Tax Laws Amendment (2007 Measures No. 3) Bill 2007

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Economics Section

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Tax Laws Amendment (2007 Measures No. 3) Bill 2007

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House: House of Representatives
Portfolio: Treasury

Commencement: New sections 1 to 3 comment on Royal Assent. The operative provisions have different commencement dates. Some are effectively retrospective. Commencement dates for each schedule, or provisions within schedules, are noted in the discussion of the relevant schedule in this Digest.

Purpose

To make necessary amendments to the following Acts:

- Income Tax Assessment Act 1936
- Income Tax Assessment Act 1997
- Fringe Benefits Tax Assessment Act 1986
- Income Tax (Transitional Provisions) Act 1997, and
- Taxation Administration Act 1953.

This Bill contains a wide variety of measures. Consequently, relevant background, position of various interest groups and political parties, pros and cons and financial implications of each measure contained in this Bill will be given at the commencement of each section.

While each of the measures enacted by this Bill have already been separately announced, the Minister for Revenue and Assistant Treasurer, The Hon. Peter Dutton MP, collectively announced all the measures on 10 May 2007.¹

Schedule 1: Distributions to entities connected with a private company and related issues

Background

The proposed changes in Schedule 1 of this Bill are to Division 7A of the Income Tax Assessment Act 1936 (ITAA36).

Under Division 7A, amounts paid, lent or forgiven by a private company to certain associated entities (including individuals) are treated as dividends (i.e. are deemed to be

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dividends), unless they come within specified exclusions. These provisions apply to non-share equity interests and non-share dividends in the same way that it applies to shares and dividends.

The dividends so paid are then taxed as ordinary income in the hands of the recipient. In these circumstances a private company’s franking account is also debited.

The provisions apply where the recipient of the payment, loan or forgiven amount is:

- a shareholder
- an associate of a shareholder, or
- a former shareholder or former associate where a reasonable person would conclude that the amount is paid, lent or forgiven because of that former status.

For these purposes, ‘associate’ has the meaning provided in existing section 318, which covers a broad range of entities that are associates of natural persons, companies, partnerships and trustees.\(^2\)

When a payment is made it is deemed to be a dividend payment. The original purpose of Division 7A was ‘to ensure that private companies will no longer be able to make tax-free distributions of profits to shareholders (and their associates) in the form of payment or loans’. In particular, the Division was intended ‘to ensure that all advances, loans and other credits (unless they come within specified exclusions) by private companies to shareholders (and their associates), are treated as assessable dividends to the extent that there are realised or unrealised profits in the company. In addition, debts owed by shareholders (or associates) which are forgiven by private companies are treated as dividends.’\(^3\)

The proposed changes generally reduce the severity of the penalties associated with Division 7A where such distributions are deemed to have been made.

**Basis of policy commitment**

The government’s intention to change the provision of Division 7A ITAA36 was announced in the Minister for Revenue and Assistant Treasurer’s media release no. 89 of 6 December 2006.

**Positions of various interest groups and press comment**

The Taxation Institute welcomed the proposed changes when they were first introduced. They considered that the proposed measures correct significant inequities in the way that Division 7A ITAA36 operated.\(^4\) There has been no significant press comment on these particular measures.

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Pros and Cons

On one hand the proposed measures could be seen as a watering down of the current rules protecting the integrity of the tax system as it applied to distributions from small business.

However, the current penalties could also be seen as excessive and unwarranted. Therefore the proposed changes could also be seen as correcting significant inequities in the current tax law applying to small business.

Further, the proposed changes will reduce the likelihood that a taxpayer might accidentally cause a ‘deemed’ dividend to occur. This will reduce tax compliance costs for a private company.

Financial Implications

The Explanatory Memorandum to this Bill notes that the financial impact of these particular changes are ‘unquantifiable’ but are expected to be small.  

Main Provisions

Division 7A deals with loans and other payments made to an entity. Under existing section 470 an entity can be a person, partnership, trustee or company.

Item 3 of Schedule 1 inserts new subsection 109D(4A). The purpose of section 109D is to allow so much of a loan made during a financial year, that remains unrepaid and unconverted to a loan under paragraph 109D(3)(c) at the company’s lodgement day for its tax return for that year, to be treated as a dividend paid to an entity and taxed accordingly.

Under the proposed change, if a payment from a private company is formally converted to a loan before that company’s lodgement day, then it is treated as a loan for tax purposes, and the un-repaid amount at lodgement day is not classed as a dividend paid to the entity.

Items 3 and 4 reduce the amount of a deemed dividend paid to an entity in a year where they have failed to make the required repayments in that year.

Under the current section 109E if an entity who has received an ‘amalgamated loan’ from a private company fails to make the required minimum yearly repayments to that private company calculated under subsection 109E(6), the deemed dividend paid to the entity is the outstanding balance of the loan and is taxed accordingly.

An amalgamated loan is simply the total of all un-repaid loans made by the private company to an entity with the same term and would cause the private company to be taken to pay a dividend. Where the amount of the outstanding amalgamated loan is large, the tax impost is also potentially very large.

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The impact of items 4 and 5 is to allow the amount of the deemed dividend raised in these circumstances to be the difference between the amount actually repaid, and the amount that should have been repaid in that particular year – not the amount of the outstanding loan.

Loans that meet the minimum interest rate and maximum term criteria under section 109N ITAA36 do not trigger a deemed dividend. Briefly these criteria are:

- for a loan secured by a registered mortgage over real property for not more than 25 years and an interest rate specified in subsection 109N(2), and
- for an unsecured loan, a maximum term of 7 years with the above interest rate.

Item 6 inserts new subsection 109E(3A) and 109E(3B) into the ITAA36. These new subsections allow the conversion of an unsecured loan meeting the requirements of section 109N to a secured loan also meeting these requirements.

Item 9 inserts new subsections 109G(3A) and 109G(3B) into the ITAA36. A company making a loan to an entity may elect to forgive an amount of an outstanding loan. Under current section 109F the amount of the deemed dividend arising from such an action would be the total amount of the loan forgiven. This would occur even if a deemed dividend in relation to the same loan also arose from the operation of section 109E ITAA36. This can lead to the double counting of a deemed dividend arising from the same event for tax purposes.

Item 9 allows for the reduction of the deemed dividend arising from the forgiveness of a loan made to an entity by a private company by the amount of any deemed dividend arising from the same loan under section 109E ITAA36. Thus, the above mentioned double counting is avoided. The general effect of Division 7A ITAA36 is to prevent the perpetual refinancing of loans made by private companies to various entities. However section 109R specifies payments that can be made to a private company for the refinancing of a loan that are not to be taken into account when assessing whether the required minimum repayment under section 109E has been made or whether some much of a loan that remains unrepaid in any one year is to be assessed as a deemed dividend payment made to an entity under sections 109D and 109E ITAA36. Item 12 expands the range of circumstances in which payments made to a private company in order to refinance it loan to an entity, without triggering the assessment of a deemed dividend payment to the entity for taxation purposes.

Item 13 inserts new section 109RB into the ITAA36. Under current law when a deemed dividend is paid from a private company the Commissioner for Taxation cannot disregard it, and that company’s franking credit account cannot be debited.

New section 109RB gives the Commissioner the ability to disregard a deemed dividend where the dividend arose from an ‘honest mistake’ or an ‘inadvertent omission’ by the receiving entity or the company deemed to have paid the dividend.
Just what circumstances lead to the assessment of an honest mistake or inadvertent omissions by the Commissioner are to be determined by reference to all of the circumstances surrounding the particular case. The Explanatory Memorandum gives various examples of these circumstances and the Commissioner’s likely response in each of these circumstances. Further, in these circumstances the private company may choose whether or not to attach dividend imputation credits to (i.e. frank the dividend) to amounts classed as deemed dividends in these circumstances.

There may be circumstances where a private company must make a dividend payment to a person as to satisfy a Family Court order. Under current law, such payments cannot be franked. That is, they cannot have the tax benefits of the dividend imputation tax regime attached to them.

**Item 13** also inserts new section 109RC into the ITAA36. This new section allows dividends paid from a private company in response to a Family Court order to be franked. That is, to have the company’s dividend imputation credits, at that company’s normal benchmark franking percentage (i.e. 100% or such lesser percentage of the dividends are normally franked) attached to such payments.

Where an entity fails to make the required annual repayment of a loan from a private company the un-repaid annual amount is classed as a deemed dividend paid by the company. **Item 13** also inserts new section 109RD, which gives the Commissioner for taxation the ability to extend the time period in which the required repayments may be made for a particular financial year, providing the reasons why the repayments were not made were beyond the entity’s control.

Under current law if an entity defaults on a loan from another party, say a bank, and a private company covers the liability, the private company’s payments to the bank are classed as a deemed dividend. **Item 14** inserts new subsection 109UA(5) into the ITAA36. The effect of this new subsection is that a deemed dividend will not arise in these circumstances where the said private company has guaranteed the repayment of the annual liability and pays that liability.

