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No. 32 2003–04

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Taxation Laws Amendment Bill (No. 7) 2003

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Contents

Purpose 1

Background 1

Main Provisions 2

Gifts 2

Consolidation and 3

Foreign Losses 3

GST 4

CGT Roll-over Relief – Financial Services Reform 5

Foreign Hybrids 7

Miscellaneous 9

Second World War payments 9

Imputation for life insurance companies 9

Overseas Forces 9

Endnotes 9

Taxation Laws Amendment Bill (No. 7) 2003

Date Introduced: 26 June 2003

House: House of Representatives

Portfolio: Treasury

Commencement: The Bill contains numerous commencement dates, many of which differ from the date the measure will apply from. The application dates are dealt with below.

Purpose

To:

- enable entities which are eligible to receive tax exempt gifts to be listed by regulation
- allow a company with foreign losses and which forms part of a consolidated group to retain the losses itself for a transitional period
- alter the definition of supply for goods and services tax (GST) purposes so that certain activities performed in the formation of a consolidated group, or for a member leaving the group, will not attract GST implications
- allow capital gains tax (CGT) roll-over relief during the transfer to the new financial services reform (FSR) regime, and
- alter the treatment of certain overseas company structures so that they are taxed in a similar basis in Australia as they are in the country where they were formed.

Background

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

Main Provisions

Gifts

For a gift or donation to be deductible a number of conditions must be met, most of which relate to status and purpose of the entity to which the donation is made. The *Income Tax Assessment Act 1997* (ITAA97) contains both general categories of entities which are eligible for deductible donations (such as public or not for profit hospitals and public benevolent institutions) but donations to such entities will only be allowable if the entity is authorised by the Australian Taxation Office (ATO) to receive deductible donations (such entities are referred to as an endorsed entity). In addition, ITAA97 lists other bodies by name and donations to these bodies are also deductible. The listing of such bodies in the ITAA97 means that the Act must be amended when bodies are added to, or deleted from, the list. Additions to or deletions from the list are generally non-controversial, other than when politically related bodies, such as certain research institutions and foundations, are involved.

As part of the Government's response to the Report of the Inquiry into the Definition of Charities and Related Organisations the Treasurer announced that the Government proposed to change the listing arrangements for those bodies specifically listed in the ITAA97, so that from 1 July 2003 these bodies would be listed in Regulations rather than the Act itself. The reasons given for the change are reduced administrative costs and the more timely listing of bodies, while Parliamentary scrutiny is still provided for by the power of either House of Parliament to disallow the regulations.[1]

Amendments contained in **Schedule 3** of the Bill provide for the continuation of the dual system of endorsed entities and specifically listed bodies, but provides for the latter entities to be listed in the Regulations rather than in the Act itself. The Bill also provides for conditions to be set for a donation to a listed body to be deductible, a power which is currently applicable to bodies listed in the ITAA97 (existing conditions principally relate to the timing of donations to be eligible for a deduction) (**items 3 to 56**)).

Proposed subdivision 30FA contains special provisions relating to regulations made for the purpose of listing charities, including:

- providing for the disallowance of regulations (the procedures and timing are essentially the same as those applying to regulations generally) (**proposed section 30-312**), and

- except for the first set of regulations, which are to commence on 1 July 2003, regulations will commence the day after the end of the period during which they could be disallowed (**proposed subsection 30-312(4)**).[2] However, a regulation which terminates or limits the deductibility of donations to a body may only have effect up to 60 days before the relevant regulation is made if there has been a public announcement by the relevant Minister to that effect before the termination/limitation comes into force (**proposed section 30-314**). (Regulations may have effect from a date before they commence under **proposed paragraph 30-105(2)(b)**.)

Currently, the ITAA97 allows deductions for gifts of property valued at more than $5000 to be spread over 5 years. This can be important where tax liability is low as deductions for gifts to charities cannot be used to create a refundable tax loss. If the ability to spread deductions over 5 years did not exist the value of the deduction could be lost, possibly leading to fewer donations. **Proposed subdivision 30-DB** will extend the ability to spread deductions to gifts of money, while maintaining existing conditions (which relate to notification) in relation to some categories of donations (**item 57**).

Application: From 1 July 2003 (**clause 2**).

