EXPOSURE DRAFT

NEW BUSINESS TAX SYSTEM (TAX PREFERRED ENTITIES – ASSET FINANCING) BILL 2003

EXPLANATORY MATERIAL

(Circulated by authority of the
Treasurer, the Hon Peter Costello, MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory material.

Abbreviation	***Definition***
A Tax System Redesigned	Review of Business Taxation: *A Tax System Redesigned*
Commissioner	Commissioner of Taxation
DAAA 1992	*Development Allowance Authority Act 1992*
IRR	internal rate of return
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
WACC	weighted average cost of capital

General outline and financial impact

Arrangements for use of property by tax exempt end users

This exposure draft will amend the existing taxation treatment of leasing and similar arrangements between taxpayers, on the one hand and tax exempt and non-resident end users, on the other, for the financing and provision of infrastructure and other assets. The proposed amendments will:

- ensure that only taxpayers who have a sufficient level of risk in respect of assets under an arrangement with a tax preferred entity will be entitled to capital allowances deductions;

- ensure that capital allowance deductions are only available where a sufficient level of risk is allocated to, are assumed by, the private sector;

- restrict access to tax benefits to non-resident end users;

- improve the notional loan tax treatment of arrangements between taxpayers and non-taxable entities, so that taxpayers will have greater certainty and neutrality as to the tax treatment of such arrangements; and

- provide sufficient protection for the revenue and more certainty and ease of compliance for taxpayers.

Date of effect: This measure will apply to all relevant arrangements where tax preferred use starts on or after 1 July 2003 except where a binding contract is entered into before that date. This measure will also apply to arrangements where the tax preferred use of the asset:

- starts after 1 July 2003, under a contract entered into before that date, and neither section 51AD nor Division 16D of Part III of the ITAA 1936 applied, or would have applied, before that date and there is an alteration to the arrangement on or after 1 July 2003 that would have enabled either section 51AD or Division 16D to apply; or

- started before 1 July 2003, and before 1 July 2003 neither section 51AD nor Division 16D of Part III of the ITAA 1936 applied, or would have applied, before that date and there is an alteration to the arrangement on or after 1 July 2003 that would have enabled either section 51AD or Division 16D to apply.

Proposal announced: This proposal was announced in Minister for Revenue and Assistant Treasurer's Press Release No. C57/02 of 14 May 2002.

Financial impact: The revenue impact of this measure is estimated to be negligible over the forward estimates assuming no behavioural response. There may be a behavioural response as a result of this measure in the form of increased asset financing arrangements with tax exempt entities, partly as a result of reduced compliance costs associated with the law. However, the net revenue cost of such a response is expected to be negligible.

Compliance cost impact: The proposal is based on the commercial substance of the arrangements and thus is a better reflection of the commercial environment in which such arrangements are structured. The proposal is expected to improve the neutrality, clarity and certainty of the tax treatment of such arrangements and is expected to lower the compliance cost to taxpayers over the longer term.

Chapter 1
Overview of the reform of the taxation of leasing and service arrangements with tax preferred entities

Outline of chapter

1.1 Chapter 1 provides an overview of the amendments to reform the taxation of arrangements such as leasing and service arrangements relating to the use of assets where the end user is, in broad terms, a tax exempt entity or non-resident. This reform entails replacing section 51AD and Division 16D of Part III of the ITAA 1936 with new Division 250 in the ITAA 1997.

1.2 Section 51AD deals with leveraged leases and similar arrangements over property financed predominantly by non-recourse debt. It seeks to deny tax deductions for interest, depreciation and other capital allowances on capital expenditure incurred by owners of property where the end user does not earn assessable income (e.g. a tax exempt State government entity or a non-resident not deriving Australian sourced income). The provision can apply where the end user is a lessee or where it has effective control of the property.

1.3 Division 16D deals with certain non-leveraged finance leases and comparable arrangements. It provides that income tax deductions are not allowable to the owner of property in respect of capital expenditure incurred on the property where it is subject to certain finance leases or similar arrangements. It applies where the end user is a tax exempt entity which uses and controls the use of the property owned by a taxable entity. Where Division 16D applies, the finance lease or similar arrangement is in effect treated as a loan arrangement and the payments made under it as having principal and interest components.

1.4 Chapter 2 explains when Division 250 applies to an asset. When this happens, the Division denies or reduces capital allowance deductions that are otherwise allowable: this is explained in Chapter 3. The consequences of this denial or reduction are explained in Chapter 4: notional loan treatment in respect of financial benefits provided for tax preferred use, adjustments that are to be made when the tax preferred use of the relevant asset ends and the treatment of the asset after Division 250 no longer applies to it. Chapter 5 covers the consequential amendments arising from the introduction of Division 250 and Chapter 6 provides a general example of the application of Division 250.

Context of amendments

1.5 Section 51AD and Division 16D of the ITAA 1936 were enacted in 1984-1985 to deny access to tax benefits in relation to property used by or for tax exempt entities or non-residents.

1.6 A general principle of income tax law is that, in order to claim deductions for expenditure relating to ownership of property, the owner must show that the property was used for the purpose of producing assessable income or in carrying on a business for that purpose. Conversely, if the property is not used for such a purpose, deductions such as depreciation and capital allowances are normally not allowable.

1.7 Arrangements were developed to circumvent this principle. While the taxpayer was the legal owner of the property and derived assessable income through rental of the property, arrangements developed under which the taxpayer transferred all, or substantially all, the risks and benefits associated with ownership of the property to the entity that was the ‘real’ or ‘end’ user of the property. This end user was typically either a government body whose income was exempt from tax or a non-resident that used the property outside Australia for the purpose of producing income that was exempt from tax (i.e. in both cases, a ‘tax exempt entity’).

1.8 Often the arrangements took the form of a finance lease, under which the taxpayer as legal owner was entitled to rental payments, and perhaps a payment at the end of the arrangement, from the tax exempt entity that effectively guaranteed the taxpayer a return of its investment in the relevant property. Thus the taxpayer was effectively lending money to the tax exempt entity and had little or no interest in the economic performance of the property, that is, it was essentially the legal but not economic owner of the property.

1.9 Typical features of such arrangements have been that the taxpayer is not responsible for repairs and maintenance in respect of the property or for any decline in value of the property. Often the tax exempt entity had day-to-day control of the property, for example by its employees operating the property and perhaps agreeing to top-up any shortfall in the taxpayer’s entitlements under the rental agreement. Another common, albeit not universal, indicator of the taxpayer having little risk has been a highly geared investment with recourse of the lenders to the taxpayer being limited to the relevant property.

1.10 The tax advantages to taxpayers of such arrangements flowed from tax deferral in a low risk setting. The tax deferral arose from the profile of taxable income over the arrangement. A typical situation was the existence of tax losses in the early years of an arrangement created by deductions for depreciation and other capital allowances (such as investment allowance) being greater than income from the property. The taxpayer could use these losses to offset assessable income from other sources. While income in later years might exceed allowable deductions, in present value terms the arrangement was tax advantaged.

1.11 Part of the tax benefit from the arrangement was generally passed back to the tax exempt entity through lower finance charges, thereby lowering the cost to the entity of using the relevant property.

1.12 Section 51AD was designed to operate as an 'anti-avoidance' provision against this background because the large scale nature of the arrangements posed a significant threat to the revenue base. Specifically, the intention of the provision was to prevent tax exempt bodies from accessing tax benefits in relation to property by entering into highly leveraged non-recourse arrangements with financiers in exchange for lower cost of finance.

1.13 The explanatory material to the *Income Tax Assessment Amendment Act 1984* that introduced section 51AD states that the section was enacted to attack arrangements whereby property is effectively used or controlled by an entity in tax exempt activities, although that property is owned by a taxable entity. Its aim was to counter certain financing arrangements whereby tax deductions normally available to the private sector were used to subsidise the cost of plant and equipment used by State bodies.

1.14 Division 16D operates to deny the owner of the property, capital allowance deductions for the cost of, or capital expenditure on, property which is subject to a finance lease or similar arrangement. Division 16D does not apply where section 51AD applies.

1.15 Division 16D provides that income tax deductions in respect of the cost of, or capital expenditure incurred on, items of property that are the subject of certain non-leveraged finance leases or similar arrangements are not allowable to the owner of the property. Where it applies, the finance lease or similar arrangement is treated as a loan arrangement and payments made under that arrangement are treated as having an interest and principal component. Division 16D operates by reference to various tests, namely whether, in broad terms:

- the end user of property guarantees payment of a specified residual value;
- the end user has a right to purchase or require transfer of the property;
- the property is to be transferred to the end user at the end of the arrangement;
- the end user has responsibility for repairs to the property;
- the term of the arrangement is long relative to the effective life of the property; and
- the payments liable to be made equal or exceed, in nominal terms, 90% of the value of the property.

1.16 Unlike Division 16D, section 51AD does not recharacterise or reconstruct a transaction for tax purposes. It simply denies a taxpayer deductions (predominantly capital allowances and interest deductions) that would otherwise be available in respect of the ownership or holding of an asset. The financial benefits received continue to be fully taxable.

1.17 The new Division 250 of the ITAA 1997 is designed to resolve a number of problems that exist under the current law including the following:

- section 51AD is overly harsh in its effect as it creates a significant tax disadvantage by taxing gross income with no allowance for costs of the relevant assets and other costs in relation to the assets such as interest and repairs;
- Division 16D incorporates inappropriate risk tests such as the mere existence of responsibility for repairs, and whether entitlements exceed a percentage of the nominal value (rather than present value) of the relevant asset;
- the provisions are based on tests that may impede commercial flexibility by, for example, inappropriately focusing on whether the tax exempt entity has day-to-day control over the relevant assets; and
- the provisions do not adequately take into account modern arrangements that provide for the use of assets to perform a service, and involve sharing of risk between tax exempt entities and taxpayers.

1.18 *A Tax System Redesigned* recommended reforming the tax law relating to tax exempt asset financing. In this regard, the report recommended the repeal of section 51AD while recognising that a provision akin to the loan treatment under Division 16D would be required for relatively high value arrangements involving tax exempt end use of assets. The specific mechanism recommended to replace Division 16D is no longer applicable because of the Government's decision not to introduce the 'generalised cash flow/tax value method' for calculating taxable income. However, like Division 250, this approach would have effectively provided loan-type treatment along the lines of Division 16D.[1]

Overall objectives of the provisions

1.19 An objective of the tax preferred entities asset financing measures is to deny or reduce certain capital allowance deductions in relation to an asset that is put to a tax preferred use where the taxable entity otherwise entitled to the deductions does not have a sufficient economic risk in the asset. The predominant economic interest in the asset is to be determined having regard to the relative effective at risk position of the counterparties to the arrangement. ***[Schedule 1, item 1, subsection 250-5(1)]***

1.20 When certain capital allowance deductions are denied or reduced, another objective is to alter for tax purposes the timing of the recognition of costs and financial benefits provided for the tax preferred use of the asset. ***[Schedule 1, item 1, subsection 250-5(2)]***

1.21 This is achieved by treating the arrangement under which the asset is put to a tax preferred use as a notional loan so that the financial benefits provided and attributable to the return of and on the investment in the asset are assessed, to the extent of a notional interest component (calculated on an accruals basis) and the component attributable to the net deductible cost for tax purposes (i.e. notional principal) will be effectively amortised and not be assessed. ***[Schedule 1, item 1, subsection 250-5(3)]***

1.22 That part of a financial benefit provided in relation to the tax preferred use arrangement not attributable to the asset for the purposes of the notional loan is to be treated as if it was provided separately and is to

[1] The tax value method would have determined taxable income for an income year based on the relative value of assets and liabilities at the start and end of the year, as well as total receipts and expenditures. The tax value method would have provided a basis for taxing leases by taking into account the changing value of the parties' assets and liabilities under lease contracts.

be subject to the ordinary income provisions (e.g. as consideration for services). ***[Schedule 1, item 1, subsection 250-5(4)]***

Summary of new law

1.23 Division 250 retains key structural elements of Division 16D, namely:

- identifying whether an arrangement between a taxpayer and tax exempt entity in relation to the use of an asset has risk characteristics similar to that of debt financing; and
- if it does, reconstructing the arrangement by:
  - denying or reducing deductions for capital allowances in respect of the asset to which the taxpayer would otherwise be entitled; and
  - treating the arrangement as akin to a loan with payments from the tax exempt entity to the taxpayer as notional principal and interest.

1.24 At the same time, the way in which this identification and reconstruction is undertaken is being reformed so as to improve the coherency and operation of the framework while ensuring its integrity and focus on substance.

1.25 Thus the amendments will replace section 51AD and Division 16D with a new provision, Division 250 of the ITAA 1997, that in broad terms will:

- restrict access to tax benefits arising from the timing effects of capital allowance deductions and the assessment of financial benefits where an asset is put to a 'tax preferred use' in relation to a tax exempt end user (or an associate) if the taxpayer does not have the 'predominant economic interest' in the relevant asset;
- determine predominant economic interest by reference to the extent and nature of risk allocated to, or assumed by, the private sector and borne by the taxpayer;
- deny access to tax benefits where there is a non-resident end user;

- not operate by reference to who, in a physical sense, operates the asset on a day-to-day basis;
- not operate merely by reference to whether the taxpayer has funded the acquisition of the asset by non-recourse financing; and
- when applicable, amortise the cost of the asset for tax purposes by treating the financial benefits under the arrangement on a more neutral notional loan basis.

1.26 Schematically, there are 3 steps in applying the new rules. The first step involves identifying the type of arrangements that are to be covered by the new tax preferred entity asset financing rules. These arrangements are between tax preferred entities and taxable entities that involve assets used for the benefit of, or on behalf of, a tax exempt or non-resident entity. Tax preferred entities include both government entities exempt from income tax and non-resident entities. Relevant taxable entities typically include financial institutions (banks and investment banks) or funding vehicles usually established by financial institutions.

1.27 The second step involves testing the identified arrangements to determine whether the tax outcome, specified in the tax preferred entity rules, is to apply. The tests focus on determining whether sufficient risk is allocated to, or assumed by, the private sector vis à vis the tax exempt sector or whether the taxable entity is bearing sufficient risk in relation to the assets used in the arrangement ***[Schedule 1, item 1, subsection 250-5(1)]***. The tests have the effect of narrowing the range of arrangements that are identified in the first step.

1.28 The third step involves applying the tax outcome specified in the tax preferred entities asset financing rules. Broadly, where assets provided by a taxable entity are used in connection with tax preferred activities and where the tax preferred entity has a predominant economic interest in the assets or the taxpayer does not have sufficient risk in relation to the relevant assets, capital allowance deductions are denied. A consequence of this is that the taxpayer is effectively treated as having made a notional loan to the tax preferred entity. The effect of the notional loan treatment in assessing only the notional interest component is to continue to recognise the cost of the asset for tax purposes, while removing potentially significant tax deferral opportunities. ***[Schedule 1, item 1, subsections 250-5(2) and (3)]***

1.29 That part of a financial benefit provided in relation to the tax preferred use arrangement that is not attributable to the use of the asset is to be treated as if it was provided separately. Generally, it would be subject to the ordinary income provisions of the tax law, for example, as consideration for services. ***[Schedule 1, item 1, subsection 250-5(4)]***

Comparison of key features of new law and current law

New law	***Current law***
Access to tax deductions for capital allowances will be restricted where a tax preferred end user of assets, rather than the private sector taxpayer, has the predominant economic interest in the assets. Predominant economic interest will be based on the extent of risk in the assets borne by the private sector and the taxpayer. The extent of risk will be determined having regard to the level of the taxpayer's assumed risk in the asset and the level of low risk financial benefits provided by the tax preferred entity. Access to tax benefits will be denied to non-resident end users.	Section 51AD denies a taxpayer deductions (predominantly capital allowances and interest deductions) that would otherwise be available in respect of the ownership or holding of an asset where the property is financed predominantly by non-recourse debt, the property is leased to an end user (or the property is used to provide goods or services and the end user has effective control over that use) and either: (a) the end user is a tax exempt entity; (b) the end user is a non-resident; or (c) the property was formerly owned by the end user.
Access to tax deductions for capital allowances will be restricted where a tax preferred end user of assets, rather than the private sector taxpayer, has the predominant economic interest in the assets. Predominant economic interest will be based on the extent of risk in the assets borne by the private sector and the taxpayer. The extent of risk will be determined having regard to the level of the taxpayer's assumed risk in the asset and the level of low risk financial benefits provided by the tax preferred entity. Access to tax benefits will be denied to non-resident end users.	Division 16D operates to deny the owner of the property capital allowance deductions for the cost of, or capital expenditure on, property which is subject to a financial lease or similar arrangement with a tax exempt end user or where the end user has effective control of the asset.

Application and transitional provisions

1.30 Subject to certain transitional arrangements, the proposed measures will apply to all relevant arrangements where the tax preferred end use of an asset starts on or after 1 July 2003. Details of the application and transitional provisions are discussed in Chapter 2.

Chapter 2
Taxable entities and assets to which Division 250 will apply

Outline of chapter

2.1 Chapter 2 explains the scope of the amendments relating to arrangements for the tax preferred use of assets.

2.2 The amendments will replace section 51AD and Division 16D of Part III of the ITAA 1936 with Division 250 of the ITAA 1997 and will generally apply, subject to transitional provisions, to relevant arrangements where the tax preferred use starts on or after 1 July 2003. The basic framework of the replacement provision involves:

- identifying the relevant arrangement for the tax preferred use of assets;
- applying the test of predominant economic interest in relation to the relevant assets; and
- where applicable, determining the tax outcomes by disallowing the relevant capital allowances for the particular asset and treating the financial benefits for the tax preferred use of that asset as payments of principal and interest on a loan.

2.3 Division 250 applies to arrangements between tax preferred entities and taxable entities that involve the tax preferred use of assets for the benefit of, or on behalf of, a tax preferred entity. Tax preferred entities include both government and non-government entities exempt from income tax and non-resident entities. Relevant taxable entities are typically financial institutions (banks and investment banks) or funding vehicles usually established by financial institutions.