**Comment**

This amendment could be seen as a way for entities to effectively receive tax free income if:

- they raise a loan from a financial institution, say a bank, and
- have the annual repayment of that loan guaranteed by a private company in which they hold shares, and
- the loan meets all the requirement of existing section 109N, and
- the entity defaults on the annual loan repayment, and
- the private company makes the required repayment.

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Under the provisions of Division 7A a private company can only be assessed as having paid a deemed dividend if it has a ‘distributable surplus’. The value of a private company’s distributable surplus is worked out according to a formula existing subsection 109Y(2).

Items 16 and 17 amend the above subsection to allow the Commissioner for Taxation wider powers to determine the correct value of a private company’s distributable surplus. This will enhance the Commissioner’s ability to correctly determine the amount of deemed dividends arising from a private company in any one year.

Item 29 repeals section 205-30 (table item 8) of the Income Tax Assessment Act 1997 (ITAA97). Currently, the effect of this particular table item in section 205-30 ITAA97 is that a private company’s franking account is automatically debited when a deemed dividend arises under Division 7A. This particular amendment means that this automatic debiting will no longer occur.

Comment

When a deemed dividend was assessed under Division 7A ITAA36 a double penalty was imposed. The receiving entity was assessed as having received this dividend, un-franked. They could not offset their income tax liability with a dividend imputation credit. Further, the company lost the associated amount of franking credits that may have been available for later distribution. The amendment in Item 29 will allow a private company to retain the associated franking credit when a deemed dividend is assessed as being paid to an entity.

Items 30 to 32 remove a loan made by a private company to its employee from the definition of a Fringe Benefit for taxation purposes, where such loans meet the requirements of section 109N ITAA36. The private company making the loan is not then subject to the Fringe Benefits Tax in respect of that loan.

Comment

The main issue concerning this particular amendment is whether the requirements of section 109N ITAA36 provide enough protection against the undue avoidance of tax in respect of these loans.

Item 42 inserts new subsection 214-60(1A) into the ITAA97. The effect of this new subsection will be to prevent the Commissioner for Taxation from making an assessment under section 214-60 ITAA97 of a corporate entity’s franking account where:

• a corporate entity is not required to give the Commissioner a franking return for an income year, and
• the same entity has otherwise lodged the required tax return for the year, and
• three years have passed since the corporate entity has lodged the tax return or was required to lodge the tax return, whichever is the later.

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This gives the Commissioner three years in which to make an assessment of a corporate entity’s franking account.

**Application**

**Item 43** provides for different dates on which the amendments made in **Schedule 1** apply, as follows:

- for loans that are not affected by the above mentioned amendments to the Fringe Benefits Tax (FBT) provisions (i.e. private company loans made to its employees) – 1 July 2006
- where the FBT amendments applies – 1 April 2007
- where new **section 109RB** applies (i.e. the Commissioner’s ability to disregard a deemed dividend arising from an honest mistake etc) – 1 July 2002, and
- where the new three year limit for the Commissioner to make an assessment of a corporate entity’s franking account applies – 1 July 2006.

**Comment**

Even though this particular schedule commences operation on the date of Royal Assent the provisions of **item 43** make this schedule retrospective tax legislation.

**Schedule 2: Superannuation contributions – transitional non-concessional contributions caps**

**Background**

As part of the recently legislated simplified superannuation arrangements limits were placed on the amount of after-tax contributions (these are non-concessional contributions) that could be made to a superannuation fund between 10 May 2006 and 1 July 2007.

The relevant legislation applied to contributions made by the superannuation fund member, or their employer. It did not apply to non-concessional contributions made by a friend of the superannuation fund member, on the latter’s behalf. The amendments in **Schedule 2** correct this oversight.

**Basis of policy commitment**

This measure was announced in the Minister for Revenue and Assistant Treasurer’s media release no. 37 of 24 April 2007.

**Positions of various interest groups and press comment**

There has been little media or interest group commentary on this proposed measure.

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Pros and Cons

This measure preserves the integrity of the recently legislated simplified superannuation legislation. Under this legislation, superannuation fund members may make up to $1 million of non-concessional contributions up to, and including, 30 June 2007. Once these contributions are inside the superannuation fund their earnings are taxed at a nominal rate of 15 per cent p.a. The actual rate of tax is often far lower. This measure prevents wealthy individuals making unlimited use of the superannuation environment as a tax shelter. Indeed, the government’s already legislated limits on non-concessional contributions are considered quite generous.

Financial Implications

The Explanatory Memorandum to this Bill notes that there is no financial impact of this proposed change.9

Main Provisions

**Item 2 of Schedule 2** inserts new **subsection 292-80(7)** to the **Income Tax (Transitional Provisions) Act 1997**. The effect of this addition is to include non-concessional superannuation fund contributions made by a person, who is not an employer of a superannuation fund member, in the assessable income of that superannuation fund. This allows such contributions to be subject to transitional limits on non-concessional contributions to superannuation funds between 10 May 2006 and 30 June 2007 mentioned above.

Schedule 3: Capital gains of testamentary trusts

**Background**

What is a testamentary trust?

Generally, a testamentary trust is a trust which is created through the grantor's will and does not become operational until the grantor's death.

Current tax treatment

Under current laws a beneficiary of a testamentary trust is generally assessed on a share of that trust’s taxable income. If this income includes capital gains of the trust’s assets, the beneficiary’s assessable income will include their share of those capital gains. Thus, the beneficiary may pay tax on capital gains to which they have no access.

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Proposed amendments

The proposed amendments will allow the trustee of a resident testamentary trust to choose to be assessed for tax purposes on the capital gains that would otherwise be included in the income of the beneficiary. The trustee would then pay the required tax on these capital gains.

Basis of policy commitment

These particular measures were announced in the Minister for Revenue and Assistant Treasurer’s media release no. 74 of 17 October 2006.

Positions of various interest groups and press comment

Industry comment was generally favourable at the time the Minister for Revenue and Assistant Treasurer first announced this proposed change.

Pros and Cons

The proposed change will allow trustees of testamentary trusts to pay tax on any capital gains the trust realises, instead of the beneficiaries who may not have access to these capital gains.

However, these proposed changes give the trustee the option of whether or not to pay the required tax. If the trustee decides not to pay this tax the beneficiary is still obliged to pay the tax.

Financial Implications

The Explanatory Memorandum to this Bill notes that the financial impact of these particular changes are ‘unquantifiable’ but are expected to be small.

Main Provisions

Item 2 of Schedule 3 inserts new section 115-230 into the ITAA97. This new section has several subsections, each with separate functions.

New subsection 115-230(2) specifies the trusts to which this policy applies. These trusts can only arise from a will or a codicil. The latter term refers to a legal instrument made subsequently to a will, modifying it. It legally becomes a part of the original will it is amending.

This new section also applies to the estates of those who die ‘intestate’. The latter term refers to those who die without leaving a will or whose estate is disposed of without a will.

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New subsection 115-230(3) specifies the circumstances in which the trustee can make the choice to pay the required tax on the realised capital gains of the estate. In particular the beneficiary does not have a vested interest in the property of the trust and that property has not been paid to this beneficiary.

In law vesting is to give an immediately secured right of present or future enjoyment. Basically that means being able to take full advantages of the asset in which one is vested. Trustees of testamentary trusts can only make the choice to pay tax on the realised capital gains of that trust if the beneficiary does not have a vested interest in the property in question.

Proposed subsection 115-230(5) ITAA97 allows the trustee to make this choice up to 2 months after the last day in the trust’s income year, or a later day allowed by the Commissioner for Taxation.

Item 3 of Schedule 3 provides that these amendments apply for the 2005–06 income year and later years.

Schedule 4: Taxation of superannuation benefits of deceased military and police personal.

Background

Normally, lump sum superannuation payments made on the death of a fund member to their dependents (including those in an interdependent relationship) are made tax free. Payments made to non-dependents are taxed, the actual rate depending on the source of the funds and the age of the person receiving the payment.

Under the proposed measure payment made to non-dependents of Defence Force personal, Australian Protective Service officers and federal or state or territory police killed in the line of duty will also be paid tax free.

This treatment will apply from 1 January 1999. Ex-gratia payments will be made to those non-dependents who received superannuation payments between 1 January 1999 and 30 June 2007. The payment of superannuation benefits will be tax free to non dependents of deceased military and police personal who die in the line of duty from 1 July 2007.

Basis of policy commitment

These particular measures were announced in the Minister for Revenue and Assistant Treasurer’s media release no. 32 of 5 April 2007.
Positions of various interest groups and press comment

There has been little media or interest group commentary on this proposed measure.

Pros and Cons

The proposed change marginally increases the benefits available from serving in the military or federal police forces.