Consolidation

Foreign Losses

The recently introduced consolidation regime allows companies with common ownership to act as a single entity for tax purposes, including having the head company submit tax documents for and on behalf of all of the companies in the consolidated entity. The consolidation regime was introduced from 1 July 2002 and while extensive consultation occurred prior to the introduction of legislation for the regime, it was acknowledged during the passage of the various Bills dealing with the new regime that there would be a need for early amendments as the regime settled in.[3]

Schedule 5 of the Bill will insert a **new Division 701D** into the *Income Tax (Transitional Provisions) Act 1997* dealing with the transitional period for foreign loss makers. **Proposed section 701D-10** provides that if a number of conditions are met, a foreign loss maker which would otherwise be a full member of a consolidated regime may elect to have their foreign losses treated under existing law for a transitional period of a maximum of 3 years. The conditions to be met include:

- the consolidated group came into existence prior to 1 July 2004
- apart from an election under this proposed section the foreign loss company would be a full member of the group
- the head company makes a choice for the proposed section to apply, and
- the foreign loss company has been a wholly owned subsidiary of the head company from 1 July 2002 until the election is made.

The Bill was referred to the Senate Economics Legislation Committee (the Committee) pursuant to a motion of the Senate of 13 August 2003 following a recommendation of the Selection of Bills Committee. One of the main reasons for the referral was the possible negative revenue implications of the changes to the consolidation regime in regard to foreign losses (see below). In evidence given to the Committee on 22 August 2003 a representative of the Corporate Tax Association of Australia Incorporated and their advisor outlined the potential problems if the amendments were not passed (basically that deductions relating to foreign losses currently allowed would be greatly reduced due to the pooling of accounts in the head company) and expressed the views that:

- in allowing only a three year transitional measure the proposed amendment was restrictive and a five year period should be allowed to enable existing losses to be fully used, and
- the measure was likely to be revenue neutral or positive.[4]

The Explanatory Memorandum generally supports the view that there will be little revenue loss stating:

> This measure essentially allows entities with foreign losses to maintain their existing tax treatment for a transitional period. The revenue impact is therefore not expected to be significant.[5]

Some Committee members were not in favour of the extension of the transitional period to 5 years.[6] The Committee reported on 10 September 2003. The change to a 5 year period was rejected and, while indicating that some submissions wanted minor changes, noted that all submissions were in favour of the Bill and the Committee recommended that it should be passed.[7]

Commencement: 24 October 2002 (the same time as relevant provisions of the *New Business Tax System (Consolidation and Other Measures) Act 2003* commenced) (**clause 2**).

GST

The concept of a taxable supply is given a wide definition in the GST regime and includes entering into various financial agreements and releasing entities from certain obligations. The consolidation legislation requires that certain taxable actions be undertaken in the formation of the consolidated entity while ordinary business activity will require additional taxable supplies to be made between the entities forming the consolidated group. Without the amendments contained in **Schedule 6** GST would be payable on arrangements between the various members forming the consolidated group. Similar liability would arise when a member quits a consolidated group. There would also be input tax credits arising within the consolidated entity to reflect the payment of GST.

The measures contained in the Bill were not announced prior to the introduction of the Bill and are estimated in the Explanatory Memorandum to have 'nil' financial impact.[8]

Item 1 of Schedule 6 will insert **new sections 110-15 to 110-30** into *the A New Tax System (Goods and Services Tax) Act 1999*. The new provisions will exempt from the definition of supply a number of transactions associated with creating a consolidated group or an entity leaving the group. The exempt transactions will be:

- supplies required under the consolidation regime (**proposed section 110-15**)
- entering into a tax sharing agreement on the formation of a consolidated group (**proposed section 110-20**)
- the release of an entity from an obligation to contribute to the tax liability of a consolidated group where the entity is leaving the consolidated group and leaves clear of any liability for the group's tax (**proposed section 110-25**), and
- the entering into of an agreement that distributes tax liability and economic benefits between the head company and members of the consolidated group (**proposed section 110-30**).

Application: To tax periods starting on or after 1 July 2002 (**item 11**).

CGT Roll-over Relief – Financial Services Reform

Prior to the introduction of the Financial Services Reform (FSR) program, the providers of various financial services were governed under different regimes depending on the nature of the product dealt with. As a result, institutions which dealt in more than one type of product found themselves having to satisfy a number of differing regulatory regimes which increased compliance costs for the institutions involved. As well, the differing disclosure rules made it very difficult for consumers to compare the costs of various products even though the products may be considered to be alternatives in the market.

The FSR program, which has been implemented since 2001, replaced the existing regimes with a single regulatory regime for those who deal with, provide advice on or market financial products.

Without roll-over relief there would be a number of capital gains tax (CGT) implications for entities changing to the new regime, principally related to the value of the licence/s to conduct financial services. For example, the existing licences will cease to have value when FSR licences are issued and this would not only result in a capital loss being incurred but could also result in pre-September 1985 licences losing their CGT exempt status as they cease to have effect and the new FSR licence takes effect. The cost bases for the new FSR licence would also reflect their recent acquisition rather than the historic cost bases of the 'old systems' licences.