Detailed explanation of new law

Purpose of the provisions

Modernisation of Division 16D

2.4 Division 250 is to provide rules for the tax treatment of certain arrangements in relation to the use of assets entered into with, or for the benefit of, tax exempt and non-resident entities (including associates). Subject to the transitional rules, the rules will effectively replace section 51AD and Division 16D of Part III of the ITAA 1936 where the tax preferred use starts on or after 1 July 2003, except where it started under a legally enforceable arrangement entered into before then.

2.5 While certain key structural elements of the framework of Division 250 are similar to those of Division 16D, Division 250 essentially involves a significant reform of the key mechanisms underpinning Division 16D by incorporating a debt based predominant economic interest risk test, a more appropriate tax preferred end user and use test and more effective and appropriate notional loan treatment. The key components are:

- determining the types of asset and asset use (tax preferred use) that fall within the scope of the measure;
- determining the predominant economic interest in the asset;
- denying or reducing capital allowance deductions; and
- applying the notional loan treatment of financial benefits including:
  - adjustments when the tax preferred use of an asset ends; and
  - treatment of the asset after the provisions no longer apply to the asset.

Scope of the measure

An asset put to a tax preferred use

2.6 Division 250 will apply to a taxable entity where:

- an asset is put to a tax preferred use for a period that is in aggregate more than 12 months and financial benefits are expected to be provided to the taxable entity (or a connected entity) for this tax preferred use by:
  - the tax preferred end user (or a connected entity); or
  - any other tax preferred entity (or a connected entity); or
  - a non-resident entity (including a non-resident partnership and a non-resident trust); and
- the present value of those financial benefits (that include some low risk financial benefits) at the start of the arrangement period (or a later test time if a change in the risk sharing triggers a reapplication of Division 250) is greater than 10% of the market value of the asset: and
  - the taxable entity does not have a predominant economic interest in the asset; or
  - the taxable entity elects to have Division 250 apply to the asset; and

except for Division 250, the taxable entity would be entitled to:

- a deduction under Subdivision 40-B in relation to a decline in the value of the depreciable assets; or
- a deduction under Subdivision 40-F (primary production depreciating assets), Subdivision 40-G (capital expenditure of primary producers and other landholders), Subdivision 40-H (capital expenditure on exploration or prospecting, rehabilitation of mining or quarrying sites, paying petroleum resource rent tax and environmental related activities), Subdivision 40-I (capital expenditure associated with projects), section 40-880 (capital expenditure to establish business structure) or section 43-140 (deductible uses of capital works) of the ITAA 1997;

- or section 73B (certain expenditure on research and development activities) or section 73BA (certain assets used for the purposes of carrying on research and development activities) of the ITAA 1936 in relation to the asset (relevant capital expenditure).

[Schedule 1, item 1, subsection 250-10(1)]

2.7 However, to ensure that Division 250 will not apply inappropriately, a taxable entity may request the Commissioner to make a determination, having regard to the circumstances under which Division 250 would apply and other relevant circumstances, that it is unreasonable that Division 250 should apply to the taxable entity and asset ***[Schedule 1, item 1, subsection 250-10(3)]***. In making the determination, consideration should be given to the objects of the Divisions set out in section 250-5.

2.8 Arrangements for the tax preferred use of an asset can be carried through interposed entities. For example, a tax exempt entity may make payments for the tax preferred use of an asset to a manager of the asset. The manager passes on the payments, less a small fee, to the owner of the asset. As a matter of substance, the financial benefits have been provided to the owner. To remove any doubt as to who the benefits are being provided, it is made clear that the financial benefits referred to in paragraph 250-10(1)(c) may be provided to a taxable entity or a connected entity directly or indirectly including through an unrelated entity of the connected entities referred to in that paragraph. ***[Schedule 1, item 1, subsection 250-10(2)]***

A taxable entity that is eligible to be an STS taxpayer or is an STS taxpayer

2.9 Division 250 will not apply to a taxable entity and an asset if the taxable entity will be eligible to be an STS taxpayer for the income year in which the arrangement period starts or where the taxable entity is an STS taxpayer, the taxable entity is able to deduct capital allowance amounts under Subdivision 328-D for the asset. ***[Schedule 1, item 1, subsection 250-10(4)]***

2.10 In accordance with section 328-365 of the ITAA 1997, a taxable entity will be eligible to be an STS taxpayer if:

- it carries on a business in that year;
- the taxable entity's STS average turnover for that year is less than $1,000,000; and

- the sum of the adjustable values of the depreciating assets (for which an amount can be deducted under Division 40 or Division 328) that the taxable entity and the grouped entities (whose value of business supplies is grouped with the taxable entity's) held at the end of that year is less than $3,000,000.

2.11 By section 328-435 of the ITAA 1997, a taxable entity is an STS taxpayer for an income year if the taxable entity is eligible to be an STS taxpayer for that year and the taxable entity notifies the Commissioner in the approved form of the choice to become an STS taxpayer for that year.

An election to have Division 250 apply

2.12 The owner of an asset that is put to tax preferred use can elect that Division 250 apply to the asset. The irrevocable election has to be for the whole of, and from the start of, the arrangement period and must apply to all assets put to a tax preferred use.

2.13 To enhance certainty and reduce compliance costs, a taxable entity's election into Division 250 is not subject to the Commissioner's discretion and the Commissioner cannot make a determination under subsection 250-10(3) that it is unreasonable that the Division 250 applies unless the taxable entity makes the request.

2.14 The 'all assets in' requirement is to prevent adverse selection which may arise if the election was on an asset by asset basis. The election is only available as an alternative to the predominant economic interest test where the other tests in section 250-10 are met. So, for example, an election is not available unless the arrangement period is greater than 12 months. ***[Schedule 1, item 1, section 250-15]***

What constitutes a separate asset for the purposes of Division 250?

2.15 Division 250 applies to an improvement to land or to a fixture on land, whether the improvement or fixture is removable or not, as if it were an asset separate from the land. ***[Schedule 1, item 1, subsection 250-20(1)]***

2.16 It is a matter of fact and circumstance as to whether a particular composite item is itself an asset or whether its components are separate assets. ***[Schedule 1, item 1, subsection 250-20(2)]***

2.17 Division 250 applies to a renewal or extension of an asset that is a right as if the renewal or extension was a continuation of the original right. This will ensure that Division 250 will apply consistently with Division 40 (subsection 40-3(5)) to one asset rather than several assets. ***[Schedule 1, item 1, subsection 250-20(3)]***

2.18 The measures will apply to an underlying asset which is an asset in which a taxable entity has an interest and one or more other entities also have an interest as if the taxable entity's interest in the underlying asset were itself the underlying asset. ***[Schedule 1, item 1, subsection 250-20(4)]***

Asset put to tax preferred end use

Tax preferred end use

2.19 A condition for Division 250 to apply is that the asset is being put to a tax preferred use ***[Schedule 1, item 1, paragraph 250-10(1)(a)]***. An asset will be put to a tax preferred end use if the end user at a particular time is a tax preferred entity or a connected entity of a tax preferred end user ***[Schedule 1, item 1, subsection 250-25(1)]***. In the case of a non-resident entity or a connected entity of a non-resident entity, an asset is put to a tax preferred end use if the assets are used or installed ready for use outside Australia other than wholly and exclusively for the purposes of producing income assessable in Australia ***[Schedule 1, item 1, subsection 250-25(2)]***. In either case, the tax preferred use of the asset need not be the sole or dominant use to which the asset is being put at the time.

2.20 The end users that put an asset to a tax preferred use are known as tax preferred end users. ***[Schedule 1, item 1, subsection 250-25(3)]***

2.21 A tax preferred entity is an exempt entity, an exempt Australian government agency, an associated government entity of an exempt Australian government agency (as defined in subsection 995-1(1) of the ITAA 1997), a prescribed excluded STB ***[Schedule 1, item 21, subsection 995-1(1)]*** or an exempt foreign government agency (as defined in subsection 995-1(1) of the ITAA 1997) ***[Schedule 1, item 1, subsection 995-1(1)]***.

Example 2.1: Tax preferred entity

An Australian resident company that is not eligible to be an STS taxpayer, Danco (the entity) contracts with an Australian government department to provide office services for a period of 3 years for agreed monthly payments. The Australian government department will be a tax preferred entity as it is an exempt Australian government agency.

2.22 These measures will apply where an asset is put to tax preferred use in arrangements such as leases, asset management and service arrangements where:

- the tax preferred end user is the lessee of the asset;
- the tax preferred end user actually uses the asset;
- the asset is used to provide goods, services or facilities to, for the benefit of, or on behalf of, the tax preferred end user; and
- the asset is used to produce goods for use by, for the benefit of, or on behalf of, the tax preferred end user.

[Schedule 1, item 1, section 250-30]

Example 2.2: Assets put to tax preferred use

For its contract with an Australian government department, Danco (the entity) will use assets that it had already acquired or will acquire to provide that service. The assets will be put to a tax preferred use as the entity will use the assets to provide services to a tax preferred end user.

2.23 For an asset to be put to a tax preferred use it does not have to be solely or dominantly used for a tax preferred use ***[Schedule 1, item 1, subsection 250-25(2)]***. Broadly, Division 250 will not apply unless assets supplied by a taxable entity are effectively used by, or to provide goods or services to, or for the benefit of, or on behalf of, a tax preferred end user. This requirement could be met whether the whole or a part of the property was used for such purpose. The taxable entity entering into the arrangement with the tax preferred end user may not be the holder of the assets but it may have a right to use the assets under an arrangement with another taxable entity (or entities) that is the holder.

Example 2.3: Not solely or dominantly put to a tax preferred use

Danco has customers other than the Australian government department for which it provides services using the same assets in providing services to the tax preferred end user. This use of the assets for providing services to non-tax preferred end users does not mean that the assets are not put to a tax preferred use.

Members of a tax preferred end user group and the tax preferred sector

2.24 Where an asset is being put to a tax preferred use the *members of the tax preferred end user group* are the tax preferred end user and connected entities of the tax preferred end user and *the members of the tax preferred sector* are the tax preferred end user (and connected entities), any tax preferred entity (or connected entity) and any non-resident. ***[Schedule 1, item 1, subsection 250-25(4)]***

End user of an asset

2.25 An end user of an asset has the meaning provided by section 250-30 ***[Schedule 1, item 5, subsection 995-1(1)]***. The end user of an asset uses an asset under an arrangement for the tax preferred use of an asset including, but not limited to, a lease arrangement. By subsection 250-30(1) an entity will be an end user of an asset if an item in the table in that subsection applies to the entity at that time. An entity will be an end user if:

- the entity has the use of the asset under a hire arrangement or as lessee under a lease agreement;
- the entity manages the asset or the use of the asset;
- the entity uses the assets or installs it ready for use;
- the asset is used or installed ready for use, to provide goods, services or facilities to the entity, for the benefit of the entity or the benefit of other entities on behalf of the entity; or
- the asset is used or installed ready for use, to produce goods for use by or supply to the entity, for the benefit of the entity or the benefit of other entities on behalf of the entity.

[Schedule 1, item 1, subsection 250-30(1), items 1 to 5 in the table]

2.26 An entity is not taken to manage an asset or manage the use to which an asset is put if the entity regulates the asset in the role of government regulator under legislation designed to protect public health or safety or to ensure the continued supply of essential services to the public ***[Schedule 1, item 1, subsection 250-30(1), item 2 in the table]***. For example, an entity is taken not to manage an asset where the entity merely regulates the use of power generation, transmission and/or distribution networks as part of a system operating rules to ensure safety or where the entity manages assets as a result of emergency ‘step-in’ powers. In any event, in many cases the manager would not fall within Division 250 either because it does not provide financial benefits or because of the *de minimis* test in paragraph 250-10(1)(d).

2.27 The concept of the 'management' of an asset is relatively narrower than the concept of the 'effective control' of an asset as used in section 51AD of the ITAA 1936, in that the 'effective control' of an asset includes more than the management of assets. That is, management is merely one aspect of 'effective control'.

2.28 A tax preferred end user does not include end users where the end user is an individual and the end use of the assets under the arrangement is for private purposes.

2.29 In this regard, the Commissioner regards effective control under section 51AD as including the situation where an authority operates a facility on a day-to-day basis through its employees or agents.[2] However, this would not of itself mean that an authority is managing the asset for the purposes of item 2 in the table in subsection 250-30(1). For example, a taxable entity that manages the asset could engage employees of a tax exempt entity without item 2 being satisfied. Of course, the factual situation would be important in determining whether it was the taxable entity or the tax exempt entity that managed the asset. However, the conclusion of who manages the asset cannot be based solely on who, in a physical sense, is involved in the day-to-day operation of an asset.

2.30 At the same time, it is important that the purpose of the measures in controlling access to tax benefits where an asset is put to tax preferred use, and financial benefits are provided by a tax preferred end user to the taxpayer owner of the asset in relation to that use, is not circumvented. In this regard, a manager of an asset that is put to tax preferred use could underwrite the taxpayer owner's investment in the asset so as to minimise its investment risk. It is accordingly necessary to include management of an asset as end use of the asset.

[2] See Taxation Ruling No. IT 2602, in paragraph 8.

2.31 Section 51AD of ITAA 1936 could be triggered merely by the taxpayer's investment in an asset being financed predominantly by non-recourse debt and the asset being operated on a day-to-day basis by employees of a tax exempt entity. For new Division 250 of the ITAA 1997 to apply to an entity that manages an asset, a number of conditions (explained later) must be fulfilled, including:

- there must be financial benefits provided by the tax exempt entity to the taxpayer in relation to the tax preferred use of the asset;
- the present value of those benefits at the start of the arrangement period for that use must exceed 10% of the market value of the asset; and
- those benefits must include low risk financial benefits.

Accordingly, new Division 250 diminishes the importance of who physically operates the relevant asset while incorporating more appropriate measures of financial risk.

2.32 The meaning of the term tax preferred 'end user' broadly reflects the description in the replaced provisions (section 51AD and Division 16D of Part III of the ITAA 1936) except that private users are not treated as tax preferred end users. For example, a lease or similar arrangement (such as residential housing lease) between a taxpayer and private end users is not to be treated as an arrangement with a tax preferred end user. However, an arrangement with an entity that is a tax preferred entity to provide public housing is to be treated as an arrangement with a tax preferred end user.

Example 2.4: End user

In accordance with item 4 in the table in subsection 250-30(1), the Australian government department is an end user of assets used by Danco (the entity) because the assets are used by the entity to provide services to the Australian government department.

Tax preferred end use of an asset

2.33 Where an asset is being put to a tax preferred use because a particular item in the table in subsection 250-30(1) applies to the entity, each use of the asset specified in the table for that item is a tax preferred use of the asset. ***[Schedule 1, item 1, subsection 250-30(2)]***

2.34 The term 'facilities' referred to in item 4 in the table in subsection 250-30(1) includes hospital or medical facilities, prison facilities, educational facilities, land transport facilities, other transport facilities, the supply of water, gas or electricity, housing or accommodation, business premises and premises for other undertakings.

Example 2.5: Tax preferred use of an asset

> The assets used by Danco to provide services to the Australian government department are put to a tax preferred use because the assets are used by a tax preferred end user.

Arrangement period for a tax preferred use

Start of the arrangement period

2.35 The arrangement period for a particular tax preferred use of an asset begins when an asset is first put to a tax preferred use. ***[Schedule 1, item 1, subsection 250-35(1)]***

2.36 If subsection 250-100(2) or (3) no longer applies to an asset because the action or inaction of a taxable entity, a connected entity of the taxable entity or a member of the tax preferred sector (as defined in subsection 250-25(4)) results:

- in a reduction of the taxable entity's assumed risk in relation to the asset; and
- if there are no regulations under paragraph 250-70(2)(b), in an increase in the taxable entity's expected low risk returns from the asset; or
- if there are regulations under paragraph 250-70(2)(b) in circumstances which the regulations specify as triggering a retesting under section 250-70,

the arrangement period for the tax preferred use of the asset commences immediately after subsection 250-100(2) or (3) stops applying to the asset. For further details regarding subsections 250-100(2) and (3) no longer applying see paragraphs 2.88 to 2.94. ***[Schedule 1, item 1, subsection 250-35(2)]***

2.37 Where subsection 250-100(2) or (3) no longer applies to the asset after an alteration to the arrangement and predominant economic interest test 1 (section 250-60) or test 2 (section 250-70) is satisfied when the asset is retested the taxable entity may not have a predominant economic interest in the asset with the result that Division 250 will apply from that time. For a discussion of the predominant economic interest tests 1 and 2 see paragraphs 2.61 to 2.71.

End of the arrangement period

2.38 The arrangement period for a particular tax preferred use of an asset ends on the date determined by the Commissioner as the date when the tax preferred use will, or is likely to, end ***[Schedule 1, item 1, subsection 250-35(3)]***. However, this is subject to subsection 250-35(4) which provides that the arrangement period ends when Division 250 no longer applies to the taxable entity and the asset if it is prior to the day determined in subsection 250-35(3) ***[Schedule 1, item 1, subsection 250-35(4)]***.

Example 2.6: Arrangement period for tax preferred use

> As Danco has contracted with an Australian government department to provide services for a term of 3 years the arrangement period will be 3 years.

