TAX UPDATE - THE NEW ENVIRONMENT

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TAX EFFECTIVE FINANCING ARRANGEMENTS

On the 20th of December 1988 the Treasurer announced a review of the economic and taxation issues associated with the transfer of benefits available under this Income Tax Assessment Act 1936 ("the Tax Act") from a tax payer to another person such as a financier. He indicated that the Government intended that tax benefits provided by the Tax Act should only be available to the tax payers who were the intended direct recipients of such benefits. He also indicated that traditional forms of passing tax benefits in a genuine way from one tax payer to another such as by leasing arrangements were not intended to be affected by this review.

There has been no further news of this review since that time. This has left the market in a condition of uncertainty as to what the outcome of the review will be. Into the gap has stepped the Commissioner of Taxation, Mr Boucher. He has now announced in several different fora including a celebrated lunch time address to the CEDA lunch in Brisbane in September last year that he is adopting a "back to fundamentals" and a "substance over form" approach in reviewing all financing arrangements that make use of tax benefits declaring "income is income" and that he will tax it wherever he can find it. In this environment tax arbitrage is anathema because structuring a transaction so that one tax payer will pay the least tax possible means to the Commissioner that another Australian pays more tax.

The Commissioner is particularly keen to target banks and other financial institutions in this regard. They are guilty he says of lending money in forms other than loans and deriving a tax advantage by receiving what is really interest income in tax preferred forms such as rebateable dividends of tax free trust distributions. The Commissioner is determined that profit by whatever name will be assessed as income. If anyone challenges his view he raises the spectre of applying Part IVA.

When tax effective financing techniques succeed the cost of funds for businesses and developments is lower. Mr Boucher may see that as an anomaly which leads to a misallocation of resources in our economy. However, if funding was provided by financial institutions only by way of loans then although these financial institutions would receive more assessable interest income (in theory) borrowers also have a larger deduction available to claim against their assessable income (also in theory). The tax take overall, one would consider would not be affected. In practice however many marginally profitable developments and projects seem to proceed because of the availability of tax effective financing techniques. One cannot help but wonder if really the argument is not so much about tax avoidance as about the possibility of misallocation of resources in our economy through the availability for some projects and developments of tax effective financing techniques lowering the cost of funds for those projects and diverting funding away from other projects. However even to state that proposition would seem to reveal a flaw in reasoning because if a project is justifiable in its own right it would seem that ultimately it will find funding regardless of the availability of tax effective financing techniques.

The development of the debate in relation to tax effective financing techniques has been much advanced in the last 12 months. There was first the decision of the High Court in the Myer Emporium case (FCT v. Myer Emporium Ltd 87 ATC 4363) (hailed as a watershed in the interpretation of s.25(1) of the Tax Act); a number of significant taxation rulings; and several interesting lower court and Tribunal decisions.

MYER EMPORIUM CASE

The Full High Court in this case determined that the proceeds from assignment by Myer of the right to receive interest income derived from a loan which it had paid to a subsidiary were not in the nature of capital receipt but rather income. There are two essential reasons for the court's decision. These were that:

(a) The payment was in reality an advance payment of the future interest income and took its character as income. A bare assignment of the right to interest attaching to a loan without an assignment of the underlying loan was not a disposal of a capital asset and the proceeds were not capital in nature.

(b) Perhaps more importantly was the second arm of the court's decision which was that the transaction was income as it was a profit-making venture undertaken by Myer as part of, although not in the ordinary course of, its business. Although it was not within the normal course of Myer's business but was an isolated transaction, it was nevertheless undertaken as part of that business with a view to deriving a profit from the transaction. The court confirmed that entering into an isolated transaction can amount to the carrying on of business and that the proceeds of an isolated transaction undertaken as a one off venture can be income. The fact that the transaction was undertaken by a company with a view to a profit and as part of Myer's ongoing business activities all led the court to the conclusion that proceeds of such a venture were income.

