equivalent deductible amount will be affected, the sub-lessee's entitlement to deductions will be worked out by reference to its own lease payments instead of the lessee's.

Non-resident lessors

These rules will not affect the tax liability of a non-resident lessor which is not required to return car lease income in Australia — for example, where it does not have a permanent establishment in Australia. Lease payments to non-resident lessors will continue to be taxed as royalties under existing withholding tax rules. However, resident lessees who lease luxury cars from non-residents will be subject to the new rules.

Genuine short-term hire

Short-term hire arrangements involving luxury cars will not be affected by these rules, subject to the necessary safeguard that the rules may not be avoided by arrangements under which a longer term car lease is disguised as a series of short-term hirings.

TREASURER

NO. 84

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

TAX EVASION ON COMPUTER EQUIPMENT

The Government will move to end wholesale sales tax fraud involving personal computers and related goods. Fraud in this area has reduced tax revenue and placed tax evaders at a competitive advantage compared to honest businesses.

Despite field work undertaken by the Australian Taxation Office (ATO) in conjunction with the Australian Federal Police, and prosecution action, fraudulent activity is continuing in relation to sales of personal computers and related equipment.

The Government believes that this activity will only be stopped by the co-operative joint action of the ATO and reputable industry members and by making changes to the sales tax law.

The ATO will consult with the computer industry and others to determine ways of improving the existing sales tax system. While the Government recognises that measures taken to deal with the fraud may impact on business arrangements, the consultation process will seek to ensure that any impact is minimised and that the most practical way of dealing with the problem is developed and implemented with industry assistance and support.

The Government has received numerous representations from genuine operators in the industry who have suffered considerable commercial disadvantage as a result of the fraudulent activities. The Government is committed to implementing appropriate measures to ensure this situation is remedied.

One option could be to postpone the ability of persons or bodies under the existing system to obtain goods free of tax until the goods are on-sold or purchased by the final user. If this was adopted, it could be given effect by suspending existing quoting arrangements so that computer manufacturers and wholesalers would account for tax on their sales and would be entitled to a credit for tax paid in relation to the goods sold.

Always-exempt organisations - such as public benevolent institutions, non-profit schools, government bodies etc - who are entitled to sales tax exemption on computer equipment purchases would be able to obtain a refund of tax paid within 28 days. If adopted, these changes would not affect the exemption status of always-exempt organisations.

When the consultation process is completed later this year the ATO will report on recommendations that have been developed. In the interim the ATO will, in conjunction with the Australian Federal Police, continue to focus their efforts to deal with the fraud by every available means.

20 August 1996
CANBERRA

Contact: Mike Cebalo (ATO)
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TREASURER

NO.

EMBARGO: Budget. Not for release before 7.30 pm EST, 20 August 1996.

RESEARCH AND DEVELOPMENT TAX CONCESSION: REDUCTION IN PREMIUM RATE OF DEDUCTION TO A MAXIMUM OF 125 PER CENT

START: A MAJOR NEW RESEARCH AND DEVELOPMENT FUNDING INITIATIVE

Total Commonwealth Government support for research and development (R&D) in 1996-97 will remain in excess of $3.5 billion in a package of measures announced by the Government tonight.

The Government has decided to reduce the premium rate for deductions for R&D expenditures to a maximum of 125 per cent. This measure will apply to R&D expenditure incurred after 7.30 pm EST 20 August 1996 except where the expenditure was required to be incurred by a contract (other than a contract of service) entered into before that time.

The Government notes that the concession for eligible R&D would be generous even with a top rate of deduction of 100 per cent. The concession allows immediate deduction or rapid amortisation of expenditures which would otherwise be either undeductible or amortised over a longer period. 125 per cent deduction for R&D represents an additional element of concessionality.

