

10 March 2009

Small Business and General Business Tax Break - Consultation
Treasury
Langton Crescent
Parkes ACT 2600

Recommended improvements and amendments to the draft of the Tax Laws Amendment (Small Business and General Business Tax Break) Bill 2009

Ernst & Young Australia ("Ernst & Young") welcomes the opportunity to respond to the invitation for submissions in relation to the Exposure Draft legislation ("the draft") and Explanatory Memorandum for the "Small Business and General Business Tax Break" ("Tax Break") released 25 February 2009.

We welcome and support the Government's efforts to stimulate capital investment in Australia. We appreciate the opportunity provided for us to have input into the development of this legislation, and the various discussions we have had with Treasury before and after issue of the draft. We support the introduction of the Bill in March 2009.

Discussions with our clients show they support the increase of the investment allowance to a 30% deduction, subject to addressing various issues.

In our analysis of the draft and discussions with our clients, we have identified a number of areas of improvement to the Bill, including policy issues which need to be aligned to the Government's intention expressed in the announcements of 12 December 2008 and 3 February 2009.

We highlight the need to:

1. include 'intangible' assets, especially software and other intangibles, which are very important in today's environment of technologically sophisticated equipment
2. extend the investment time and first use time for committed projects, which can be done consistently with the desire to stimulate investment now rather than seeing it deferred
3. deal with multiple assets and networks for purposes of the investment threshold
4. clarify the meaning of starting or commencing construction, to avoid uncertainty and disputes
5. clarify the ambiguity in the 'investment time, to avoid uncertainty and disputes
6. clarify the issues around sale and leasebacks and leasing
7. allow for assets used partly outside Australia by Australian businesses in the transport sector
8. adjust tax-deduction incentives given our dividend imputation environment

and some further issues of a more technical or drafting nature.

If you would like to discuss this submission, please do not hesitate to contact, in the first instance, Trevor Hughes on (03) 8650 7363, Tony Stolarek on (03) 8650 7654 or Richard Czerwik on (03) 9288 8408.

Yours sincerely

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Recommended improvements and amendments to the draft of the Tax Laws Amendment (Small Business and General Business Tax Break) Bill 2009

Intangible depreciating assets, particularly software, should be included

The draft expressly precludes intangible assets such as computer software¹ from the claim. This may be consistent with the investment allowances of 20 years ago; however it is inappropriate for a measure to stimulate capital investment in the technological environment of the 21st century, and is inconsistent with the inclusion of computer software and other intangibles in the capital allowances regime.²

Failure to extend the allowance to computer software and to business intangibles associated with capital equipment, particularly when associated with hardware, would:

- a) ignore the significant value that IT delivers to the business environment, at a time when businesses are facing unprecedented challenges in seeking to achieve innovation, efficiency and productivity, cost rationalisation, value and competitive differentiation and risk management
- b) Be inconsistent with stimulating the employment of skilled IT employees and consultants
- c) cause highly inefficient compliance tasks when businesses engage in capital expenditures comprising hardware, software and services, in that taxpayers must then seek to exclude directly relevant software and intangibles from the cost of a capital expenditure project (e.g. excluding operating software and systems software from the cost of computers, process control software from machinery, telecommunications management software from communications and connectivity projects).

Example: in one case an IT distributor/supplier of network attached data management hardware and software provides post-sales support to customers including virtualisation architecture and backup and recovery infrastructure. With its products/services offerings to customers, it is anticipated only 41% of the total 'package' to customers would be eligible for the allowance.

Looking at the intangible assets listed in the capital allowances rules at s. 40-30(2)

- (a) *mining, quarrying or prospecting rights;
- (b) *mining, quarrying or prospecting information;
- (c) items of *intellectual property;
- (d) *in-house software;
- (e) *IRUs;
- (f) *spectrum licences;
- (g) *datacasting transmitter licences;
- (h) *telecommunications site access rights

we accept that there are larger policy issues only in respect of eligibility of items of intellectual property such as copyrights and patents which are not directly connected with capital expenditure projects on machinery and equipment in the relevant investment period. However the other categories of intangible assets appear appropriate for investment allowance, certainly where capital expenditure on these is associated with new projects which are initiated or activated.