To this extent the judgment is unremarkable as it has long been the law that the proceeds from an isolated venture may be assessable income depending upon the circumstances. One of the interesting results of the decision appears to me to be, however, that the reasoning of the court illustrates that there has never really been any need for s.25A (or s.26(a) as it was previously) in the Tax Act. Section 25(1) when given its full operation will render liable to tax as income those transactions which are assessable under s.25A. The decision of course was a godsend for the Commissioner in formulating his new policy that "income is income".

He has sought to rely upon the decision in Myer in a series of appeals since the judgment was handed down and in a series of public pronouncements.

In Tribunal Case 146 (1986-87) 8 ATR 4066, the Administrative Appeals Tribunal held that the decision in Myer still required, though, that for a profit from an isolated venture to constitute income the activity or property generating the income must have been entered or acquired for the purpose of profit-making by the means giving rise to the profit. For elimination of doubt, Parliament amended s.10ZB and enacted s.10ZCA to ensure that such assignments of income, without the underlying asset, wound not be tax effective.

PART IVA

The Commissioner has made it clear now by a series of tax rulings and public statements that in his view Part IVA has sounded the death knell for the choice principle established by the Barwick High Court. The most recent example of that was the issue of income tax ruling number IT2456 which has been seen in some quarters as an attempt by the Commissioner to paper over perceived weaknesses in Part IVA by means of a tax ruling. In this ruling the Commissioner has stated his view that a tax benefit to which Part IVA would apply will exist where a scheme results in an amount not being included in the assessable income of a taxpayer which might reasonably be expected to have been included under a particular provision of the Act in a tax payer's assessable income if the scheme had not been entered into even if the scheme results in:

(a) an amount being included in assessable income under another provision; or

(b) an amount of income of a different description or nature being included in assessable income under the same provision.

Of course it will be apparent to all that different tax consequences can flow from such arrangements for example by the conversion of capital gains to rateable dividends or the conversion of interest income to non-interest income. This ruling states that even if a scheme does not reduce the overall income of the tax payer or even if this scheme increases the income but in such a way that there is a tax benefit over all then Part IVA may apply.

PROJECT FINANCING

As many of you are aware a popular technique for financing major projects in Australia in the last few years has been through the use of trusts known as financing unit trusts. The popularity of these arrangements came to a standstill in August last year with the release by the Commissioner of a draft ruling which subsequently became income tax ruling IT2512. In the ruling the Commissioner expressed the opinion that the two common forms of financing unit trusts were ineffective to pass tax benefits from developers to their financiers. In summary the types of financing unit trusts in question were described in the ruling as follows:

Type 1

In the first case the trustee of the financing unit trust would acquire property from a developer. The units in the trust were of different classes, one class being held by the developer and the other by the financier. The trustee would derive income by leasing the property and would set off against this income the operating costs including non-cash deductions such as for depreciation of plant and Division 10D write-off for eligible income producing building. Invariably the non-cash deductions would lead to tax losses being generated within the trust to set off against its income. This led to the situation that the trust net income for tax purposes was less than the trust net income for accounting purposes. The excess of the accounting income over the tax net income would be distributed to the financier unitholders. They would claim the receipt as a tax free capital distribution.

Upon the financier being recouped for its initial investment and return the financier's units would be sold pursuant to an option granted to the developer at the outset. It was argued that this attracted the operation of s.26AAA (as the option was given within 12 months of the acquisition of the units) and this took the transaction outside the capital gains tax provisions of the Tax Act (see s.160L(3)(b)).

Type 2

Under the second type of arrangement a trust would be similarly structured as under type 1. The trustee, however, would use the moneys subscribed for units in the trust to make an interest free loan to a developer. The developer would use these moneys to retire existing debts. The developer would lease the property to the trustee under a development lease. The trustee would derive income by subleasing the property.

The rent received by the trustee would be set off against the rent paid and the non-cash deductions for development of the property such as depreciation and Division 10D write-off of income producing buildings. The developer makes repayments of the interest free loan to the trustee and these amounts and any excess of accounting income over tax net income are returned to the financier unitholders as tax free distributions.