In this Budget the Government announces new support for R&D, establishing the Strategic Assistance for Research and Development (*Start*) Program. Under the program, the Government will provide a flexible package of assistance totalling $340m over the next four years to encourage large projects containing highly innovative or technically risky R&D that has strong support for commercialisation from the private sector. The program will be administered by AusIndustry with the Industry Research and Development Board responsible for determining who receives funding. The new program will provide:

- a new competitive R&D replacement program for R&D syndication for large projects;
- a mix of grants, loans and interest subsidies; and
- the flexibility for the development of any new market-based measures over time.

Grants and loans will be provided for large R&D projects which have clear economic spillovers, which would not gain the full financial benefit of the tax concession and which would not otherwise proceed due to lack of finance. Additional long-term loans will also be provided where private sector finance cannot be induced. The level of support will be related to the degree of demonstrable additionality and broader economic benefit, with greatest support for high risk projects involving collaboration between several businesses. Attached is a brief outline of Government R&D programs.

CANBERRA
20 August 1996

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Alan Evans (AusIndustry) (06) 276 1410 (*Start*)

BUDGET SUPPORT FOR RESEARCH AND DEVELOPMENT AND THE R&D TAX CONCESSION

Government provides substantial assistance to Australian research and development (R&D) through both tax expenditure and outlays programs. As part of the 1996-97 Budget processes, the Government has reviewed the scope and composition of those programs, and has affirmed the importance of such assistance for promoting Australian R&D. To increase the effectiveness of R&D assistance, the Government is focusing that assistance towards increased outlays on R&D and away from taxation expenditures. It will also be introducing a new program of specifically targeted loans and grants, while retaining concessional tax arrangements.

R&D Tax Concession

Tax concessions for R&D were introduced by the former Government with effect from 1 July 1985. They allowed eligible taxpayers to deduct qualifying expenditure incurred on R&D activities, including R&D carried out on their behalf, against taxable income at highly concessional rates of up to 150 per cent.

These tax arrangements have been subject to extensive amendments. In particular, in 1987 the then Government introduced a concession to allow companies to undertake eligible R&D in partnership. This concession was aimed at R&D projects too large or too risky for a single company to undertake. In practice, the provisions spawned various methods to give R&D tax deductions to investors through partnership structures known as syndication.

In reviewing the tax arrangements in the broader context of overall assistance to R&D, the Government decided the following changes, effective from 23 July 1996. These are described in detail in the Press Release of the same date.

- to abolish the concessions for R&D partnerships and syndicate type arrangements;
- to make significant amendments with respect to deductions for pilot plant, feedstock for processes where the output is sold, interest expense and core technology; and
- to limit the time in which a registered company can amend its tax return to claim research and development expenditure.

As part of its Budget measures on research and development, the Government has decided to reduce the maximum concessional rate of deduction from 150 to 125 per cent, for expenditure incurred after 7.30 pm EST 20 August 1996, except where the expenditure was required to be incurred by a contract (other than a contract of service) entered into before announcement.

Operation of the Tax Concession

The main features of the general R&D concession, following the measures announced in the budget, are:

(a) Annual eligible R&D expenditure must exceed $20000 to obtain the full 125 per cent deduction. Eligible expenditure includes:

— *wages, salaries, and other labour costs:* deductible at 125 per cent;

— *core technology* used for R&D activities: deductible at a rate of 100 per cent (subject to pro-rata limits applied annually), for example, a company may acquire rights to use a particular technology that is currently available to undertake R&D activities and obtain immediate amortisation of this capital expenditure;

— qualifying expenditure on *plant* and on *pilot plant*: deductible at the rate of 125 per cent over three years from the year the plant is first used exclusively for R&D, or over the useful life of pilot plant;

— *interest*: deductible at a rate of 100 per cent; and

— capital expenditure on constructing or reconstructing *buildings* (or parts of buildings) used for R&D: deductible in the same way as similar capital expenditure on buildings used for income producing purposes (generally the expenditure is written off over a forty year period).

