

Tax Brief

26 February 2009

Investment Allowance – Draft Legislation Released

Given that the Government's "full strength" investment allowance has just over 4 months to live, it was certainly time for the Government to put its cards on the table. On Wednesday 25 February the Treasurer released a draft of the legislation to enact the investment allowance so that businesses can now start making investment decisions with some degree of confidence – they can see a bit more clearly whether the fine print will indeed execute the Government's announcement.

This Tax Brief updates the detail in our two earlier Tax Briefs on the investment allowance, now inelegantly labelled the Business Tax Break, which are available at http://www.gf.com.au/477_714.htm (16 December 2008) and http://www.gf.com.au/477_721.htm (5 February 2009).

Key points

The draft legislation gives effect to the key points of the Government's announcement:

- the Business Tax Break is delivered in the form of a new additional allowable deduction in the year in which an asset is installed ready for use or money on improving an existing asset is spent;
- the amount of the deduction is 30% of the cost of the item if it is acquired and installed between 13 December 2008 and 30 June 2009, or 10% of cost if it is installed between 1 July 2009 and 31 December 2010;
- the deduction does not affect the taxpayer's depreciation or the computation of a balancing charge if the asset is sold or scrapped;
- the Business Tax Break is only available for expenditure on tangible depreciating assets (including cars) which qualify for depreciation deductions under Division 40 of the *Income Tax Assessment Act 1997* ("ITAA 1997");
- the Business Tax Break is given to the taxpayer entitled to claim depreciation, including equipment lessors;
- the incentive is available for both the cost of acquiring and constructing additional assets and for the cost of making non-deductible improvements to existing assets;

- for large businesses – in general terms, businesses with an annual turnover over \$2m – the amount spent on acquiring or improving the asset must be \$10,000 or more to qualify for any incentive; and
- the relevant asset must have been acquired under a contract entered into, or the construction or improvements must commence, on or after 13 December 2008.

The Business Tax Break is available only to taxpayers carrying on a business; investors do not qualify.

Some “elaborations”

It is invariably the case that the fine print of the legislation to enact any new measure contains a few surprises. The Exposure Draft of the Business Tax Break legislation is no exception.

Leasing. The former investment allowances (the Investment Allowance which operated from 1975 to 1985 and the Development Allowance which operated from 1992 to 2002) both contained highly elaborate rules restricting the availability of the incentive where the asset was leased.

Judging by the two announcements, the rules governing the Business Tax Break were intended to be far less constrained and this impression is not challenged by the draft legislation. The Business Tax Break is afforded to the taxpayer who enjoys the depreciation deduction, which, for equipment, would ordinarily mean the lessee of a luxury car, the lessor of items provided under an operating or finance lease, or the hirer under a hire purchase arrangement or the buyer under an instalment purchase arrangement.

Some issues that will arise if an eligible asset is leased to a non-resident, or used outside Australia, or both, are discussed below.

Start date. The Business Tax Break is available if the taxpayer has entered a contract to acquire the asset, or construction of the asset commences, after 12 December 2008. This same rule applies whether the incentive is being claimed for the costs of buying, constructing or improving an asset. If the taxpayer has entered a contract with another person to construct an asset for it, the relevant date appears to be the date of contract rather than commencement of construction.

A special anti-avoidance rule has been added to try to prevent taxpayers cancelling and re-entering contracts executed prior to 13 December 2008, or ceasing and then re-commencing construction or improvements to an asset after 12 December.

New and used assets. The previous investment allowances dealt only with the cost of acquiring or constructing assets – not making improvements to existing assets – and so it was common practice to restrict access to those incentives just to “new” – in the sense of unused – assets. It is probably no great surprise, therefore, that the current incentive is also effectively restricted to the cost of acquiring or constructing new assets. The restriction is effected through a requirement that “the first time that you or

any other entity have used the asset for any purpose” (other than testing or trialling) occurs during the relevant periods.

Note, however, that this limit only applies if the taxpayer wants to claim the incentive for the cost of acquiring or constructing additional assets. If the taxpayer wants to claim the incentive for the cost of making improvements to existing assets, this restriction is not relevant.

Which depreciating assets. The incentive is made to work by tying it to the operation of the depreciation rules in Division 40 ITAA 1997, and more specifically, just to the core rules in Division 40, not the entire regime. Tying the Business Tax Break just to these rules has implications that are obvious and some that are not.