Common features of both of these arrangements outlined in the ruling were:

1. The financiers subscribing for units were banks, insurers, financial institutions.

2. The financier unitholder would be guaranteed an agreed rate of return in much the same way as interest.

3. Commercially from the financier's viewpoint the investment might be regarded as a substitute for a loan.

4. There would be an agreement by the developer to acquire or for the trustee to redeem the financier's units at an agreed date for an agreed price. The price would be structured to reflect the initial subscription made by the financier plus an agreed rate of return.

5. The financier's involvement in the trust is otherwise limited. The financier undertook few risks of ownership.

6. The developer would be liable to "top up" any shortfall in funds required to meet the financier's agreed rate of return.

7. The financier would be indemnified against third party liabilities.

8. The financier would be indemnified against "loss" if the whole arrangement was not tax effective.

9. The other parties to the arrangement would be developers or persons in similar positions who could not take full and immediate advantage of deductions for depreciation of plant interest and building write-off which would otherwise be available.

It would be no surprise if the Commissioner, in examining tax effective financing arrangements of other kinds in the future would look for similar features in deciding whether or not to apply the type of reasoning used in IT2512 to those other arrangements.

The conclusion reached in IT2512 was that these features demonstrated that the financing arrangements were a substitute for loans which would otherwise have been made. Further the arrangements were undertaken by the financial institutions involved as part of their normal business activities. There was no need to rely on the principle in the Myer case. Therefore the distributions received by them are to be regarded as in the nature of income under s.25(1) or s.25A. Although the character of such distributions from trust might, in the case of other beneficiaries in other circumstances be regarded as tax free distributions of capital in accordance with general legal principles, in looking at the character of the income (as one is required to do) in the hands of the recipient the nature of the recipient's business and course of dealings must be taken into account. The character of the distribution is not capital in the hands of the finance unitholder just because it has that character in the hands of the trustee.

In reaching this conclusion the Commissioner confirmed his view that Division 6 of Part III of the Tax Act is not an exclusive code for the taxing of distributions from trusts. Such distributions may still be assessed upon s.25(1) or s.25A.

The Commissioner said that in case he was wrong in these views then he would be prepared to examine in each case the applicability of Division 16E of Part III of the Tax Act to the guaranteed return of income at the end of the contractual period to the finance unitholder and as a fail safe device to apply Part IVA.

Before leaving this ruling it is important to note two broad categories of arrangements which are said by the ruling itself to fall outside the ruling.

(a) The first is that the ruling does not affect cases where the Commissioner had previously given opinions that a financing unit trust arrangement was effective nor arrangements entered into on or before the 18th of August 1988 (which was the date of issue of tax ruling IT2500 setting out the Commissioner's policy on advance opinions) where there are no material differences between those arrangements and those on which the private rulings were given. It is my understanding that because of the difficulties in obtaining private advance opinions from the Commissioner at the time when financing trust arrangements were in vogue, many arrangements were entered into without a specific private ruling but were structured so as to duplicate so far as possible the structures in other cases where private rulings had been obtained. Obviously it will be necessary for packagers of finance to be able to satisfy the Commissioner in cases where private rulings were not obtained that they were materially the same as other situations where rulings had been obtained.

(b) The second exemption from the ruling is in relation to "ordinary" trusts. The ruling states that distributions made in excess of tax net income in ordinary trusts will not be affected by IT2512. The expression "ordinary trust" is explained by the ruling to mean a family trust or a trust created by will or a unit trust where the beneficiaries/ unitholders are entitled to both corpus and income of the trust. That is where they bear all the risks of ownership and participate in profit. The interests in such trusts the ruling says are not ones where it would normally be concluded that the beneficiary/unitholder is obtaining a return on commercial activities carried on by the beneficiary/unitholder.

PRIVATE ADVANCE OPINIONS

IT2500 was issued by the Commissioner it seems as a result of the furore arising out of the draft ruling on financing unit trusts. This is because of the existence of earlier private rulings given by the Commissioner to some tax payers which was directly contradictory to the draft ruling. IT2500 now states, among other things, that an advance opinion will only apply to the tax payer to whom it is given. It cannot be taken as a precedent for other cases. It will have application only in respect to the facts situation presented and the transaction specified in the application.