(b) For an R&D project to be eligible for the concession, it must be based on R&D activity that involves either:

— innovation — requires the presence of an appreciable element of novelty; or

— high levels of technical risk — technical risk requires that the probability of obtaining a given technical outcome cannot be known or determined in advance on the basis of current knowledge or experience. The technological or scientific uncertainty can only be removed through a program of systematic and investigative and experimental activities. Systematic and investigative and experimental activities mean activities in which scientific method has been applied, in a systematic progression of work from hypothesis to experiment, observation and evaluation, followed by logical conclusion. In addition the work will have been based upon principles of physical, biological, chemical, medical, engineering or computer sciences.

(c) The R&D must be carried out for the company claiming the expenditure. The greater part of eligible R&D activity must generally be carried out in Australia; the R&D activity must have adequate Australian content; and the results of the R&D must be exploited on normal commercial terms and for the benefit of the Australian economy.

(d) If companies incur expenditure on having R&D done for them by relevant registered research agencies, such as CSIRO, the expenditure threshold is waived.

Studies of Australian Government Support for Research and Development

Comparisons of R&D tax-based instruments indicate that Australia provides one of the most generous R&D tax incentives in the world.[1] The generosity of this concession has meant that the proportion of business expenditure on R&D funded by government in Australia is among the highest of OECD countries.[2]

The R&D tax concession is provided to eligible companies whether or not they would have undertaken R&D without it, thereby implying a high transfer component — that part of the cost of the concession which supports R&D that would have taken place in the absence of the concession.

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1 Industry Commission, Research and Development, Report No. 44, 1995, D.25.

2 Industry Commission, *ibid*, D.19.

The high transfer component was one of the major criticisms of the concession in reports by the Bureau of Industry Economics and the Industry Commission.

- The Bureau of Industry Economics found that the amount of additional R&D expenditure encouraged in recent years by the tax concession might lie in the range of 10 to 17 per cent of eligible R&D expenditure.[3]

International Comparison of Tax Concessions for Research and Development

Few countries provide deduction rates of over 100 per cent for any kind of R&D expenditure. In many of those countries that do, only a smaller range of R&D expenditures qualify for concessionary treatment. Capital expenditures are often deductible only under ordinary depreciation or other effective life provisions.

Malaysia and Singapore are often cited as having R&D tax concessions competitive with Australia's. Overall, the Australian tax concession compares favourably, because of its substantially wider scope and entitlement basis, even at its revised deduction top rate of 125 per cent.

Whilst Malaysia and Singapore have attractive headline deductions (at 200 per cent) for expenditure on R&D, the concessions in these countries are far more restrictive than those available in Australia. Many research projects which qualify for the R&D tax concession in Australia would not qualify for the concession in those countries. Most expenditures claimed under the Australian R&D tax concession would receive *less* concessionary treatment in Singapore and Malaysia.

The premium concessions are at the discretion of the relevant Ministers in both Singapore and Malaysia. In Australia the concession is entitlement based.

Capital expenditure of various kinds (which comprises the majority of R&D expenditure in Australia) is more concessionally treated in Australia than in Singapore or Malaysia.

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[3] Bureau of Industry Economics, R&D, Innovation and Competitiveness, Research Report 50, 1993, p xi.

Table C1: Comparison of Tax Treatment of R&D Expenditures Across Australia, Singapore and Malaysia.

	Australia	Singapore	Malaysia
Manpower, materials expended in qualifying R&D activities	125 per cent deduction available to companies registered under the Industry Research and Development Act 1986.	200 per cent deduction for manufacturing companies and some service companies. R&D must have approval of Minister who may, at his discretion, specify amount of expenditure and period for which deduction may be allowed.	200 per cent deduction. Tighter definition of R&D than Australia. R&D must have approval of Minister.
Buildings used in R&D	Ordinary provisions.	Ordinary provisions.	Qualifies for industrial building allowance.
Plant and machinery used in R&D; and pilot plant, under R&D development	Deductible at up to 125 per cent over three years. Pilot plant may be taken over life of plant.	Deductible at 100 per cent over three years. Heavy capital expenditure may receive investment allowances of up to 50 per cent fully at discretion of Minister.	Normal depreciation only if used in a business of research, or if used on research approved by Minister: otherwise no depreciation.
Rights to use technology necessary for R&D	100 per cent deduction for purchases of core technology for R&D (subject to pro-rata limits applied annually).	Ordinary provisions for capital payments to acquire 'know how': amortisation over five years, if for use in taxpayer's own manufacturing trade or business.	Undeductible capital expenditure.
Development of technology for patent	Deductible at up to 125 per cent if part of R&D.	Ordinary provisions for 'know how' as above.	Undeductible capital expenditure.
Formally registering a patent over results of R&D	100 per cent deduction for all registration costs if not eligible for R&D deductions at higher rates.	Ordinary provisions for 'know how' as above.	Undeductible capital expenditure.

