



11 March 2009

BY EMAIL

Small Business and General Business Tax Break – Consultation
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: investmentallowance@treasury.gov.au

Dear Sir/Madam

**Re: Exposure draft legislation and explanatory material for the proposed
Small Business and General Business Tax Break (“the investment
allowance”)**

Ref: SUB 010.09

The Institute of Chartered Accountants in Australia (“the Institute”) welcomes the opportunity to provide comments on the exposure draft legislation (ED) and explanatory material (EM) for the proposed investment allowance released by the Government for public comment on 25 February 2009.

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in your capital city

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Timing

The Institute is mindful that given the 30% investment allowance deduction requires *inter alia* the investment time to be by 30 June 2009 (before dropping to a 10% rate) and with the current sittings of parliament scheduled to end on 19 March, the Treasury faces strict time constraints. The Institute considers that in the interests of certainty, the Bill containing these measures needs to be finalised and introduced into parliament as soon as possible. However, we also appreciate that this creates tensions between what changes and refinements to the exposure draft are feasible.

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We have set out some issues below (both policy and technical) for your consideration. They are not in any particular order of importance.

All references are to the *Income Tax Assessment Act 1997*.

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POLICY

1. Intangibles – software

The Institute queries why software or a licence to use software has been excluded from the investment allowance measures. Typically, businesses would outlay significant capital expenditure on software to use in their business. For businesses in certain industries, software is a major capital expenditure item; for example, leasing managers, call centres, and logistics companies. The tax break would appear to be discriminating between industries that use physical assets as opposed to significant intangible assets.

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The basis for excluding expenditure on software is unclear as it would appear that expenditure on this is no different to other capital expenditure.

Recommendation

Capital expenditure on intangible items such as software should be eligible for the tax break where the item is used in the business.

2. Subdivision 40-F - Primary production depreciating assets

The Institute considers that if the asset would otherwise qualify for decline in value under section 40-25 (i.e. but for Subdivision 40-F) then there should be no reason to preclude entitlement to the investment allowance on the basis that there are accelerated deductions under Subdivision 40-F.

In other words, although Subdivision 40-F gives concessional treatment, the concession only gives rise to a timing benefit (shorter write-off) as opposed to the investment allowance which is a permanent tax benefit.

Extending the investment allowance to such expenditure, which includes water facilities, is also in line with the Government's policy to conserve water.

It may well be that some items fall under Subdivision 40-F but would never give rise to deductions under section 40-25 eg earthworks (generally). With the exception of these, depreciating assets that fall under Subdivision 40-F should qualify for the investment allowance in the same way that an item used in exploration/prospecting qualifies for the investment allowance notwithstanding that there is a 100% write-off in the first year (see section 40-80). In this case the item will attract the investment allowance because section 40-80 simply is the calculation of the decline in value for such items which are then deductible under section 40-25.

(The above reasoning may also apply to some items under Subdivisions 40-G and 40-J).

Recommendation

The investment allowance should be available for items which would otherwise qualify for decline in value under section 40-25 but are currently excluded in the exposure draft legislation on the basis that there are accelerated deductions available under Subdivision 40-F.

3. Leasing

One of the conditions for an investment allowance deduction in relation to an asset is that the taxpayer must, under draft s41-105(1)(b), be entitled to a deduction in relation to the asset in respect of the asset's decline in value under s40-25.

This means that, in general terms, in the case of an asset which is leased (other than a luxury car), the taxpayer who is entitled to a deduction under s40-25 will be the lessor, not the lessee (see Item 10 of the Table in s40-40). This means that taxpayers who can only obtain use of assets through lease finance arrangements will be disadvantaged since their only means of obtaining benefits as a result of the concession will be through negotiating more favourable lease payments. This is acknowledged by the EM which notes, at paragraph 1.43, that: "As is currently the case with capital allowance deductions, how the Tax Break is factored into lease prices will be a matter for commercial negotiations." In practice however, this suggested solution will disadvantage many taxpayers (and in particular the small business taxpayer) for the reasons set out below.

Firstly, the suggested solution requires the lessee to be in a position to negotiate lease terms so that the benefits of the allowance are passed to the lessee by the lessor. In our view, to achieve a full flow through of the benefits to the lessee, the leasing arrangements between the parties would, out of necessity, be complex and would clearly be different than the model generally used by leasing companies where the lessee makes a fixed monthly instalment for a specified number of months. Whilst including in such a lease the condition that upon receiving benefits from the

investment allowance the lessor be required to make a payment to the lessee equal to the benefit, this approach would unnecessarily complicate the arrangements between the parties, and would inappropriately link the lessee's right to the benefit to the tax position from time to time of the lessor. Where the lessor has tax losses so that it is not presently paying tax, the mechanism for the lessor passing on the benefit to the lessee may never be triggered.