2.39 In determining when the arrangement period for a tax preferred use of an asset ends, the Commissioner must take into consideration the terms of any arrangement dealing with the tax preferred use of the asset and the terms of any arrangement dealing with the provision of financial benefits in relation to that tax preferred use. The Commissioner – in determining when the tax preferred use of an asset ends – is to assume that any right to renew or extend such an arrangement will not be exercised unless it is reasonable to assume that the right to renew or extend will be exercised because of the commercial consequences for either of the parties to the arrangement of not exercising that right. ***[Schedule 1, item 1, subsection 250-35(5)]***

Example 2.7: Right to extend an arrangement

> A taxable entity enters into an arrangement with a tax preferred entity for the tax preferred use of an asset for a period of 20 years. The tax preferred entity has 2 options to extend for a further 10 years each. The first option may be exercised at the end of 20 years while the second option may be exercised (if applicable) at the end of 30 years.
>
> The arrangement period for the tax preferred use of the asset will be 20 years. However, if it is reasonable to assume that the first option will be exercised (because of the adverse commercial consequences of not doing so for the tax preferred entity), the end of the tax preferred use of the asset and thus the arrangement period will be at the end of 30 years. The arrangement period would extend to 40 years if it is reasonable to assume that both options to extend will be exercised because of the adverse commercial consequences for the tax preferred entity of not so extending.

2.40 In calculating the arrangement period for a tax preferred use of an asset, the tax preferred use of an asset by an entity and the tax preferred use of the same asset by a connected entity are taken to be a single tax preferred use of an asset. ***[Schedule 1, item 1, subsection 250-35(6)]***

Continue tax preferred use after end of arrangement period

2.41 Where Division 250 applies to a taxable entity and an asset that is put to a tax preferred use and the arrangement period ends on a particular date, called a termination date, and the tax preferred use of the asset continues beyond the termination date, the tax preferred use beyond the termination date is taken to be a separate and distinct tax preferred use of the asset before the termination date. Accordingly, the new tax preferred arrangement will be retested under section 250-10 to determine whether Division 250 will apply to the taxable entity and the asset. The provision would apply in Example 2.7 if the arrangement period did not include the 10 year option period that was subsequently exercised. This provision is an integrity measure that ensures the correct treatment under Division 250 for where the tax preferred use of an asset continues beyond the original arrangement period. In the absence of this provision there would be an incentive to understate the arrangement period so that subsequent tax preferred use falls outside Division 250. ***[Schedule 1, item 1, section 250-40]***

Financial benefits in relation to tax preferred use

2.42 By subsection 995-1(1) of the ITAA 1997 the term 'financial benefit' has the meaning given by section 974-160 of the ITAA 1997. Broadly, by section 974-160 the term 'financial benefit' means anything of economic value and includes property and services, even if the transaction that confers the benefit on an entity also imposes an obligation on the entity. In this context, financial benefits will include the provisions of economic benefits in relation to the use of an asset including benefits such as repairs and improvements, asset risk insurance or loan guarantees. The financial benefits will include general tax and charges exemptions only if there is an obligation on the taxable entity to pay those taxes and charges. To reduce compliance costs, financial benefits will exclude payments for routine maintenance so that relatively minor financial benefits are not taken into account.

2.43 For the purposes of Division 250, the financial benefits provided or to be provided in relation to a tax preferred use of an asset include not only any periodic financial benefits but also a financial benefit provided in relation to:

- the readying of the asset for tax preferred use;

- the end of the tax preferred use of the asset;
- the termination/expiration of an arrangement that deals with tax preferred use of the asset or provision of financial benefits in relation to the tax preferred use of the asset; and
- the purchase of the asset by or transfer of the asset to the tax preferred entity user or a connected entity.

[Schedule 1, item 1, subsection 250-45(1)]

Example 2.8: Financial benefits provided for tax preferred use

> The Australian government department makes agreed monthly unitary payments to Danco for the tax preferred use of the specialised assets. As this is a unitary payment for services related to the tax preferred use of the specialised assets all payments are included for the purposes of predominant economic interest test (explained later) unless the financial benefits are otherwise specified for services unrelated to the use of the specialised assets.

2.44 Where an asset is put to a tax preferred use and the entity is an end user because, for example, it manages the asset or the use to which it is put, any financial benefit that entity or connected entity provides that is calculated by reference to receipts, revenue or income generated by the use of the asset is also taken to be a financial benefit provided in relation to the tax preferred use of the asset. ***[Schedule 1, item 1, subsection 250-45(2)]***

2.45 Take, for example, a tax preferred entity that operates a facility. It matches the fees collected from users of the facility on a dollar-for-dollar basis. The matching amounts paid by the tax preferred entity are taken to be financial benefits provided in relation to the tax preferred use of the asset.

2.46 For the purposes of Division 250, other than subsection 250-45(3), a financial benefit that is provided by a member of the tax preferred sector ***[Schedule 1, item 1, paragraph 250-25(4)(b)]*** in relation to the tax preferred use of an asset is taken not to be provided by a member of the tax preferred sector to the extent to which the financial benefit merely passes on, or represents, financial benefits provided by an entity that is not a member of the tax preferred sector.

2.47 The purpose of subsection 250-45(3) is to ensure that financial benefits do not include those payments merely collected by a member of the tax preferred sector on behalf of a non tax preferred entity. For example, financial benefits would not include road tolls paid by road users that are merely collected by a tax preferred entity to the extent that they are passed on to the taxable entity. Another example is national marketing and distribution arrangements for electricity that involve a tax preferred authority where the authority provides financial benefits to the generators of electricity that would represent financial benefits payable by the users of the electricity. ***[Schedule 1, item 1, subsection 250-45(3)]***

2.48 If a financial benefit is provided in relation to the use of a number of assets a separate financial benefit is to be reasonably attributed to each of the assets. ***[Schedule 1, item 1, subsection 250-45(4)]***

2.49 To avoid doubt, a financial benefit may be provided in relation to a tax preferred use of an asset even though it is provided before the tax preferred use of the asset begins. ***[Schedule 1, item 1, subsection 250-45(5)]***

2.50 If a financial benefit consists of a number of components and at a particular time the amount or value of a component or components is certain and the amount or value of a component or components is uncertain each of those components is take to constitute a separate financial benefit. If a financial benefit consists of a component that is a fixed amount and a component that is a variable amount based on usage of the asset, each component will be treated as being in respect of separate financial benefits. ***[Schedule 1, item 1, subsection 250-45(6)]***

Example 2.9: Components of financial benefits

> The monthly payments payable by the Australian government department to Danco consist of an amount that is fixed each month and an amount that depends on the number of service hours. Each of these components is treated as a separate financial benefit.

2.51 A financial benefit that is not an amount, for example a financial benefit in the form of goods or services, is taken to become due and payable when the entity (including the tax preferred end user or a connected entity of the tax preferred end user) providing the benefit becomes liable to provide the benefits and is taken to be paid when it is provided. A financial benefit that is paid without becoming due and payable is taken to have become due and payable on the day on which it was paid. ***[Schedule 1, item 1, subsection 250-45(7)]***

Present value of financial benefits

2.52 If a financial benefit has been provided before a particular time the present value of the financial benefit is the nominal amount or value of the financial benefit. For financial benefits expected to be provided after that time it is the nominal amount or value discounted by the discount rate applicable under subsection 250-50(2) for the period that starts at that time and ends when the financial benefit is provided. ***[Schedule 1, item 1, subsection 250-50(1)]***

2.53 Where the total value of each financial benefit provided or to be provided to the taxable entity by any entity in relation to the use of the asset during the arrangement period is known or can be reasonably estimated, and it is possible to calculate the WACC, on a pre-tax basis, for the asset, the applicable discount rate is the pre-tax WACC for the asset where that is less than the IRR of an asset. ***[Schedule 1, item 1, subsection 250-50(2), item 1 in the table)]***

2.54 The pre-tax WACC rather than the post-tax WACC is to be used as the financial benefits are pre-tax financial benefits. The legislation does not prescribe a method for calculating the pre-tax WACC of an asset. However, the pre-tax WACC is well known in corporate finance. The most common formula is:

$$\text{Pre-tax WACC} = (Rd \times D/(D + E)) + (Re \times E/(D + E))$$

Where:

Rd = the cost of debt for the asset (per annum)

Re = the cost of equity for the asset (per annum)

D = market value of the taxable entity's amount of debt in the asset at the particular time

E = market value of the taxable entity's amount of equity in the asset at the particular time

2.55 The internal rate of return of an asset is the compound interest rate that when used to discount all the financial benefits provided to a taxable entity, in respect of any use of the asset during the arrangement period, results in the sum of the present value of the financial benefits equalling the market value of the asset.

Example 2.10: Pre-tax WACC and pre-tax IRR

Assume a firm's pre-tax cost of debt for the asset is 5% per annum while its pre-tax cost of equity is 9% per annum. The ratio of debt to equity for the asset is 80 to 20.

The pre-tax WACC of the asset per annum is calculated using the formula in paragraph 2.54:

$$\begin{aligned}\text{Pre-tax WACC} &= (5\% \times 80/(80 + 20)) + (9\%e \times 20/(80 + 20)) \\ &= (5\% \times 80/100) + (9\% \times 20/100) \\ &= 4\% + 1.8\%\end{aligned}$$

= 5.8% per annum

Assume the asset costs \$100 and has the following expected cash flows are to be provided by a tax preferred end user.

At the end of year 1: \$10 payment

At the end of year 2: \$10 payment

At the end of year 3: \$110 payment

This gives a pre-tax IRR of 10% per annum. As the pre-tax WACC is less than the pre-tax IRR, the pre-tax WACC is the discount rate to be applied to the financial benefit in respect of this asset.

2.56 If the total value of each financial benefit is unknown or cannot be reasonably estimated and the IRR cannot be calculated, the applicable discount rate is the pre-tax WACC of the asset ***[Schedule 1, item 1, subsection 250-50(2), item 2 in the table)]***. If it is not possible to calculate the IRR of the asset or the pre-tax WACC of the asset, the applicable rate is the compounding rate determined by the Commissioner as reasonably reflecting the pre-tax WACC for the asset ***[Schedule 1, item 1, subsection 250-50(2), item 3 in the table)]***. In doing so the Commissioner is to have regard to the nature of the use to which the asset is to be put including the nature of the project in which the asset is used, and any other relevant matter ***[Schedule 1, item 1, subsection 250-50(3)]***.

2.57 It is necessary to calculate compound rates and discount rates to determine the expected low risk returns in relation to an asset in subsection 250-75(1). The expected low risk returns are calculated by finding, the present value of the low risk financial benefits using the applicable discount rate in subsection 250-50(2). Where an asset is used in a project, and a pre-tax WACC has been determined for the project, this WACC is taken to be the WACC for the asset. ***[Schedule 1, item 1, subsection 250-50(4)]***

Compounding period

2.58 The compounding period used is not to be greater than 12 months and is to be used in discounting the financial benefits that are expected to be paid after a particular time. ***[Schedule 1, item 1, subsection 250-50(5)]***

2.59 If the compound rate of the WACC of the asset, the IRR asset or the rate determined by the Commissioner is based on a particular compounding period and the discount rate uses a different compounding period the compounding period for the compound rate is to be converted to that of the discount rate. ***[Schedule 1, item 1, subsection 253-50(6)]***

Example 2.11: Conversion

If an asset has a pre-tax WACC of 6% per annum that compounds annually but the discount rate is compounded monthly this WACC is to be converted into a rate that compounds monthly. Using the formula:

$$(1 + j_1) = (1 + j_m/m)^m$$

Where:

j_1 = the effective rate per annum

m is the number of compounding periods per annum

jm = nominal rate of interest compounding m times per annum

jm/m = the effective rate per 1/mth of the year

$$1.06 = (1 + j_{12}/12)^{12}$$

$$1.06^{1/12} = 1 + j_{12}/12$$

$$12 \times (1.0048676 - 1) = j_{12}$$

j_{12} = 5.8411% (nominal rate convertible monthly)

When discounting a low risk financial benefit in, say, the 4th compound period, the low risk financial benefit would be divided by $(1 + 0.058411/12)^4$.

2.60 Regulations may be made to specify the method to be used in working out the pre-tax WACC of the asset and to apply and make provision in relation to the determination of a rate by the Commissioner under subsection 250-50(2). These regulations would be designed to provide certainty and reduce taxpayers' compliance costs in relation to the calculation of pre-tax WACC or the compound interest rate to be used as a discount rate. ***[Schedule 1, item 1, subsection 250-50(7)]***

Predominant economic interest in an asset

2.61 A condition for the application of Division 250 is that the relevant taxable entity does not have a predominant interest in the particular asset (assuming an election to have the Division apply is not made). This condition forms the basis for determining whether there has been sufficient risk allocated to, or assumed by, the taxable sector vis a` vis the tax preferred (any, in many cases, public) sector and the particular taxable entity vis a` vis other entities in the taxable sector.

2.62 The predominant economic interest test is designed to ensure that the measures apply where the economic owner of the asset is the tax preferred end user rather than the taxable entity. Where a taxable entity does not have a predominant economic interest in an asset, subparagraph 250-10(1)(g)(i) will be satisfied. A taxable entity does not have a predominant economic interest in an asset if any of the tests in section 250-60, 250-70, 250-80, 250-90 or 250-95 apply to the asset. Conversely, if none of the tests apply the taxable entity will have a predominant economic interest in the asset at that time and therefore relevant capital allowances will not be denied or reduced. There are 5 tests:

- assumed risk in relation to the asset (test 1: section 250-60);
- level of expected low risk returns (test 2: section 250-70);
- effectively non-cancellable, long term arrangement (test 3: section 250-80);
- right to acquire the asset (test 4: section 250-90); and
- prior ownership of the asset by a member of the tax preferred end user group (test 5: section 250-95).

Assumed risk in relation to an asset (test 1)

2.63 A taxable entity's assumed risk in relation to an asset at a particular time represents the amount of loss the taxable entity would bear if the asset were to continue in existence but lose all its value at that time. ***[Schedule 1, item 1, subsection 250-65(1)]***

2.64 The assumed risk test will be met if the taxable entity's assumed risk ***[Schedule 1, item 1, section 250-65]*** in relation to the asset is less than:

- 20% of the market value of the asset if it is put to a tax preferred use by a tax preferred entity end user; and
- 50% of the market value of the asset if it is put to a tax preferred use by a non-resident tax preferred end user.

[Schedule 1, item 1, section 250-60]

Example 2.12: Test 1

Danco acquired the specialised assets for $100,000 by borrowing this amount fully secured by other assets. Prior to the acquisition Danco had assets of $50,000, debt of $35,000 and owner's equity of $15,000. After the acquisition of the specialised assets Danco has assets of

$150,000, debt of $135,000 and equity of $15,000. If the value of the specialised assets falls to nil then the loss borne by Danco is $15,000 (i.e. $150,000 – $135,000) that is, the net worth of Danco. If the specialised assets continued in existence but became worthless the loss that the entity would bear is the net worth of the entity. Test 1 will be satisfied as the assumed risk in relation to the asset is less than 20% of the market value of the specialised assets at the time when the specialised assets are first put to the relevant tax preferred use.

1. 20% of market value of the specialised assets = $20,000 (20% × $100,000);

2. assumed risk amount = $15,000 (net worth of Danco);

3. as the assumed risk amount of $15,000 is less than 20% of the value of the specialised assets, Danco would satisfy this test.

2.65 In determining the amount of the loss, consideration must be given to:

- whether there are any guarantees, arrangements or other factors that would have the effect of mitigating or eliminating the loss of the taxable entity or the connected entity (e.g. forward sales);

- any limitations or restrictions on the creditors of the taxable entity or a connected entity, specifically in relation to borrowings to fund the asset;

- whether the taxable entity or a connected entity is able to effectively access the value of the investment in the asset, or the connected entity's investment in the asset; and

- any other relevant matters.

[Schedule 1, item 1, subsection 250-65(2)]

2.66 In determining the amount of the loss the following are to be disregarded:

- any right that the taxable entity has to compensation or indemnity in respect of damage to the asset under an insurance contract entered into during the ordinary course of business; and

- any right that the taxable entity has to compensation or indemnity in respect of the quality or condition of the asset under a sale contract or lease entered into during the ordinary course of business.

[Schedule 1, item 1, subsection 250-65(3)]

2.67 In determining the loss borne by a taxable entity where an asset is a partnership asset, a nil value is to be attributed to any losses that would be borne by a partner who is a tax preferred entity or a connected entity of a tax preferred entity. Accordingly, 100% of the loss is borne by the taxable entity which would then have to be compared with 20% of the market value of the asset under paragraph 250-60(a). ***[Schedule 1, item 1, subsection 250-65(4)]***

2.68 Regulations may be made for the application and operation of section 250-65. These regulations may be used to prescribe rules for determining the amount of loss an entity would bear or specify rights and interests that are to be taken into account or disregarded ***[Schedule 1, item 1, subsection 250-65(5)]***. It should be noted that in accordance with subsection 48(2) of the *Acts Interpretation Act 1901*, a regulation will have no effect retrospectively if doing so would cause a person to be disadvantaged or liabilities imposed.

Level of expected low risk returns or alternative risk test (test 2)

2.69 The level of expected low risk returns is compared to the market value of the asset to determine whether they represent a proxy for a loan to purchase the asset. The greater the level of expected low risk returns relative to the market value of the asset the closer the arrangement is to a debt financing by the taxable entity of an asset purchase by a tax preferred entity.

2.70 Test 2 will apply to the asset if the expected low risk returns ***[Schedule 1, item 1, section 250-75]*** from the tax preferred use of the assets exceeds 50% of the market value of the asset ***[Schedule 1, item 1, subsection 250-70(1)]***. To determine the expected low risk returns in relation to the asset, it is firstly necessary to determine the low risk expected financial benefits as at the start of the arrangement period ***[Schedule 1, item 1, subsections 250-75(2) to (9)]***.

Example 2.13: Test 2

> Danco's assets put to a tax preferred use have a market value of $100,000. If the present value (for the arrangement period of 3 years) of the entity's low risk financial benefits (expected low risk returns) attributable to the tax preferred use of the assets is $80,000 the expected low risk returns are more than 50% of the market value of the asset. Therefore test 2 is satisfied.