Eligible R&D in Singapore and Malaysia is limited to systematic or intensive study carried out in the field of science or technology, the results of which are to be used for the production or improvement of products, produce or processes. The Australian concession allows seeking of new knowledge, whether or not of immediate or practical application. Singapore and Malaysia exclude the same items from R&D tax treatment as the Australian concession, and also expressly exclude quality control.

Where R&D expenditure receives special treatment elsewhere in the world, it commonly receives earlier deductibility than for comparable expenditure that is not on R&D, an advance tax deduction clawed back in following years, an additional deduction based on increased R&D compared to earlier years, or some combination of these.

What is Concessional Treatment of R&D Expenditure?

The tax concession for eligible R&D would be concessional even with a top rate of deduction of 100 per cent. The concession allows immediate deduction or rapid amortisation of expenditures which would otherwise be either undeductible or amortised over a longer period. The 125 per cent deduction for R&D is more concessional than the tax concession for Australian films: 100 per cent immediate deduction of capital expenditure on film production.

The bulk of Australian R&D expenditures are of a capital nature: without a specific concession they would be deductible over long periods (if at all). Without specific concessions for R&D, the whole of any expenditures of any kind on R&D would be undeductible capital expenditure for many taxpayers. For those taxpayers whose business included carrying out R&D for the purpose of profit, some expenditures might be of a revenue nature and deductible; for instance salaries and wages, or interest. For example:

- Expenditure on R&D plant would only be deductible according to the same broad-banded rates as other plant.

- Expenditure on pilot plant might not be deductible at all.

- Expenditure on core technology, needed to properly develop and use new R&D, would normally be deductible over its whole effective life.

Tax concessions greater than 100 per cent for items not consumed in use raise serious possibilities for tax abuse. A deduction greater than 100 per cent allows an item to be transferred from taxpayer to taxpayer creating net deductions on each sale. This possibility makes necessary complex cross compliance procedures.

Who Benefits From the Tax Concession?

The benefits from the R&D tax concession go disproportionately to large companies. In 1993-94, 2,828 companies claimed the concession. The total expenditure claimed was approximately $2 billion. The top ten company groups to make claims accounted for more than half of these claims, over $1 billion. One public company (which does not describe itself as a research company) made claims for more than $200 million. In 1994-95 there was a 25 per cent increase in R&Dclaims by companies claiming more than $5 million in R&D expenditure.

At the other end of the spectrum the R&D concessions (particularly the partnership provisions) have been associated with some businesses achieving very low levels of tax. For example, in 1993-94

there were 29,157 private companies with taxable incomes (after deductions, including R&D deductions) between $1 and $1,999. Of these, only 33 claimed the R&D tax concession, and they claimed an average of almost $100,000 each. Very large claims relative to taxable income are the norm amongst the small number of private companies with taxable incomes below $100,000 which claim the concession.

Outlays Support for Research and Development

In addition to taxation measures significant support for research and development is provided through outlay programs. The main source of funding for research is through grants to universities. The Government's initiatives in this area are covered in the *Ministerial Statement on Higher Education*. Other outlays measures are summarised below. More detail on Budget measures is contained in the *1996-97 Science and Technology Statement*.