However, it is questionable whether non-dependents of such deceased persons are actually in need of the benefits they stand to receive. There overall interests in retirement may be better served if they are given access to these funds under the same general conditions as other Australians; that is once they have reached their preservation age (between 55 and 60) and have retired from then workforce. This would provide resources to the non-dependent at a time closer to their retirement. Such use of these funds is the original intention of superannuation benefits.

Financial Implications

The Explanatory Memorandum to this Bill notes that the financial impact of this particular change will be a cost of $0.2 million per year.\textsuperscript{12}

Main Provisions

Item 2 of Schedule 4 inserts new subsection 302-195(2) into the ITAA97. This new subsection allows a non-dependent to be treated as a ‘death benefit dependent’ if they receive a superannuation benefit as a result of the death of a Defence force or police officers if they die in the line of duty. Superannuation benefits received by a death benefit dependent are free of tax.

Exactly what may constitute a death in the line of duty will be specified in regulations.

Item 5 of Schedule 4 allows (but does not require) the Commissioner of Taxation to make an ex-gratia payment in relation to a superannuation payment received before 1 July 2007, where:

- the payment arose because of the death of another person, and
- the person who received the lump sum is not a dependent of the deceased person.

The purpose of such payments is to refund any tax paid in relation to those superannuation payments, if they were received between 1 January 1999 and 30 June 2007.

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Schedule 5: Thin capitalisation

Readers are referred to pages 73-74 of the Explanatory Memorandum for information on this amendment, which deals with an extension to the transitional period relating to accounting standards under the thin capitalisation rules.

Schedule 6: Repeal of dividend tainting rules

Background

What are tainted dividends?

With certain exceptions, dividends that are debited to, or paid out of amounts transferred from, a ‘disqualifying account’ are not frankable (ITAA36 sections 46G to 46M: the ‘dividend tainting rules’) and are classed as tainted for corporate tax purposes.

A ‘disqualifying account’ is:

• a share capital account
• an account consisting of shareholders' capital in relation to a statutory fund of a life company
• a reserve to the extent that it consists of profits from the revaluation of assets of the company that have not been disposed of by the company, and
• if the company is a life company, are not assets of a statutory fund.13

Proposed changes

The proposed changes will repeal the dividend tainting rules and make consequential amendments that will:

• ensure that distributions by a company from a share capital account (including a tainted share capital account) will continue to be unfranked (i.e. not have dividend imputation credits attached to them). Normally dividends are not paid from a company’s share capital account, and
• modify the general dividend imputation anti-avoidance rules so that when considering whether to apply the rule the Commissioner of Taxation can take account of whether the distribution is sourced from unrealised or untaxed profits.14

Why are these changes being made?

The removal of the dividend tainting rules arises due primarily to the previous repeal of the provisions covering the inter-corporate rebate. The dividend tainting rules were introduced in 1995 to prevent corporate taxpayers from taking advantage of this rebate to

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make tax free distributions to corporate shareholders or transferring franking credits to shareholders by inappropriate means.\textsuperscript{15}

The inter-corporate rebate rules were removed with effect from 1 July 2003 at the same time as the introduction of the corporate tax consolidation regime. This regime made it impossible for a company to enter into transactions that misused the inter-corporate rebate. As a consequence, the dividend tainting rules are now without a primary objective.

Further, the dividend tainting rules may be inadvertently triggered by the requirements of the Australian Equivalent of the International Financial Reporting Standards.\textsuperscript{16} Australia has adopted the International Financial Reporting Standards for its corporate reporting from 1 January 2005 and all corporate entities must now prepare their reports for taxation purposes in accordance with these standards.\textsuperscript{17} There are many benefits of reporting under these standards, including better financial information for shareholders and regulators, enhanced comparability, improved transparency of results, and increased capability to secure cross-border listing and funding.\textsuperscript{18} The proposed changes avoid the inadvertent triggering of the dividend tainting rules by the latter’s removal from the ITAA36.

**Basis of policy commitment**

These particular measures were announced in the Minister for Revenue and Assistant Treasurer’s media release no.80 of 9 November 2006.

**Positions of various interest groups and press comment**

The Institute of Charted Accountants have welcomed the government’s proposed measures.\textsuperscript{19}

**Pros and Cons**

There are some apparent advantages to the proposed changes:

- they remove unnecessary sections of the ITAA36
- they avoid a potentially unintended consequences of the introduction of the International Financial Reporting Standards regime
- they maintain the tax avoidance intent of the tainted dividend rules, and
- the proposed changes are claimed to reduce costs of tax compliance through companies no longer having to maintain separate disqualifying accounts.\textsuperscript{20}

**Financial Implications**

The Explanatory Memorandum to this Bill notes that there is a negligible financial impact of the proposed changes.\textsuperscript{21}

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Main Provisions

Item 1 repeals existing sections 46G to 46M of the ITAA36.

Item 2 inserts new paragraph 177EA(17)(ga) into the ITAA36. Section 177EA contains anti-tax-avoidance measures applying to the payment of franked dividends. The proposed amendment to this section allows the Commissioner to determine whether a franking credit (i.e. an imputation tax credit) is attached, or not attached, in circumstances where the distribution arises from unrealised or untaxed profits of a company. This amendment is necessary due to the removal of the tainted dividend rules in item 1 above.

Item 4 repeals paragraph 202-45(e) of the ITAA97 and substitutes a new one in its place. This amendment is necessary because the current paragraph 202-45(e) refers to the tainted dividend rules that are repealed by item 1 above. The replacement text preserved the same rule, namely that dividends paid from a company’s share capital account cannot be franked.

Item 5 repeals subsection 375-872(4) of the ITAA97 and substitutes new text in its place. Again, this change is necessary due to the current text referring to the tainted dividend rules that are to be repealed by item 1 above.

Item 8 provides that the amendments made by Schedule 6 of this Bill apply to distributions made by a company on or after 1 July 2004.

Schedule 7: Clarification of the interest withholding tax exemption

Background

What is ‘interest withholding tax’?

‘Interest withholding tax’ is payable on interest derived by a non-resident unless an exemption applies. Interest withholding tax applies where interest is paid by:

- a resident, except where the interest is wholly incurred by the resident as an expense of carrying on a business overseas at or through a overseas branch, or
- a non-resident and the interest is an expense wholly or partly incurred by the non-resident in carrying on a business in Australia at or through a branch in Australia.

Withholding tax payments are required, not only where interest is actually paid to a non-resident, but also where interest is payable and has been dealt with on behalf of, or at the direction of, the non-resident by, for example, being reinvested.

In addition, to avoid a possible loophole, interest derived by a resident in the course of carrying on a business through an overseas branch is subject to interest withholding tax if it is paid by:

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• another resident and it is not wholly incurred by the payer in carrying on a business in a foreign country through a branch in that country, or
• a non-resident and it is wholly or partly incurred in carrying on business in Australia through a branch.

Interest withholding tax is imposed at a flat rate of 10% on the gross amount of interest paid (i.e. without deducting expenses incurred in deriving that interest, etc). With some exceptions, this rate is unaffected by Australia's Double Taxation Agreements.

The Explanatory Memoranda to this Bill contains an excellent background to the proposed measures. The following comments seek to explain some of the terms used in this background.

What is 'non-debenture debt'?

The term refers to debts owed by a company that are not raised by way of a debenture. A debenture is a long term debt instrument used by governments and large companies to obtain funds. A debenture is unsecured in the sense that there are no liens or pledges on specific assets. It is however, secured by all properties of the issuing company not otherwise pledged. In the case of bankruptcy, debenture holders are considered general creditors.

Thus, a ‘non-debenture’ debt is a debt that is not secured by way of a debenture and would most likely be a debt secured by a charge over a specific asset of the issuing company.

What are 'non-equity' shares?

The Explanatory Memorandum notes that non-equity shares are shares in a company that are viewed as equity on a legal form assessment, but are characterised as debt interests based on their economic function. An example of such an instrument may be a preference share issued by a company. Generally, preference share dividends, and capital returns (if any) are paid first before dividends paid in respect of ordinary shares.

What is a ‘syndicated loan facility’?

A syndicated loan (or syndicated bank facility) is a large loan in which a group of banks or other lenders work together to provide funds for a borrower. There is usually one lead bank (the Arranger or Agent) that takes a percentage of the loan and syndicates the rest to other banks. A syndicated loan is the opposite of a bilateral loan, which only involves one borrower and one lender (often a bank or financial institution.)

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What interest payments made to foreign entities are currently exempted from interest withholding tax?

Interest paid under a debenture is exempt from interest withholding tax if the issue of the debenture satisfies a ‘public offer’ test (section 128F ITAA36). If the issuing company is a resident, it must also be a resident at the time of payment. If the issuing company is a non-resident, the issue must be after 30 June 2001, the company must be a non-resident at the time of payment, and the issue and payment must be made through a permanent establishment of the company in Australia.