ALTERNATIVE STRUCTURES

Since the release of IT2512 there has been a careful examination of the ruling and consideration of other forms of legal structure which might achieve the types of tax benefits formerly achieved through the use of financing unit trusts.

At the present time most research appears to concentrate upon the use of -

(a) Leases (including leveraged leases); and

(b) Partnerships (including limited partnerships)

as possible means for the transfer of tax benefits such as depreciation on plant, write off of income producing buildings and financing costs.

(a) Leasing

Traditional leases have been expressly exempted by the Treasurer in his statement of the 20th of December 1988 from the policy review into the economic and tax issues surrounding the transfer of tax benefits. However it can be expected that that review will not overturn the existing rulings and policy of the Government in relation to leveraged lease arrangements (refer income tax rulings IT114, 2051 and 2220) and equity leasing arrangements (refer income tax ruling IT2169).

In a simple lease arrangement the tenant (which would be a body in which the financier had an interest) would enter into a development lease with the owner of property. Under this arrangement the tenant would make expenditure on acquisition of plant, construction of income producing buildings and other development costs. The deductions in respect of eligible income producing buildings under Division 10D are specifically made available to eligible lessees expending moneys upon construction of the building.

However in relation to expenditure upon plant and equipment the availability of the deduction for depreciation depends upon the tenant being the owner of the plant. Of course plant can include fixtures but there is always a threshold question to be answered as to whether in relation to plant which is affixed to the building or land whether the tenant is able to claim a deduction for depreciation as owner or not. This is because of the supervening legal principle that upon affixation to the land the plant becomes part of the land and not the property of the tenant. In Tax Ruling IT175 the Commissioner indicated that despite the strict legal position, he would accept depreciation on fixtures installed by a tenant provided the tenant had a specific right of removal or compensation on termination of the lease.

(b) Partnerships

Partnerships are also a viable alternative to financing unit trusts due to the ability for partners to directly share in profits and losses of the partnership. Indeed an advantage which partnerships have over unit trusts is that with trusts of any sort losses are quarantined until further income is earned by the trust which can be offset against the losses. With the partnership the losses are effectively "distributed" to the partners and are available to the partners to be applied against their separate income from other sources. Partnerships are able to claim the same deductions for depreciation and building write off and financing costs as corporations, individual tax payers or trustees.

However there are some features of the treatment of partnerships which are disadvantageous from the point of view of using them as a structure for financing arrangements. Some of these features are:

1. The commercial disadvantages of the unlimited liability of the partners in a common form partnership. Traditionally this exposure to unlimited personal liability on the part of the partners is overcome by using limited liability companies (or other structures offering limited liability) as the partners in the partnership. It is important to note that with the provisions for transfer of company losses within wholly owned company groups (under s.80G of the Tax Act) the possibilities for the effective use of this type of structure are considerably expanded.

2. Under the capital gains tax provisions in Part IIIA of the Tax Act the taxation treatment of partnerships remains uncertain. The Commissioner adopts a "fractional" approach in which he regards each partner as having a separate fractional interest (according to his partnership share) in all of the assets of the partnership. On this view rearrangements of partnerships cause a disposal of the outgoing partner's interest in those assets but the interests of the other partners remain unaffected. However the difficulties with this approach are that there is no legislative authority in Part IIIA of the Tax Act for this theory and there is the general legal principle that changes in a partnership constitute a dissolution of the partnership and a formation of a new partnership. Prima facie this would indicate a complete disposal of all of the assets of the partnership and a reacquisition. Time does not permit a complete analysis of this problem but what has been said is sufficient to highlight the difficulties presented.

3. Rearrangements of partnerships (certainly in Queensland) may involve the imposition of stamp duty as a disposal of an interest in a business.

(c) Limited Partnerships

Being a Queenslander it would be remiss of me to leave this topic without mentioning the possible future role of limited partnerships as a structure in financing arrangements. Presently limited partnerships are available to be used only under the legislation in Western Australia, Tasmania and Queensland. The provisions in Queensland are contained in the Mercantile Act 1865. Over a number of years limited partnerships have received little use or attention due to the formalities and problems associated with their use. The major problems apart from the difficulty in complying with the formal requirements have been associated with the doubts surrounding the status of such partnerships when they trade outside the jurisdiction of the State under whose legislation they are established. Nevertheless the form of structure is a very popular one in the United States, particularly in raising venture capital.