This tie is the rule which restricts access to the incentive to the cost of acquiring or improving assets that qualify for depreciation rather than, say, trading stock, most buildings and capital works, or non-depreciating capital assets such as land or shares.

This mechanism also links the threshold – the asset or improvement must cost more than \$10,000 if the taxpayer is a large business – to the item which is the depreciating asset under Division 40. So, a taxpayer cannot aggregate the costs of several related assets to satisfy the \$10,000 test if these assets would each be regarded as a separate depreciating asset for the purposes of Division 40.

However, the tie to the depreciation rules is both under-inclusive and over-inclusive in terms of the assets covered and so some adjustments are then made. For example, all intangible depreciating assets are excluded. Hence, the cost of acquiring or developing new software, patents or other intangibles is ineligible.

But tying the incentive just to the core depreciation rules would exclude some cars, assets that qualify under the R&D regime and some small businesses from the Business Tax Break because the depreciation claim for these assets is made under rules other than the core rules in Division 40 ITAA 1997. Small business assets, R&D assets and some cars are thus specifically added back so that expenditure on these assets may be eligible. However, other special regimes – for example, who claim a deduction for car expenses based on the cents per kilometre method or use various rules for primary producers, mining or environmental protection – are not added back and expenditure which gives rise to depreciation deductions under those rules remains ineligible.

Mixed, tax-preferred and changed use of assets. The draft legislation contains no explicit rules about pro-rating the Business Tax Break if the asset is used to produce exempt income. Nor are there explicit rules about the impact of a post-acquisition change of use. The explanatory material is quite explicit that the test is whether the asset was genuinely intended to be used in carrying on a business in Australia, determined once and at the time that the asset was *first* used or installed ready for use.

The provisions require that the asset be used in carrying on a business in Australia, and this removes the possibility that the asset might be purchased

in Australia for use in a branch which generates exempt income. Hence, a taxpayer who acquires an asset for use in a foreign branch will not become entitled to the Business Tax Break if the asset is relocated into Australia, and a taxpayer who genuinely acquires an asset for use in Australia will not have to refund some or all of the Business Tax Break if the taxpayer subsequently decides to relocate the asset offshore.

The explanatory material is silent however about the consequence that arise if an asset is acquired by a taxpayer carrying on business in Australia but leased to a taxpayer who uses it outside Australia. If that situation triggers the special rules on the tax-preferred use of assets in Division 250 ITAA 1997, it seems that the Business Tax Break will not be available to the lessor – the rules in Division 250 will strip the lessor of the depreciation deduction and as a consequence, the lessor would not be entitled to the Business Tax Break as well. But if the arrangement does not trigger these rules, it seems that the lessor will remain entitled to the Business Tax Break.

Distributions of Business Tax Break. The draft legislation makes no amendments to the rules about distributions from trusts and companies which represent untaxed amounts such as the Business Tax Break. Hence, the incentive will prove most valuable for companies which retain profits. For companies which in effect distribute the Business Tax Break, the distribution will be unfranked to that extent and the value of the Business Tax break will be clawed back from the shareholder; for beneficiaries and unitholders of fixed trusts, the Business Tax Break will be clawed back by reducing the investor's cost in its interest.

What next

Taxpayers have until 10 March to comment on the draft before the text is finalised. Hopefully, that process can be straightforward and the legislation passed quickly. There is a brief window after submissions are due and before the March sitting of Parliament ends. If that opportunity is missed, the legislation may languish for some time as the next sitting is not until May and that is the Budget sitting which tends to be both brief and, understandably, focussed almost exclusively on the Budget.

For further information, please contact

Sydney

Andrew White

andrew.white@gf.com.au

phone 61 2 9225 5984

Josh Cardwell

josh.cardwell@gf.com.au

phone 61 2 9225 5887

Andy Hirst

andrew.hirst@gf.com.au

phone 61 2 9225 5924

Melbourne

Tim Neilson

tim.neilson@gf.com.au

phone 61 3 9288 1054

Toby Eggleston

toby.eggleston@gf.com.au

phone 61 3 9288 1454

These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

Greenwoods & Freehills Pty Limited

ABN 60 003 146 852

Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia

Facsimile (02) 9221 6516 Telephone (02) 9225 5955

Liability limited by a scheme approved under Professional Standards Legislation