An exemption also applies where the sale of a debenture is deemed to give rise to deemed interest under section 128AA ITAA36 on or after 29 August 2001, and the public offer test is satisfied. This is intended to ensure that there will be an exemption where the debenture is on-sold by a non-resident to an Australian resident before the debenture's maturity date.

A company will satisfy the public offer test if the debentures were offered for issue in any of the following circumstances:

- to at least 10 persons operating in a capital market
- to at least 100 investors whom it was reasonable for the company to have regarded as either having previously acquired debentures or likely to be interested in acquiring debentures
- as a result of the debentures being accepted for listing by a stock exchange where the company had previously entered into an agreement with a dealer, manager or underwriter requiring the company to seek such a listing
- as a result of negotiations initiated publicly in electronic form (eg through Reuters or Bloomberg), or in another form, used by financial markets for dealing in debentures, or
- to a dealer, manager or underwriter for the purpose of placement of the debentures.

Debentures which are global bonds also satisfy the public offer test.25

Proposed Measures

The proposed measures are that only non-debenture debt interests that are non-equity shares and syndicated loans will be eligible for the exemption from interest withholding tax unless the non-debenture debit interest is prescribed as eligible for exemption by separate regulations.26

Despite this statement it is not clear whether the proposed changes are also meant to exclude interest paid on debentures from the interest withholding tax exemption. The Explanatory Memorandum also notes that the requirement for interest arising from issued

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debentures still applies, though it is not clear whether this is meant to relate to debentures already on issue, or debentures issued after the date on which these amendments take effect.\textsuperscript{27} The following section on the Bill’s main provisions in relation to this measure considers whether the actual wording of the amended legislation actually precludes interest paid on debentures from the interest withholding tax exemption.

The Explanatory Memorandum also notes that the purpose of these amendments is to restore the original intent of previous amendments to the interest withholding tax provisions of 2005\textsuperscript{28} and to eliminate a risk to tax system integrity.\textsuperscript{29}

**Basis of policy commitment**

These measures were announced in the Minister for Revenue and Assistant Treasurer’s media release no. 91 of 7 December 2006

**Positions of various interest groups and press comment**

The proposed changes to interest withholding tax have not led to substantial comment from either the press or industry groups.

**Pros and Cons**

The restoration of the policy intent of the 2005 changes to the interest withholding tax provisions is helpful in containing tax avoidance behaviour. The Explanatory Memorandum notes that an unintended consequence of these changes was that a wider range of interest payments qualified for an exemption from this particular tax than was intended.\textsuperscript{30} The proposed changes seek to restrict types of debts whose interest payments, when effectively made to a foreign entity, may benefit from this exclusion.

However, the proposed changes leave the way open for Australian business to raise finance from overseas sources. Interest payable on these debts may still be exempt from the interest withholding tax if they are a non-debenture debt that is also a non-equity share, or the funds come from a syndicated loan, or the particular financial instrument used to source the funds is prescribed by regulation as being exempt from this particular tax.

Business may be concerned that the reduction in the types of interest payments that may benefit from this exemption will restrict their capacity to raise loans from overseas.

**Financial Implications**

The Explanatory Memorandum notes that these proposed measures have no financial impact.\textsuperscript{31}

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Main Provisions

Item 1 of Schedule 7 repeals the existing paragraph 128F(1)(e) ITAA36 and substitutes new text in its place. The new text ensures that interest payable by a resident company arising from a debt interest that is either a non-equity share, or a syndicated loan, or a debenture interest prescribed by regulations is eligible for an exemption from the interest withholding tax if they satisfy the public offer test set out later in section 128F ITAA36.

Item 2 achieves the same end for a non-resident company operating through a permanent establishment in Australia, and that establishment issues the debt and pays the interest arising from that debt.

Item 3 repeals paragraph 128F(1B)(b) ITAA36 and substitutes a new paragraph of the same number. It deals with applying the interest withholding tax exemption to a particular type of debt security. The purchase price of a debt security may be made up of both the amount lent, and the interest payable. The effect of Item 3 is to ensure that only the interest component of the purchase price is exempt from the interest withholding tax if that security otherwise meets the public offer test.

Comment - do these amendments necessarily exclude debenture interest from the interest withholding tax exemption?

When considering this question is worth noting the full text of the proposed new subsection 128F(1) ITAA 36:

INCOME TAX ASSESSMENT ACT 1936 - SECT 128F

Division does not apply to interest on certain publicly offered company debentures or debt interests

Interest to which this section applies

(1) This section applies to interest paid by a company in respect of a debenture or debt interest in the company if:

(a) the company was a resident of Australia when it issued the debenture or debt interest; and

(b) the company is a resident of Australia when the interest is paid; and

(c) for a debt interest other than a debenture – the debt interest:

(i) is a non-equity share; or

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(ii) consists of 2 or more related schemes (within the meaning of the Income Tax Assessment Act 1997) where one or more of them is a non-equity share; or

(iii) is a syndicated loan; or

(iv) is prescribed by regulations for the purposes of this section; and

The vital point here is to observe that paragraph (a) above refers to debentures and new paragraph (c) above does not exclude debentures from the operation of section 128F ITAA36. Rather, it includes the interest paid on debts that are not a debenture and which are either a non-equity share or a syndicated loan as being eligible for the interest withholding tax exemption. This pattern of wording is repeated in the amendments in Items 2 and 3 of Schedule 7.

If this interpretation of the proposed changes in Items 1 to 3 above is accepted, despite the apparent stated intent of these changes in the Explanatory Memorandum noted above, it appears that the proposed changes do not necessarily exclude interest paid on issued debentures from the interest withholding tax. This point may need to be further clarified with the benefit of legal advice.

Item 4 inserts new subsection 128F(3A) into the ITAA36. This insertion ensures that loans made through a syndicated loan facility sill comply with the public offer test.

Item 5 inserts new subsection 128F(5AA) into the ITAA36. This amendment specifies conditions under which a syndicated loan facility will fail the public offer test. Briefly, the grounds for such a failure are that a member of the lending syndicate is an associate of the borrowing company and would not have become a member of the lending syndicate in the normal course of commercial practice.

Items 6, 7 and 8 define the terms ‘syndicated loan’ and ‘syndicated loan facility’ for the purposes of section 128F of the ITAA36.

Items 9, 10, 11 and 12 achieve the same outcomes for the trustee of an eligible unit trust, as items 1 to 8 do for a company. That is, the exemption of interest paid by a trustee of an eligible unit trust, in respect of non-debenture non-equity shares and syndicated loans, from the interest withholding tax.

Comment

However, it appears that the precise wording of the amendments in items 9 and 10 also appear to continues to allow the interest paid in respect of debentures to be exempt from this tax. Again, the government’s intent at this point should be clarified.

Item 16 provides for these measures to take effect from 7 December 2007.

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Schedule 8: Forestry managed investment schemes

Background

Taxation and forestry

Since the mid 1980s the forest plantation industry has lobbied for, and achieved, a number of changes to the tax treatment of forestry aimed at:

removing legal anomalies and unintended consequences, and warding off potential policy mistakes …[these] campaigns have focused on removing impediments in the tax system, rather than on seeking special incentives for forestry. These various impediments had been nominated for attention in numerous federal and national reports and strategies, including the report of the National Plantations Advisory Committee (1991), the Forest and Timber Inquiry conducted by the Resource Assessment Commission (1992), the National Forest Policy Statement (1992), the Wood and Paper Industry Strategy (1995), and the national plantations strategy, Plantations for Australia: The 2020 Vision (1997).

One of the major issues in the taxation of plantation forestry is that of ‘period inequity’. This refers to the length of the time period between when costs are incurred - essentially the establishment phase - and income is received from harvesting.

Introduction to Managed Investment Schemes

Managed Investment Schemes (MIS) facilitate investor participation in timber plantation schemes. The structure of an MIS which distinguishes it from other forms of investment is that each investor/grower pays lease and management fees to a contracted plantation manager, via a ‘product disclosure statement’, to carry on a primary production business on the grower’s behalf, in concert with other growers. This structure results in investors purchasing one or more woodlots - usually around 1 ha.

The plantation management company pays tax on its profits from the growers’ subscriptions (fees). Much later, the grower pays tax on the assessable income from the harvest proceeds. Under interpretation of taxation legislation adopted by the Australian Taxation Office (ATO), until recently growers’ initial non-capital expenditure was considered as incurred in gaining or producing assessable income and hence deductible in the year they are incurred. MIS allow retail investors to invest in plantation forestry thereby, in effect, becoming primary producers even though they are not ‘on-the-land’.