2.71 Regulations may specify the circumstances under which section 250-70 applies to an asset and the circumstances that cause a retesting against section 250-70 ***[Schedule 1, item 1, subsection 250-70(2)]***. Where regulations for the purposes of paragraph 250-70(2)(a) are in force, section 250-70 applies to the asset at that time as specified in the regulations and subsection 250-70(1) will be disengaged at the time ***[Schedule 1, item 1, subsection 250-70(3)]***. Regulations made for paragraph 250-70(2)(a) may apply, adopt or incorporate issues contained in accounting standards or in an international standard that deals with accounting issues. These regulations will allow future consideration of the adoption of accounting standards ***[Schedule 1, item 1, subsection 250-70(4)]***.

Expected low risk returns

2.72 The expected low risk returns in relation to an asset is the total of the present values of the low risk financial benefits ***[Schedule 1, item 1, subsections 250-75(2) and (3)]*** that have been, or assuming normal operating conditions, either will be or can reasonably be expected to be, provided in relation to the tax preferred use of the asset by a member of the tax preferred sector to an entity who is not a member of the tax preferred sector ***[Schedule 1, item 1, subsection 250-75(1)]***.

Low risk financial benefits

2.73 A financial benefit is low risk at a particular time if it has been provided before that time or the financial benefit is to be provided at or after that time and both the amount or value and the timing are certain at that time ***[Schedule 1, item 1, subsection 250-75(2)]***. A financial benefit will also be low risk if it is provided after a particular time and either the amount/value or timing or both are not certain at that particular time and the financial benefits satisfies subsection 250-75(4), (5) or (6) ***[Schedule 1, item 1, subsection 250-75(3)]***.

2.74 A financial benefit satisfies subsection 250-75(4) if the amount of the financial benefit will not be materially reduced or otherwise affected by the financial benefits that entities other than the members of the tax preferred sector would in a competitive market be willing to provide from time to time for the use of the asset or goods, services, facilities provided by or produced by the use of the asset. ***[Schedule 1, item 1, subsection 250-75(4)]***

2.75 Subsection 250-75(4) considers whether the financial benefits provided in relation to the tax preferred use of an asset (or for goods, services or facilities provided by or produced by the use of the asset) by a member of the tax preferred sector to someone outside that sector are affected by market forces from time to time. Suppose that a private sector operator of an asset charges members of the public for the use of an asset as and when they use it (for example on each occasion or on, say, a monthly basis for an ongoing contract), the demand for which will be affected by the price charged and, where appropriate, the cost of using alternative assets. Members of the public will decide how much to use the asset after assessing the costs and, as appropriate, the costs of using the alternative assets as well as other factors. Therefore the financial benefits received by the operator would be subject to market forces from time to time.

2.76 Suppose, on the other hand, that the tax preferred entity agrees that it, rather than members of the public, will pay the private sector operator for the use of the asset. The amount or value of the payment is independent of how much members of the public would otherwise have had to pay from time to time under the conditions referred to in the previous paragraph. Therefore the financial benefits provided to the operator would not be affected by market forces from time to time. Those financial benefits would accordingly be low risk financial benefits.

Example 2.14: Competitive market on the value of financial benefits

> An airline provides air freight services using its aircraft to an Australian government agency as the preferred contractor for 3 years. The agency agrees to pay fees based on the market rate from time to time determined by the demand of competing users of the services (comprising both members of and other than the tax preferred sector). The agency receives a 5% rebate in respect of the charges, to which other non-tax preferred users under similar conditions would also be entitled.
>
> The financial benefits will not be low risk under subsection 250-75(4) as the air freight fee that the agency is charged is determined by market demand from time to time for the services.

2.77 A financial benefit will satisfy subsection 250-75(5) if the financial benefit is to be provided for the purchase or transfer of the asset to the tax preferred end user or a connected entity of the tax preferred end user and the amount or value of the financial benefit is not calculated by reference to the market value of the asset at the time of the purchase, acquisition or transfer. ***[Schedule 1, item 1, subsection 250-75(5)]***

2.78 A financial benefit satisfies subsection 250-75(6) if the level of use of the assets by entities other than the members of the tax preferred sector, from time to time, will not be materially affected by the amount of or value of the financial benefit or the amount or value of the financial benefits will not be materially affected by the level of use of the asset by entities, other than members of the tax preferred sector, from time to time. ***[Schedule 1, item 1, subsection 250-75(6)]***

2.79 Subsection 250-75(6) looks at the relationship between the level of usage of an asset and the amount or value of the relevant financial benefit in determining whether that benefit is low risk. Generally, if the owner of an asset is at risk in respect of an asset that it earns income from by allowing someone else to use it, the amount it earns depends on how much the asset is used.

2.80 As a general notion, if the income of an owner of an asset is based on how much it is used by taxable entities (and it is not insulated from market forces), the owner takes risk in relation to that asset. Conversely, if the owner is entitled to a certain level of payment irrespective of the level of that use, its risk in relation to that payment is significantly diminished.

Example 2.15: Private hospital

Health Co owns a hospital and charges individual patients the full cost of using it, that is, (leaving aside private medical insurance) no tax preferred entity provides financial benefits in relation to its use. How much Health Co earns is materially affected by the level of usage by members of the public, not by members of the tax preferred sector.

Example 2.16: Level of usage

The level of usage of a road by road users is not affected by the payment of a shadow toll by a tax preferred entity to a taxable entity because the road users do not pay the shadow toll.

Example 2.17: Availability charges

Under an arrangement, Danco provides hospital services including buildings and plant to a State government. A unitary payment includes an availability fee and a variable fee that is contingent on usage. The availability fee is a fixed amount for making the buildings and plant available for use. This fee is a low risk financial benefit because its amount or value will not be affected by how much the hospital is used by members of the public.

2.81 Regulations may provide whether a financial benefit is or is not low risk at a particular time ***[Schedule 1, item 1, subsection 250-75(7)]***. The regulations may specify a method to calculate the amount or value of a financial benefit and make provision for the application and operation of subsections 250-75(4) to (6) ***[Schedule 1, item 1, subsection 250-50(8)]***. Regulations made for subsection 250-75(7) may apply, adopt or incorporate issues contained in an accounting standard or in an international standard that deals with accounting issues. The regulations will allow for the future adoption of accounting standards, or concepts from accounting standards, that are currently under development ***[Schedule 1, item 1, subsection 250-75(9)]***.

Effectively non-cancellable, long term arrangement (test 3)

2.82 An effectively non-cancellable long term arrangement is an indicator of a predominant economic interest in the asset because the tax preferred end user cannot cancel or effectively cancel (due to contractual conditions requiring a new contract or severe penalties) the arrangement. This generally means that the end user, for example a lessee, has to continue making payments in relation to the asset for a long period relative to the effective life of the asset. The payments are therefore likely to cover all or a substantial proportion of the cost of the asset. Therefore, all or a substantial proportion of the risks and benefits of ownership remain with the tax preferred end user rather than the taxable entity. This is consistent with *Accounting Standard AASB1008* (Leases) in respect of "non-cancellable leases".

2.83 It is necessary to determine if an arrangement is effectively non-cancellable to determine if test 3 in section 250-80 is satisfied. This test will apply to an asset if any tax preferred use arrangement or, the financial benefits to be provided by the members of the tax preferred end user group or the tax preferred sector, is effectively non-cancellable and:

- where the asset is real property the arrangement period is 50% or more of the period, in the Commissioner's opinion, of the remaining expected life of the asset ***[Schedule 1, item 18, subsection 995-1(1)]***; or
- where the asset is not real property the arrangement period is 75% or more of the period, in the Commissioner's opinion, of the remaining effective/expected life of the asset ***[Schedule 1, item 1, section 250-80]***.

Example 2.18: Test 3

> The contract between Danco and the Australian government department is able to be cancelled by the tax preferred entity should Danco fail to achieve the normal specified service standards and the tax preferred entity is not required to pay any financial benefits (other than those unpaid amounts for services provided) on cancellation. In accordance with proposed section 250-60, this contract will not be effectively non-cancellable as Danco's permission is not required to cancel the contract and there is no requirement to enter into a new contract or make any penalty payment.

2.84 An arrangement in relation to the tax preferred use of an asset is effectively non-cancellable if the arrangement can be cancelled only with the permission of a taxable entity, a connected entity of the taxable entity, an agent of or an entity acting on behalf of a taxable entity or a connected entity or, if the arrangement were cancelled, the member or another member of the tax preferred sector would have to enter into a replacement arrangement or incur a detrimental penalty. ***[Schedule 1, item 1, subsection 250-85(1)]***

2.85 If a member of the tax preferred sector defaults under such arrangement and as a result the arrangement is cancelled, the arrangement is taken to have been cancelled without the permission required in subsection 250-85(1). An arrangement that is cancelled without the requisite permission will be an effectively non-cancellable arrangement if, as a consequence, a detrimental penalty is incurred, for example, a payment equivalent to the unrecouped investment in the asset. ***[Schedule 1, item 1, subsection 250-85(2)]***

A right to acquire an asset (test 4)

2.86 Test 4 is relevant in determining whether the taxable entity or the tax preferred end user has the predominant economic interest in an asset because the right of the tax preferred end user to acquire the asset indicates the tax preferred end user, rather than the taxable entity, has the rights and benefits of the owner of the asset.

2.87 This test will apply to the asset if a member of the tax preferred end use group has or will have the right or an obligation to purchase or acquire the asset or a right to require the transfer of the asset when the tax preferred use of the asset ends and the consideration for the asset is not fixed as the market value of the asset at the time of purchase, acquisition or transfer. This test will not apply to an asset just because a taxable entity's interest in the asset is one that ceases to exist after the passing of a certain period of time. ***[Schedule 1, item 1, section 250-90]***

Example 2.19: Test 4

> The hospital as in Example 2.14 which was built by Danco on crown land will revert to the State government at the end of the 40 year arrangement period. Accordingly, the arrangement will not satisfy test 4.

Prior ownership by a member of a tax preferred end user group (test 5)

2.88 The prior ownership by a member of a tax preferred end user group test (test 5) will apply to the asset if a member of the tax preferred end user group ***[Schedule 1, item 1, paragraph 250-25(4)(a)]*** owned the asset and used or held the asset for use before the taxable entity acquired it ***[Schedule 1, item 1, subsection 250-95(1)]***. However, this test will not apply if the asset was first used or held for use by a member of the tax preferred end user group 6 months before it was acquired by a taxable entity and at the time (when the asset was first used or held for use) there was an arrangement that the asset would be sold or transferred to another entity and that entity would enter into an arrangement for the tax preferred use of the asset by a member of the tax preferred end user group ***[Schedule 1, item 1, subsection 250-95(2)]***.

2.89 Test 5 will also not apply where the asset is:

- a privatised asset in accordance with section 58-5 of the ITAA 1997 or would have been a privatised asset if it were a depreciating asset ***[Schedule 1, item 1, subsection 250-95(3)]***; or
- an asset put to a tax preferred use by a non-resident tax preferred end user and the asset is used wholly or principally for a purpose other than leasing or hiring the asset ***[Schedule 1, item 1, subsection 250-95(4)]***.

2.90 Test 5 is a 'sale and lease back' integrity rule designed to deal with refinancing arrangements for second hand assets that are sold to the private sector sometimes at inflated values, and there is an arrangement to provide use of the assets back to the tax preferred vendor involving the payment of financial benefits including low risk amounts and the benefits exceed 10% of the market value of the asset (*de minimis*).

2.91 Division 58 provides special rules that apply in calculating deductions for the decline in the value of depreciating assets and balancing adjustments for assets previously owned by an exempt entity if the assets continue to be owned by that entity after the entity becomes taxable or are acquired from that entity, in connection with the acquisition of the business, by a purchaser that is a taxable entity. Two choices are available for each depreciating asset, firstly the notional written down value and the other, the undeducted pre-existing audited book value.

Example 2.20: Prior ownership by a member of the tax preferred end user group

Danco acquired a specialised asset from Fredco, another unconnected taxable entity. Fredco had purchased the specialised asset from a State government when the asset was privatised. The prior ownership by a member of the tax preferred end user group test will not apply to the asset as a privatised asset.

Retesting of predominant economic interest against test 1 and test 2

2.92 The retesting of the predominant economic interest is an integrity measure to ensure that if there is a reduction in the assumed risk (test 1) or an increase in the level of the expected low risk returns (test 2) subsequent to the previous testing that there is a retesting to determine if Division 250 should apply or continue to apply to the arrangement.

2.93 Continuous retesting is not required. The retesting of the predominant economic interest in tests 1 and 2 only occurs if either of the parties cause the assumed risk or the level of expected low risk returns to change. Retesting will not be required merely because market conditions change. The retesting applies only in respect of financial benefits from the time of retesting onwards. The financial benefits provided before the time of retesting are ignored for the purposes of retesting.

2.94 Where there is alteration to the arrangement that reduces the taxable entity's assumed risk in relation to the asset or increases the expected low risk returns from the asset it is necessary to reapply tests 1 and 2 to determine if there is a change in the taxable entity's predominant economic interest in an asset.

2.95 If neither test 1 (assumed risk in relation to an asset) nor test 2 (level of expected low risk returns) is satisfied at the start of the arrangement period, both of these tests are taken to remain non-applicable to the asset. This means that provided that the other tests (test 3, 4 or 5 in respect of predominant economic interests in an asset) are not satisfied, the taxable entity will continue to have a predominant economic interest in the asset. ***[Schedule 1, item 1, subsection 250-100(2)]***

2.96 However, if at a time after the start of the arrangement period either the level of the taxable entity's assumed risk in relation to the asset is reduced, or a taxable entity's expected low risk returns from the asset is increased and neither test 1 or test 2 applies to the asset at that time both these tests are taken to remain non-applicable to the asset. This means that provided that the other tests (in respect of predominant economic interests in an asset) are not satisfied the taxable entity will continue to have a predominant economic interest in the asset. ***[Schedule 1, item 1, subsection 250-100(3)]***

2.97 If, as a result of the alteration to the level of assumed risk or expected low risk returns test 1 or 2 is satisfied then the entity or a connected entity will no longer have a predominant economic interest in the asset. ***[Schedule 1, item 1, subsection 250-100(4)]***

2.98 If the taxable entity's assumed risk in relation to the asset or expected low risk returns from the asset are altered because of an action by an unrelated third party, tests 1 and 2 will remain non-applicable to the asset. In other words, the taxable entity will continue to have a predominant economic interest in the asset. ***[Schedule 1, item 1, subsection 250-100(5)]***

Compound rates of interest and compound discount rates

2.99 For the purposes of Division 250, a rate of compound interest or a discount rate has both a percentage interest or discount rate and a compounding period. For example, a discount rate may be expressed as an annual rate, compounding monthly such as 6% per annum, compounding monthly. ***[Schedule 1, item 1, section 250-105]***

Application and transitional provisions

2.100 Division 250 will apply to all relevant arrangements where the tax preferred use of an asset starts on or after 1 July 2003 and does not occur under a valid contract entered into before 1 July 2003. ***[Schedule 1, subitem 71(1)]***

2.102 Where subitem 71(2) applies to an asset, section 51AD or Division 16D of Part III of the ITAA 1936 will not apply to the asset and Division 250 will apply to the tax preferred use of the asset after an alteration. ***[Schedule 1, subitem 71(3)]***

2.103 Subitem 71(2) applies to an asset that is put to a tax preferred use where:

- the tax preferred use starts on or after 1 July 2003;
- this tax preferred use is under a valid contract entered into before 1 July 2003;
- immediately before 1 July 2003 neither section 51AD or Division 16D applied or would apply to the asset. (It is assumed that the asset was in existence and was being put to a tax preferred use before);
- this arrangement is altered on or after 1 July 2003; and
- except for this subitem, section 51AD and Division 16D would apply to the asset immediately after the alteration.

[Schedule 1, subitem 71(2)]

2.104 Where subitem 71(4) applies to an asset, Division 250 will apply to the tax preferred use of the asset after an alteration. ***[Schedule 1, subitem 71(5)]***

2.105 Subitem 71(4) applies to an asset that it is put to a tax preferred user where:

- the tax preferred use starts before 1 July 2003;
- immediately before 1 July 2003 neither section 51AD or Division 16D applied or would apply to the asset;
- this arrangement is altered on or after 1 July 2003; and
- except for this subitem, section 51AD and Division 16D would apply to the asset immediately after the alteration.

[Schedule 1, subitem 71(4)]

2.106 In determining if Division 16D would have applied to the arrangements prior to 1 July 2003 and on and after that date, and taking into account the subsequent alterations to the arrangements, section 159GL of the ITAA 1936 is to be disregarded. ***[Schedule 1, subitem 71(6)]***

2.107 Section 159GL operates to exclude from the operation of Division 16D certain qualifying arrangements relating to buildings in respect of which capital expenditure deductions are available under Division 10C or 10D of the ITAA 1936. The section ensures that a taxpayer cannot, because of the application of Division 16D, receive a benefit that would not have been available had Division 16D not applied.

2.108 Under Divisions 10C and 10D, capital expenditure deductions are available over a set period (either 25 or 40 years depending on the time at which the qualifying expenditure was incurred). However, under Division 16D, because the owner of the property has only the interest components, and not the principal components, of arrangement payments included in assessable income, effective capital expenditure deductions may, at least in part, be allowed over the period of the arrangement. That period may be shorter than the set period for Division 10C or 10D purposes so that the owner could, in the absence of section 159GL, receive a tax advantage from the application of Division 16D.

2.109 The disengagement of section 159GL means that if Division 16D would not have otherwise applied to Division 10C and 10D assets prior to alteration, and subsequently would apply Division 250 will apply to those assets.

2.110 In applying Division 250 to the tax preferred use of an asset after an alteration of the arrangement, the arrangement period is taken to start on the day on which the alteration occurs. ***[Schedule 1, subitem 71(7)]***

Application of section 51AD

2.111 Section 51AD will not apply to property that is put to a tax preferred use where the tax preferred use starts on or after 1 July 2003 and does not occur under a valid contract entered into before 1 July 2003 ***[Schedule 1, item 37, subsection 51AD(1A)]***. Nor will section 51AD apply to property on or after 1 July 2003 if Division 16D of Part III of the ITAA 1936 applied to the property immediately before 1 July 2003 or section 51AD did not apply to the property immediately before 1 July 2003 and Division 16D would have applied immediately before that date but for subsection 159GH(2) (which prevented Division 16D from applying to an item of eligible property if section 51AD applied to the item of eligible property in relation to a taxpayer) ***[Schedule 1, item 37, subsection 51AD(1B)]***.