Secondly, because leasing companies are unlikely to be "small business entities" for the purposes of draft s41-135(a), generally the investment threshold applicable to assets acquired for the purposes of leasing will be \$10,000 (draft s41-135(b)). This means that where a leasing company incurs a recognised new investment amount (as defined in draft s41-120) in respect of an asset which is below that threshold, and the asset is leased to a small business entity, the leasing company will not be eligible for the investment allowance in relation to that asset, and thus there will be no benefit to be factored into the lease payment under the lease to the small business entity. In this situation, the investment allowance incentive may not achieve the objective of seeking to encourage business investment and economic activity. There is no incentive for the small business entity to seek to lease a new asset, nor any incentive for the leasing company to buy a new asset below their investment threshold.

Possible solutions

One way this could be resolved under the rules currently in the ED would be for the arrangement to be structured so that it is effectively a hire purchase, or that the small business entity "lessee" is in some way effectively the economic owner of the asset, and therefore the holder of the asset for the depreciation rules, and accordingly, eligible for the investment allowance. However, this may not always be commercially acceptable.

A possible solution would be to allow the lessor to waive any entitlement that it may have to the investment allowance, and where this occurs, the lessee would have the right to claim the investment allowance if, assuming that the lessee was the "holder" of the leased asset and had incurred the costs incurred by the lessor to acquire the asset, the lessee would qualify to claim the allowance. Under this mechanism where a "small business entity" was the lessee of an asset which cost the lessor more than \$1,000, the "small business entity" would be entitled to claim the investment allowance provided the asset was first used by the "small business entity" in Australia principally in carrying on business to gain or produce assessable income. The mechanism under which the lessor waived its entitlement to the investment allowance could take the form of a simple certificate given by the lessor to the lessee upon commencement of the lease. Without the certificate the lessee would have no entitlement to the investment allowance with any claim then being made by the lessor. Whether or not a certificate is issued would depend upon agreement between the parties on commencement of the lease. Broadly, this approach would allow a lessee to obtain the benefit of the allowance directly which was a feature of previous investment allowance regimes.

Recommendation

A mechanism is required for taxpayers (and in particular the small business taxpayer) to have the right to claim the investment allowance by allowing leasing companies to transfer tax breaks to the lessee. This could involve allowing the lessor to waive any entitlement that it may have to the investment allowance by way of a certificate.

4. Pooling of costs/expenditure for multiple items

Where individual items do not meet the minimum spend thresholds, there is no ability to pool expenditure in order to satisfy this requirement.

The draft legislation introduces a minimum spend threshold of \$1,000 for small businesses and a minimum spend threshold of \$10,000 for all other businesses. The thresholds apply to assets on an individual basis. While there is scope for taxpayers to aggregate staggered expenditure on an individual investment/item to meet the thresholds, the measures do not extend to aggregating expenditure on different investments/items.

Many businesses would view this tax break as an opportunity to invest significantly in upgrading capital assets, however many assets that a business may wish to upgrade would be, particularly in the case of businesses that do not meet the definition of small business, less than the requisite minimum spend threshold.

The \$10,000 threshold for the investment allowance would also appear to discriminate between industries. For example, in the property industry, office fit-outs form key expenditure by the relevant business. Many individual assets in an office fit-out would have a cost of less than \$10,000 however the total cost would significantly exceed \$10,000. Other industries with a large number of lower cost assets (for example some construction and manufacturing entities) may also miss out on the tax break where there is significant capital expenditure on a certain project or transaction but the minimum spend threshold is not met for each individual item in that project or transaction.

Additionally, the compliance costs of identifying assets acquired in a single transaction for greater than or less than \$10,000 must be considered. Contracts may not specify the breakdown of the assets in a transaction. Issues may also arise in respect of valuing composite items, and where the transaction or item must be split this will give rise to additional costs and further compliance.

(The Appendix provides some examples of where pooling of costs/expenditure for multiple items may be warranted).