MIS operate in accordance with the Chapter 5C of the Corporations Act 2001 (the Act) and the Product Rulings program from the ATO, which was introduced in mid 1998. The Act requires the contract between investors (growers) and the plantation manager to be covered by a Product Disclosure Statement (PDS). A PDS is regulated by the Australian Securities and Investments Commission (ASIC) under the Act and ASIC’s policy statement ‘Prospective Financial Information’.

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ATO rulings are sought for MIS projects to confirm the tax deductibility of growers’ expenditure. In effect the ATO assesses a project to determine whether growers will be carrying on a business on a commercial basis. Neither the ATO nor ASIC make a judgement about the commercial viability of the project.

Prepayment deductibility

The deductibility of prepayments for investors in forestry MIS has been the subject of significant debate in recent years. Under the general prepayment rules for business, the deduction for expenditure which is prepaid is apportioned over the period covered by the services up to a maximum of 10 years.

However, in the case of forestry the income tax system provides a '12 month rule' that, in effect, facilitates an immediate deduction for certain prepaid expenditure incurred under a plantation forestry managed agreement. The 12 month rule applies to expenditure for 'seasonally dependent agronomic activities' that will be carried out during the establishment period of a particular planting of trees and the concession applies provided a range of conditions are satisfied.

From the mid 1980s until November 1999 prepayment arrangements were based on a ‘13 month rule’. However, a problem arose with MIS companies not being required to pay tax on profits at the same time as the investor claimed the deduction. By completing the prepaid services in July of the year following that when growers/investors claimed the tax deduction for the services, MIS companies were deferring paying tax on profits until the second financial year. This amounted to a ‘tax holiday’.

With the introduction of the 12 month rule MIS companies were required to include the prepaid expenditure in assessable income in the same year in which the deduction is first available to the investor and not when the work is done on the investor's behalf.

The general prepayment provisions mentioned earlier continue to apply to the extent that any part of a prepayment does not satisfy the particular arrangements for forestry MIS.

The 12 month rule relating prepayment provisions for seasonally dependent agronomic activities is the only taxation concession specific to forestry MIS. This provision is classified by Treasury as an accelerated write off and the cost to revenue is relatively small as reported in Tax Expenditures Statement.

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Prepayment rule for forestry managed investments

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Tax expenditure type: Accelerated write-off

Expiry date: 2001

Legislative reference: Section 62KZMD ITAA96

Prepayments on seasonally dependent agronomic operations in the establishment of a forestry plantation are immediately deductible. This is conditional upon the prepayment expenditure meeting the requirement described in B66. This tax expenditure is available for investors in forestry managed investment schemes. The benchmark treatment of prepayments is that they are deductible over the period of the expenditure. This allows deductions to be spread over a shorter period and consequently it allows greater deductions than the benchmark treatment.

In the 2005-06 Budget the Government announced an extension of the prepayment rule until 30 June 2008, while a review is conducted into support for the plantation timber industry.

A sunset clause of 30 June 2006 was initially applicable to the 12 month prepayment rule. However the Government announced in the May 2005 Budget that this would be extended to 30 June 2008 to allow an extensive review to be conducted into all aspects of support for the plantation timber industry. The extension was intended to help minimise disruption to investors in forestry MIS and MIS managers while the review was conducted and options are developed to support the industry over the long term.

Review of taxation arrangements for plantation forestry

In the 2005-06 Budget, the Government announced that it would undertake a review of the taxation treatment of plantation forestry covering the application of taxation law to plantation forestry in the context of the Government’s broader plantation and natural resource management policies. The review was undertaken within Government by Treasury and the Department of Agriculture, Fisheries and Forestry (DAFF).

Following the receipt of the report of the review, the Government announced on 9 May 2006 that it was proposing new arrangements as the basis for consultation. The Government said the proposed arrangements:

- were designed to remove the uncertainty surrounding whether MIS investments are deductible under the current law in respect of the requirement that investors be carrying on a business

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would reduce the administrative and compliance burden on investors and MIS companies, and

be fully reviewed in 2011 to examine the appropriateness of the arrangements in the context of the Government's forestry and broader policy objectives.\textsuperscript{39}

Submissions to this consultation closed on 14 August 2006.\textsuperscript{40}

Proposed changes

The outcome of the consultation was jointly announced on 21 December 2006 by the Assistant Treasurer and Minister for Fisheries, Forestry and Conservation.\textsuperscript{41} The specifics of the administrative requirements foreshadowed in this announcement were detailed on 8 May 2007.\textsuperscript{42} The key features of the new arrangements are:

- from 1 July 2007, investors in forestry MIS will be entitled to immediate upfront deductibility for all expenditure provided that at least 70 per cent of the expenditure is ‘direct forestry expenditure’. Direct forestry expenditure comprises:
  - expenditures associated with planting, tending and harvesting of trees at any time over the life of the investment and
  - annual costs of the land used to develop forestry, whether that be effective rental costs or lease payments for land
- the deduction will be provided by way of a separate statutory provision and taxpayers will not need to demonstrate that they are carrying on a business in order to access the statutory deduction
- the Government will not remove deductibility under the general deduction provision for contributions to forestry MIS. However, under the general prohibition against double deductions, the forestry MIS investor will not be able to claim a deduction under both provisions
- an integrity rule requiring use of arm’s length prices in determining the value of expenditure directly related to forestry. For purchased services this would include the normal profit margin that an arm’s length supplier would require
- an administrative requirement for promoters to
  - notify the ATO when they first receive income from a forestry MIS to ensure that the ATO is aware of all industry participants
  - document the basis on which the scheme satisfies the 70 per cent direct forestry expenditure rule; and
  - notify the ATO should the trees not be established within 18 months.

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• forestry investors using the specific deduction will be treated as passive investors for GST purposes, and

• tax deductibility arrangements for forestry MIS to be reviewed within two years of commencement in the context of the development of a secondary market.

The Government also announced in-principle support for establishment of a secondary market for forestry MIS interests. The Government believes that trading of forestry MIS interests will introduce pricing information into the market and increase liquidity of the interests. Following a further review of this issue by Treasury and DAFF the Government announced on 8 May 2007 that from 1 July 2007, initial investors can trade their interests after four years and also taxpayers who invested prior to 1 July 2003. The four-year restriction applies only to initial investors.

The Government advised that the income tax law would be amended to:

• allow existing interests to be traded
• require initial investors (both existing and future) to hold their interests for four years
• extend the amendment period for forestry MIS investors to allow the Australian Taxation Office (ATO) to enforce the holding period rules
• introduce a market value pricing rule at the time of first sale from an initial to secondary investor to reduce tax arbitrage
• treat secondary investors (other than those holding interests as trading stock) on capital account for acquisition and disposal of their interests. For these purposes harvest proceeds will be treated as a disposal and
• allow secondary investors a deduction for ongoing costs, to limit the incentive to front-load fees, and introduce a matching provision that seeks to recoup on revenue account these deductions from the sale or harvest proceeds.

**Basis of policy commitment**

The proposed changes relating to investments in forestry managed investment schemes are contained in the Minister for Revenue and Assistant Treasurer’s media release no. 97 of 21 December 2006.

The proposed changes relating to investments in forestry managed investment schemes are based on, firstly, the outcomes of a review of the taxation treatment of plantation forestry and secondly, the subsequent consultation with industry on the proposed new arrangements arising from the review. Both of these have been detailed in the previous section.

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Positions of various interest groups and press comment

The plantation forestry industry and the MIS sector have generally supported the new arrangements. The National Association of Forest Industries (NAFI) said:

The Australian Government has put in place a system which ensures the ongoing confidence in the plantation forestry industry by providing appropriate taxation arrangement for investors … [and]… the development of a secondary market will also assist in ensuring the investment in plantations is sustainable in the long-term.  

Australian Forest Growers (AFG) which is the national association representing and promoting private forestry and commercial tree growing interests in Australia, i.e. not only managed plantations, has given a mixed reaction. It has observed that:

Changes to managed investment scheme rules announced in the [2007] federal budget should allow more investment in longer rotation plantations further expanding the plantation sawlog estate.

while the approval of trading of immature MIS plantations

… implements long standing AFG policy relating to secondary markets, which would allow trading of MIS plantations prior to harvest. … This will underpin future investment in secondary processing by assisting in providing consistent wood flows.

However AFG also stated that:

private forest growers remain concerned that the Government has not fully responded to the plantation tax review announced in the 2005 budget. …Forestry MIS has been a focus of the review, and we welcome progress being made in that area, but we are concerned that the many other longstanding issues such as period inequity (lumpy returns), enhanced tax deductibility for natural resource management plantings, and transfer of income into superannuation, continue to await a Government response.

Treefarm Investment Managers Australia (TIMA) and A3P have jointly welcomed the conclusion to review of taxation arrangements for Australian plantation forestry saying it:

reaffirms the Government’s commitment to maintaining a supportive tax arrangement for plantation investment.