2.112 Subparagraph 51AD(4)(a)(iii) and sub-subparagraph 51AD(4)(b)(ii)(D) will not apply to property acquired or constructed by a taxable entity where the property is acquired by the taxpayer on or after 1 July 2003 and the property is not acquired under a legally enforceable agreement entered into before 1 July 2003. ***[Schedule 1, item 37, subsection 51AD(1C)]***

Application of Division 16D

2.113 Division 16D will not apply in relation to the item of eligible property that is put to a tax preferred use that starts on or after 1 July 2003 and does not occur under a legally enforceable agreement entered into before 1 July 2003. ***[Schedule 1, items 42 and 43, subsection 159GH(1A)]***

Chapter 3
Denial or reduction of capital allowance deductions

Outline of chapter

3.1 Chapter 2 explains the categories of arrangements, entities and assets to which Division 250 applies. This Chapter explains the tax consequences in relation to capital allowance deductions for a taxable entity with an arrangement in relation to an asset that falls within these measures. Broadly, the taxable entity is taken not to be entitled to capital allowance deductions in relation to the asset. However, in certain situations (e.g. where the asset is partly used to derive assessable income from a taxable entity), a partial deduction may be allowable.

3.2 Chapter 4 will then explain how, even where the capital allowance deduction is not allowable, notional loan treatment will nevertheless allow the cost of the relevant asset to be recognised for tax purposes, albeit that the timing of the recognition is likely to be altered having regard to the accruals treatment for the interest component of financial benefits in respect of the asset.

Detailed explanation of new law

3.3 Where Division 250 applies, capital allowance deductions under the following provisions are denied:

- Subdivisions 40-B, 40-F, 40-G, 40-H, 40-I and sections 40-880 and 43-140 of the ITAA 1997; and
- sections 73B and 73BC of the ITAA 1936.

[Schedule 1, item 1, section 250-110]

3.4 The table in section 250-110 sets out the manner in which these deductions are denied, having regard to the basis on which each deduction would have otherwise been allowable. Set out below is a brief explanation of each of these deductions and how Division 250 operates to deny the deduction where the Division applies.

ITAA 1997

Subdivision 40-B

3.5 Subdivision 40-B contains rules for deductions in respect of depreciating assets. Where Division 250 applies, a taxable entity is taken not to be using the asset for taxable purposes at that time. ***[Schedule 1, item 1, section 250-110, item 1 in the table]***

Subdivision 40-F

3.6 Subdivision 40-F deals with deductions for capital expenditure on depreciating assets that are water facilities, horticultural plants or grapevines. Where Division 250 applies, the applicable condition in section 40-525 is taken not to be satisfied for the asset at that time. ***[Schedule 1, item 1, section 250-110, item 2 in the table]***

3.7 The applicable condition in respect of water facilities is that the capital expenditure incurred on the construction, manufacture, installation or acquisition of the water facility must have been incurred primarily for the purposes of conserving or conveying water for use in a primary production that a taxable entity conducts on Australian land.

3.8 For horticultural plants the condition to be satisfied is one of the following:

- the taxable entity owns the horticultural plant and any holder of the lease, lesser interest or licence relating to the land does not carry on a business of horticulture on the land; or
- the horticultural plant is attached to land a taxable entity holds under a lease or a quasi-ownership right granted by an exempt Australian government agency or an exempt foreign government agency; and
  - the lease or quasi-ownership right enables the taxable entity to carry on a horticulture business on the land; and
  - any holder of a lesser interest or licence relating to the land does not carry on a horticultural business on the land.

3.9 For grapevines one of the following conditions must be satisfied:

- the taxable entity owns the grapevine; or

- the grapevine:
  - is attached to land a taxable entity holds under a quasi-ownership right granted by an exempt Australian government agency or an exempt foreign government agency;
  - was planted by the taxable entity or by a previous landholder under the quasi-ownership right; and
  - is used in a primary production business.

Subdivision 40-G

3.10 Subdivision 40-G contains rules for deductions for capital expenditure incurred on landcare operations or on electricity connections or telephone lines. Where Division 250 applies and the asset is land, a taxable entity is taken to be using the land at the time for a purpose other than the purpose of carrying on a primary production business or a business for the purposes of producing assessable income from the use of rural land (except a business of mining operations). ***[Schedule 1, item 1, section 250-110, item 3 in the table]***

Subdivision 40-H

3.11 Subdivision 40-H provides for immediate deductibility for certain capital expenditure in respect of exploration or prospecting, rehabilitation of mining or quarrying sites, paying petroleum resource rent tax and environmental protection activities. Where Division 250 applies, a taxable entity cannot deduct expenditure that it incurs in relation to the asset at that time. ***[Schedule 1, item 1, section 250-110, item 4 in the table]***

Subdivision 40-I (including section 40-880)

3.12 Subdivision 40-I provides for deductibility over time for certain capital expenditure associated with projects that are carried on involving mining operations or a transport facility. Amounts are deducted over the life of the project using a pool. Where Division 250 applies, a taxable entity is taken not to be using the asset for taxable purposes at that time. ***[Schedule 1, item 1, section 250-110, item 5 in the table]***

Section 40-880

3.13 Under section 40-880 certain business related capital expenditure is deductible over 5 years. Where Division 250 applies, a taxable entity cannot deduct an amount for capital expenditure it incurs in relation to the asset at that time. ***[Schedule 1, item 1, section 250-110, item 6 in the table]***

Section 43-140

3.14 Section 43-140 allows deductions where capital works are used for the purpose of producing assessable income or carrying on research and development activities.. Where Division 250 applies, a taxable entity is taken not to be using the asset at the time for the purposes of producing assessable income or carrying on research and development activities. ***[Schedule 1, item 1, section 250-110, item 7 in the table]***

ITAA 1936

Section 73B

3.15 Section 73B provides incentives for certain expenditure on specified research and development activities. Where Division 250 applies, a taxable entity is taken not to have qualifying expenditure at that time in relation to the use of the asset. ***[Schedule 1, item 1, section 250-110, item 8 in the table]***

Section 73BC

3.16 By subsection 73BC(1), an eligible company has a notional Division 40 deduction for a section 73BA depreciating asset if it would be entitled to a deduction under section 40-25 of the ITAA 1997 which allows a deduction for an amount equal to the decline in value in an income year for depreciating assets held during the income year. This is a condition for a deduction under subsection 73BA(2) for certain assets used for the purpose of carrying on research and development activities. Where Division 250 applies, the asset is taken as not being used or installed ready for use for the purposes of carrying on, by or on behalf of an eligible company, of research and development activities. ***[Schedule 1, item 1, section 250-110, item 9 in the table]***

Apportionment rule

3.17 Even though Division 250 applies to an asset, there are certain situations in which a partial deduction may be available in respect of the asset. Specifically, a taxable entity may elect to have the apportionment rule apply if:

- Division 250 applies to the taxable entity and the asset;

- it is reasonable to expect that during the arrangement period for the tax preferred use of the asset, particular financial benefits will be provided to the taxable entity; and
- it is reasonable to expect that those financial benefits will be provided in relation to a non tax preferred use of the asset or will be provided for tax preferred use of the asset but are not attributable to financial benefits provided by members of the tax preferred sector.

[Schedule 1, item 1, subsection 250-115(1)]

3.18 The amount or value of those financial benefits must be known or can reasonably be estimated.

3.19 The election for the apportionment rule is irrevocable and must be for the whole of the arrangement period for the tax preferred use of the asset. ***[Schedule 1, item 1, subsection 250-115(2)]***

Example 3.1: Apportionment rule

If Danco used an asset to which Division 250 applied but also used the asset during the relevant time for other contracts that do not involve tax preferred use and made an election for apportionment, then a relevant percentage of the capital allowances would be denied.

3.20 If the apportionment rule applies, the Commissioner may make a determination to apportion the reduction of a taxable entity's capital deductions ***[Schedule 1, item 1, subsection 250-115(3), items 1 to 9 in the table]***. The Commissioner's determination will specify the allowable percentage. The disallowed percentage will be 100% minus the allowable percentage ***[Schedule 1, item 1, subsection 250-115(4)]***. The allowable percentage cannot, however, exceed 50% ***[Schedule 1, item 1, subsection 250-115(5)]***.

Example 3.2: Commissioner's determination

The present value of the financial benefits from the tax preferred entity is 90% of the market value of the asset. Where there is a reasonable expectation that financial benefits will be provided by taxable users a reasonable apportionment could be to disallow 90% of the capital allowances.

3.21 Just as the table in section 250-110 sets out how capital allowance deductions are denied where Division 250 applies, the table in section 250-115 sets out how a partial deduction may be allowed under the respective capital allowance provisions. This is explained in the following paragraphs.

ITAA 1997

Subdivision 40-B

3.22 If the apportionment rule applies, the Commissioner may determine at the time for the purposes of Subdivision 40-B, that the taxable entity is taken to be using the asset for taxable purposes (producing assessable income, exploration or prospecting, mining site rehabilitation or environmental protection activities) to the extent specified, expressed as a specified percentage. ***[Schedule 1, item 1, subsection 250-115(3), item 1 in the table]***

Subdivision 40-F

3.23 If the apportionment rule applies, the Commissioner may determine at that time the application condition in section 40-525 is taken to be satisfied for the asset to a specified percentage. ***[Schedule 1, item 1, subsection 250-115(3), item 2 in the table]***

Subdivision 40-G

3.24 If the apportionment rule applies, the Commissioner may determine that where the asset is land, a taxable entity is taken to be using the land at the time for the purpose of carrying on a primary production business or a business for the purposes of producing assessable income from the use of rural land (except a business of mining operations) to the specified percentage. ***[Schedule 1, item 1, subsection 250-115(3), item 3 in the table]***

Subdivision 40-H

3.25 If the apportionment rule applies, the Commissioner may determine a taxable entity can deduct expenditure that it incurs in relation to the asset at that time to the specified percentage. ***[Schedule 1, item 1, subsection 250-115(3), item 4 in the table]***

Subdivision 40-I (including section 40-880)

3.26 If the apportionment rule applies, the Commissioner may determine at that time a taxable entity is taken to be using the asset for taxable purposes to the specified percentage. ***[Schedule 1, item 1, subsection 250-115(3), item 5 in the table]***

3.27 If the apportionment rule applies, the Commissioner may determine a taxable entity can deduct an amount for capital expenditure it incurs in relation to the asset to the specified percentage. ***[Schedule 1, item 1, subsection 250-115(3), item 6 in the table]***

Section 43-140

3.28 If the apportionment rule applies, the Commissioner may determine a taxable entity is taken to be using the asset at the time for the purposes of producing assessable income or carrying on research and development activities to the specified percentage. ***[Schedule 1, item 1, subsection 250-115(3), item 7 in the table]***

ITAA 1936

Section 73B

3.29 If the apportionment rule applies, the Commissioner may determine a taxable entity is taken to have qualifying expenditure at that time in relation to the use of the asset to the specified percentage. ***[Schedule 1, item 1, subsection 250-115(3), item 8 in the table]***

Section 73BC

3.30 If the apportionment rule applies, the Commissioner may determine at that time that the asset is taken to be used or installed ready for use for the purposes of carrying on by or on behalf of an eligible company of research and development activities to the specified percentage. ***[Schedule 1, item 1, subsection 250-115(3), item 9 in the table]***

3.31 The Commissioner, in making the determination is to consider and compare the sum of the present values of the financial benefits provided, or to be provided by the members of the tax preferred end user group for the tax preferred use of the asset to the market value of the asset, if they are known or can be reasonably estimated and any other relevant matter. ***[Schedule 1, item 1, subsection 250-115(6)]***

Chapter 4
Notional loan treatment of financial benefits provided for tax preferred use

Outline of chapter

4.1 Chapter 2 described the scope of Division 250, that is, the taxable entities and assets to which the Division applies. Chapter 3 explained how deductions for capital allowances to which a taxable entity would otherwise be entitled are to be denied or reduced where the Division applies.

4.2 When the Division applies to deny or reduce deductions for capital allowances, it applies a notional loan treatment to the financial benefits provided to the relevant taxable entity, by a tax preferred end user, for tax preferred use of an asset. The effect of the notional loan treatment is to alter the tax timing benefits of these arrangements by assessing as notional interest a component of the financial benefits, and to amortise, and not assess, the notional principal component attributable to the deductible cost of the asset.

4.3 The notional loan treatment adopts an accruals basis for bringing to account notional interest, subject to adjustments to reflect the amount and level of financial benefits actually provided as well as adjustments to be made when the tax preferred use of an asset finishes. A further consequence of notional loan treatment is the existence of rules for when Division 250 no longer applies to the asset. This chapter explains the application of notional loan treatment and its consequences.

Detailed explanation of new law

Notional loan treatment

Assessment of notional interest when accrual event occurs

4.4 Subdivision 250-D provides for notional interest to be included in assessable income where Division 250 applies. More specifically, where Division 250 applies to a taxable entity and an asset at a particular time and an accrual event ***[Schedule 1, item 1, subsection 250-130(1)]*** occurs at that time an amount equal to the notional interest amount ***[Schedule 1, item 1, subsection 250-135(1)]*** for the accrual period ***[Schedule 1, item 1, subsection 250-130(2)]*** for that accrual event is included in the taxable entity's assessable income for that income year ***[Schedule 1, item 1, subsection 250-120(1)]***.

4.5 Division 250 can apply to deny or reduce capital allowances in respect of a number of assets that would otherwise attract deductibility under different provisions of the income tax law: as explained in Chapter 3, this denial or reduction is effected through particular items in the tables in sections 250-110 and 250-115. Where multiple capital allowance deductions are denied or reduced:

- there is a separate notional interest amount for each of those items in the tables in sections 250-110 and 250-115 for each accrual event that occurs;
- there is a separate balance of the notional loan principal for each of those items; and
- a separate component of each financial benefit that is subject to the notional loan treatment and becomes due and payable is to be allocated to each of those items.

Financial benefits subject to the notional loan treatment

4.6 A financial benefit that is subject to notional loan treatment and is provided to a taxable entity in relation to the tax preferred use of the asset by a member of the tax preferred end user group or tax preferred sector ***[Schedule 1, item 1, subsection 250-125(2)]***, is not included in the taxable entity's assessable income ***[Schedule 1, item 1, subsection 250-125(1)]***. The reason for this is that the notional loan treatment already takes the financial benefits into account in determining how much is to be included in assessable income as notional interest. If the financial benefit is itself included in assessable income in these circumstances, there could be a double-counting of assessable amounts.

4.7 A financial benefit is subject to notional loan treatment if the financial benefit has been, will be or can, assuming normal operating conditions, reasonably be expected to be provided to a taxable entity or connected entity of a taxable entity and the financial benefit is provided by a member of the tax preferred sector in relation to the tax preferred use of the asset (and is not provided by a connected entity of the taxable entity). This is distinguished from financial benefits being provided for reasons other than for the tax preferred use of the asset, for example, as consideration for the provision of services. ***[Schedule 1, item 1, subsection 250-125(2)]***

4.8 A reasonable estimate of the end value of the asset ***[Schedule 1, item 1, section 250-160]*** is a financial benefit that is subject to the notional loan treatment:

- if the asset is not to be purchased or acquired by or transferred to the tax preferred end user or a connected entity at the end of the arrangement accrual period under a legally enforceable arrangement;
- if the asset is a privatised asset or would become a privatised asset if it were a depreciating asset; or
- where a taxable entity elects to have Division 250 apply. ***[Schedule 1, item 1, subsection 250-125(3)]***

Discussion of the rules for determining the end value of an asset is found in paragraphs 4.37 to 4.44.

4.9 The financial benefit is subject to the notional loan treatment only to the extent to which it represents a return of or on an investment in the asset rather than consideration for services rendered. In determining the extent that the financial benefit reflects a return of or on investment, factors to be considered include the market value of the asset, the discount rate used to calculate the expected low risk returns and the taxable entity's debt financing of the asset. Regulations may provide rules to determine the extent to which a financial benefit is a return on an asset. ***[Schedule 1, item 1, subsection 250-125(4)]***

Example 4.1: Financial benefits

Under a long term arrangement that falls within Division 250, Danco receives monthly payments from an Australian government department. Having regard to the discount rate for the asset (discussed in paragraphs 2.52 to 2.55) and the value of the asset, the financial benefits for the purposes of the notional loan for the relevant period equals 85% of the monthly payment while the other 15% of the payment is for services provided in connection with the arrangement for the tax preferred use of the asset. The financial benefits subject to the notional loan treatment are those 85% of the monthly payments relating to the tax preferred use of the asset.

4.10 Where the tax preferred use of an asset commences before Division 250 starts applying, to a taxable entity and an asset, only those financial benefits provided after Division 250 starts applying are subject to the notional loan treatment. ***[Schedule 1, item 1, subsection 250-125(5)]***

Accrual event and accrual period

4.11 An accrual event for an asset occurs when a financial benefit that is subject to notional loan treatment becomes due and payable, irrespective of whether it is actually paid or an income year ends ***[Schedule 1, item 1, subsection 250-130(1)]***. The accrual period for an accrual event is the period between the accrual event and the most recent earlier accrual event or between the accrual event and the start of the tax preferred use of the asset if the accrual event is the first accrual event for the asset ***[Schedule 1, item 1, subsection 250-130(2)]***.

Example 4.2: Accrual events

> Danco is paid on a monthly basis for a period of 3 years by an Australian government department. Accordingly, an accrual event occurs at the end of each month for those 3 years (i.e. when the payment from the Australian government department is due and payable) or at the end of each income year, that is, 36 accrual periods.

