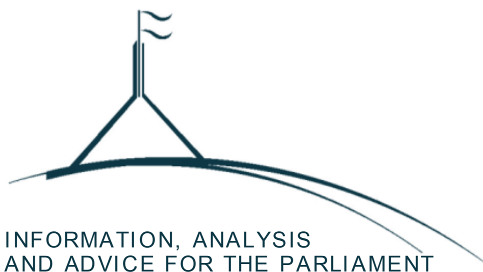

INFORMATION AND RESEARCH SERVICES

Bills Digest
No. 144 2002–03

Taxation Laws Amendment Bill (No. 8) 2002

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Taxation Laws Amendment Bill (No. 8) 2002

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9 May 2003

Contents

Purpose . . . 1

Background . . . 1

Main Provisions . . . 2

Petroleum Resource Rent Tax (PRRT) . . . 2

General . . . 2

Closing Down Costs . . . 2

Capital Gains Tax – Employee Share Schemes . . . 4

Franking of Distributions by Co-operatives . . . 6

AGL – Conversion to Public Company . . . 7

Endnotes . . . 8

Taxation Laws Amendment Bill (No. 8) 2002

Date Introduced: 5 December 2002

House: House of Representatives

Portfolio: Treasury

Commencement: The formal provisions of the Bill commence on Royal Assent. The measures contained in the Bill have various application and commencement dates which are detailed in the discussions of the various matters dealt with in the Bill.

Purpose

To:

- allow for the earlier deduction of closing down costs relating to certain petroleum projects when the facilities are to be subsequently used under an infrastructure licence
- ensure that the 50% capital gains tax discount for assets held for over 12 months extends to rights under an employee share ownership scheme when the entitlement is held in an employee share trust
- extend the imputation system to co-operative companies, and
- remove any taxation consequences from the conversion of AGL from a statutory corporation to one registered under the Companies Code.

Background

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

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Main Provisions

Petroleum Resource Rent Tax (PRRT)

General[1]

The PRRT is a Federal tax on 'economic rent'. Rent is a payment to a factor of production, such as labour, that exceeds the amount necessary to keep that factor in its current occupation. For example, if a person receives a salary of $50 000 but would earn $40 000 in the next best alternative employment, the person receives rent of $10 000.

As applied to petroleum production, investors require a certain rate of return to undertake a project. A return above this threshold rate would result in the investors receiving rent. The PRRT applies to the return after all costs associated with exploration, development and production have been deducted. The PRRT is thus tied directly to the profitability of a project. In contrast, production-based taxes, such as the crude oil excise, are not tied directly to profitability.

The PRRT also provides the community-the ultimate owners of Australia's petroleum resources-with a fair proportion of the potentially high returns from the exploitation of scarce and non-renewable resources.

Under section 5 of the *Petroleum Resource Rent Tax Act 1987* (the 87 Act*)*, the rate of tax is 40 per cent. The PRRT is levied before income tax, and is deductible for income tax purposes. Projects incurring the PRRT are not subject to excise or royalties.

The 87 Act provides for the assessment and collection of the PRRT. The PRRT is generally assessed on a project basis. The tax base is net cash flows after recovery of eligible exploration expenditure, operating costs, and capital expenditure. Any excess of expenditure over receipts can be compounded forward (at the long-term bond rate plus 15 percentage points for exploration and the long-term bond rate plus five percentage points for other expenditures provided they are incurred less than five years before the production licence commenced) for deduction against future receipts from the project.

Closing Down Costs

Currently, the 87 Act provides for closing down expenditure to be deductible when facilities cease to be used in relation to a project. However, if the facilities are subsequently used for other purposes related to a petroleum project, or projects, the deduction is not allowed until after that use has been terminated. Under section 39 of the 87 Act closing down expenditure is defined to include either capital or income expenditure incurred in ceasing the project, including expenditure on environmental restoration during the closing down.

Under guidelines issued by the Department of Industry Tourism and Resources, safety and environmental plans must be prepared prior to the decommissioning of a production facility, pipelines and related facilities. Such facilities operate under a number of licensing

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regimes under the 1987 Act, the production licence being the most relevant for closing down expenditure. Production licences relate only to the area covered by the licence.