Also, it is increasingly the case that the operating systems for major plant and machinery are separate from and supplied by different vendors or sub-vendors to those providing the actual hardware. The capital expenditure is effectively in relation to the one asset (ie equipment) with the software or intangible asset being inherently connected with the hardware or machinery asset and incapable of practical separation even though, for Division 40, two assets are considered to have been acquired.

Recommendation:

1. Most if not all of the intangible assets mentioned in s. 40-30(2) should be eligible for the investment allowance, where these are associated with capital expenditure on capital equipment investments.

It would be useful if the EM referred to computer software being eligible, including software used for:

- communications and telecommunications

¹ S. 41-105(1)(a)

² Further, s 40-30(1) provides that items of intellectual property and in-house software are depreciating assets; hence their exclusion is not justified

- IT risk and security management including anti-virus/anti-spyware
- business continuity management including backup and data storage and management
- increased mobility through remote access
- operational/infrastructure costs reduction
- customer relationship management and
- data protection/simplified data management.

The investment and first use deadlines for committed projects should be extended, in the 2009 Budget if not in the Bill introduced in March

We recognise the government's desire to use the tax break to stimulate immediate expenditure rather than deferred expenditure, and the objective is not to have the stimulus encouraging deferred investment after the global financial crisis has passed. We suggest however that the downturn will be protracted and the timelines may not achieve the government's objectives.

Consultation with our clients has confirmed that for larger projects:

- a) it is difficult enter into a contract with an unrelated supplier by 30 June 2009, given the many issues involved in locking down a major project. The welcome increase of the allowance to 30%, announced only in February, means that the contracting and investment period from February to June 2009 is too short for many larger projects. This requires an extension of the investment time for at least some businesses.
- b) entry into contracts with unrelated suppliers requires bank and other financial approval which is very challenging and time-consuming in today's global financial crisis. This requires an extension of the investment time for at least some businesses.
- c) in larger projects involving installation of custom-made complex equipment (as distinct from assembling networks of standardised components) it will be difficult to have substantial expenditure in place and first used by 31 December 2010. This requires an extension of the relevant first use deadline for at least some businesses.
- d) In the current economic climate, many large organisations have placed a freeze on all capital investment as they are focusing on their financial health and the preservation of existing jobs. Feedback to us suggests that, for many, the capital freeze is likely to last until well into 2010. This suggests a need for more general extension of the deadlines, in the 2009 Budget if not in the March Bill.

Recommendations:

2. The Government should consider an extension of the concession either now, when the Bill is introduced, or in the 2009 Federal Budget
3. The extension could include, perhaps in the March 2009 Bill:
 - An extension of the investment time beyond 30 June 2009 for purposes of the 30% claim for all taxpayers
 - An extension of the investment time for businesses which, by 30 June 2009, announce their intention to make investments and commence negotiations for contracts which are concluded by 31 December 2009 or some other date
 - An extension of the capital expenditure and first use time (perhaps of 12 months) for larger projects comprising the acquisition of larger assets or constructed assets. If necessary, this might be supplemented by a requirement for a substantial proportion of the expenditure will have occurred by 30 June 2010, and might be limited to projects with a minimum expenditure, say \$10 million for the project.

These modifications should continue to provide stimulus for immediate spending and thus maintain the Government's policy settings, thus not dissipating the incentive for smaller-unit investments such as motor cars or standard off-the-shelf equipment.

Multiple investments should be aggregated for investment threshold purposes

The treatment of multiple assets, multiple investments and the definition of an asset needs clarification and needs examples in the EM to make the legislation clear.

Currently, EM 1.49 talks about amalgamating multiple amounts called recognised new investment amounts in relation to the same assets. Proposed S. 41-105(1)(d) is relatively clear in terms of bulking together various elements of cost (first and second element etc) in relation to one asset.