Calculation of notional interest amount for accrual period

4.12 The notional interest amount for the accrual period for that accrual event is calculated by multiplying the balance of the notional loan principal at the start of the accrual period ***[Schedule 1, item 1, subsections 250-135(2), (3) and (4)]*** by the notional compound interest rate (on a proportional compounding basis) ***[Schedule 1, item 1, subsection 250-135(1)]***. This notional interest amount is included in the taxable entity's assessable income for the income year in which the accrual event occurs ***[Schedule 1, item 1, subsection 250-120(1)]***.

4.13 At the start of the first accrual period, the balance of the notional loan principal is the undeducted tax cost ***[Schedule 1, item 1, subsection 250-135(5), items 1 to 3]*** of the relevant asset or relevant capital expenditure as at that time or the disallowed percentage of the undeducted tax cost for the relevant asset or relevant capital expenditure as at that time if the Commissioner has made a determination under subsection 250-115(3) ***[Schedule 1, item 1, subsection 250-135(3)]***. This alignment between the balance of the notional loan principal and the undeducted tax cost (or percentage thereof) is important in ensuring that the effect of Division 250 is to alter the timing of recognition of the cost of the asset for tax purposes, not the amount that is recognised.

4.14 The balance of the notional loan principal at the start of subsequent accrual periods is determined by using 3 steps. The first step is to take the balance of the notional loan principal for the first accrual period adding up the cumulative sum of notional interest amounts until the end of the accrual period preceding this particular accrual period (reference accrual period). The second step is to take the cumulative sum of the financial benefits that are subject to the notional loan treatment and that have become due and payable up until the end of the accrual period preceding the reference accrual period (which is the same as before the beginning of the reference accrual period). The final step is to deduct the amount calculated in step 2 from the amount calculated in step 1. ***[Schedule 1, item 1, subsection 250-135(4)]***

Example 4.3: Balance of notional loan principal

The opening balance of the notional loan principal at the beginning of the first accrual period is $200,000. The notional interest for the first accrual period is $14,399.58. The financial benefits provided are $25,000. The balance of the notional loan principal at the start of the second accrual period is therefore $189,399.58:

($200,000 + $14,399.58 – $25,000).

The notional interest for the second accrual period is $13,636.37 while the financial benefits provided are $25,000. The balance of the notional loan principal at the start of the third accrual period is $178,035.95:

($200,000 + ($14,399.58 + $13,636.37) – ($25,000 + $25,000)).

4.15 The undeducted tax cost of the relevant asset or relevant capital expenditure cost depends upon the type of relevant asset or capital expenditure. If the relevant asset is a depreciating asset (as defined in section 40-30 of the ITAA 1997), the undeducted tax cost is the adjustable value of the asset (as defined in subsection 995-1(1) of the ITAA 1997). Where the relevant capital expenditure falls within Division 40 of the ITAA 1997, the undeducted tax cost is the amount of the capital expenditure in respect of which a deduction has been denied under the relevant Subdivision of Division 40. If the relevant capital expenditure falls within Division 43, the undeducted tax cost is the undeducted construction expenditure (in accordance with sections 43-235 and 43-240 of the ITAA 1997) in relation to the capital expenditure. ***[Schedule 1, item 1, subsection 250-135(5), items 1 to 3]***

Calculation of the notional compound interest rate

4.16 The notional compound rate is the compound discount rate that, if applied to calculate the present value of the financial benefits that are subject to notional loan treatment (discussed in paragraph 4.8) and whose amounts or values are known or can reasonably be estimated, would give present values whose sum equals the opening balance of the notional loan principal at the beginning of the first accrual period. ***[Schedule 1, item 1, subsection 250-140(1)]***

4.17 Where the nominal amounts or values of all the financial benefits that are subject to the notional loan treatment are not known, or cannot be reasonably estimated, the Commissioner may determine the nominal amounts or value of those financial benefits. ***[Schedule 1, item 1, subsection 250-140(2)]***

4.18 In determining the nominal amounts or value of those financial benefits, the Commissioner is to have regard to:

- the nature of the use to which the asset is put including the nature of any project in which the asset is used;
- any arrangement that relates to the tax preferred use of the asset or the financial benefits to be provided by the members of the tax preferred sector (in relation to the tax preferred use of the asset); and
- any other relevant matters.

[Schedule 1, item 1, subsection 250-140(3)]

4.19 Regulations may be made that specify a method to be used in calculating the amount or value of a financial benefit that is subject to notional loan treatment. ***[Schedule 1, item 1, subsection 250-140(4)]***

What happens when the balance of the notional loan principal reaches nil or the estimated end value?

4.20 When the balance of the notional loan principal is reduced to nil for a relevant asset that is a depreciating asset, or the estimated end value of the relevant capital expenditure, all financial benefits that are subject to notional loan treatment that subsequently become payable are wholly included in a taxable entity's assessable income. ***[Schedule 1, item 1, section 250-145]***

4.21 The amount included in a taxable entity's assessable income when the balance of the notional loan principal is reduced to nil is calculated by taking all the actual financial benefits for the accrual period and deducting both the notional interest amount for that period and the amount of notional principal outstanding at the beginning of the accrual period.

Example 4.4: Notional principal reaches zero

> Where the notional principal reaches zero at the end of the eighth accrual period (which is the same as the start of the ninth accrual period) all the actual financial benefits payable after the notional principal reaches zero are included in the taxable entity's assessable income for the income year in which the ninth accrual period ends. This amount is calculated by taking all the actual financial benefits for the ninth accrual period and deducting the notional interest amount for the ninth accrual period and the amount of notional principal outstanding at the beginning of the ninth accrual period.

Negative and positive adjustment calculations

4.22 As discussed, the notional loan treatment under Division 250 adopts an accruals basis for recognising financial benefits for tax purposes. However, some financial benefits may be relatively uncertain as to timing or amount or both. It would be inappropriate to accrue such benefits. Accordingly, the notional loan treatment incorporates certain adjustments so as to reduce the impact that accruing such benefits would otherwise have.

4.23 The adjustment calculations ensure that, where the cumulative sum to date of the notional interest amounts differs from the cumulative sum to date of the actual financial benefits received, the amount included in assessable income for that tax year is the amount of the notional interest for the accrual periods that fall within that income year. Where these cumulative sums are equal there is no need to make any adjustments.

4.24 There are 4 steps in determining whether a taxable entity has a negative or positive adjustment for a particular income year. The first is to add:

- the cumulative sum from the start of the arrangement period until the end of the particular income year (reference year) of the notional interest amounts included in a taxable entity's assessable income under subsection 250-120(1);
- the cumulative sum from the start of the arrangement period until the end of the particular income year (reference year) of

amounts included in a taxable entity's assessable income under section 250-145; and

- the cumulative sum from the start of the arrangement period until the end of the particular income year (reference year) of the amounts included in a taxable entity's assessable income under subsection 250-150(3).

4.25 The second step is to add:

- the cumulative sum from the start of the arrangement period until the end of the particular income year (reference year) of the amounts of financial benefits that are subject to notional loan treatment and have become due and payable before the end of the reference year; and

- the cumulative sum from the start of the arrangement period until the year ending before the reference income year of the amount of any deductions in relation to the relevant asset or relevant capital expenditure.

4.26 By step 3, where the amount obtained in step 1 exceeds the amount in step 2, the taxable entity has a negative adjustment of the amount of the excess for the reference income year. By step 4, where the amount obtained in step 2 exceeds the amount in step 1, the taxable entity has a positive adjustment of the amount of the excess for the reference income year. If the amounts in step 1 and step 2 are equal, there is no excess in step 3 or step 4 and thus there is no negative or positive adjustment for that income year. ***[Schedule 1, item 1, subsection 250-150(1)]***

4.27 A taxable entity is entitled to a deduction for that income year of the lesser of the amount of the negative adjustment and the cumulative sum of the actual non-low risk financial benefits that are paid or due and payable before the end of the particular income year. ***[Schedule 1, item 1, subsection 250-150(2)]***

4.28 Where a taxable entity has a positive adjustment for the reference income year there are 4 steps to determine if the taxable income for the reference year includes an amount under subsection 250-150(3).

4.29 The first step is to add all the amounts that the taxable entity has deducted in earlier income years under subsection 250-150(2). The second is to add any amounts that the taxable entity has included under subsection 250-150(3) for income years prior to the reference income year in relation to the relevant asset or capital expenditure. The third step is to compare steps 1 and 2 and where the amount calculated under step 1 exceeds the amount calculated under step 2 the taxable entity's assessable income will include an amount under subsection 250-150(3) for the reference income year. Step 4 calculates the amount to be included in the taxable entity's assessable income as the lesser of the excess calculated in step 3 and the amount of the positive adjustment calculated under subsection 250-150(1) for the reference income year.

Example 4.5: Negative adjustments and positive adjustments

Under a lease arrangement that falls within Division 250, at the end of year 1 the notional interest payment is calculated to be $14.40 while the actual payment is $14.00. The financial benefit that is not an expected low risk return in that year is $5.00. At the end of year 2, the notional interest payment is calculated to be $14.49 while the actual payment is $20.00.

At the end of year 1 the sum of the notional interest to date is $14.40 (step 1) and the sum of the actual payments to date is $14.00 (step 2). As the amount under step 1 exceeds the amount under step 2 there will be a negative adjustment of $0.40 (i.e. $14.00 – $14.40). An amount of $0.40 is deductible under subsection 250-155(2) as this is less than the cumulative sum of actual non-low risk financial benefits of $5.00.

At the end of year 2 the sum of the notional interest to date is $28.89 (i.e. $14.40 + $14.49) (step 1) and the sum of actual payments to date is $34.00 (i.e. $14 + $20) and the sum of deductions under subsection 250-150(2) is $0.40 (step 2). Accordingly, as the amount under step 2 exceeds the amount in step 1 there is a positive adjustment of $5.51. An amount is to be included in assessable income for the second year as the cumulative sum of amounts previously deducted under subsection 250-150(2) exceed the cumulative sum of amounts included in assessable income under subsection 250-150(3). The amount is $0.40 as this is the lesser of the excess of the subsection 250-150(2) deductions over the subsection 250-150(3) and the positive adjustment of $5.51.

Adjustments when arrangement period ends

Recalculation of notional interest and principal components at the end of the tax preferred use of an asset

4.30 Where Division 250 applies to a taxable entity and an asset and the arrangement period ***[Schedule 1, item 1, section 250-35]*** for the tax preferred use of the asset ends, the difference between an amount calculated under subsection 250-155(4) and an amount calculated under subsection 250-150(6) is to be calculated ***[Schedule 1, item 1, subsection 250-155(1)]***. This is to ensure that the amount of financial benefits included in assessable income over the period of the arrangement is equal to the actual amount of benefits received.

Balancing assessable amount or deduction

4.31 If the first amount calculated ***[Schedule 1, item 1, subsection 250-155(2)]*** is greater than the second amount calculated ***[Schedule 1, item 1, subsection 250-155(6)]*** the excess is included in the taxable entity's assessable income for the income year in which the final accrual period ends. If the first amount is less than the second amount a deduction will be allowed for the income year in which the final accrual period ends ***[Schedule 1, item 1, subsection 250-155(3)]***.

Calculation of the amount under subsection 250-155(4)

4.32 There are 2 steps in calculating the amount under subsection 250-155(4). The first step is to add the amounts or values of all the actual financial benefits subject to the notional loan treatment and that have become due and payable. The second step is to deduct from the amount calculated under step 1 the opening balance of the notional loan principal at the start of the arrangement period. ***[Schedule 1, item 1, subsection 250-155(4)]***

4.33 Where the asset is not to be purchased, acquired by, or transferred to the tax preferred end user or a connected entity of a tax preferred end user at the end of the arrangement period under a valid contract, an amount equal to the end value of the asset is taken for the purposes of step 1 (in subsection 250-155(4)) to be a financial benefit, that is, the end value of the asset is included in the total of the financial benefits in step 1.

Calculation of the amount under subsection 250-155(6)

4.34 The amount to be calculated under subsection 250-155(6) uses 3 steps. The first step is to add:

- the sum of all the notional interest amounts included in a taxable entity's taxable income under subsection 250-120(1) during the arrangement period in relation to the relevant asset or capital expenditure;

- all the amounts included in a taxable entity's assessable income under section 250-145 during the arrangement period in relation to relevant asset or relevant capital expenditure; and

- any amounts included in the taxable entity's assessable income under subsection 250-150(3) during the arrangement period in relation to the relevant asset or relevant capital expenditure.

4.35 The second step is to add any amounts deducted from your assessable income under subsection 250-150(2) during the arrangement period in relation to the relevant asset or relevant capital expenditure. The final step is to deduct the amount calculated in step 2 from the amount calculated in step 1. ***[Schedule 1, item 1, subsection 250-155(6)]***

4.36 Where the asset is not to be purchased by or transferred to the tax preferred end user or a connected entity of the tax preferred end user, an amount equal to the actual end value of the asset is (subject to the effect of the apportionment rule discussed in paragraphs 3.17 to 3.21) taken to be a financial benefit that is subject to notional loan treatment and is paid or became due and payable on the last day of the final accrual period. ***[Schedule 1, item 1, subsection 250-155(5)]***

Example 4.6: Balancing amount

A depreciating asset that falls within Division 250 costs \$200 million. The sum of the actual financial benefits paid or due and payable for the tax preferred use of the asset over the term of the arrangement is \$162.5 million. The sum of the notional interest amounts was \$35 million and there were no adjustments as the result of negative adjustment and positive adjustment calculations. The asset is not to be purchased at the end by the tax preferred end user. The end value is \$76 million.

The first amount is \$38.5 million (i.e. \$162.5 million + \$76 million – \$200) whilst the second amount is \$35 million (i.e. \$35 million + \$0 – \$0). The difference between the 2 amounts is \$3.5 million. As the first amount exceeds the second amount a balancing amount of \$3.5 million is included in the taxable entity's assessable income for the income year in which the final accrual period ends.

End value of the asset

4.37 The end value of an asset is to be determined using the table in subsection 250-160(1). ***[Schedule 1, item 1, subsection 250-160(1), items 1 to 6 in the table]***

Item 1 in the table

4.38 Where the relevant asset is purchased, acquired by or transferred to the tax preferred end user (or a connected entity) prior to the end of the income year in which the arrangement period ends and the relevant asset would have had a termination value (in accordance with section 40-300 of the ITAA 1997) at the time of the purchase, acquisition or transfer if Division 250 had not applied, the end value is the amount that would have been the termination value. ***[Schedule 1, item 1, subsection 250-160(1), item 1 in the table]***

Item 2 in the table

4.39 Where the relevant asset is purchased, acquired by or transferred to the tax preferred end user (or a connected entity) prior to the end of the income year in which the arrangement period ends and the relevant asset would not have had a termination value (in accordance with section 40-300 of the ITAA 1997) at the time of the purchase, acquisition or transfer (if Division 250 had not applied) the end value is the capital proceeds for the disposal of the asset determined under Division 116 of the ITAA 1997. ***[Schedule 1, item 1, subsection 250-160(1), item 2 in the table]***

Item 3 in the table

4.40 Where the relevant asset is not purchased, acquired by or transferred to the tax preferred end user (or a connected entity) prior to the end of the income year in which the arrangement period ends and the relevant asset would have had a termination value (in accordance with section 40-300 of the ITAA 1997) if Division 250 had not applied to the asset and the end of the arrangement period were a balancing adjustment event, the end value is the amount that would have been the termination value if Division 250 had never applied to the asset and the end of the arrangement period were a balancing adjustment event. ***[Schedule 1, item 1, subsection 250-160(1), item 3 in the table]***

Item 4 in the table

4.41 Where the relevant asset is not purchased, acquired by or transferred to the tax preferred end user (or a connected entity) prior to the end of the income year in which the arrangement period ends and the relevant asset would not have had a termination value (in accordance with section 40-300 of the ITAA 1997) if Division 250 had not applied to the asset and the end of the arrangement period were a balancing adjustment event, the end value is the amount that would have been the adjustable value of the asset at the time when the arrangement period ended if Division 250 had never applied to the asset. ***[Schedule 1, item 1, subsection 250-160(1), item 4 in the table]***

Item 5 in the table

4.42 Where there is relevant capital expenditure, if expenditure that apart from Division 250 would have attracted a capital allowance deduction under Division 40 of the ITAA 1997, the end value is the amount of the capital expenditure less the capital allowance deductions that would have been allowable under Division 40 in relation to the expenditure if Division 250 had never applied. ***[Schedule 1, item 1, subsection 250-160(1), item 5 in the table]***

Item 6 in the table

4.43 Where the relevant capital expenditure if expenditure that apart from Division 250 would have attracted a capital allowance deduction under Division 43 of the ITAA 1997 the end value is the amount that would have been the undeducted construction expenditure in relation to the asset for the purpose of section 43-15 of the ITAA 1997 at the end of the arrangement period if Division 250 had never applied. ***[Schedule 1, item 1, subsection 250-160(1), item 6 in the table]***

More than one item in the table applies

4.44 If more than one item in the table in subsection 250-160(1) applies to a particular asset the end value is the sum of the end values for each item. ***[Schedule 1, item 1, subsection 250-160(2)]***

Treatment of the asset after Division 250 no longer applies to the asset

4.45 For the purposes of Division 40 of the ITAA 1997, if Division 250 applies to a taxable entity and an asset and the arrangement period ends and the asset would have had an adjustable value at that time if Division 250 had never applied to the asset, the adjustable value of the asset immediately after the end of the arrangement period is taken to be the end value of the asset. ***[Schedule 1, item 1, subsection 250-165(1)]***

4.46 For the purposes of Division 43 of the ITAA 1997, if Division 250 has applied to a taxable entity and an asset and the arrangement period ends and there would have been an undeducted construction expenditure in relation to the asset at that time if Division 250 had never applied to the asset, the undeducted construction expenditure in relation to the asset immediately after the end of the arrangement period is taken to be the end value of the asset. ***[Schedule 1, item 1, subsection 250-165(2)]***

4.47 If Division 250 has applied to a taxable entity and an asset and the arrangement period ends the cost base and reduced cost base of the asset are each taken to be reduced at the end of the arrangement period by an amount equal to the difference between:

- the sum of the financial benefits subject to the notional loan treatment for the arrangement period; and
- the net amount included in the taxable entity's assessable income under Division 250 in relation to the tax preferred use of the asset (taking into account deductions and amounts

included in assessable income under section 250-150) for the arrangement period.