With regard to the introduction of the 70 per cent direct forestry expenditure requirement, a move designed to address concerns that MIS schemes were charging inflated fees to investors, TIMA and A3P said that they:

… believe that retail forestry companies will be able to demonstrate that their projects comply with the condition that 70% of the fees paid by investors must be spent directly on forestry over the life of the projects.

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Traditional farmer organisations have been less than enamoured with MIS. Although the National Farmers Federation (NFF) has not specifically commented on the Government’s announcements which are the subject of this Bill, it has previously been highly critical of MIS. It asserts that investor interest in MIS is driven by tax deductibility considerations rather than market forces and hence has resulted in distorted markets for both inputs, especially land and water, and the outputs produced, especially non-forestry commodities.

In its submission on the forestry consultation, the NFF was opposed to the proposed cap on the deductible amount; called for the removal of the 12 month prepayment rule and expressed concerns about the proposed secondary market.

The debate over MIS has seen widely differing views expressed by members of the Coalition. For example Hon. Peter McGauran MP, the Minister for Agriculture, Fisheries and Forestry has been very critical of MIS whereas the Hon. Sen Abetz, the Minister for Fisheries, Forestry and Conservation, has publicly defended them.

**Position of ALP and other parties**

The ALP has been critical of the Government’s handling of the decision to end favourable product rulings for non-forestry MIS and has unsuccessfully sought to establish a Senate inquiry into non-forestry MIS. However, in relation to the measures proposed by this Bill, the ALP has not actually indicated a position.

The Greens have described forestry MIS as ‘ecologically destructive market intervention’ which they would stop.

**Pros and Cons**

The ATO has advised that from 1 July 2008 it will cease issuing Product Rulings supporting non-forestry MIS based on its current interpretation of the income tax law. While that matter is not the subject of this Bill there is a relevant point to be drawn from that decision given that, to date, Product Rulings supporting forestry MIS have been based on the same interpretation of the law by the ATO.

The ATO’s change of interpretation means that it no longer considers any investors in MIS i.e. both forestry and non-forestry to be ‘carrying on a business’. The measures proposed in this Bill mean that prepayment deductibility for forestry MIS will continue and be based in legislation not interpretation. It is widely expected that without favourable Product Rulings supporting investment under MIS, expansion of the non-forestry agri-business will be significantly affected. The Government has not explained why it is only facilitating the continuation of one category of MIS, that being forestry.

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Financial Implications

The Explanatory Memorandum contains a table on the revenue impact of these proposed measures.  

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Main Provisions

Item 2 inserts new Division 394 into the ITAA97. This Division sets out rules about tax deductions for contributions to forestry managed investment schemes. It also sets out the tax treatment of proceeds from the sale of interests in such schemes and the proceeds from harvesting trees under such schemes.

New section 394-10 of the ITAA97 sets out the basic conditions for claiming a tax deduction in respect of contributions to a ‘forestry managed investment scheme’. This latter term is defined in new section 394-15 as a scheme is for establishing and tending trees for felling in Australia.

This new section allows a deduction for both initial investors in a scheme, whose contributions establish that scheme. It also allows a tax deduction to investors who purchase an interest in the scheme on a secondary market, in relation to their own contributions to the scheme made after they purchase that interest. This latter provision is one of a number of provisions that support the establishment of a secondary market for interests in forestry management schemes in Australia.

New subsection 394-10(3) denies this deduction to a person who has purchased an interest in a forestry managed investment scheme if they have bought that interest on a secondary market. Nor is the deduction available to a person whose contribution first established the scheme, but who sells their interest within 4 years after the end of the income year in which they first invested in the scheme, under new subsection 349-10(5).

New subsection 394-10(4) ITAA97 requires that a scheme’s trees have to be established within 18 months of the end of the relevant income year in order for a deduction to be claimed for that year.

New subsection 394-35 outlines the ‘70% DFE rule’ for the purposes of this Division. Briefly, a forestry managed investment scheme satisfies this rule if at least 70 per cent of the amount of payments under the scheme are devoted to direct forest expenditure (i.e. DEF).

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The value of this amount, under **subsection 394-10(3)** is the ‘net present value’, on the 30 June of the income year, of all amounts that all current and future participants in the scheme have paid, or will pay, under the scheme.

A net present value is the future stream of benefits and costs converted into equivalent values today. This is done by assigning monetary values to benefits and costs, discounting future benefits and costs using an appropriate discount rate, and subtracting the sum total of discounted costs from the sum total of discounted benefits. Under **subsection 394-10(7)** the required discount rate is the yield on 10 year Australian Government Treasury Bond.

**Item 2** also inserts **new subsection 394-25** into the ITAA97. This item allows the proceeds of the disposal of an interest in a forestry management scheme (referred to in the proposed legislation as a CGT event) to be market value of the interest or the decrease in the market value of the interest. The amount added to the taxpayer’s assessable income is not the actual amount received for the interest. The Explanatory Memorandum notes that this allows these proceeds to be treated as the taxpayer’s assessable income and prevents undue tax minimization practices.⁵⁸

The net proceeds that a secondary investor receives from the sale of their interest in a forestry managed investment scheme is also included in their assessable income under **new section 394-30** ITAA97, also inserted by **item 2**. These receipts are capital in nature and the 50 per cent capital gains tax discount applies. The calculated amount of assessable income takes account of the:

- the amount paid for the interest
- the amount of incidental income received during the period the interest was held (e.g. income received from thinning operations, and
- the amount of deductions claimed under **new section 394-10**.

Example 9.10 in the Explanatory Memorandum gives a good example of how a secondary investor’s assessable income is worked out under these new provisions.⁵⁹ Further examples illustrate the tax treatment of a secondary investor’s tax treatment upon receiving the proceeds of a harvest.

**New section 394-45** defines what is included in the term ‘direct forestry expenditure’ or DEF. This amount includes:

- amounts paid for the establishing, tending, felling and harvesting or trees, and
- notional amounts reflecting the market value of goods, services and the use of the land provided by the forestry manager.

**Item 3** makes additional amendments, in relation to investments in forestry managed investment schemes to the *Taxation Administration Act 1953* (TAA53).
New **section 394-5** TAA53 requires a forestry manager to give the Commissioner for Taxation a statement about the scheme, the identity of its management and amounts payable under the scheme, and any other information the Commissioner for taxation may required, within 3 months after the end of the income year in which that scheme’s contributions are received.

This allows the Commissioner for Taxation to keep track of the number of forestry managed investment schemes in operation and their expected effect on revenues.

**Item 26** applies the provisions of this schedule from 1 July 2007.

**Schedule 9: Non-resident trustee beneficiaries**

**Background**

These proposed amendments alter the current law in relation to the tax treatment of trust distributions made to non-resident trustee beneficiaries.

What is a ‘non-resident trustee beneficiary’?

A non-resident trustee beneficiary is a trustee of a non-resident trust who receives a distribution from a resident trust. It is not clear whether the non-resident trustee beneficiary must themselves reside away from Australia.

Under current law, a resident trustee does not pay tax on a distribution paid to a non-resident trustee beneficiary. This tax status contrasts sharply with a resident trustee’s obligation to pay tax on trust distributions made to:

- a non-resident company under subsection 98(3) ITAA36, and
- a non-resident individual under subsection 98(4) ITAA36.

**Proposed measures**

These amendments extend a resident trustee’s liability to pay tax in respect of distributions made to non-resident trustee beneficiaries.

**Basis of policy commitment**

This measure was announced in the Treasurer’s media release no. 39 of 9 May 2006, as part of the 2006–07 Budget.

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Positions of various interest groups and press comment

Numerous press articles identified the proposed measure as one dealing with tax avoidance by wealthy Australians.\(^6\) The Investment and Financial Services Association welcomed the proposed changes.\(^6\)

Pros and Cons

The ability to avoid Australian tax requirements through ensuring that trust distributions are paid to non-resident trustee beneficiaries is obvious. The proposed measures plug this tax loophole.

Financial Implications

The Explanatory Memorandum contains a table on the revenue impact of these proposed measures.\(^6\)

<table>
<thead>
<tr>
<th></th>
<th>2006-07</th>
<th>2007-08</th>
<th>2008-09</th>
<th>2009-10</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Nil</td>
<td>$250m</td>
<td>$270m</td>
<td>$280m</td>
</tr>
</tbody>
</table>

Main Provisions

Chain of Trusts

The provisions of this schedule deal with the taxation of distributions where they are paid from one trust to another trust. In particular this schedule contemplates arrangements, where the distributions are paid from a resident trust into a non-resident trust or a series of non-resident trusts. This arrangement is called a chain of trusts and can involve a number of trusts receiving distributions from a resident trust by being passed along the chain.