Strategic Assistance for Research and Development (Start) Program

Following consultations with industry and researchers, the Government has reconfirmed its commitment to encourage industry R&D by establishing the new Strategic Assistance for Research and Development (*Start*) Program.

Under the program, the Government will provide a flexible package of assistance totalling $340 million over the next four years to encourage large projects containing highly innovative or technically risky R&D that has strong support for commercialisation from the private sector. The program will be administered by AusIndustry with the IR&D Board responsible for determining who receives funding.

The new program will:

- provide a new competitive R&D replacement program for R&D syndication for large projects;
- provide a mix of grants, loans and interest subsidies; and
- provide the flexibility for the development of any new market-based measures over time.

Grants and loans will be provided for large R&D projects which have clear economic spillovers, which would not gain the full financial benefit of the tax concession and which would not otherwise proceed due to lack of finance. Additional long-term loans will also be provided where private sector finance cannot be induced. The degree of support will be related to the degree of demonstrable additionality and broader economic benefit, with greatest support for high risk projects involving collaboration between several businesses.

Rural Research and Development

The Budget has honoured the Coalition's commitment on funding of rural research through Rural Research and Development Corporations (RDCs), as outlined in the Primary Industry Statement *Reviving the Heartland*. It ensures that, over the next four years, the Commonwealth will continue to match rural industry contributions to R&D on a dollar-for-dollar basis, up to 0.5 per cent of the gross value of production of an industry. In meeting this commitment, the Commonwealth will provide funding of $106 million in 1996-97 to the rural sector, based on current industry levy

contribution rates. The Government funding will be higher if the industry increases its levy contributions.

These RDCs commission and manage research activities. This system of rural RDCs, and the joint industry/government funding arrangements that support them, have played a critical role in increasing rural investment in R&D so essential to ongoing rural productivity growth. In 1984-85, the industry contributed $26.5 million to rural R&D. In 1995-96, the industry contribution was $99 million, an increase of 126 per cent over that period, after allowing for inflation. Some 2600 researchers are supported by the RDCs, as well as about 430 postgraduate students.

The rural sector also benefits from CSIRO's substantial rural research activities and research done in universities. CSIRO is estimated to devote about half of its expenditures to research of a rural nature. Excluding research commissioned by the RDCs, that ratio is estimated to be close to 40 per cent.

Ongoing Programs

Direct Support to Industry R&D

The existing Competitive Grants for Research and Development will be focused specifically on smaller projects. Funding will be about $53 million in 1996-97 and $40 million in each of 1997-98 and 1998-99. The grants assist small businesses unable to fully use the R&D tax concession. The grants also support collaborative R&D projects, trial and demonstration activities between technology developers and potential customers, and company specific R&D projects involving the employment of a graduate student.

The Concessional Loans for Commercialisation of Technological Innovation Program is aimed at supporting small high technology oriented businesses in the early stages of commercialisation. Funding will rise from about $10 million in 1995-96 to $13 million in 1996-97.

Technology Support Centres assist small and medium sized enterprises with technical advice, access to research and development facilities and skills training they need to improve their international competitiveness. The program enables businesses to understand, evaluate and adopt technology appropriate to their needs. Funding will be maintained at about $7 million in 1996-97.

AusIndustry is a Federal and State Government initiative which aims to help businesses become more internationally competitive. Through a national delivery network, it provides industry with accurate and high-quality information and referral services. AusIndustry provides Australian business with advice and assistance in areas including research and development, commercialisation and business development.

Science Agencies

CSIRO is a multidisciplinary research organisation, serving Australia through excellence in research and technological development. Its research priorities cover a wide range of activities having regard to anticipated returns to identified socio-economic objectives including the competitiveness and sustainability of Australian industry. In recent years it has increased its focus on links with industry and developing research results. The Government has honoured its election commitment to restore CSIRO's funding base and has provided an additional $115 million over the next four years. Funding for CSIRO in 1996-97 is estimated to be $444 million rising to $509 million in 1999-2000.

