Attachment C

TIGHTENING THE 13 MONTH RULE FOR ADVANCE EXPENDITURE UNDER TAX SHELTERS

The Government will tighten the provision allowing immediate deductibility for advance expenditure ('prepayments') incurred in respect of services to be completed within 13 months, where such expenditure relates to a tax shelter arrangement. This change is being made in order to reduce tax minimisation opportunities, particularly through end-of-year tax schemes.

Key features

The Government has already announced a tightening of the '13-month rule' for immediate deductibility of prepayments. This change does not apply to prepayments incurred by small businesses or outside of a business — for example, by an individual — and is subject to transitional arrangements. Legislation giving effect to this has already been introduced into the Parliament in the *New Business Tax System (Integrity and Other Measures) Bill 1999.*

This further measure is consistent with recommendations 4.4 and 17.2 in *A Tax System Redesigned*.

In broad terms, the measure is directed at arrangements, managed by a person other than the taxpayer, where deductions exceed income from the arrangement in the same year.

It does not apply to prepayments by a small business or outside of a business that are made in respect of a standard negatively geared investment, such as rental property or shares.

This new measure will mean that all revenue prepayments relating to participation in a tax shelter will be deducted over the period to which they relate. If, in substance, the payment contributes to the creation of, or is directed towards acquiring, an asset — that is, it is of a capital nature — it will not be immediately deductible, consistent with the current law. The created or acquired asset will then be treated under the relevant provisions of the tax law.

Commencement

Consistent with the previously announced tightening of the 13-month rule, this measure will apply to all expenditure incurred after 1pm, Australian eastern summer time, 11 November 1999 but exclude those prepayments to which the taxpayer is irrevocably committed under a contractual obligation entered into prior to that time. The taxpayer is irrevocably committed where the obligation to make the prepayment cannot be escaped by unilateral action by the taxpayer.

Current arrangements

Prepayments for things to be done wholly within 13 months, including those relating to tax shelter arrangements, are immediately deductible for small business taxpayers and for payments outside a business (for example by an individual), unless the general anti-avoidance rule applies to the arrangement.

Prepayments affected by the measure introduced into Parliament in the *New Business Tax System (Integrity and Other Measures) Bill 1999* are subject to a transitional arrangement which phases-in the initial impact of that measure over a period of five years. However, those transitional arrangements will not apply to prepaid expenditure affected by this measure.

Why the change is needed

This measure, along with that dealing with losses on non-commercial activities, will provide a structural solution to address a key part of many tax minimisation schemes, particularly end-of-year schemes. Limiting the tax advantages that are derived from participation in tax shelters by limiting immediate deductibility for prepayments will promote equity in the tax system and more productive investment activity.

Appendix to Attachment C

TIGHTENING THE 13 MONTH RULE FOR ADVANCE EXPENDITURE UNDER TAX SHELTERS — FURTHER DETAILS

The prepayment rules in Subdivision H of Division 3 of Part III of the *Income Tax Assessment Act 1936* are being modified to require deductions for advance expenditure incurred in respect of participation in certain arrangements (defined below) to be apportioned over the eligible service period (defined in subsection 82KZL(1)) using the method set out in that Subdivision.

- The change will affect expenditure (other than excluded expenditure — as defined in subsection 82KZL(1)) incurred in return for the doing of a thing under the agreement that is to be wholly done within 13 months after the day on which it is incurred.

Under the change, prepaid expenditure deductible under section 8-1 of the *Income Tax Assessment Act 1997* will be deductible over the period it covers if:

- the expenditure is incurred after 1pm, Australian eastern summer time, 11 November 1999 under an arrangement, except if it is incurred under a contractual obligation, entered into prior to that time, to which the taxpayer is irrevocably committed; and
- the taxpayer's allowable deductions under the arrangement for the income year in which the expenditure is incurred exceed the assessable income under it for that year; and
- all significant aspects of the management of the arrangement during that income year are conducted by people ('the manager') other than the taxpayer; and
- either:
  - more than one taxpayer participates in the arrangement; or
  - the manager, or an associate of the manager, also manages similar arrangements on behalf of others.

However, this will not be the case if all of the following exist:

- the prepaid expenditure is for building and contents insurance, or is interest in respect of money borrowed by the taxpayer to fund the acquisition of real property, shares or units in a unit trust; and
- under the arrangement, the taxpayer has obtained, or is reasonably expected to obtain in the future, rent from real property, dividends or distributions from a unit trust and no other income (except capital gains); and
- all aspects of the arrangement are conducted at arm's length.

This formulation will ensure standard negatively geared investments will not be affected by this change.

Commencement

The change set out above will apply to expenditure incurred after 1pm, Australian eastern summer time, 11 November 1999.

However, if the expenditure is incurred after that time under a contractual obligation entered into before that time, it will not be subject to the change. This will only be the case if the taxpayer is irrevocably committed to incur the expenditure in advance of the provision of the thing under the prepayment agreement. The taxpayer is irrevocably committed where the obligation to make the prepayment cannot be escaped by unilateral action by the taxpayer.