Item 1 of Schedule 9 repeals current subsections 98(3) and (4) ITAA36 and inserts new subsections 98(2A), 98(3) and 98(4) into the ITAA36. New subsections 98(2A) and 98(3) restate the current provisions. New subsection 98(4) imposes a tax liability on a resident trustee in respect of distributions made to a beneficiary who is themselves the trust of a non resident trust. This is the major operative amendment of this particular schedule.

Item 4 inserts new subsections 98A(3) and (4) into the ITAA36. The effect of this item is to ensure that the ultimate non-resident beneficiary of trust distribution is not taxed a second time on amounts that have already been subject to taxes when paid by a trustee in a chain of trusts.

\(^6\) This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.

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**Item 5** inserts new section 98B into the ITAA36. This new section ensures that a beneficiary’s tax obligation in respect of Australian sourced income is reduced by the amount of tax a trustee earlier in the chain of trusts has already paid. Again, this prevents the double taxation of the same amount of money. This section applies to both resident and non-resident trust beneficiaries.

**Items 6, 7 and 8** also amend the ITAA36 to prevent the taxation of Australian sourced trust distributions that have already been subject to tax in the hands of a trustee of another trust. Further, amounts that are not assessable income for Australian tax purposes, when received by a non-resident beneficiary through a trust distribution, are also not subject to further tax.

**Item 11** inserts new subsection 100(1B) into the ITAA36. This new provision ensures that a resident beneficiary of a trust, who has no other source of income and is only a beneficiary of a single trust in a chain, is assessed on income that has already been taxed under new subsection 98(4) noted above. Of course, this beneficiary’s tax liability would be reduced to the extent of the tax already paid on this income under **items 6 to 8** discussed above.

**Item 21** inserts new section 115-222 into the ITAA97. This section ensures that a non-resident trust beneficiary:

- that is subject to tax under new subsection 98(4) of the ITAA36, and
- whose assessable income includes a capital gain

does not benefit from the 50 per cent discount of assessable capital gains available to resident taxpayers. This treatment [i.e. the denial of the discount] is similar to the treatment of capital gains received by non-resident company trust beneficiaries under section 115-220 of the ITAA97.

**What is conduit foreign income?**

**Item 23** deals with the receipt of ‘conduit foreign income’ by a non-resident trustee and a non-resident beneficiary.

In general terms, conduit foreign income is foreign income which is derived by a foreign resident through an Australian corporate tax entity (the conduit), and which would not normally be assessable to that Australian entity.\(^{64}\)

**Item 23** inserts new section 802-17 into the ITAA97. This new section exempts both a non-resident beneficiary and a non-resident trustee from Australian tax liability on any conduit foreign income they receive.

**Item 30** specifies that, with some exceptions, the provisions of this schedule apply from 1 July 2006.

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Schedule 10: Distributions to foreign residents from managed investment trusts

Background

Current arrangements

Like any other trustee, the trustee of a managed investment trust is required to withhold an amount from distributions made to non-resident unit-holders. However, the rate at which the tax is withheld can vary, depending on whether the non-resident unit-holder is a trust, a company or an individual.

This situation is further complicated if the resident managed investment trust makes payments to non-resident unit-holders through an intermediary, such as a bank acting on the resident investment trust’s behalf. Apparently, there is significant uncertainty about the relations between the three parties to a transaction (i.e. the resident investment trust, the intermediary and the non-resident unit-holder) in these situations which lead to undue complications about the correct rate at which the withholding tax is levied.  

The general rates of withholding tax payable on payments to non-residents are as follows:

- dividends 30%
- interest 10%
- royalties 30%.

These general rates are subject to limits set under Australia’s double taxation agreements. In most cases where Australia has entered into an agreement the withholding tax rates on gross payments made to non-residents are:

- dividends 15%
- interest 10%
- royalties 10%.  

This variation in possible rates that may apply to a resident managed investment trust’s distributions to a non-resident unit-holder, through an intermediary, may be one potential cause of the above-mentioned confusion. Another cause may be that the resident investment trust is not aware of whether the non-resident unit-trust holder is a company, trust or individual, especially if payments are made through an intermediary. In these circumstances the potential for the wrong rate of withholding tax to be applied may be significant.

Further, under the proposed amendments in Schedule 9 of this Bill, a trustee of a resident managed investment trust would be required to withhold tax at the appropriate rate from distributions made to a non-resident unit holder. This would require the trustee to be aware of whether the non-resident unit-holder was a company, a trustee or an individual. The

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amendments in this schedule are also necessary to avoid that outcome and preserve the simplicity of imposing one flat rate on all such non-resident unit-holders.\textsuperscript{67} Finally the Explanatory Memorandum notes that the proposed changes in \textbf{Schedule 10} will result in compliance savings, especially by the Australian property trust industry.\textsuperscript{68}

\textbf{International comparisons}

The following table illustrates the gross rate of withholding tax apparently imposed by other countries on distributions from their resident managed property investment funds to overseas investors.

\textbf{Table 1: Comparison of Australian and overseas withholding tax rates}

<table>
<thead>
<tr>
<th>Country</th>
<th>Rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>30</td>
</tr>
<tr>
<td>Canada</td>
<td>15</td>
</tr>
<tr>
<td>France</td>
<td>15</td>
</tr>
<tr>
<td>Germany</td>
<td>15</td>
</tr>
<tr>
<td>Netherlands</td>
<td>15</td>
</tr>
<tr>
<td>UK</td>
<td>15</td>
</tr>
<tr>
<td>US</td>
<td>15</td>
</tr>
<tr>
<td>Singapore</td>
<td>10</td>
</tr>
<tr>
<td>Japan</td>
<td>7</td>
</tr>
</tbody>
</table>

Source: Property Council of Australia\textsuperscript{69}

The above table only notes the gross rates. Because of the effect of Australia’s double tax agreements Australia’s final rate of tax on these distributions may be well below the headline rate of 30 per cent – if the non-resident unit-holder submits the appropriate Australian tax return.

\textbf{Proposed changes}

Generally, the proposed changes seek to remedy this situation by imposing a flat rate of withholding tax of 30 per cent on all distributions made by resident managed investment trusts to non-resident unit-holders, no matter how the distribution is made. The non-resident unit-holder may then submit an Australian tax return to claim back any excess tax withheld.

If the resident managed investment trust makes the payment to the non-resident unit-holder, it will be liable to impose the 30 per cent withholding tax. If an intermediary makes the payment to the non-resident unit-holder, that entity will be responsible for applying the withholding tax to these payments.

Income consisting of dividends, interest or royalty income is generally excluded from this measure, as are capital gains on assets other than taxable Australian property.\textsuperscript{70}

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Basis of policy commitment

The measures in this schedule were also announced in the Treasurer’s media release no. 39 of 9 May 2006, as part of the 2006–07 Budget.

Press comment has focused on the apparent increase in the withholding tax rate for property investors; from zero in some cases to 30 per cent. Unfavourable comparisons have been drawn between the proposed withholding tax rate for Australia of 30 per cent and the much lower withholding tax rate in other countries. The Real Estate Institute of Australia has called for a flat 12.5 per cent withholding rate instead of the proposed 30 per cent rate. The Institute is concerned to ensure the Australian property industry’s international competitiveness by the adoption of this proposed rate. By this it means the ability of the Australian property industry to attract international funds.

Pros and Cons

The proposed changes will greatly simplify the current withholding tax regime applying to distributions made to non-resident unit holders in resident managed investment trusts.

However, there is a danger that these non-resident unit-holders may be paying a higher rate of tax than they may be required to pay unless they submit an Australian tax return in respect of that income. Further, the headline rate of 30 per cent for this withholding tax contrasts with the lower rates of a similar tax imposed by other countries.

Financial Implications

This measure is expected to increase revenue by $10 million in the first year of its application. Thereafter, the measure is expected to increase revenue by $15 million per annum.

Main Provisions

Item 1 of Schedule 10 inserts Subdivision 12-H, entitled ‘Distribution of managed investment trust income to foreign residents’ into the Tax Administration Act 1953 (TAA53).

New section 12-385 is inserted by Item 1. This section requires that the trustee of an Australian managed investment trust that makes a fund payment to an entity covered by new section 12-410 must withhold an amount equal to the corporate tax rate by the amount of the payment. The current corporate tax rate is 30 per cent per annum.

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New section 12-390, also inserted by Item 1 of Schedule 1, requires that an intermediary making a fund payment to an entity covered by new section 12-410 (see below) must also withhold an amount from that payment equal to the corporate tax rate by the ‘notice part’ of that payment by the corporate tax rate.

The ‘notice part’ of the payment made to the entity is, according to new paragraph 12-390(1)(b) is so much of the total payment made to the entity as is attributable to an ‘earlier payment’. This latter term is defined as an amount in respect of which the intermediary has received a notice from the trustee of a managed investment trust declaring it to be a ‘fund payment’. New section 12-415 further defines the content of this notice (see further comment below).