There is the possibility that once a production rig has ceased to be used for resources covered by its production licence that producers, either the current owners or purchasers of the facility, may find it economical to use that platform for the processing or transporting of petroleum resources (including gas) from adjacent licence areas. Such activities would be undertaken under an infrastructure licence rather than a production licence. As noted above, the continuing use of such a facility would preclude a deduction for closing down expenditure as the use of the facility (or project) had not been terminated. The Bill proposes that closing down costs be deductible on the termination of a production licence even if an infrastructure licence comes into force on the termination of that licence.

Item 1 of **Schedule 5** will insert a definition of 'external petroleum' into section 2 of the 87 Act. This will be petroleum (including gas) recovered from an area or areas other than that covered by the production licence for the project.

Future closing down expenditure is defined in proposed section 2C to be incurred where:

- the project terminates on the cessation of a production licence or licences
- on termination, an infrastructure licence comes into force in respect of the facilities and other property that comprised the project immediately before termination, and
- if the infrastructure licence had not come into force closing down expenditure would have been incurred.

The amount of future closing down expenditure incurred will be the amount of such expenditure which the person would expect to incur in closing down the project discounted to give a present value for the future expenditure (this is calculated by reference to the number of years that the infrastructure licence is expected to be used for and the long term bond rate) (**item 6**).

Section 27 of the 87 Act provides for amounts received on the disposal or termination of a project to be included in assessable property receipts and so subject to tax. While closing down expenditure is allowed as a specific deduction, future closing down expenditure will be taken into account by **item 13** which will amend section 27 to provide that in calculating assessable property receipts future closing down expenditure is to be taken into account. If the future closing down expenditure exceeds the eligible property receipts, the future closing down expenditure will be deemed to be nil.

However, where the amount has been deemed to be nil but there is an excess of future closing down expenditure, the excess will be deemed to be closing down expenditure (**item 20** which will amend section 39 of the 87 Act). (Sections 46 and 47 of the 87 Act provides that if closing down expenditure exceeds assessable receipts and there are no tax debts, 40% of the amount is payable by the Commissioner.)

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The other amendments contained in **Schedule 5** deal with the inclusion of income from external petroleum in a projects income and the deductibility of expenditure associated with such petroleum.

Commencement: Royal Assent (**clause 2**).

Capital Gains Tax – Employee Share Schemes

In their purest form, employee share ownership schemes (ESOS) aim to encourage participation in the ownership of an enterprise by the employees of the enterprise, giving rise to a greater community of interests between the employer and employees. The theory is that this will give rise to greater communication and commonality of interests between the parties to secure the greater success of the enterprise. However, ESOS may be used for other purposes, such as to defer a pay increase by offering shares in an enterprise, particularly when both the employer and employees know that a pay increase cannot be afforded. The effectiveness of an ESOS is more dependant on the circumstances in which it is offered and accepted rather than merely because such a scheme exists.

In addition to determining the effectiveness of an ESOS, which will largely be a subjective matter for employees, judging their impact is also hampered by an absence of statistical information on the area. There are no figures available on the number of ESOS operating or of their value so that much of the commentary in the area is either of a general nature or based on a small number of cases.

The area was examined by the House of Representatives Standing Committee on Employment, Education and Workplace Relations in its report *Shared Endeavours*, dated September 2000. The Committees aims were to foster the use of ESOS and to curtail their use for aggressive tax planning and it made a number of recommendations, including:

- the Australian Taxation Office (ATO) collect annual statistics on a number of aspects of the coverage of ESOS (Recommendations 1) and that an Agency be established in the ATO under which all ESOS be registered (Recommendations 18 and 19).
- Public policy be developed to promote ESOS in order to:
  - better align the interests of employers and employees
  - develop national savings
  - facilitate the development of sunrise enterprises, and
  - facilitate employee buyouts and succession planning (Recommendation 5), and
- that tax laws be examined to prevent the abuse of ESOS, particularly in regard to plans available to executives only (various Recommendations, eg rec 15).