On 21 February 2003 the Assistant Treasurer and Minister for Revenue announced that during the transitional period between the old regime and the FSR regime (11 March 2002 to 11 March 2004) CGT roll-over relief would be available in respect of intangible assets (principally licences) replaced by another intangible asset (the new licence). The aim of the amendments is to remove any impediments to movement to the new FSR regime.[9]

CGT roll-over relief is a relatively common occurrence when new taxation rules or asset restructuring occurs and is designed to prevent consequences where an asset maintains its same underlining ownership but ownership is transferred to a new structure either directly as a result of general policy implementation (as in this case) or through changes in the taxation treatment of various corporate structures (eg changes in business taxation).[10] The basic rule with a roll-over is that any capital gain or loss occurring at the roll-over time is ignored and the existing cost bases flow through to the new asset. Any capital gain or loss arising from the future disposal of the replacement asset is calculated according to the cost bases carried forward from the old asset and any changes since the new asset came into being.

The Explanatory Memorandum to the Bill estimates that the measures will result in a 'small revenue deferral'.[11]

Schedule 9 deals with roll-overs during transition to the new FSR regime. The amendments have the same basic result if an application for relief is made during the transitional period, ie that any capital gain or loss is ignored, although the costs of the transition and whether these cost are added to the cost bases may differ, and that any existing pre-CGT status will apply to the new asset. In brief the categories of roll-over relief are:

- a licence or right to conduct a financial service under the old regime is replaced by a licence under the FSR regime which relates to the performance of some or all of the functions covered by the original licence and the licences are held by the same owner. In such cases, the costs of acquiring the new assets will be included in their cost bases (**proposed sections 124-880 - 124-895**), and

- a new owner has acquired an existing licence/right and has applied for, and been granted, a FSR licence. Their CGT status will be as described above, with any amount paid to acquire the new assets being spread amongst the assets acquired (proposed sections **124-900 – 124-920**).

The transition period may be extended by the Australian Securities and Investments Commission (ASIC) beyond the 10 march 2004 ending date**. Proposed sections 124-925 and 124-930** provide that if the date is extended by ASIC then the transitional period for the purposes of roll-over relief will also continue until the end of the period specified by ASIC.

Application: To CGT events occurring on or after 11 March 2002 (**item 17**).

Foreign Hybrids

The amendments regarding foreign hybrids were announced by the Assistant Treasurer and Minister for Revenue in a Press Release dated 8 April 2003 and deal with the situation where certain business structures used overseas are taxed on a different basis in the country they are formulated in and Australia. The rules are highly technical and also deal with the treatment of foreign hybrids by Australian foreign taxation rules, principally those dealing with controlled foreign companies (CFC) and foreign investment funds (FIF). Due to the technical nature of the amendments only a general view of their application will be provided in this Digest. For a more technical examination of the rules readers are referred to the Explanatory Memorandum to the Bill and the Treasury explanation of the proposed rules.[12]

Under other countries' tax rules, structures which are treated as corporations in Australia for tax purposes, with the tax imposed on the separate corporate entity, can be treated as partnerships with the taxation consequences being on the individual in a similar manner as partnerships are taxed in Australia. Examples given of such entities are limited liability partnerships in the US and UK and, perhaps more importantly, limited liability companies in the US which are treated as partnerships for the purposes of US tax law (such entities are the 'foreign hybrids').

The difficulties with the different classification between Australia and other countries arises with the application of the CFC and, to a lesser degree, FIF rules where attributable income and taxation paid in other countries depends on the classification of the foreign entity earning the income or paying the tax. While the purpose of the CFC and FIF rules is to prevent tax avoidance by residents diverting income to low taxed foreign tax regimes (principally by levying additional tax on tainted income which was subject to lesser tax rates), it is possible for an entity to be classified as having a certain structure in one tax jurisdiction (eg as a limited liability company) but for this classification not to be recognised in Australia. In such cases it is possible that the tax paid in the original jurisdiction will not be recognised in Australia, leading to the double taxation of profits if they are returned to Australia. It has been reported that the likelihood of double taxation has operated to prohibit a number of Australian companies, such as CSR, Lend Lease and Westfield, from repatriating profits.[13]

Changes to the treatment of foreign hybrids were detailed by the Assistant Treasurer and Minister for Revenue on 8 April 2003. It was announced that such entities would be treated as partnerships, rather than companies, for Australian taxation purposes so long as they are also subject to the CFC or FIF rules. This will allow their prior tax treatment to be taken into account in determining any Australian tax payable and should remove the possibility of double taxation of profits.

