



INFORMATION, ANALYSIS  
AND ADVICE FOR THE PARLIAMENT

INFORMATION AND RESEARCH SERVICES

Bills Digest  
No. 114 2002–03

## Taxation Laws Amendment Bill (No. 6) 2002

ISSN 1328-8091

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Taxation Laws Amendment Bill (No. 6) 2002

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28 February 2003

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# Taxation Laws Amendment Bill (No. 6) 2002

**Date Introduced:** 19 September 2002

**House:** House of Representatives

**Portfolio:** Treasury

**Commencement:** Other than the measures relating to interest withholding tax, which commence on 29 August 2001, the measures contained in the Bill commence on Royal Assent. However, the measures have varying application dates which are dealt with in the Main Provisions section of this Digest.

## Purpose

To:

- exempt from interest withholding tax certain amounts associated with international dealings
- ensure that capital gains tax does not apply to compensation payments made to slave and forced labourers used by the National Socialist (Nazi) regime, and
- place various products issued by friendly societies in the same taxation position as similar products issued by other bodies.

## Background

As there is no central theme to the Bill the background to the various measures will be discussed below.

## Main Provisions

### Withholding Tax

According to the second reading speech to the Bill the changes to interest withholding tax (IWT)<sup>1</sup> are aimed at enhancing Australia's development as a centre for financial services in the Asia-Pacific region.<sup>2</sup> The current major financial centres in the region are Japan,

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Hong Kong and Singapore. A number of arguments are put forward to attract businesses from these centres or persuade new entrants to the industry to establish in Australia, including:

- the high quality of life style in Australia
- the presence of a skilled workforce
- high quality communications infrastructure, and
- a strong regulatory regime.

Governments have expressed the desire to promote Australia as a regional financial centre for a number of years principally through the modification of various tax laws, including IWT, to remove any disadvantage when compared to overseas financial centres. Since 1971 section 128F of the *Income Tax Assessment Act 1936* (ITAA36) has provided that IWT does not apply to certain debentures issued to non-residents, although a number of conditions had to be met for the exemption to apply, including that the Commissioner had approved the arrangements. At this stage the exemption could be seen more as improving Australian companies access to international capital rather than as a measure directed towards promoting Australia as a regional financial centre.

An example of the promotion of Australia as a financial centre relates to Offshore Banking Units (OBUs), which are, in their simplest form, companies which borrow funds overseas and then lend the funds raised to non-residents. Prior to 1992, OBUs were not subject to IWT but were taxed on their profits at the normal company tax rate. Other regional countries had lower tax regimes, for example 10% in Singapore and no tax in the Cook Islands which was attempting to establish itself as a tax haven in the region. In the February 1992 One Nation statement, the then Prime Minister stated:

To help establish Offshore banking Units (OBUs) in Australia, the industry requested a number of concessions from the Commonwealth. After careful examination, the Government decided that its contribution to the industry's efforts would take the form of a favourable company tax rate for OBUs.

The government has decided that the taxable income derived from pure offshore banking transactions by an authorised offshore banking unit in Australia will be taxed at the reduced rate of 10 per cent from 1 July 1992.<sup>3</sup>

A further example of concessions being offered to encourage the growth of Australia as an international financial centre can be found in the 1997 statement *Investing for Growth*. The statement outlined further concessions for OBUs, including clarifying and extending the IWT exemption for such entities, and also extending the IWT exemption for the domestic corporate debt market by removing the requirement that debentures be issued, and interest paid, outside Australia.<sup>4</sup>

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While it is very difficult to gauge the success of the measures taken to encourage the use of Australia as a financial centre, some idea of Australia's place in the world financial markets can be gauged from the three-yearly survey conducted by the Bank of International Settlement (BIS), the most recent of which relates to April 2001. The Reserve Bank of Australia Media Release relating to the BIS report noted that:

- foreign exchange turnover in April 1991 was 11% greater than in April 1998 and that 'Activity in Australia was boosted by the relocation by a number of global players of their Asian time zone foreign exchange businesses to Australia.'
- transactions between resident dealers and foreign banks accounted for 65% of foreign exchange turnover in April 2001, compared to 'just over' 50% in 1998, and
- turnover in foreign exchange derivatives increased by 24% between 1998 and 2001.<sup>5</sup>

Regarding the position of Australia in global financial markets, the BIS survey provides some technical figures which give a general guide to the relative position of countries, but these are divided into a number of areas defined by international accounting terms and so should be used as a general guide. In 'foreign exchange turnover net of local inter-dealer double-counting', the following can be observed:

- the largest market by a substantial degree is the United Kingdom (daily average turnover in April 2001 of approximately US\$462 billion<sup>6</sup>) followed by the US (\$236b)
- in the region, Japan had an average daily turnover of \$135b, Singapore \$96b, Hong Kong \$65b and Australia \$50b
- approximately half of the Australian turnover was in Australian dollars rather than 'pure' international trading involving other currencies
- of the 48 countries surveyed, in addition to the countries mentioned above only two others, Germany and Switzerland, exceeded the Australian turnover<sup>7</sup>, and
- a similar pattern occurred in foreign exchange derivatives, although turnover was substantially lower and Australia's turnover (at \$1.6b) was greater than Hong Kong's.<sup>8</sup>

These figures suggest that while compared to the two major players in international finance (UK and US) Australia plays only a minor role, it is still an important market and even in a region with 4 (including Australia) of the 8 major markets, Australia plays a major role. However, what role financial concessions compared to lifestyle choice plays in making Australia a relatively important market cannot be calculated.

In 1999 the Government established AXISS Australia, as a part of the Treasury, to assist in furthering Australia's position as a financial centre. AXISS Australia works with the private financial sector and educational institutions to encourage overseas financial service firms to relocate to Australia and also acts as an information point for overseas firms contemplating relocating to Australia.

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The measures to be implemented by this Bill were announced by the Assistant Treasurer and Minister for Financial Services and Regulation on 29 August 2001 and will apply from that date. The explanatory memorandum to the Bill estimates that the amendments will cost \$10 million per year.

**Item 3 of Schedule 1** of the Bill will insert a definition of ‘nostro account’ into section 128A of the ITAA36. This will be an account that:

- an authorised deposit taking institution holds with a foreign bank solely to settle international transactions, and
- amounts deposited in the account are held for a maximum of 10 days and overdrafts on the account are repaid within 10 days.

Interest derived from a nostro account by a non-resident foreign bank will be exempted from IWT by **item 4** which will amend section 128B of the ITAA36.

Section 128AA of the ITAA provides that where a security is transferred for more than the issue price, or for more than any payments remaining due on the security, the excess is deemed to be interest and so subject to IWT. **Item 5** will amend section 128F of the ITAA36 to provide that such deemed interest will be exempt from IWT if it satisfies the existing public offer tests. (The test aims to ensure that tax minimisation schemes cannot be used to take advantage of the exemptions.)

Subsection 128F(5) of the ITAA36 provides that if the issuer of a debenture knew, or could reasonably suspect, that an interest would be acquired by a resident or an associate of the issuing company, other than for dealing purposes, it will fail the public offer test and so IWT will apply. **Item 6** proposes to substitute a **new subsection 128F(5)** that will restrict the grounds for failure of the public offer test. Specifically, the test will only be failed where:

- the debenture or an interest in it was acquired by an associate and
  - the associate is a non-resident and the interest is not acquired in carrying on a business, or permanent establishment, in Australia, or
  - the associate is a resident of Australia and the interest is acquired in carrying on a business, or permanent establishment, outside Australia, and
- the interest has not been obtained for dealing purposes.

The effect of the changes is to allow the exemption from IWT to apply to a range of dealings with associates even though there is a connection with Australia.

**Item 7** will make similar amendments to subsection 128F(6) of the ITAA36 which currently provides that interest paid to an associate is not exempt from IWT.

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**Application:** From 29 August 2001 (**item 10**).

## Slave Labour Compensation

In 2000 the German parliament established a foundation to pay compensation to those who, under the National Socialist Government, were:

- slave labourers
- forced labourers, or
- suffered severe personal health damage as a child due to their being lodged in a home for children of slave or forced labourers. The parents of a child who died in such accommodation may also claim against the fund.

The heirs of such people may also lodge a claim in a limited number of circumstances. Claims by heirs may only be made in respect of an eligible person who died on or after 16 February 1999.

The fund is financed through contributions by German companies which used such labour and the German government. It has been reported that the fund totalled approximately \$8.4 billion, that more than 2000 companies contributed, and that maximum compensation payments would be \$12 700 for people held as slave labourers, or who had medical experiments performed on them or are the parents of a child who died in a home for children of slave or forced labourers. Forced labourers for a firm or public authority would reportedly be eligible for maximum compensation of \$4 200, while those who were forced to work in agriculture would be eligible for a maximum payment of \$1 700.<sup>9</sup> However, the actual level of payments will depend on the number of claims compared to the funds available. Claims against the fund had to be lodged by 31 December 2001.