However, EM 1.48 says "a taxpayer needs to satisfy the relevant new investment threshold on a per asset basis. That is investments in multiple, different assets will not be able to be amalgamated ..." and cross-references draft S. 41-120 with the implication of the EM is that multiple, identical (non-different) assets can be bulked together. However:

- we cannot see any such reference to a "non-amalgamation" rule in 41-120;
- the EM implication that investments in multiple assets which are not different will be able to be amalgamated is not in the statute.

Clarity is needed on what is an asset, with examples in the EM.

Australia does not need uncertainty or a re-run of the unproductive litigation in previous investment allowances about the "unit" of property which led to cases such as *Monier Colourtile*, where a company had a holding/pallet system designed to produce roof tiles which they considered to be one asset but which ultimately a Court held were different assets and a radio communications system which the Court held were a number of separate units; and the *Tully Co-operative* case where a sugar plant was held to be one integrated asset notwithstanding the ATO argument that it comprised a collection of different assets.

We highlight issues such as:

- Computer systems - EM example 1.7 discusses a computer, a separate multi-function photocopier and book-keeping software. We believe a further example should cover the situation if the computer comprises a "box" and keyboard from one manufacture and a monitor from another manufacturer, but acquired as one package. Here we would think that there is one asset for purposes of the investment threshold.

Additionally if a large business buys a "fleet" of 20 computers each having a cost of \$900 and a server for \$7,000, as part of its re-equipment for a total cost of \$25,000, the issue is whether there is one asset for \$25,000 (which we prefer) or 21 assets.

Only major equipment purchases by large organisations e.g. tape back-up libraries, major servers, storage area networks etc. would meet the \$10,000 threshold. Again, we submit that aggregation should be permitted in these circumstances.

- Computer software is typically licensed on a per unit/user basis and is not sold on a block payment basis to businesses. Consequently, if software is to be included in eligibility for the allowance, it would be essential to use an aggregation basis to determine whether the minimum expenditure threshold had been satisfied.
- Retail store fitouts - fitouts commonly comprise multiple related items that are acquired/purchased as part of a single overall investment. From the perspective of the acquirer, the fitout is a single expenditure in relation to a single asset.
- Materials handling and factory systems typically involve the use of pallets which are intended to operate as 'bundles' or 'sets' or 'pools' of assets.

Recommendations:

4. The legislation should include aggregation rules that allow for 'bundling' assets for the new investment threshold in sec.41-135, rather than leaving the interpretation uncertain and in the hands of the ATO which would inevitably lead to disputes and litigation. In discussions you have noted consideration of the 'sets of assets' approach used for low value pools³. We agree this formulation would prove useful.

We recognise that there needs to be some integrity measure to prevent inappropriate 'bundling' so that say 3 unconnected assets are purported to be bundled. However we would be concerned if any 'bundling integrity' rule was impractical and created new levels of uncertainty. On balance we prefer a general concept such as 'sets' or 'systems' or 'networks'.

³ 40-425(4)(c) "the asset is not one that is part of a set of assets that you started to hold in that income year where the total cost of the set of assets exceeds \$300"

The 'bundling' should apply only to the new investment threshold in sec.41-135 and should not apply for purposes of the first use determination under sec.41-130.

Otherwise, a project of say 3 stages, of which 2 had been installed by the statutory first use date, might be precluded from the investment allowance if the law allowed an interpretation that there was only one project comprising all 3 stages of the project, and the first use of the total 3-stage project had not occurred by the statutory first use date.

Meaning of 'start to construct' and 'construction commenced'

The terms 'starts to construct' and 'commenced construction' need clarification on their impact for taxpayers that self construct assets. These terms are particularly relevant to the concept of 'investment time' used in the proposed s. 41-125.

None of the draft, EM or FAQs deal with the meaning of these terms and the EM does not provide any examples of how the proposed legislation may apply to taxpayers with self-constructed assets.

The Bill and EM should provide taxpayers with clarity around these issues, rather than leaving interpretation to the Australian Taxation Office and/or the Courts. There is a need to determine when construction will be taken to have commenced and what activities are considered 'construction' under the proposed legislation, as opposed to activities that are preparatory/preliminary to construction.