While interests in foreign hybrid CFCs will automatically fall within the new rules, holders of investments in foreign hybrid FIFs must elect to have the new rules apply. The difference is based on the expected amount of knowledge of the operations of the foreign hybrid involved. The argument is that a small investor in a FIF will generally not have the information to act as a partner for tax purposes so that they will automatically be excluded from being considered a partner, but will have the option of being treated as a partner if they so elect.

Item 15 of Schedule 10 will insert a **new Division 830** into the ITAA97. A foreign hybrid may be either a:

- foreign hybrid limited partnership – basically an entity formed in a foreign country that is taxed as a partnership in that country, is not an Australian resident during the tax year and is a CFC or an election has been made to be treated under these rules (**proposed section 830-10**), or
- foreign hybrid company – a company that is formed in the USA and treated as a partnership under their tax laws which at no time during the year under consideration was a resident of Australia, and was a CFC during the year (**proposed section 830-15**).

Where a company is to be treated as a partnership, the interests in the partnership will be in the same proportions as the interests in the company (**proposed subdivision 830-B**). As the company is still limited in liability for general purposes (the company is only treated as a partnership for tax purposes) there will also be a limit placed on the capital and revenue losses which may be claimed by the deemed partnership. Such items may only be claimed up to the extent of the partner's 'loss exposure amount'. In brief, this will be equal to the long term (over 180 days) contributions made to the entity less repayable loans and the relevant proportion of losses made by the entity (**proposed section 830-60**).

When an entity becomes, or ceases to be, a foreign hybrid, it is necessary to value the interests of the various members of the partnership/company. For a hybrid company, this will be based on their respective 'tax costs' which are to be calculated in accordance with **proposed subdivision 830-D**. Basically this will reflect the taxpayer's percentage interest in the entity that would be available if the entity was wound-up. If the hybrid is a partnership, the tax cost will be based on the proportional interest held in the various assets.

The ability to elect that an interest in a FIF be treated as an interest in a foreign hybrid is dealt with in **proposed section 485AA** of the ITAA36. The taxpayer may, at the end of a tax year, elect that such an interest be treated under the new rules. If such an election is not made, current FIF treatment will apply.

Application: Generally to the 2003-04 and later years. However, taxpayers will have the option of electing that the rules also apply to the 2002-03 year and may also amend assessments for earlier years during the general period allowed to amend assessments (usually 4 years) (**Part 3 of Schedule 10**).

Miscellaneous

Second World War payments – **Schedule 1** of the Bill will make it clear that no tax, including CGT, applies to payments from a foreign country where the payment relates to loss or damage during the Second World War. It will include payments from enemy regimes and enemy-associated regimes. **Application**: For the 2001-02 and later income years (**item 4**).

Imputation for life insurance companies – **Schedule 7** will retain the current access for life insurance companies to the imputation system. The Bill will insert a new Division 219 into the ITAA97 which reflects the current treatment and may be considered a re-writing of the existing provisions. **Application**: For events occurring on or after 1 July 2002 (**item 8**).

Overseas Forces – The ITAA36 currently contains a number of provisions providing concessional treatment for pay for service overseas. The actual concession available largely depends on who the service is provided for, eg UN or a foreign government. **Schedule 8** will make it clear that only one concession can apply to such income. **Application**: For service provided on or after 1 July 2001 (**item 3**).

Endnotes

1 Treasurer, *Press Release*, 29 August 2002.

2 Regulations normally have effect from the time they are Gazetted unless the regulation specifies another time or date (*Acts Interpretation Act 1901*, s. 48).

3 See, for example, the Press Release of the Assistant Treasurer and Minister for Revenue, 30 June 2003, where examples of future 'finetuning' of the consolidation regime are mentioned: http://assistant.treasurer.gov.au/atr/content/pressreleases/2003/067.asp.

4 Senate, Economics Legislation Committee, 22 August 2003, pp. E1–E3.

5 *Explanatory Memorandum*, p. 5.

6 ibid., p. E4.

7 http://www.aph.gov.au/senate/committee/economics_ctte/tlab7_03/report/report.pdf

8 *Explanatory Memorandum*, p. 6.

9 Assistant Treasurer and Minister for Revenue, *Press Release*, 21 February 2003.

10 Examples of existing roll-over relief include the roll-over of assets owned by individuals, trusts or partnerships into wholly owned companies, the replacement of assets following involuntary disposal and script for script company restructures.

11 *Explanatory Memorandum*, p. 8.

12 http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=588

13 *The Australian*, 15 April 2003, p. 18.