Following an increase in demand for this type of structure in Queensland in recent years, particularly in the fields of syndication of property developments, primary production, film production and, more recently, technology related ventures, the Queensland Parliament has enacted the Partnership (Limited Liability) Act to replace the existing provisions of the Mercantile Act 1865. The Partnership (Limited Liability) Act at the time of writing has been enacted but will probably not come into force until about the 13th of May 1989. At the time it comes into force it is likely that the Attorney-General will also announce some amendments to remedy perceived flaws in the legislation, particularly relating to the loss of limited liability in circumstances where there is any change in the makeup of the partnership until the change is registered. It is presently proposed that these amendments will be retrospective to the commencement of the legislation. The present Partnership (Limited Liability) Act removes a number of difficulties associated with the previous provisions of the Mercantile Act 1865. No new partner limited partnerships are presently allowed to be formed under the Mercantile Act 1865.

The new Act preserves the following features of a limited partnership:

(a) a limited partnership is a partnership which exists between persons one or more of whom is a general partner and one or more of whom is a limited partner;

(b) a limited partner in a limited partnership is liable to contribute towards the liabilities of the firm but so as not to exceed the sum shown in relation to that limited partner in the register to the extent to which he is liable to contribute;

(c) the contribution made by a limited partner towards the discharge of liabilities of the firm must be in the form of money only;

(d) a limited partner must not take part in the management of the partnership and where he does so in breach of that provision he is liable for all liabilities of the firm while he does so as if he were a general partner.

The following substantial changes are made from the previous Act:

(a) there will no longer be a 7 year time limit upon the duration of the partnership;

(b) the limit of liability of partners is not limited to debts but extends to any debt, obligation or other liability howsoever arising;

(c) the Bill expressly provides that a limited partner has no power to bind the firm;

(d) provisions are made for the introduction and retirement of partners without dissolution of the limited partnership;

(e) there is no requirement for a limited partner to actually contribute his capital to the partnership but he may become a limited partner simply by agreeing to do so;

(f) there is a much clearer statement of the procedures to be followed for formation and registration of the limited partnership;

(g) the advertising requirement preliminary to the creation of the partnership is removed;

(h) the partners may by agreement alter the extent to which a partner is liable to contribute and must give notice of that alteration;

(i) generally, the Act is streamlined and modernized from the procedures and circumstances pertaining under the previous Act;

(j) most significantly, the procedures for transfer of the interests of limited partners and retirement and addition of limited partners have been substantially amended without the dire consequences of loss of limited liability.

Perhaps the most significant, outstanding disadvantage associated with limited partnerships, even under the new Act, will be the continuing question of the status of the limited partners in relation to activities conducted by the partnership outside Queensland. It would appear that this problem cannot be overcome by Queensland legislation and one of the following remedies would have to be followed:

(a) a practical remedy of the limited partnership acquiring a limited liability company to conduct its activities outside the State;

(b) corresponding and reciprocal legislation passed in each other jurisdiction in Australia; or

(c) a national co-operative scheme similar to that presently operating in relation to companies and securities legislation.

There are two important notes relating to the taxation of limited liability partnerships. These are:

The argument that has from time to time been raised, both in Australia and in the United Kingdom, is the manner of distribution of tax losses among the partners in a limited partnership. The provisions of Division 5 of Part III of the Tax Act in relation to the taxation of partnerships do not specifically refer to the situation of limited partnerships. However, it appears to me that the better view is that a limited partner is entitled to share in a partnership loss in the same way as an ordinary partner. This view is consistent with the wording of sub-s.5(3) of the Partnership Act Queensland and s.64 of the Mercantile Act 1865 ("... all the members of a limited partnership shall be subject to the liabilities and entitled to the rights of general partners") and s.40(2) of the Partnership (Limited Liability) Act ("... the liability of a limited partner in a limited partnership to contribute is that of a partner in a partnership that is not a limited partnership").