[Schedule 1, item 1, subsection 250-165(3)]

Objections against the Commissioner's determinations and decisions

4.48 A provision has been inserted to provide a taxpayer with a right to appeal against an administrative determination or decision made by the Commissioner. More specifically, a taxable entity is not satisfied with a Commissioner's determination or decision to which section 250-170 applies may object against the determination or decision under Part IVC of the *Taxation Administration Act 1953*. ***[Schedule 1, item 1, subsection 250-170(3)]***

4.49 The Commissioner's determinations that section 250-170 applies are those in:

- subsection 250-10(3) where the Commissioner is requested to make a determination that it is unreasonable that Division 250 applies to a taxable entity and an asset at a particular time having regard to the circumstances that cause Division 250 to apply and to any other relevant circumstances;
- subsection 250-35(3) where the Commissioner is to determine on which day an arrangement period may reasonably be expected to or is likely to end;
- item 3 in the table in subsection 250-50(2) where the Commissioner is to determine the compound interest rate that reasonably reflects the pre-tax WACC for the asset;
- subsection 250-115(3) where the Commissioner may make one of 9 kinds of determination, if the apportionment rule applies (see paragraphs 3.22 to 3.31); and
- subsection 250-140(2) where the Commissioner may determine the nominal amounts or values of all the financial benefits that are subject to the notional loan treatment if they are not known or cannot be reasonably estimated.

[Schedule 1, item 1, subsection 250-170(1)]

4.50 The Commissioner's decision under section 250-80 by which the Commissioner is to provide an opinion as to the remaining expected life of the asset when the tax preferred use of an asset starts where the asset is either real property or non-real property. ***[Schedule 1, item 1, subsection 250-170(2)]***

Chapter 5
Consequential amendments

Outline of chapter

5.1 Chapter 5 explains the consequential amendments required as a result of the introduction of Division 250 to replace section 51AD and Division 16D of Part III of the ITAA 1936.

Detailed explanation of new law

DAAA 1992

5.2 The DAAA 1992 was introduced in 1992 to provide support for major capital works in the form of tax concessions for lenders. The scheme was administered by a project applying for a certificate, under which interest payments made by companies, corporate unit trusts and public trading trusts on capital borrowings related to specific property would not be taxable. The ability to apply for new certificates under the scheme was terminated in 1997.

5.3 There are 2 sections of the DAAA 1992 which refer to section 51AD and Division 16D. The first of these is section 93K which required that an applicant for a certificate have the intention of not causing section 51AD or Division 16D of Part III of the ITAA 1936 to apply to the relevant facilities.

5.4 The second section is section 93R, which imposes a condition on the certificate that if the certificate applies to a "direct infrastructure borrowing" the holder must not cause section 51AD or Division 16D to apply to the facilities to which the certificate applies. Under section 93ZB of the DAAA 1992, the Development Allowance Authority may cancel a certificate if the conditions under which it was granted are not complied with.

5.5 To ensure that the certificates are not cancelled because of the effective replacement of section 51AD and Division 16D of Part III by Division 250 amendments, inserting references to Division 250, have been made to paragraphs 92K(2)(c), 92K(4)(c), 93R(b)(v) and subparagraph

93R(c)(ii) of the DAAA 1992. ***[Schedule 1, items 33 to 36, paragraphs 92K(2)(c), 92K(4)(c), 93R(b)(v) and subparagraph 93R(c)(ii) of the DAAA 1992]***

ITAA 1936

Section 51AD

5.6 As Division 250 is effectively replacing section 51AD, property put to a tax preferred use on or after 1 July 2003, new subsections have been inserted in section 51AD and reference included in subsection 51AD(4) to this new subsection, to give effect to this. ***[Schedule 1, items 37 and 38, subsections 51AD(1A), (1B), (1C) and (4)]***

Sections 73B and 73BC

5.7 A note has been added to subsection 73B(15AA) to clarify that where Division 250 applies to a taxable entity and an asset the taxable entity is taken to have qualifying expenditure to the extent specified in a determination under subsection 250-115(3) of the ITAA 1997 or if Division 250 applies to a taxable entity and an asset but section 250-115 does not apply the taxable entity is not taken to have such qualifying expenditure. ***[Schedule 1, item 39, subsection 73B(15AA)]***

5.8 A note has been added to subsection 73BC(2) stating that where Division 250 applies to a taxable entity and an asset, and the apportionment rule in section 250-115 applies the asset is taken to be used or installed ready for use, for the purpose of carrying on, by or on behalf of the eligible company, of research and development activities to the extent specified in a determination made under subsection 250-115(3) of the ITAA 1997 or if Division 250 applies to a taxable entity and an asset but section 250-115 does not apply the asset is taken not to be used, or installed ready for use for such a purpose. ***[Schedule 1, items 40 and 41, subsection 73BC(2)]***

Division 16D of Part III

5.9 As Division 250 is replacing Division 16D for tax preferred financing arrangements entered into on or after 1 July 2003, subsection 159GH(1) has been amended to give effect to this. ***[Schedule 1, items 42 and 43, subsections 159GH(1) and (1A)]***

Subsection 170(10AA) item 175 in the table

5.10 Subsection 170(10AA) is to be amended to include a reference to Division 250. ***[Schedule 1, item 44, subsection 170(10AA)]***

ITAA 1997

Checklists

5.11 As a result of the amendments to the ITAA 1997, a number of references to terms used within Division 250 have been inserted into the checklists within the ITAA 1997. ***[Schedule 1, items 45 to 50, section 12-5]***

Capital allowances

5.12 A taxable purpose for the purposes of section 40-25 will be modified when Division 250 and section 250-115 does not apply. If Division 250 applies to a taxable entity and an asset (that is a depreciating asset) and if section 250-115 applies the taxable entity is taken to be using the depreciating asset for a taxable purpose to the extent specified in a determination made under subsection 250-115(3). However, if Division 250 applies to a taxable entity and an asset but section 250-115 does not apply, the taxable entity is taken to be using the asset for a taxable purpose. A note to this effect has been added to subsection 40-25(7). ***[Schedule 1, items 51 and 52, section 40-25 and subsection 40-25(7)]***

Primary production depreciating assets

5.13 Notes have been added to the end of subsections 40-525(1), 40-525(2) and 40-525(3) clarifying that a condition in those subsections are taken to be satisfied where Division 250 applies to a taxable entity and those particular assets and where section 250-115 applies to the extent specified in a determination under subsection 250-115(3). However, if Division 250 applies to a taxable entity and an asset but section 250-115 does not apply, the conditions in those subsections are taken not to be satisfied. ***[Schedule 1, items 53 to 55, subsections 40-525(1) to (3)]***

Landcare operations

5.14 At the end of subsection 40-630(1) a note has been added that provides that, if Division 250 applies to a taxable entity and an asset (being land) and section 250-115 applies, the taxable entity is taken to be using the land for the purpose of carrying on a primary production business or a business for the purposes of producing assessable income from the use of (rural) land (except a business of mining operations) to the extent specified in a determination made under subsection 250-115(3). If Division 250 applies to the taxable entity and the land but section 250-115 does not apply, the taxable entity is taken not to be using the land for such a purpose. ***[Schedule 1, item 56, subsection 40-630(1)]***

Expenditure on exploration or prospecting

5.15 At the end of subsection 40-730(1), a note has been added providing that, where Division 250 applies to a taxable entity and an asset, if section 250-115 applies then the taxable entity can deduct expenditure it incurs in relation to the asset/land to the extent specified in a determination made under subsection 250-115(3). However, if Division 250 applies but section 250-115 does not apply, the taxable entity cannot deduct such expenditures. ***[Schedule 1, item 57, subsection 40-730(1)]***

Expenditure of mining site rehabilitation

5.16 At the end of subsection 40-735(1), a note has been added providing that, where Division 250 applies to a taxable entity and an asset, if section 250-115 applies then the taxable entity can deduct expenditure it incurs in relation to the asset/land to the extent specified in a determination made under subsection 250-115(3). However, if Division 250 applies but section 250-115 does not apply, the taxable entity cannot deduct such expenditures. ***[Schedule 1, items 58 and 59, subsection 40-735(1)]***

Payments of petroleum resource rent tax

5.17 At the end of subsection 40-750(1), a note has been added providing that, where Division 250 applies to a taxable entity and an asset, if section 250-115 applies then the taxable entity can deduct expenditure it incurs in relation to the asset/land to the extent specified in a determination made under subsection 250-115(3). However, if Division 250 applies but section 250-115 does not apply, the taxable entity cannot deduct such expenditures. ***[Schedule 1, items 60 and 61 , subsection 40-750(1)]***

Environmental protection activities

5.18 At the end of subsection 40-755(1), a note has been added providing that where Division 250 applies to a taxable entity and an asset, if section 250-115 applies then the taxable entity can deduct expenditure it incurs in relation to the asset/land to the extent specified in a determination made under subsection 250-115(3). However, if Division 250 applies but section 250-115 does not apply, the taxable entity cannot deduct such expenditures. ***[Schedule 1, item 62, subsection 40-755(1)]***

Project pools

5.19 At the end of section 40-835, a note has been added providing that, where Division 250 applies to a taxable entity and an asset, if section 250-115 applies then the taxable entity is taken to be using the asset for taxable purposes to the extent specified in a determination made under subsection 250-115(3). However, if Division 250 applies but section 250-115 does not apply then the taxable entity will be taken not to be using the asset for taxable purposes. ***[Schedule 1, item 63, section 40-835]***

Business related costs

5.20 At the end of subsection 40-880(1), a note has been added providing that, where Division 250 applies to a taxable entity and an asset, and section 250-115 applies then the taxable entity can deduct an amount for capital expenditure it incurs in relation to the asset to the extent specified in a determination made under subsection 250-115(3). However, if Division 250 applies but section 250-115 does not apply, the taxable entity cannot deduct such capital expenditure. ***[Schedule 1, item 64, subsection 40-880(1)]***

Uses of capital works

5.21 At the end of subsection 43-140(1), a note has been added providing that, where Division 250 applies to a taxable entity and an asset that is a capital work, and section 250-115 applies then the taxable entity is taken to be using that asset for the purpose of producing assessable income or for the purposes of carrying on research and development activities, to the extent specified in a determination made under subsection 250-115(3). However, if Division 250 applies but section 250-115 does not apply, the taxable entity is not taken to be using the asset for such a purpose. ***[Schedule 1, items 65 and 66, subsection 43-140(1)]***

Cost base modifications

5.22 A reference to the cost base modification rules that apply when Division 250 no longer applies to an asset has been inserted after item 24 in the table in section 112-97. ***[Schedule 1, item 67, section 112-97]***

Land transport facilities borrowing

5.23 The example at the end of subsection 396-75(2) has been replaced by another example providing that the Commissioner may advise the relevant Minister that a lender is a non-resident, or that section 51AD of the ITAA 1936 may apply to the project or that Division 250 may apply in relation to the project. ***[Schedule 1, item 68, subsection 396-75(2)]***

5.24 Paragraph 396-85(1)(c) has been replaced by a new paragraph which contains an additional condition for land transport facilities borrowing agreements. This additional condition is that the borrower will not cause Division 250 to apply to any of the facilities concerned. ***[Schedule 1, item 69, paragraph 396-85(1)(c)]***

Debt/equity measures

5.25 Subparagraph 974-130(4)(a)(vi) provides another condition for a lease or bailment not to be taken to be entered into raise finance. The additional condition is that the leased or bailment is not an arrangement to which Division 250 applies. In other words, if all the other conditions are satisfied but Division 250 applies the lease or bailment will be taken to raise finance. ***[Schedule 1, item 70, subparagraph 974-130(4)(a)(vi)]***

Chapter 6
Division 250 example

Outline of chapter

6.1 Chapter 6 contains an example that illustrates how the proposed amendments would apply to a taxable entity with an arrangement that falls within the scope of Division 250.

Detailed example of new law

6.2 This example shows how Division 250 applies to an arrangement in relation to an asset put to a tax preferred use and the consequences of Division 250 applying.

The facts scenario

6.3 An Australian resident company, Specialised Equipment Co (the entity) contracts with an Australian government agency (tax exempt entity) to provide specialised equipment and specialised support services for a period of 10 years.

6.4 The Australian government agency is to provide financial benefits, at the end of each income year, comprising a component for the availability of the equipment at a certain operational standard and a component for operational assistance (including operation of hardware and software applications) services. The expected financial benefits payable for the tax preferred use of the specialised equipment are estimated in Table 6.1, column 2. It is assumed that 80% of the expected financial benefits are low risk. All software is licensed directly to the tax preferred entity from third parties. The assets will be used by employees of the agency and by members of the public to utilise the services of the agency.

6.5 The agreement is able to be terminated by the Australian government agency (the tax preferred entity) but in that event the Australian government agency is required to provide a financial benefit at least equal to the unrecouped value of the specialised equipment supplied.

6.6 Before the acquisition of the specialised equipment, Specialised Equipment Co has total assets of $50 million, represented by total debt of $35 million and total equity of $15 million. Specialised Equipment Co acquires the specialised equipment from the manufacturer for $100 million utilising entirely debt and would, but for Division 250, be entitled to capital allowance deductions in respect of the decline in value of the assets. After acquisition of the assets, Specialised Equipment Co has total assets of $150 million, represented by total debt of $135 million and total equity of $15 million. The Australian government agency is not purchasing the specialised equipment at the end of the arrangement period – which has an estimated end value of nil. There is no requirement to replace the assets during the period of the contract.

6.7 At the start of the arrangement period Specialised Equipment Co has an STS average turnover of $20 million, and its pre-tax WACC is 7.2% per annum, compounded annually.

Application of Division 250 to a taxable entity and an asset

6.8 Division 250 would apply to Specialised Equipment Co (the taxable entity) and the specialised equipment because:

- the specialised equipment is being put to a tax preferred use;
- the arrangement period is greater than 12 months – the contract is for a period of 10 years;
- financial benefits are to be provided to Specialised Equipment Co by the Australian government agency, which is a tax preferred end user;
- at the start of the arrangement period, the present value of those financial benefits is greater than 10% of the market value of the equipment;
- those financial benefits include low risk benefits;
- Specialised Equipment Co would otherwise be entitled to a capital deduction for a decline in the value of the equipment or for capital expenditure in relation to the equipment;
- Specialised Equipment Co does not have a predominant economic interest in the specialised equipment; and
- Specialised Equipment Co is not eligible to be an STS taxpayer under section 328-365 of the ITAA 1997.

These factors are consider below at paragraphs 6.9 to 6.21.

The asset is being put to a tax preferred use at the time

6.9 The specialised equipment will be put to a tax preferred use as the assets will be used by either the Australian government agency (the tax preferred entity) or members of the public and will also constitute facilities that are provided for the benefit, or on behalf, of the tax preferred entity.

The arrangement period is greater than 12 months

6.10 Under the terms of the contract the arrangement period is for 10 years. It begins at the start of the 10 year contract and ends when the tax preferred use of the asset is expected to end 10 years later.

Financial benefits to be provided to be provided by a tax preferred end user

6.11 The financial benefits that are to be provided to Specialised Equipment Co, at the end of each income year, for the availability of the equipment and the operational assistance in respect of those assets are financial benefits provided in relation to the use of the equipment that is to be used by, or for the benefit of, the tax preferred entity. Since Specialised Equipment Co is a tax preferred entity, this condition will be satisfied.

Present value of financial benefits greater than 10% of the market value of the asset

6.12 At the start of the arrangement period the present value of the expected financial benefits provided for the tax preferred use of specialised equipment to Specialised Equipment Co using its pre-tax WACC is \$100.005 million which exceeds 10% of the market value of the equipment, namely \$10 million.

The financial benefits include low risk benefits

6.13 The financial benefits received by Specialised Equipment Co include low risk financial benefits.

Specialised Equipment Co would be otherwise entitled to a capital allowance deduction

6.14 Specialised Equipment Co would be otherwise entitled to a capital allowance deduction for a decline in the value of the specialised equipment under Subdivision 40-B of the ITAA 1997.

No predominant economic interest in the specialised equipment

Test 1 (assumed risk in relation to asset)

6.15 Test 1 would be satisfied should the realisable value of the assets be nil. Under the terms of the loan, Specialised Equipment Co's loss of its investment in the asset would be to the extent of its loss of net assets (assets – liabilities = $15 million). This would be less than 20% of the market value of the specialised equipment when first put to a tax preferred end use (i.e. 20% of $100 million = $20 million).

Test 2 (level of expected low risk returns)

6.16 Test 2 will be satisfied as the present value of Specialised Equipment Co's expected low risk returns from the tax preferred use of the asset will exceed 50% of the market value of the specialised equipment of $100 million.

6.17 The steps used to calculate expected low risk returns are as follows:

1. Determine the arrangement period for the asset.

2. Determine the estimated financial benefits for the asset for the arrangement period.

3. Calculate the internal rate of return for the assets from these estimated financial benefits (7.2% per annum).

4. Calculate the pre-tax WACC for the asset (7.2%).

5. The lower of steps 2 and 3 (7.2% per annum) is used to discount the low risk financial benefits to calculate the expected low risk returns.

6. Determine the estimated low risk financial benefits for the asset.

7. Calculate the expected low risk returns by calculating the present value of the low risk financial benefits using the discount rate in step 5 (see Table 6.1).