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For shares issued under an ESOS after 28 March 1995 at a discount on market price, Division 13A of the *Income Tax Assessment Act 1936* (ITAA36) offers some relatively minor income tax concessions so long as the share or right issued falls within the definition of a qualifying share or right. To be classified as a qualifying share or right a number of conditions must be met, the most important of which are that the ESOS is open to at least 75% of permanent employees and that immediately after the acquisition the taxpayer's interests in the shares of the company do not exceed 5%. The available concessions are that:

- the amount of the discount can be deferred from inclusion in assessable income for up to 10 years, or
- if the amount of the discount is included in assessable income in the year of receipt of the shares or options, the first $1000 of the discount is excluded.

On disposal of the shares, and restrictions on when shares may be disposed are a feature of many ESOS, normal capital gains tax (CGT) rules apply (though there are some modifications in the calculation of the cost base), including the 50% discount when the asset has been held for at least 12 months.

One of the difficulties in applying the 50% CGT discount to ESOS is where the scheme requires the shares to be held in an employee share trust before the employee becomes their full legal and beneficial owner (for example, shares may have to be held in the trust until restrictions on their disposal terminate). In such cases, the employee will only be considered to be the owner of the shares when they hold full legal and beneficial ownership, so that the 12 month discount period will only apply from this date. To address this matter, the then Assistant Treasurer announced on 27 February 2001 that if the employee has chosen to be taxed on any discount in the year that the share or right was provided and it was provided through a trust structure, then:

- the period for the 50% discount will apply from the time that the trust receives the shares, and
- the cost base of the share or right will be based on the market value of the instrument on the day it is received by the trust.

It was also announced that the changes would apply from the date of announcement.[2]

The above measures will be implemented by **Schedule 2** of the Bill. Section 109-55 of the *Income Tax Assessment Act 1997* (ITAA97) contains a number of specific rules governing when an asset will be deemed to have been acquired for CGT purposes. **Item 3** will insert a new item which provides that where the conditions in the proposed amendments to section 115-30 are satisfied (see below), and a share or right is received from an employee share trust, the taxpayer will be deemed to have acquired the asset at the first time that they acquired a beneficial interest in the share or right (ie generally when it is placed in the trust).

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Division 115 of the ITAA97 deals with discount capital gains. Amendments to sections 115-30 and 115-80 provide that the discount will be available where the share or right:

- was acquired under an ESOS
- was acquired from an employee share trust, and
- the share or right is a qualifying share or right

then the taxpayer will be deemed to have acquired the share or right when they first acquire a beneficial interest in the instrument so long as they have elected to have any discount (less the $1000 exemption) included in assessable income in the year of receipt (**items 5 and 6**).

Item 9 will amend section 130-85 to provide that where the above conditions are met, the cost base and reduced cost base of the asset will be based on its market value at the time when a beneficial interest is acquired.

Application: From 5 p.m. on 27 February 2001 (**item 12**).

Franking of Distributions by Co-operatives

Franking forms part of the imputation system and refers to the situation where a credit, generally for company tax paid, is passed along with a dividend to reduce the tax payable by the recipient of the dividend. Such dividends are referred to as being wholly or partly franked.

Co-operative companies are companies which have limits on the maximum number of shares which a single shareholder can hold, are not listed on a stock exchange and which are established for carrying on one or more of the purposes listed in section 117 of the ITAA36. These are:

- the disposal, distribution or acquisition of commodities or animals to or from it's members
- the storage, marketing, packing or processing of members commodities
- rendering services to its members, or
- obtaining funds from members to lend to other members to acquire residential or business/residential property.

To remain with the definition, at least 90% of the companies ordinary business must be conducted with its members.

Co-operative companies are assessable on all 'normal' assessable income, including that gained from its members. However, unlike other companies co-operative companies can claim a deduction for distributions made to members, including any interest and dividends paid. Their dividends are currently not subject to franking.

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The then Assistant Treasurer announced on 27 August 2001that the ability to frank dividends would be extended to co-operative companies from 1 July 2002. Such companies would retain the option of paying unfranked dividends and claiming a deduction for the distribution.[3] The announcement was expanded on by the current Assistant Treasurer in a Press Release dated 21 November 2002 which contained the statement that: 'This means that the imputation rules will apply to a co-operative company in the same way as they apply to any other company.'[4]

Section 120 of the ITAA36 deals with the availability of deductions for distributions made by co-operative companies. **Item 1 of Schedule 3** will add a number of subsections to section 120 providing that:

- no deduction will be available to the extent that a distribution is franked
- if the franking percentage is less than 100% and part of the distribution is attributable to non-assessable income, it is to be assumed that the franked part of the distribution is attributable to the greatest extent to the non-assessable income, and
- if a distribution is made within 3 months of the end of an income year, the co-operative company may elect to have it treated as if it was made on the last day of the year.