It is also consistent with the ordinary reading of the words "the individual interest of the partner in the partnership loss" contained in sub-s.92(2) of the Tax Act. Each individual partner has an individual interest in the losses to the extent that they reduce the amount of profits which might be available to him regardless of the extent of his personal liability in general terms for the debts of the partnership.

This view is also supported by the 1986 House of Lords decision in Reed (Inspector of Taxes) v. Young (1986) WLR 649. Although the wording of the relevant statute was different, the House of Lords dealt with the matter rather in general principles than by specific reference to the precise wording of the statutes (see page 654 of the Report).

Alternative views hold that a special partner is only entitled to share in the partnership loss to the extent of the capital contributed by him and that a limited partner is only entitled to share in a partnership loss in the same proportion as his capital bears to the overall capital contributed. It does not appear that this view has found any support in the United Kingdom.

I have been unable to find any specific authority on the point by an Australian court. However, for a tax case in which the deductibility of losses for a limited partnership was considered recently see AAT Case 4769 20 ATR 33.

IT2519 FINANCING PARTNERSHIPS

However, many of the proposals for the use of leases and partnerships as alternative vehicles for tax effective financing arrangements may have been overtaken by the release at the end of February this year of Tax Ruling IT2519 which considered a financing partnership.

The facts in this case were that a company wished to construct a new processing plant on land in Australia. A group of Australian financiers agreed instead of providing financial accommodation by way of loans to the company that a partnership would be formed in which the company and the financiers would be equity partners. The partners provided funds to the partnership by way of contribution of capital. The partnership entered into a lease of the land upon which the processing plant was to be constructed. The other relevant facts are briefly set out in the ruling as follows:

1. The equity partnership acquires shares to sufficiently fund 26% of the total cost of construction of the processing plant. The balance of the costs are met by finance obtained by A1 from independent banking sources and on-lent to the equity partnership and by funds made available through a hire purchase facility applicable to the plant and equipment by D, a non-resident finance company, in which A has a minority shareholding interest. (See steps (3), (5) and (6)).

2. The equity partnership pays A1 to construct the plant and buildings on land owned by A1. A1 leases the land to the equity partnership which, under the site lease, is given a right to remove the plant. A1 is also paid by the equity partnership to manage and operate the plant. The equity partnership repays the loan from A1 referred to in (1) above (see step (4)).

3. D purchases from the equity partnership the plant progressively during the course of construction of the plant by A1.

4. A2 pays the equity partnership to process materials at the plant. The charges for this are calculated to cover any loan repayments to be made by the equity partnership to A1 under (2) and hire purchase payments under (5) plus a predetermined guaranteed annual return. Payment is to commence before the plant is completed and is to be made whether or not materials are processed.

5. C acquires the plant from D by way of a hire purchase agreement under which C will have a right to purchase the plant for a purely nominal amount after the hiring is terminated, (Alternatively, C may purchase the plant from D instead of entering into a hire purchase agreement).

6. The equity partnership acquires the plant from C under a hire purchase agreement with similar terms to (5) (or by direct purchase).

7. If the agreement in (5) is a hire purchase agreement, the benefits are assigned to A4.

8. The financiers own the shares in E1, E2 and E3. At the end of the arrangements, or upon the happening of certain events, the financiers have the right to require A3 to purchase their interests for certain preset amounts which ensure a determined rate of return on the funds provided. The equity partnership is to dissolve at the end of the arrangement.

Under the documentation the financiers were guaranteed a predetermined rate of return. The financiers could require the other partner (the operator) to buy their partnership shares for pre-set amounts. The partnership was to dissolve at the end of the arrangements.

Guaranteed payments were to be made to the partnership for processing material, whether or not processing was undertaken. Payments for processing were also to begin before the plant was completed.

In the circumstances, the Commissioner considered that the arrangement was essentially a tax effective financing.

Effectively a loan was being made by the financial institutions and their return was in substance interest. In relation to the specific matters on which the Commissioner's opinion was requested in the Ruling, the Commissioner advised:

1. He was concerned that the whole arrangement was uncommercial and gave rise to the concern that it was merely a tax effective financing to take advantage of tax benefits.