The Australian Nuclear Science and Technology Organisation (ANSTO) is Australia's premier nuclear research organisation, conducting research at the Lucas Heights nuclear facility. The Government has decided to maintain ANSTO's funding base, which is expected to rise from $64 million in 1995-96 to $71 million in 1999-2000.

The Australian Institute of Marine Science (AIMS) undertakes research and development to generate new knowledge in marine science and technology, promotes its application to industry, government and ecosystem management and undertakes collaborative activities with industry and Government. Funding for AIMS will be maintained at about $17 million a year.

The Defence Science and Technology Organisation (DSTO) provides important research services for the defence community which can provide spinoffs to the private sector. Funding for DSTO will be maintained at about $230 million a year.

Cooperative Research Centres (CRC)

The CRC program provides support for long term collaborative ventures linking research and research users from universities, Commonwealth and State funded research organisations and business enterprises. The program promotes high quality cooperative research and education programs through centres of research concentration, strengthening the links between research and its commercial and other applications. CRCs are jointly funded by the Commonwealth and various partners. Commonwealth funding will be maintained at $145 million in 1996-97 rising to $148 million in 1998-99.

Currently 64 CRCs are funded for a 5 to 7 year period at the end of which they are expected either to be completely self-funding or to compete for renewal of Commonwealth funding. This will enable the Commonwealth's contribution to be used to develop new CRCs. CRCs are established in six broad fields of research: manufacturing technology, information and communication technology, mining and energy, agriculture and rural-based manufacturing, environment, and medical science and technology.

National Health and Medical Research Council (NH&MRC)

The NH&MRC advises the Australian community on the achievement and maintenance of the highest practicable standards of individual and public health and fosters research directed at improving these standards. The Council provides funding for over 1600 research projects as well as block funding for five major research centres and institutes. The Government will maintain funding for NH&MRC at $150 million in 1996-97.

Table C2: Major Programs — Science and Innovation

	1994-95 $m	1995-96 $m	1996-97 $m (est)
Australian Research Council(a)	310.2	346.4	396.2
Other Higher Education R&D	1167.1	1204.8	1232.1
Cooperative Research Centres	112.7	132.7	145.1
Industry R&D	132.0	125.5	113.8
Start Programme(b)	-	-	40.0
Rural R&D	134.0	126.5	136.7
National Health & Medical Research Centre	125.5	141.3	150.0
Other Health R&D	26.8	21.7	14.1
Other R&D Grants(c)	21.3	21.8	14.1
CSIRO(d)	467.8	422.5	449.7
Defence Science and Technology Organisation	239.3	248.2	228.8
Other R&D Agencies	234.4	237.3	284.7
Total Commonwealth Outlays	1249.1	1219.3	3205.3
150 per cent Tax Concession(e)	739.0	790.0	341.0
Total Commonwealth Support	3710.1	3818.7	3546.3

(a) Represents total of Budget and *Higher Education Funding Act 1988* funding.
(b) Funding under this new programme rises to $100 million in each of the years 1997-98, 1998-99, and 1999-2000.
(c) Australian Biological Resources Study, Greenhouse research grants, Energy R&D and Australian Road Research Board.
(d) Includes funding through Department of Primary Industry and Energy for Australian Animal Health Laboratories. Note that $20 million from the 1995-96 allocation was borrowed in 1994-95. In addition to the budget funding shown, CSIRO expects to earn over $262 million from external sources in 1996-97.
(e) Tax concession numbers based on taxpayer year of income. These numbers represent Government commitment to R&D through the tax concession, not Budget bottom-line effect. The Budget bottom-line effect arises when taxpayer liabilities fall due. For some liabilities this occurs in the following financial year. Reporting tax expenditures by year of income is not consistent with Table B1: Aggregate Tax Expenditures and Direct Outlays 1989-90 to 1999-00, in Appendix B: Tax Expenditures. Both Appendix B and the *Tax Expenditure Statement* report tax expenditures in the year in which the impact on revenue occurs.