Proposed section 218-5 of the ITAA97 provides that with two minor modifications the imputation system applies to co-operative companies in the same way in which it applies to other companies. The modifications are that distributions subject to a deduction are to be included in the definition of a distribution and that the co-operative company which makes an unfranked frankable distribution to a member need not provide a distribution statement to the member (**item 4**).

Application: For distributions made after 1 July 2002 (**item 6**).

AGL – Conversion to Public Company

The Australian Gas Light Company (AGL) was established by NSW legislation in 1837 as a company of proprietors with a limit on an individual's maximum interest of 2%. It was originally established to provide lighting for Sydney streets and was listed on the Sydney stock exchange in 1871. Since its beginnings AGL has grown to become a major player in the energy market, supplying both gas and electricity to NSW and other States and the ACT. AGL also plays a minor role in electricity generation. With the introduction of national competition rules, AGL has also become a major dealer in the energy market, both buying and selling energy to meet its clients and its own needs. According to a newspaper report, AGL holds 31% of the total eastern Australian retail energy market and 37% in Victoria.[5]

As noted, when established AGL had a maximum individual holding of 2%. This was increased to 5% in 1986 and, following restructuring and the deregulation of the NSW gas market in 1994, AGL questioned the need for the 5% limit and AGLs incorporation under the

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specific NSW legislation. Negotiations began with the NSW government to remove the 5% ownership limit and to have AGL incorporated under the general corporations law and in 2000 AGL announced that it was working with the government towards these aims. The result, incorporating these measures, was announced by the NSW Minister for Energy on 2 April 2001. The enabling legislation passed the NSW Parliament on 9 May 2002 and came into force on receiving Assent on 16 May 2002. As part of the conversion process a general meeting of the proprietors (shareholders) of AGL was required and a special general meeting approved the changes on 3 July 2002.

Without specific roll-over relief, the conversion would give rise to a CGT event, with subsequent liability for tax, and other possible tax liabilities. Roll-over relief has been made available in a number of situations where there has been a change in structure of an organisation while the interests of the owners and assets held remained constant. The Minister for Revenue and Assistant Treasurer announced on 23 May 2002 that roll-over relief would be made available on the conversion of AGL and that this would be achieved by regarding the new body as the old one for taxation purposes.[6]

Clause 5 of the Bill provides that there is to be no taxation consequences from the conversion of AGL to a registered company and that the original AGL and its other identities are to be taken to be the same entities for taxation purposes. **Clause 5** also provides that:

- the legal and beneficial ownership of shares and interests in shares are taken not to have been altered by the conversion, and
- actions taken by the Secretary of the previously structured AGL will be deemed to have been taken by the new body.

Commencement: 11 October 2002 (the time of conversion) (**clause 2**).

Endnotes

1 The following general information is taken from Research Note Number 20 of 2000-01 authored by Richard Webb of the Economics, Commerce and Industrial Relations Group. The endnote for the above section: (1) Other taxes applied to crude oil production are royalties and crude oil production excise. Petroleum production not subject to PRRT is generally subject to either Commonwealth or State/Territory royalties. Crude oil production excise applies to on-shore fields producing stabilised crude and off-shore fields in the North West Shelf. This excise should not be confused with the excise on refined products such as petrol and diesel. For a description of the latter, see: http://www.aph.gov.au/library/pubs/rp/2000-01/01RP06.htm

2 Assistant Treasurer, *Press Release*, 27 February 2001.

3 Assistant Treasurer, *Press Release*, 27 August 2001.

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4 Assistant Treasurer, *Press Release*, 21 November 2001, Attachment A.

5 *The Age*, 6 July 2002.

6 Minister for Revenue and Assistant Treasurer, *Press Release*, 23 May 2002.

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