2. The partnership could not claim a deduction for depreciation of plant which had become a fixture on the leasehold property. Normally a site lessee may be treated as the owner of plant or articles for depreciation purposes, where the plant is a fixture on the leasehold property or is a structural improvement (refer IT175). But in this case, the tenant had not retained the necessary degree of ownership to be regarded as eligible for the depreciation deduction under s.54. The Ruling indicated that the Commissioner would look at the types of matters that are normally looked at to determine whether plant has become a fixture of the land or not in determining whether a tenant could claim the depreciation deductions. The tax office looks at:

    (a) the precise nature of the tenant's rights in respect of the plant;

    (b) the nature of the plant;

    (c) the circumstances of annexation.

Plant generally forms property of the land owner if part of the original building itself or if because the object and purpose of the annexation makes the plant a permanent part of the land.

Although in this case the partnership had a contractual right to remove the plant, in reality, this right was not only illusory (as the whole intent was that the partnership would not remove the plant or be paid for it) as the partnership was to terminate at about the same time as the relevant hire purchase agreement terminated the partners would never own the plant for more than a brief period.

In these circumstances, neither IT175 nor IT196 would enable the claiming of the depreciation deduction by the partnership.

It seems clear that in formulating IT2519 similar types of considerations have borne upon the Commissioner's mind as were evident in IT2512 in relation to financing unit trusts.

Further, he no longer is prepared to extend the flexible, practical approach which he previously adopted under IT175 and IT196 to the depreciation of tenants' fixtures to a case involving transfer of that tax benefit to a financier.

Other relevant rulings

There have been two other significant Tax Rulings in the last 12 months which reinforce the Commissioner's attitude towards the use of tax effective financing techniques. The first was IT2495 in relation to debt defeasance arrangements where the Commissioner ruled that the defeasance did not result in the derivation of tax free capital gains but rather assessable income of a borrower under s.25(1) or s.25A and IT2513 in relation to margin lending arrangement to deny the lender's entitlement under such arrangements to a s.46 rebate.

In each case the Commissioner has treated arrangements which resulted in tax preferred treatment of receipts as assessable income on ordinary concepts under s.25(1) and, failing that, has sought to apply Part IVA to deny any tax benefit which would otherwise result from the arrangements. For the purposes of our discussion today the terms of these rulings need not be considered in detail but it is important to note them as further examples of the same principle and techniques being pursued by the Commissioner to deny tax advantages from various financing techniques which he perceives to be artificial structures designed to convert ordinary income into a tax preferred receipt either in the nature of a tax free capital receipt, exempt income, rebateable income or income of a different character.

The environment is one in which s.25(1) will be applied in the first instance and in the event that the Commissioner cannot succeed in an argument that the relevant receipts are income ordinary concepts, he will attempt to apply Part IVA.

DEDUCTIBILITY OF INTEREST

In the same vein as the Commissioner's "back to fundamentals" approach, I thought it would be appropriate to refer in passing to Tax Ruling IT2461 and AAT Case U90 87 ATC 513. This is a ruling and a case which have not received much attention but they would appear to establish a vitally important principle for all those interested in developing property and financing such developments. Case U90 involved simple facts in which a taxpayer was a family company which acquired two vacant parcels of land. At the time of acquisition the taxpayer had vague intentions of constructing houses for rent on each block but no specific plan. A loan was taken out to acquire the land. The land was held undeveloped with no steps being taken toward progressing any development of the land for several years. The taxpayer claimed a tax deduction for the holding costs of the land including interest. Mr Roach, a senior member of the Tribunal, disallowed the claim for holding costs. He analysed the principle referred to in Income Tax Rulings IT166 and IT2374 and established by the case of Travelodge Papua New Guinea Limited v. Chief Collector of Taxes 85 ATC 4432. All of these stand as authority for the proposition that where a taxpayer has at all material times the intention to develop land to derive assessable income, then the fact that no assessable income is generated in the year of expenditure on holding costs does not preclude a deduction for those holding costs from being allowable.