The typical project expenditure profile might be as follows:

- Prior to project approval (up to 6months) - project cost estimates and preliminary design drawings
- Following project approval (up to 6months) - project planning and design, and letting of contracts to constructors and suppliers
- Physical construction (up to 1year) - materials delivery, site clearing, civil works
- Project finalisation (up to 6months) - testing and commissioning of plant

Recommendation:

5. We submit that construction commencement should be clarified in the EM and possibly the Bill. We submit that physical construction (as identified at stage 3 above) is the most appropriate point at which construction should be considered to commence.

Clarify the dates for 'investment time' and 'first use time' especially for substituted accounting period taxpayers

We believe the draft and EM are unclear on these dates, particularly in relation to taxpayers with substituted accounting periods (SAPs). It is unclear whether the 'investment time' dates of 30 June 2009 and 31 December 2009 apply to all taxpayers, regardless of their income year end, although Treasury has, in our recent discussions, indicated the intention to have a 'hard' 30 June investment time.

There are some confusing references to 'income year' in the draft law. For example, it appears that a late balancer whose 2009 income year ends on 30 September 2009 has until that time to make an investment and qualify for the 30% deduction – refer s. 41-115(1) and its interaction with s. 41-120(1)(b), given that s. 41-115(1) contains no mention of the 30 June 2009 date and simply refers to recognised new investment amounts for the 2008/09 income year being eligible for the 30% deduction.

Thus, the implication in relation to the 2008/09 year seems to be that there is no fixed investment time date before 31 December 2009 for late-balancing SAPs.

But then this contrasts with the position for the 2009/10 income year, where s. 41-115(2)(a) seems to imply that there is a hard date of 30 June 2009 in order to qualify for the 30% deduction.

This, in conjunction with s. 41-120(c) seems to disadvantage early balancing taxpayers. For example, an early balancer whose 2009/10 income year ends on 31 December 2009 would appear to need to have an investment time by 30 June 2009 and a first use time by 31 December 2009, meaning that it would have only a 6 month window instead of the 12 month window that a 30 June year end taxpayer would have.

Recommendation:

6. You have indicated to us the intention to have a 'hard' 30 June investment time. The rules need to be unambiguous about the dates for 30 June balancers, early balancers and late balancers.

Allow for sale and leaseback scenarios

One important adjustment relevant to businesses generally and the leasing industry is the practice of sale and leaseback, which is quite common in relation to major construction projects. A taxpayer will typically undertake a construction project that is intended to be leased and, when construction is complete, sell the project to the financier under a sale and lease back or hire-purchase arrangement because the financier does not want to be responsible for the risk and management of the construction contracts.

The sale and leaseback or hiring arrangement in this type of scenario may cause problems in relation to first use. The substance of the arrangement would be that first use is with the lessor, however the form of the arrangement may imply that first use was with the lessee-user, which was the owner or holder before the sale and leaseback was entered into. Thus the financier might be denied the tax break. This problem was resolved in earlier investment allowance and other rules by express sale and leaseback rules which provide that the lessor is the first user if a sale and leaseback occurs within 6 months of an asset being first used.

This can be resolved quite simply in the first use definition by incorporating some concepts such as those in s. 51AD(6) of ITAA 1936. This would be simpler than the former s.57AM(4)(ba) of ITAA 1936.

Recommendation

7. the treatment of sale and leaseback arrangements should be clearly laid out, with s.41-130 allowing an asset to be first used if it has been transferred under a financing arrangement such as a sale and leaseback arrangement concluded within 6 months of its first use by an earlier taxpayer.

Assets used partly outside Australia in an Australian business should qualify

The draft refers to assets used in Australian businesses and requires the first use to be in Australia (s.41-120(1)(d)). However some Australian businesses in the transport industry will use their ships and aircraft inside and outside Australia. For example a bulk ore carrier ship, or an international aircraft, might be used by an Australian business with some use offshore. More relevantly the first use might be a contract from its construction location.