One mechanism to tackle this issue could be to introduce some form of pooling for project based or transaction based expenditure, particularly in circumstances where the expenditure is linked to or in connection with a broader project being undertaken. Where investments in a project/transaction qualify for capital allowances under section 40-25 of the ITAA 1997, then those costs could be aggregated in order to meet the minimum spend thresholds. This would be a fair outcome as the business is still making a significant investment and spending the required amount and satisfying the underlying policy intent of the measures to stimulate capital investment in Australia, albeit in the form of multiple items.

Recommendation

The exposure draft should be amended to provide a mechanism to pool certain expenditure in order to meet the minimum spend thresholds. This could be in the form of pooling expenditure on a project or transaction basis.

5. Tax offset

Where the taxpayer is in a loss position, the investment allowance does not offer any immediate cash benefit as there is of course no tax payable to be reduced. In this situation, the small business and general business tax break would act as a more powerful incentive to invest in eligible assets to such taxpayers if it was in the form of a refundable tax offset. We believe this may be particularly pertinent for smaller businesses that may be having difficulties with cash flow.

Recommendation

Consideration should be given to providing a refundable tax offset, instead of an additional upfront 30% or 10% deduction, at least in some circumstances.

TECHNICAL

6. Section 41-115 and its operation for substituted accounting period (SAP) taxpayers

We note that the operation of draft s41-115 appears to be inconsistent with the previous media releases for those taxpayers that have year ends other than a 30 June year end.

In short, the draft section (and the EM commentary on the investment allowance) do not appear to appropriately operate in circumstances where taxpayers have a SAP in lieu of 30 June income year. In some cases, such taxpayers might be entitled to a 10% investment allowance when it should be

a 30% investment allowance (and vice versa), when compared to the application dates provided for in the media release.

Recommendation

The provisions of draft sections 41-115 and 120 need to be amended to reflect the actual cut off dates in the earlier media release.

7. Difficulties with the use of the term 'investment time'

The definition of "investment time" in draft s.41-125(1) specifies three alternative times in relation to "first element" claims, and two in relation to the "second element". However, the definition provides no guidance as to which should prevail if more than one of the alternative times applies. The legislative intent seems to be that the earliest to occur will be relevant; however, it would be useful to say so.

8. Comments on the explanatory material (EM)

As a general comment, the Institute considers that the EM would benefit from more examples. Specifically, we make the following comments.

8.1 General Outline and Financial Impact (page 3 of the EM)

Investment on 12 December 2008 will not qualify for the new tax break. For precision, the reference to "between 12 December 2008 and the end of December 2009" therefore should be to "between 13 December 2008 and the end of December 2009".

8.2 Lack of clarity - paragraph 1.6 in the EM

Paragraph 1.6 of the EM appears to introduce an extra-statutory element into the concept of "new investment" - the time that the taxpayer "made an investment decision":

1.6 New investment in this context means that the taxpayer made an investment decision after 12 December 2008.

- Assets that a taxpayer held or entered into a contract to hold on or before 12 December 2008 will not qualify.
- Similarly, assets that had been used or installed ready for use (by any entity) on or before 12 December 2008 will not be eligible.
- However, additional investment in such assets undertaken after 12 December 2008 may be eligible for the Tax Break.

The three bulleted points are a reasonable summary of the relevant aspects of the definition of "recognised new investment amount" in draft s.41-120 (acknowledging the inevitable limitations of summaries). However, the header should be replaced with something more neutral. The same problem afflicts paragraph 1.77 of the EM.

8.3 Paragraph 1.40 of the EM

The reference to "prior to 12 December 2008" should be "on or before 12 December 2008" for accuracy and also for consistency with the remainder of the EM.

8.4 Sale and leasebacks - Example 1.5

In this example:

Collie Mining Company arranges to lease a new dragline from Big Machine Leasing Pty Ltd. Under their 'sale and lease back' contract Collie Mining Company is responsible for acquiring and assembling the necessary components. After testing the dragline in operational use, the ownership is transferred to Big Machine Leasing. The prior use of the dragline only amounts to reasonable testing and trialling.

The example appears to be incomplete. It would be useful to consider amending the example to provide certainty as to who is entitled to the tax break. For example, the example may benefit from the following additional comments:

Where Collie Mining is found to be the holder of the asset under section 40-40, Collie Mining is entitled to the tax break. If Big Machine Leasing Pty Ltd is the holder of the asset under section 40-40, Big Machine Leasing would receive the tax break.