However, in Case U90 the Tribunal held that the circumstances of that case were distinguishable from those considered in the earlier rulings and in the Travelodge case as in the present case the taxpayer had no clear income producing intention at the time the expenditure was incurred. However, in reaching this conclusion, Mr Roach gave an example which must fill developers and financiers alike with some concern. He said that the taxpayer's intention in this case was not sufficient in terms of turning the land to income producing purposes to justify deduction for the holding costs. He said that:

> "To that extent the state of mind of the applicant was akin to that of a promoter interested in the development of tourist facilities on a freehold site who might intend to build a licensed hotel or an unlicensed motel or other facilities serving the tourist trade; but who has yet to settle on basic features of the design of any of those particular developments. As to the hotel project, matters which might lie undetermined would be the number and size of bedrooms and suites, their standard of construction and fitting out, the sitting of the building, the percentage of the site to be occupied, the number of storeys, what service facilities in the way of lounges, bars, dining rooms, sporting facilities and entertainment complexes should be provided and so on. In that regard the only significant difference between the circumstances of the present application and those of Travelodge is that the design of its hotel complex was probably at a more advanced stage when its tender was accepted. In the Board decision (referred to in IT2374) the distinction is that the property was already in a lettable condition when it was purchased, although the taxpayers chose not to commit it to an income earning course at that time."

That passage, if correct, would mean that holding costs claimed by many developers would not be eligible for deduction.

Mr Roach also found that the real estate, developed to a condition in which it would be suitable for letting was the "profit yielding" subject. Following the decision in Sun Newspapers (Sun Newspapers Ltd and Associated Newspapers Ltd v. FCT (1938) 61 CLR 337), the Tribunal considered that the interest and rates holding costs were costs of establishing that asset as distinct from operating it and therefore were non-deductible capital expenses.

In IT2461 the Commissioner considers the decision in Case U90. He states that the case does not affect the existing Rulings given in IT166 and 2374 which were correct in relation to the facts situations to which they related. Provided he is satisfied that the necessary income producing purpose was held at the time that holdings costs were incurred, a deduction for those holding costs will continue to be allowed. However, from the example given by Mr Roach in Case U90, it would appear that the Commissioner's prior practice reveals a divergence between when he regards the relevant income producing intention to exist and when a court or Tribunal may regard it to exist.

Tax rates and depreciation rates

The other major "environmental" impact upon tax effective financing in recent times has been the reduction in the effective deductions available for non-cash items, by the reduction in the corporate tax rate to 39%, and the removal of accelerated rates of depreciation for plant acquired after 25 May 1988. The new system of depreciation over effective life (or 10 years, whichever is less) with a 20% loading will severely limit tax benefits available for transfer.

CONCLUSION

Therefore, it appears that the major environmental changes in recent times which have reduced the attractiveness of tax effective financing techniques have been:

1. The reduction in the amount of benefits which might be available for transfer from one taxpayer to another in such financing arrangements, specifically by the reduction in the corporate tax rate and the removal of accelerated depreciation rates.

2. The new "back to basics" approach adopted by the Australian Taxation Office in dealing with tax effective financing arrangements. As reflected in recent tax rulings, this approach will be to "look through" the form of financing techniques and to label the underlying financial accommodation as a loan by the financier with income in the form of interest being derived as a return on these loans.

3. The willingness of the Commissioner to rely upon the threat of Part IVA of the Tax Act to strike at financing techniques as uncommercial and tax avoidance techniques while not actively seeking to litigate on Part IVA so that the exact boundaries of its operations are not yet decided by the courts.

In response to these initiatives by the Government, the environment is now one in which other techniques which may be perceived as more "legitimate" are being examined to pass tax benefits from taxpayers who cannot make effective use of them to taxpayers who may be able to do so. The techniques which are possible in this regard are leasing, the us of "ordinary" trusts, partnerships and limited partnerships. However, it appears from Tax Ruling IT2519 that the Commissioner will apply the same criteria which he developed in Tax Ruling IT2512 in relation to financing unit trusts to establish whether or not a financing arrangement is legitimate or a "tax effective financing" which he should challenge. The underlying message appears to be that the Government's apparent policy in past years of allowing the transfer of tax benefits to reduce financing costs is to be discontinued.