We do not propose allowing the investment allowance for businesses carried on wholly in foreign countries. However we suggest that Australian businesses operating these assets internationally should qualify for the tax break.

Recommendation

8. The references to first use in s.41-120, and the EM, should expressly refer to the first use by assets used in Australian businesses for the purpose of generating assessable income (rather than first use in Australia) and should recognise that (especially for ships and aircraft) that the first use time might occur outside Australia.

Tax concessions in a dividend imputation environment

Given the global financial crisis, it is possible that some companies may have low taxable income or tax losses and, consequently, may not place full value on the tax benefit conferred by the allowance. As well, some companies might be able to use the investment allowance deduction but that will reduce their capacity to frank their dividends to investors, again diluting the incentive effect.

In other words, the tax deductions offered to companies, which will reduce their franking capacity, will result in increased tax liabilities from Australian investors receiving dividends from those companies – clawing back the tax break and blunting the incentive effect.

Such companies can explore the scope to undertake leases of their equipment, thus transferring the investment allowance to lessors in return for lower lease rentals. However these measures will involve intermediation costs and commercial negotiations, with loss of efficiency and delay – particularly problematic given the government's desire to introduce incentives in this context.

We note that the Cutler Review, looking to R&D concessions, recommended a conversion of at least some deductions to government grants.

Recommendation:

9. The government should consider, if not for this incentive, then for further incentives in relation to the global financial crisis:
 - The use of government grants instead of tax deductions
 - Providing publicly listed companies with an imputation credit as well as the investment allowance, which can be used to continue to pay franked dividends to investors, so that the signals to companies paying franked dividends are not blunted.

Drafting issues and issues to clarify in the EM

Investment time and contract date

Some people are concerned that it may be necessary for the asset to be held ready for use in the same income year as the contract because s.41-125(1)(a)(i) refers to “enter into a contract under which you hold the asset at that time, or will hold the asset at a later time”, implying that the holding time might need to be in the same income year – e.g. by 30 June 2009. We are sure that this is not intended.

A further issue arises in relation to taxpayers who enter into contracts to have assets constructed by third parties. There are three investment times mentioned in s.41-125(1). We understand that the investment time for these taxpayers is determined by s.41-125(1)(a) and that s.41-125(1)(b) would only apply to determine the investment time for self-constructed assets.

There is however some confusion over this issue and it has been argued by some that s.41-125(1)(b) could also apply to determine the investment time for third party construction projects. We submit that this issue needs to be clarified, either through changes to the wording of the law or by some additional comments in the EM.

Recommendations:

10. to remove doubt, we suggest that the word ‘either’ might be inserted before the word ‘hold’ or that the EM might state clearly that the later holding can be in a later income year, not just the same income year.
11. We suggest that additional words are inserted into the EM to clarify the intention of the law in relation to the relevant investment time for self-constructed assets and for assets constructed by third parties.
12. We suggest also that the term ‘investment time’ is confusing for some might be better described as ‘investment commitment time’ or ‘investment commencement time’ or ‘investment start time’.

Joint venture assets

Another issue that is related to the expenditure threshold is the position concerning assets held by joint ventures (JVs). There is no guidance in the draft law or EM on whether the threshold refers to the actual cost of the asset or the value of the JV participant’s share of the asset. So, in a mining or energy joint venture where a participant might have 16.67% of the project, the capital allowance rules allow the participant to capitalise and depreciate their share of each asset.

Recommendation:

13. s. 40-35 dealing with jointly held assets for capital allowances purposes should apply also to this tax incentive
14. the investment threshold should look to the total value of the asset not just the joint venturer’s share. That is, if an asset costs \$54,000 and a joint venture participant has a one-sixth interest, the asset should be treated for investment threshold purposes as having a cost of \$54,000 and not \$9,000 (which would be below the investment threshold for that joint venture participant).

Clarify use of financing strategies to transfer investment allowance

We recognise that lessors and asset financiers can design transactions which retain the tax recognition of asset ownership and investment allowance with the lessor or alternatively move asset ownership to the lessee/user/hirer – EM 1.42 etc. These rules are not clearly expressed.

