

Tax Brief

7 October 2008

Interim Division 6C Measures – legislation introduced into Parliament

In a Tax Brief in July this year [available at http://www.gf.com.au/477_672.htm] we outlined measures which the Assistant Treasurer had just released proposing amendments to Division 6C of Part III of the *Income Tax Assessment Act 1936* (Cth). The proposed amendments were a milestone in the ongoing consultations being conducted by Treasury on 'interim measures' to improve the operation of Division 6C, pending the more complete review of Division 6C being undertaken by the Board of Taxation [see our earlier Tax Brief available at http://www.gf.com.au/477_624.htm].

Consultations on the proposed amendments were undertaken in the following two months, and on 28 September the Government introduced into Parliament a Bill to give effect to the conclusions it had reached.

There have certainly been some useful changes (as well as cosmetic changes) made to the text in the period between the July draft and the September Bill and we highlight below two of the most significant. Unfortunately, not all of the defects of the draft measures discussed in our July Tax Brief were remedied. We will, therefore, focus in this Tax Brief on the improvements to the July draft; readers are directed to our July Tax Brief for our discussion of the remaining difficulties (and readers are spared any discussion of the cosmetic changes!)

Profit-based rents

Our July Tax Brief noted the emergence of a new notion in Division 6C, 'excluded rent.' Excluded rent was (and is) a concept that matters principally for the rules which govern access to the new safe harbours which the Government hoped would remove many trifling and innocuous situations from potentially falling foul of Division 6C.

Excluded rent was originally defined in such a way that turnover-based rents between associates would put in jeopardy the trust's access to either of the two safe harbours that are to be introduced (see below). The September Bill retains the notion of 'excluded rent' but employs a narrower definition. Transactions between associates are no longer put under suspicion *per se*. Instead, 'excluded rent' will only arise where:

- the rent is worked out by reference to the profits or receipts of the entity that uses the land; and

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- there is an arrangement in place 'that is designed to result in the transfer of all, or substantially all, of what would otherwise be the profits of the entity to another party to the arrangement.'

In other words, what matters now is the intended effect of the arrangement, rather than the identity of the parties to it.

The safe harbours

Our July Tax Brief noted a number of difficulties with the design and interaction of the 2 'safe harbours' being introduced. A number of improvements have been made to these regimes in the Bill.

Access to the first safe harbour – the '25% safe harbour' – now requires the trust to meet three tests:

1. at least 75% of the gross revenue of the trust consists of rent; and
2. not \$1 of the remaining 25% of gross revenue is 'excluded rent' (defined more narrowly than before, noted above); and
3. not \$1 of the remaining 25% of gross revenue comes from carrying on a business, although business income is not fatal if the business is incidental and relevant to renting the land.

The formulation of this third limb of the 25% safe harbour is certainly clearer in the Bill than in the July draft. The July draft prohibited the trust from deriving any revenue from 'carrying on a trading activity on a commercial basis on the land' which is clearly a broader concept. Under the July draft, all business activity was prohibited; under the Bill business activity is prohibited only where it is not incidental and relevant to renting the land, noting that trading in land is expressly excluded.

The new test would mean, for example, that a trust can derive up to 25% of its revenue from licensing advertising space, operating a car park or self-storage operation on the land, provided those activities are incidental and relevant to the renting of land.

The revenue streams to be counted when applying the 25% safe harbour have also been clarified. Capital gains and losses from any CGT event arising from a disposal or other realisation of land are now excluded, rather than only excluding capital gains arising from CGT Event A1 as was the case in the July draft.

A similar expansion has been made to the other safe harbour – the '2% safe harbour.' The July draft prohibited the trust from deriving any of its 2% from 'carrying on a trading activity on a commercial basis on the land;' the Bill prohibits the trust from deriving any of its 2% from a business that is not incidental and relevant to renting the land.

Given the expansion of the 25% safe harbour, it is hard to see that the 2% safe harbour will play a significant role in practice. Judging by the Explanatory Memorandum to the Bill, the Government sees the 2% safe harbour as relevant primarily for revenue from isolated activities that do not amount to a business at all – it gives as examples of amounts within the 2% safe harbour directors fees, guarantee fees, option premiums and income from 'non-financial arrangements.'

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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.

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