8. Calculate the expected low risks returns by multiplying the estimated financial benefits in Table 6.1, column 2 by 80% then discount these amounts using the pre-tax WACC. The sum of these amounts is $81, 732, 000. Compare the expected low risk returns to the market value of the asset. The expected low risk returns for the assets is $81,732,000, as this exceeds 50% of the market value of the asset (i.e. 50% of $100,000,000 = $50,000,000) test 2 applies.

Test 3 (effectively non-cancellable, long term arrangement)

6.18 The first element of test 3 will be satisfied as the arrangement is effectively non-cancellable. The tax preferred entity would in the event of terminating the arrangement have to pay an amount equal to the value of the assets at the time of termination. The second element of test 3 would also be satisfied if the arrangement period in relation to each asset (10 years) is greater than the relevant percentage (75%) of the effective life of the asset at the commencement time (when the assets are first used or installed ready for use).

Test 4 (right to acquire asset)

6.19 Test 4 will not be satisfied as the tax preferred end user will not have, even on termination, the right to purchase or require the transfer of the asset.

Test 5 (prior ownership by a member of the tax preferred end user group)

6.20 Test 5 will not be satisfied as a tax preferred end user did not own the assets, and use or hold the assets for use, before acquisition by Specialised Equipment Co.

The taxable entity is not eligible to be an STS taxpayer

6.21 By section 328-365 of the ITAA 1997 a taxpayer is eligible to be an STS taxpayer if the taxpayer carries on business in an income year, the taxpayer's STS average turnover for that year is less than $1 million and the sum of the adjustable values of the depreciating assets held at the end of the year is less than $3 million. At the start of the arrangement period, Specialised Equipment Co is not eligible to be an STS taxpayer as its average STS turnover of $20 million is greater than $1 million and the adjustable values of the assets of $50 million is in excess of the $3 million threshold.

Consequences of Division 250 applying

Denial of or reduction in capital deductions

6.22 As Division 250 applies under item 1 of section 250-115, Specialised Equipment Co is taken not to be using the asset for taxable purposes at that time. This would result in the denial of the otherwise allowable capital allowance deductions (undeducted tax cost) under Subdivision 40-B of the ITAA 1997.

Financial benefits subject to notional loan treatment

Assessment of notional interest when accrual event occurs

6.23 As Division 250 applies to Specialised Equipment Co and the specialised equipment – and an accrual event occurs at the end of each income year for 10 years – an amount equal to the notional interest amount for each accrual period, subject to any amounts deducted as a result of negative adjustment calculations or any amounts added as a result of positive adjustment calculations, is included in Specialised Equipment Co's assessable income for that income year.

6.24 Specialised Equipment Co has to calculate the expected financial benefits attributable to the asset for the 10 year arrangement period. These expected financial benefits should, in general, be available as part of the contracting or tendering process when entering into the arrangement with the tax preferred end user. They could have been used in applying test 2 of the predominant economic interest tests. The nominal amount of the financial benefits attributable to the asset may also be derived using the discount rate in test 2 which, if applied to those amounts and having regard to the expected payment profile under the arrangement, would give a present value equal to the fair market value of the asset.

6.25 The actual financial benefits of the assets may not be known until the end of the accrual period because this is when the payments are paid, or due and payable, to Specialised Equipment Co.

6.26 The methodology to determine the amounts to be included in assessable income follows:

First accrual period

1. Determine the opening balance of the notional loan principal for the asset. In this case it is the undeducted tax cost of the asset of $100 million.

2. Estimate financial benefits for the asset for the term of the arrangement period. See paragraph 6.24 and column 2 of Table 6.1.

3. Calculate the notional compound interest rate based on the IRR using as the cash flows the notional principal in step 1 (i.e. $100 million outflow) and the estimated financial benefits from step 2. This is 7.2% per annum, compounding annually.

4. To calculate the notional interest amount for the first accrual period, multiply the opening balance of the notional loan principal in step 1 for the first accrual period by the notional compound interest rate in step 2.

This amount of \$7.2 million (\$100 million $\times$ 7.2%) is assessable income.

Assessable and deductible adjustments

5. Calculate the cumulative sum of notional interest amounts for the first income year. As this is the first accrual period this will be the same as calculated in step 4 that is, \$7.2 million.

6. Calculate the amount included in assessable income when the balance of the notional loan principal reaches nil or the estimated end value for income years prior to the first year. This will be nil because there are no prior income years.

7. Calculate the amounts included in assessable income resulting from a positive adjustment for prior income years. This will be nil as this is the first income year there is no prior income year.

8. Add the amounts from steps 5 to 7. This is \$7.2 million (i.e. \$7.2 million + \$0 + \$0).

9. Calculate the cumulative sum of the actual financial benefits until the end of the first income year. This is \$15 million (see Table 6.1).

10. Calculate the amounts deducted resulting from a negative adjustment for income years earlier than the first income year. This will be nil as this is the first income year there is no prior income year.

11. Add the amounts from steps 9 and 10. This is \$15 million.

12. Determine if the amount in step 8 exceeds step 11 or vice versa. If step 8 exceeds step 11 there is a negative adjustment, and if step 11 exceeds step 8, there is a positive adjustment. In this case as step 11 exceeds step 8 there is a positive adjustment of \$7.8 million (i.e. \$15 million – \$7.2 million).

13. Determine if the positive adjustment results in an amount being included in assessable income. This is done by:

- calculating the cumulative sum of the amounts deducted resulting from a negative adjustment in income years prior to the first income year. This will be nil as there are no prior income years; and
- calculating the cumulative sum of amounts included in assessable income resulting from a positive adjustment for

income years prior to the first income year. This will be nil as there are no prior income years.

14. As both amounts are nil there are no amounts included in assessable income resulting from a positive adjustment for the first income year. The assessable income for the first year will be $7.2 million, that is, the notional interest amount.

There are no assessable or deductible adjustments.

Second accrual period

1. Calculate the opening balance of the notional principal for the second accrual period by taking the opening balance of the notional principal at the start of the first accrual period ($100 million) and adding the cumulative sum of notional interest amounts before the second accrual period ($7.2 million) and deducting the cumulative sum of actual financial benefits paid or due and payable before the start of the second accrual period ($15 million). This gives an opening balance of the notional principal of $92.2 million.

2. To calculate the notional interest amount for the second accrual period multiply the opening balance of the notional loan principal for the second accrual period in step 1 by the notional compound interest rate. This is $6.64 million (i.e. $92.2 million × 7.2% per annum). This amount is assessable income.

Assessable and deductible adjustments

3. Calculate the cumulative sum of notional interest amounts for the second income year and the first income year. This is $13.84 million ($7.2 million + $6.64 million).

4. Calculate the amount included in assessable income when the balance of the notional loan principal reaches nil or the estimated end value for income years prior to the second income year. This will be nil because the notional principal has not reached nil, which is also the end value.

5. Calculate the amounts included in assessable income resulting from a positive adjustment for prior income years. This will be nil as no amount was included in the first income year.

6. Add the amounts from steps 3 to 5. This is $13.84 million (i.e. $13.84 million + $0 + $0).

7. Calculate the cumulative sum of the actual financial benefits until the end of the second income year. This is $30 million ($15 million from the first income year and $15 million from the second income year).

8. Calculate the amounts deducted resulting from a negative adjustment for income years earlier than the first income year. This will be nil; no amount was deducted in the first income year.

9. Add the amounts from steps 7 and 8. This is $30 million.

10. Determine if the amount in step 5 exceeds step 8 or vice versa. If step 5 exceeds step 8 there is a negative adjustment, and if step 8 exceeds step 5 there is a positive adjustment. In this case, as step 8 exceeds step 5 there is a positive adjustment of $16.16 million
(i.e. $30 million – $13.84 million).

11. Determine if the positive adjustment results in an amount being included in assessable income. This is done by:

- calculating the cumulative sum of the amounts deducted resulting from a negative adjustment in income years prior to the second income year. This will be nil as there were no amounts deducted resulting from a negative adjustment in the first income year; and

- calculating the cumulative sum of amounts included in assessable income resulting from a positive adjustment for income years prior to the first income year. This will be nil as there were no amounts included in assessable income resulting from a positive adjustment in the first income year.

12. As both amounts are nil there are no amounts included in assessable income resulting from a positive adjustment for the first income year. The assessable income for the first year will be $6.64 million, that is, the notional interest amount.

13. Calculate the opening balance of the notional principal for the third accrual period by taking the opening balance of the notional principal at the start of the first accrual period ($100 million), and adding the cumulative sum of notional interest amounts before the third accrual period ($13.84 million), and deducting the cumulative sum of actual financial benefits paid or due and payable before the start of the third accrual period ($30 million). This gives an opening balance of the notional principal of $83.84 million.

14. This methodology is applied for each of the accrual periods before the final accrual period but in this example there is a variation in the ninth accrual period because the notional principal reduces to zero during the ninth accrual period.

Ninth accrual period

1. To calculate the notional interest amount for the ninth accrual period multiply the opening balance of the notional loan principal for the ninth accrual period. This is $0.82 million (i.e. $11.34 million × 7.2% per annum). This amount is assessable income.

Assessable and deductible adjustments

2. Calculate the cumulative sum of notional interest amounts for the ninth income year and earlier income years. This is $39.67 million:
($7.2 million + $6.64 million + $6.04 million + $5.39 million + $4.70 million + $3.96 million + $2.98 million + $1.94 million + $0.82 million).

3. Calculate the amount included in assessable income when the balance of the notional loan principal reaches nil or the estimated end value for income years prior to the ninth income year. As the notional principal reaches zero during the ninth accrual period rather than an earlier year this is nil for the ninth income year.

4. Calculate the amounts included in assessable income resulting from a positive adjustment for prior income years. This will be nil as no amount resulting from a positive adjustment was included in any prior year.

5. Add the amounts from steps 2 to 4. This is $39.67 million (i.e. $39.67 million + $0 + $0).

6. Calculate the cumulative sum of the actual financial benefits until the end of the ninth income year. This is $145 million ($15 million for each income year from the first income year to the fifth income year (i.e. $15m × 5) and $17.5 million for each income year from the sixth income year to the ninth income year (i.e. $17.5 million × 4)).

7. Calculate the amounts deducted resulting from a negative adjustment for income years earlier than the ninth income year. This will be nil as there have been no deductions resulting from negative adjustments to date.

8. Add the amounts from steps 6 and 7. This is $145 million.

9. Determine if the amount in step 5 exceeds step 8 or vice versa. If step 5 exceeds step 8 there is a negative adjustment and if step 8 exceeds step 5 there is a positive adjustment. In this case as step 8 exceeds step 5 there is a positive adjustment of $105.33 million
(i.e. $145 million – $39.67 million).

10. Determine if the positive adjustments result in an amount being included in assessable income. This is done by:

- calculating the cumulative sum of the amounts deducted resulting from a negative adjustment in income years prior to the ninth income year. This will be nil as there were no amounts deducted resulting from a negative adjustment in the income years to date; and

- calculating the cumulative sum of amounts included in assessable income resulting from a positive adjustment for income years prior to the ninth income year. This will be nil as there were no amounts included in assessable income resulting from a positive adjustment in income years to date.

11. As both amounts are nil there are no amounts included in assessable income resulting from a positive adjustment for the ninth income year. The assessable income for the ninth income year will be $6.16 million (i.e. $5.34 million because the notional principal was reduced to zero and $0.82 million notional interest amount).

12. As the notional principal reached zero during the ninth accrual period this gives an opening balance of the notional principal of nil for the tenth accrual period.

Final accrual period

1. To calculate the notional interest amount for the tenth accrual period multiply the opening balance of the notional loan principal for the tenth accrual period. This is nil (i.e. $0 × 7.2% per annum).

Assessable and deductible adjustments

2. Calculate the cumulative sum of notional interest amounts for the tenth income year and earlier income years. This is $39.67 million:
($7.2 million + $6.64 million + $6.04 million + $5.39 million + $4.70 million + $3.96 million + $2.98 million + $1.94 million + $0.82 million + nil).

3. Calculate the amount included in assessable income when the balance of the notional loan principal reaches nil or the estimated end value for income years prior to the tenth income year. As the notional principal reached zero during the ninth accrual period all the actual financial benefits payable after the notional principal reaches zero are included in Specialised Equipment Co's assessable income. This was an amount of $5.34 million which is calculated by taking all the actual financial benefits for the ninth accrual period ($17.5 million) and deducting the notional interest amount for the ninth accrual period ($0.82 million) and the amount of notional principal outstanding at the beginning of the ninth accrual period ($11.34 million).

4. Calculate the amounts included in assessable income resulting from a positive adjustment for prior income years. This will be nil as no amount resulting from a positive adjustment was included in any prior year.

5. Add the amounts from steps 2 to 4. This is $45.01 million (i.e. $39.67 million + $5.34 million + $0).

6. Calculate the cumulative sum of the actual financial benefits until the end of the tenth income year. This is $162.50 ($15 million from the first income year to the fifth income year and $17.5 million from the sixth income year to the tenth income year).

7. Calculate the amounts deducted resulting from a negative adjustment for income years earlier than the tenth income year. This will be nil as there have been no deductions resulting from negative adjustments to date.

8. Add the amounts from steps 6 and 7. This is $162.5 million.

9. Determine if the amount in step 5 exceeds step 8 or vice versa. If step 5 exceeds step 8 there is a negative adjustment and if step 8 exceeds step 5 there is a positive adjustment. In this case as step 8 exceeds step 5 there is a positive adjustment of $117.49 million (i.e. $162.5 million – $45.01 million).

10. Determine if the positive adjustment results in an amount being included in assessable income. This is done by:

- calculating the cumulative sum of the amounts deducted resulting from a negative adjustment in income years prior to the tenth income year. This will be nil as there were no amounts deducted resulting from a negative adjustment in the income years to date; and

- calculating the cumulative sum of amounts included in assessable income resulting from a positive adjustment for income years prior to the tenth income year. This will be nil as there were no amounts included in assessable income resulting from a positive adjustment in income years to date.

11. As both amounts are nil there are no amounts included in assessable income resulting from a positive adjustment for the ninth income year. The assessable income for the ninth income year will be \$17.5 million (i.e. \$17.5 million because the notional principal was reduced to zero).

Table 6.1

1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**
Year	***Estimated***	***Notional***	***Actual***	***FB less***	***Cumulative***	***Negative***	***Subsection***	***Net tax***	***Notional***	***NP = 0 or***	***Assessable***
	financial	***interest***	***financial***	***Notional***	***sum FB less***	***adjustment***	***250-150(2)***	***position***	***principal***	***end value***	***income***
	benefits	***(NI) 7.2%***	***benefits***	***interest***	***cum sum***		***deductions***		***(NP)***	***section***	
	(FB)			***per annum***	***NI***					***250-145***	
	$ million		***$ million***	***$ million***	***$ million***	***$ million***	***$ million***	***$ million***	***$ million***	***$ million***	***$ million***
0	-100.00								**100.00**		
1	12.24	**7.20**	15.00	7.80	7.80	0.00	0.00	7.20	**92.20**	0.00	7.20
2	12.73	**6.64**	15.00	8.36	16.16	0.00	0.00	6.64	**83.84**	0.00	6.64
3	13.24	**6.04**	15.00	8.96	25.13	0.00	0.00	6.04	**74.87**	0.00	6.04
4	13.77	**5.39**	15.00	9.61	34.73	0.00	0.00	5.39	**65.27**	0.00	5.39
5	14.32	**4.70**	15.00	10.30	45.04	0.00	0.00	4.70	**54.96**	0.00	4.70
6	14.89	**3.96**	17.50	13.54	58.58	0.00	0.00	3.96	**41.42**	0.00	3.96
7	15.49	**2.98**	17.50	14.52	73.10	0.00	0.00	2.98	**26.90**	0.00	2.98
8	16.11	**1.94**	17.50	15.56	88.66	0.00	0.00	1.94	**11.34**	0.00	1.94
9	16.75	**0.82**	17.50	16.68	105.34	0.00	0.00	0.82	**0.00**	5.34	6.16
10	17.42	**0.00**	17.50	17.50	122.84	0.00	0.00	0.00	**0.00**	17.50	17.50
	146.95	***39.66***	*162.50*					*39.66*		*22.84*	62.50
Internal rate of return	7.2%										
Low risk financial benefits = 80% of expected financial benefits											

Adjustments when tax preferred use of assets ends

6.27 The assets that fall within Division 250 cost $100 million. The sum of the actual financial benefits paid or due and payable for the tax preferred use of the asset over the term of the arrangement is $185.3 million (i.e. $162.5 million + $22.8 million). The sum of the notional interest amounts was $39.7 million (see Table 6.1, column 3), but there were no adjustments as the result of negative adjustment and positive adjustment calculations. However, $22.8 million was included in assessable income as the notional principal reached zero. The asset is not to be purchased at the end by the tax preferred end user.

6.28 Where Division 250 applies to a taxable entity and an asset, at the end of the arrangement period the difference is to be calculated between the amounts calculated under subsections 250-155(4) and (6).

6.29 The first amount is calculated by taking the total of all the actual financial benefits that were subject to the notional loan treatment $162.5 million and deducting the opening balance of the notional loan principal ($100 million). The first amount is $62.5 million.

6.30 The second amount is calculated by adding the total notional interest amounts ($39.7 million) and amounts included in assessable income over the arrangement period under section 250-145 when the notional principal equals nil or the estimated end value ($17.5 million + $5.3 million). This is to be reduced by the amounts deducted over the arrangement period under subsection 250-150(2) ($0). The second amount is $62.5 million.

6.31 The second amount is then deducted from the first amount. As there is no difference between the first and second amount there is no excess and no balancing adjustment is made to the assessable income for the final accrual period.

Treatment of the asset after Division 250 no longer applies

6.32 Where the asset is not acquired by the tax preferred end user, the adjustable value of the asset immediately after the arrangement period for the purposes of Division 40 will be the end value of the asset as per item 5 in the table in section 250-150.

Index

Schedule 1: Tax preferred entities (asset financing)

Bill reference	*Paragraph number*
Item 1, subsection 250-5(1)	1.19, 1.27
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