Recommendation:

15. The EM should provide a clearer signal that it will be acceptable for lessees and lessors to use mechanisms such as
 - hire purchase arrangements or
 - leases with lessee options to purchase the assetsto alter the tax ownership of assets for purposes of capital allowances even where the lessor/financier is the legal owner.

Correct an unintended aspect of the investment time integrity measure

We understand that the purpose of the investment time integrity rule contained in s.41-125(2) is to deal with arrangements whereby pre-13 December 2008 contracts/construction/other holdings are effectively replaced by post-12 December 2008 contracts/construction commenced/other holding that meet the investment time requirements in s.41-125(1) ("refreshing" arrangements) - see EM para 1.58.

We are concerned that the current wording of the integrity rule is too broadly drafted and may inappropriately apply to situations where new contracts/construction/other holding are entered into post 13-December additional to pre-13 December contracts or construction projects or other holdings that continue to exist.

For example, if a company had purchased a fleet of vehicles before 13-December 2008, and then decides to purchase an additional fleet of similar vehicles after 12 December 2008 from the same supplier in order to benefit from the investment allowance, the 'identical or substantially similar assets' would appear to breach the investment allowance integrity rule in s.41-125(2)(b)(i). The integrity rule in this case will frustrate the clear objective of the investment allowance which is to encourage additional purchases and expenditure.

Recommendation:

16. The integrity rule in s.41-125(2) should apply only where pre-13 December 2008 contracts/construction/other holding is cancelled and substantially replaced by post-12 December 2008 contracts/construction/other holding. A suggested solution may be to add a new paragraph 41-125(2)(d) as follows:
"the contract, construction or other form holding covered in paragraph (2)(a) is cancelled or substantially replaced by the result of paragraph (2)(b)"

Define 'carrying on a business' to cover super funds, property investors etc.

There is a concern that some taxpayers 'carrying on a business' may not be eligible for the allowance, or their entitlement might be questioned by the ATO, if they are trusts, superannuation funds and special purpose vehicles investing in property or other asset holdings, which might not be considered to be carrying on a business.

We presume that the intention of the investment allowance is not to discourage legitimate business activity. We therefore submit that the legislation be amended to ensure that all legitimate business activities qualify for the allowance, regardless of how those activities are carried on or by whom.

Recommendations:

17. The legislation should be amended to include a broad definition of 'business', to ensure that no businesses are disadvantaged. One way to achieve this would be to include eligibility for any enterprise that is registered for GST.
18. The legislation should (perhaps accompanied by an example) clarify the eligibility for the allowance of investors which do not carry on a business.

Cover taxpayers not carrying on a business but using assets for business purposes

Some individual taxpayers who are not carrying on a business will be eligible for the allowance as they will, prima facie, satisfy all of the conditions of s.41-105 but may not have a “recognised new investment amount” as per s.41-120(1)(d).

This will be a particularly relevant issue for individuals who may purchase cars primarily for business use (ie in relation to their employment)

Recommendation:

19. Some comments (perhaps accompanied by an example) should be made in the EM to clarify the eligibility for the allowance in relation to taxpayers who do not carry on a business but purchase cars primarily for business use (ie in relation to their employment).

Transferability of investment allowance

In the current economic environment, it is possible that some leasing companies may have low taxable income or tax losses and, consequently, may not place full value on the tax benefit conferred by the allowance. In such cases, there may be no passing on of the allowance entitlement and thus the benefit is effectively lost, which may be a disincentive to activity in this area. There might be transactions already locked in, since 13 December 2008, where it is impossible to restructure the transaction and where the lessor is unable to utilise the investment allowance.

As discussed with you, the approach of the previous investment allowance was to incorporate a transfer of investment allowance from lessor to lessee. There might scope to at some future time to expressly allow for transfer of the deduction from a lessor to a lessee, along the model of the former s.82AD of ITAA1936. We recognise this is not feasible to cover in the March 2009 Bill.