The ITAA36 currently provides that pensions, annuities and allowances paid under German legislation relating to persecution under the National Socialist government are tax exempt. However, the payment of a lump sum as compensation has the possibility of capital gains tax (CGT) implications if the entitlement is passed on to heirs. The then Assistant Treasurer announced on 18 October 2001 that such payments would be exempt from CGT.

**Schedule 2** will make it clear that any capital gains or losses associated with various payments made to compensate people for forced labour during the 'National Socialist period' will be exempt from CGT (**item 1 of Schedule 2** which will amend section 118-37 of the *Income Tax Assessment Act 1997* – ITAA97).

**Application:** For the 2001-02 and later income years (**item 2 of Schedule 2**).

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## Friendly Societies

Friendly societies are associations originally established for the relief of members in cases of sickness and to assist surviving spouses and children in the case of the death of a member. Their role expanded in the areas in which members could be assisted to include areas such as life insurance, funeral policies and scholarship plans. Members contribute to the society and their entitlements are based not only on their own contributions but also on the society's earnings on the money held. Over time friendly societies have gone from a tax free basis to having the investment income on certain of their products, particularly life insurance, taxed in the same manner as other institutions offering similar products. Member's contributions remain exempt.

The Review of Business Taxation (Ralph Report) recommended a number of changes to the taxation of life insurers, including friendly societies, and other products offered by friendly societies. The basis of the recommendations was to place the various bodies offering such products in the same taxation position so that they could compete on equal ground.<sup>10</sup> While a number of the recommendations relating to friendly societies have been implemented following government responses to the Ralph Report, a number have been deferred.

On 14 May 2002 the Minister for Revenue and Assistant Treasurer announced that from 1 January 2003 friendly societies would include investment income from income bonds, scholarship plans and funeral policies issued after 30 November 1999<sup>11</sup> in their assessable income. A deduction would be allowed in respect of such amounts paid to policy holders.<sup>12</sup> This will place friendly societies in the same position as other sellers of such products.

Section 320-35 of the ITAA97 currently provides that income received by Friendly Societies from income bonds, scholarship plans and funeral policies issued after 30 November 1999 are exempt from taxation until 1 July 2000. **Item 3 of Schedule 3** proposes to extend this exemption until 1 January 2003.

**Part 2 of Schedule 3** provides for deductions to be available to friendly societies in respect of funeral policies, scholarship plans and income bonds after 31 December 2002. The amount of the deduction will be costs reasonably related to the benefit provided less amounts otherwise deductible under section 320-75 (which provides for premiums, less fees and charges, to be deducted). The result of the amendments is that payments from these policies will be fully deductible, reflecting their income being included as assessable income.

**Part 3 of Schedule 3** will amend the ITAA36 to reflect the amendments described above.

**Application:** The above amendments will apply to the income year which includes 1 January 2003 and later year (**items 6 and 11 of Schedule 3**).

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## Endnotes

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- 1 IWT refers to the requirement for residents who pay interest to non-residents to retain a certain amount (generally 10%) of the interest payable and forward this amount to the Australian Taxation Office. The rules can also apply to interest payments to residents in certain circumstances, such as where the recipient of the payment is acting as an intermediary for a non-resident. The general IWT rules have been significantly modified in regard to how they apply to a number of situations, including in respect of overseas financial transactions.
- 2 House of Representatives, *Hansard*, 19 September 2002, p. 6782.
- 3 *One Nation*, 26 February 1992, p. 77.
- 4 *Investing for Growth*, December 1997, pp. 62 and 63.
- 5 Reserve Bank of Australia, *Media Release*, 10 October 2001.
- 6 The following figures are also approximate daily turnover expressed in US\$.
- 7 Bank of International Settlement, *Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity 2001*, pp. 60 and 61.
- 8 *ibid.*, p. 105.
- 9 *The Sydney Morning Herald*, 28 June 2001.
- 10 *Review of Business Taxation, A Tax System Redesigned*, July 1999, p. 489.
- 11 The measures apply to policies sold after 30 November 1999 as the Treasurer announced in a Press Release dated 21 October 1999 that the proposal would apply to policies sold after 30 November 1999. It was originally intended that the changes would apply from 1 July 2001 but their adoption has been delayed while other recommendation of the Ralph Report regarding the general taxation of life insurance were considered.
- 12 Minister for Revenue and Assistant Treasurer, *Press Release*, 14 May 2002.

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