Furthermore, it would be useful to explain under which item in the table to section 40-40 either Collie Mining or Big Machine Leasing would be treated as the 'holder' and therefore eligible for the tax break.

Additionally, if Big Machine receives the tax break, there should be a mechanism for transferring the tax break to Collie Mining or keeping the requirements with the initial purchaser (Collie Mining) as discussed above.

8.5 Investments over 2 tax years - Example 1.18

While we agree with the result of example 1.18 (where a \$9,000 first element of cost outlay in 2008/9 is added to a \$1,200 second element of cost outlay in 2009/10 to produce a recognised new investment amount of \$10,200 in 2009/10 and thus an entitlement to the investment allowance in that year), it is not clear from the wording of the legislation how this result is achieved.

For example, the proposed section 41-120 refers to an amount being a recognised new investment amount "for the income year" (our emphasis) which implies a 'once only/single shot' test.

We suggest therefore, that consideration be given to amending the above section so that it reads something like:

"An amount is a recognised new investment amount for the purposes of determining whether the new investment threshold for an income year has been met if ..."

We also suggest that the proposed section 41-135 dealing with the new investment threshold for an income year is amended along the following lines:

"The new investment threshold in relation to an asset for an income year (the relevant income year), which can be met by adding together recognised new investment amounts for the asset in that or another income year, means ..."

8.6 Split or merged assets

At least one example is required in the explanatory memorandum to show how the proposed sub-section 41-120(3) is intended to operate. At the moment, there is only one paragraph in the EM that deals with this proposed sub-section (i.e. paragraph 1.70) and this paragraph does not contain an example.

8.7 Sundry comments on EM examples

Some of the examples in the explanatory memorandum could benefit from additional work:

Example 1.1

Is the "software" the operating system that comes pre-installed on the computer's hard disk drive, or application software such as an accounting package that was purchased separately? If the former, is this example intended to indicate that the purchaser of a computer must divide the purchase price between hardware and software?

Example 1.4

This example needs to be more definitive. Would a dealer's demonstrator vehicles qualify under the "reasonable testing and trialling" exception or not?

Example 1.7

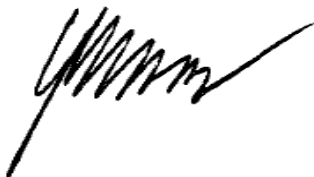
Same point as in relation to example 1.1 (although in this instance we note the clarification regarding "book keeping software").

Example 1.15

Who is Evelyn? In example 1.9, Frank made a \$5,000 investment and Gail made investments of \$4,500 and \$500.

If you have any questions on the above, please do not hesitate to contact me on (02) 9290 5623 or Karen Smith on 0425 326 564.

Yours sincerely,



Yasser El-Ansary
Tax Counsel

APPENDIX

Examples - Pooling of costs/expenditure for multiple items

Example 1.1 – computer upgrade project

A business undertakes a project to upgrade its computers. The business purchases four computers for \$3,000 each, the total expenditure for the business in this transaction would be \$12,000. Assuming the business does not meet the definition of small business, the minimum spend threshold for each asset is \$10,000. Given that each computer is only worth \$3,000 individually, the business would be precluded from claiming the tax break.

Typically, office based computers may not cost more than \$1,000. For the purpose of the second part of this example, assume a small business undertakes a computer upgrade project and purchases 20 computers at a sale price of \$800 each. The small business is making a significantly capital outlay of \$16,000 but would not receive the tax break due to each individual item not meeting the required \$1,000 minimum spend threshold.

Example 1.2 – office fit-out

A property management business purchases a new building. The business then fits-out the building so that it can be rented out. As part of the fit out, the business would purchase a large number of low cost depreciating assets which would not meet the minimum spend threshold of \$10,000 by themselves. Typically, depreciating assets acquired in a fit out would include general office furniture and other chattels. These types of items would typically be far less than the requisite \$10,000 and to some extent far less than the \$1,000 threshold for small businesses. Although a fit-out may cost \$100,000+ with all items accounted for, the tax break would not be available to many of the assets acquired for the purposes of the fit-out.

Example 1.3 – composite assets

Further issues arise where there are composite assets. Taking the example of purchasing a computer system where the taxpayer might receive the physical computer system box, the monitor, and the software. The monitor, box and software are distinct items, however have been sold as the one package. If the package was worth \$1,500, but the box \$900, monitor \$400 and software \$200 individually, how would such an item qualify for the tax break in the case of a small business?