New sections 12-385 and 12-390 are the main operative parts of this schedule.

Item 1 also inserts new section 12-395 into the TAA53. This section defines a managed investment trust for the purposes of subdivision 12-H of that Act. Briefly, a trust is a managed investment trust if in an income year:

- the trustee was an Australian resident or the central management and control of the trust is in Australia, and
- it was a managed investment scheme as defined by section 9 of the Corporations Act 2001, and
- it was operated by a financial service licensee as defined by section 761A of the Corporations Act 2001, and
- the units in the trust are listed for quotation in the official list of an approved stock exchange in Australia, or the trust has at least 50 members, or it is one of the entities noted in new subsection 12-395(2) TAA53.

New subsection 12-295(2) lists a wide range of entities capable of being a managed investment trust for these purposes. Generally either listed or unlisted trusts, superannuation trusts or life insurance companies or an entity recognised under a foreign law as having a similar status to a managed investment scheme and has at least 50 members (subparagraph 12-395(2)(d)) qualify for classification as a managed investment trust under this section.

An exception to this classification is detailed in new subsection 12-395(3) TAA53, where an entity that may meet the requirements of subsections (1) and (2) cannot be a managed investment trust for these purposes if a foreign resident controls 10 per cent or more of the interests of the trust or receives 10 per cent or more of any distribution of income that the trustee may make.

The requirements that managed investment trusts either be listed, have at least 50 members (if unlisted) and cannot be dominated by foreigners ensures that only widely held trusts are eligible for classification as a managed investment trust.
**Item 1** also inserts new **section 12-400** TAA53 which defines the term ‘fund payment’ for the purposes of the main operative sections. There are **three steps** in calculating this amount.

Under step one dividends, royalty income, capital gains that do not arise from the realisation of taxable Australian property and amounts that are not from an Australian source are excluded from this term by **subsection 12-400(1)**. The resulting payment is the step one payment.

**Comment**

A foreign resident’s liability for CGT (for CGT events that happen on or after 12 December 2006) is based on whether the relevant asset is taxable Australian property. The following assets are taxable Australian property:

1. taxable Australian real property
2. an indirect interest in Australian real property
3. a business asset of a permanent establishment in Australia
4. an option or right to acquire any of the CGT assets in items 1 to 3 above, or
5. a CGT asset that is deemed to be Australian taxable property where a taxpayer, on ceasing to be an Australian resident, makes an election under s 104-165.

By including capital gain that arise only from the realisation of taxable Australian property in a trust’s fund payments the integrity of the current CGT arrangements for the taxation of non-resident unit-holders is maintained.

The remaining income is then adjusted by the trustee’s reasonable expectation, based on their knowledge at the time of payment, of the trust’s annual net income (that is income excluding the amounts mentioned in **subsection 12-400(1)**). This is called the **step two** payment.

**Step two** of the **Method Statement** in new **subsection 12-400(2)** TAA53 requires that the trustee remove the effect of the 50 per cent discount of realised capital gains, available to a resident tax payer, from the Fund payment at this point. It does this by doubling any amount that it is reasonable to expect will be included within the actual payment made by the trust in any one income year. Thus, a non-resident unit-holder will not get the benefit of the 50 per cent CGT discount in any fund payment they receive.

Under **step three** of this **Method Statement** the fund payment is so much of the **step two** amount minus the **step one** amount (i.e. the excluded income). Further, account is taken of any earlier fund payment made by the trustee and the expected amounts of any later fund payments made by the trustee in any one income year when arriving at the amount of a particular fund payment.

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Comment

The above process is a complex one. Managed investment trust staff will find the example included in the Explanatory Memorandum of this process very helpful in working out how to apply these legislative provisions.75

**Item 1** also inserts new section **12-405** into the ITAA53. This new section defines the term intermediary for the purposes of **Subdivision 12-H** of this Act. Briefly, an intermediary must have a relevant connection to Australia, must satisfy certain **Corporations Act 2001** requirements for the conduct of an intermediary business (i.e. be appropriately licensed) and must have received a notice from the trustee of an Australian managed investment trust relating to the fund payment it is to distribute. New section **12-415** TAA53 deals with this notice (see below).

New section **12-410** is also inserted into the TAA53 by **Item 1** of **Schedule 10**. This provision defines the entities to which a fund payment is made. The salient point is that the payer has a degree of latitude to treat the recipient as a non-resident unit-holder if they have reasonable grounds to believe that this is the case. The onus would be on the recipient to prove that they are not a foreign resident where the payer has partial information on the residency status of the recipient.

The requirements for a notice given to an intermediary in respect of a fund payment are set out in new section **12-415**, also inserted into the TAA53 by **Item 1**. Briefly, this notice must contain all the information necessary to enable an intermediary to calculate the necessary withholding tax amount from any fund payment made to a non-resident.

The Explanatory Memorandum notes that if a notice under section **12-415** is not given the withholding arrangements of this schedule do not apply and the tax obligation to withhold amounts may rest with another entity (say another entity in a chain of entities) or under another tax regime.76

Comment

It is not clear whether the proposed withholding arrangements would apply at all if a notice under new section **12-415** were not provided to an intermediary.

**Item 2** of **Schedule 10** inserts new section **18-50** into the TAA35. The purpose of this new section is to ensure that a non-resident beneficiary receives a tax credit for the amount of tax withheld from their Australian investment trust distribution under **Subdivision 12-H** of this Act.

**Item 32** of **Schedule 10** provides for its provisions to commence from the first 1 July after the day on which this Act receives Royal Assent.

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Concluding comments

These schedules make many worthwhile amendments to Australia’s taxation arrangements, particularly in the areas of preventing undue tax minimisation and evasion.

However, apparent technical difficulties noted in relation to Schedule 1, Item 13 and Schedule 7, Items 1 – 3 may mean that these proposed changes achieve their full potential.

Endnotes

2. CCH 2007 Australian Master Tax Guide, Topic 4-200 ‘Deemed Dividends – Payments by Private companies to associated entities (Div 7A)’.
7. The amount of a loan forgiven under section 109F ITAA36 is limited by section 109Y to the total distributable surplus of the private company for that income year.
8. Explanatory memorandum, ibid, pp. 21 to 29.
9. ibid, p. 3.
11. Explanatory Memorandum, ibid, p. 5.
14. Explanatory Memorandum, ibid, p. 75.
16. Explanatory Memorandum, ibid, pp. 75–76.

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22. CCH, ibid, Topic 22-022 – Interest’.

23. Explanatory Memorandum, ibid, pp. 81 – 85.

24. Explanatory Memorandum, ibid, p. 83.


27. Explanatory Memorandum, ibid, p. 87.

28. The amending Act was the New International Tax Arrangements (Managed funds and Other Measures) Act 2005, No. 21, 2005.

29. The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, ‘Government to make further improvements to the tax system’, Media Release, No. 91, 7 December 2006.

30. Explanatory Memorandum, ibid, p. 82.


33. For additional background on forestry and taxation issues see Plantations for Australia: The 2020 Vision Establishing Plantations in Australia: A Review of Legislative and Regulatory Frameworks November 2004; Forest and Wood Products Research and Development Corporation Impediments to Investment in Long Rotation Timber Plantations, Project No. PN05.1011, 2005; Australian Forest Growers and Treefarm Investment Managers of Australia Timber Plantations and Managed Investment Schemes ...Essential Tax Basics, February 2005; and Alan Cummine, ‘Timber Industry’s future depends on ordinary investors’ continued backing of MIS sector,’ Australian Forest Grower, Autumn 2005.

34. This section draws on Cummine op cit and submissions to the Government’s 2005 Review of Taxation of Plantation Forestry by the National Association of Forest Industries and Tree Plantations Australia; Australian Forest Growers and Treefarm Investment Managers of

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Australia; and NSW Government.

35. MIS have also operated in other sectors of agriculture in recent years but the Government has announced that the ATO will no longer issue favourable product rulings after these after 30 June 2008. That matter is not the subject of this Bill and hence only of passing relevance to this Bills Digest.


37. The terms of reference of the review can be found here while the submissions can be accessed here.

38. This report has not been made public.


43. Ibid

44. Treating the income on the capital account simply means that the income is capital in nature and is assessed under the Capital Gains Tax (CGT) regime.

45. Reference to the ‘revenue account’ simply means that the amounts are subject to normal income taxation, rather than tax assessment under the CGT arrangements.


48. TIMA is the industry group within TFG that represents the interests of the managed plantation timber investments sector.

49. A3P is the peak national body for Australia’s plantation products and paper industry.


See also National Farmers Federation, Media Releases, ‘NFF Warns Govt: Don’t Allow MIS to Distort Agriculture’ 11 September 2006 http://www.nff.org.au/read/2428457160.html and

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57. Explanatory Memorandum, ibid, p. 8.

58. Explanatory Memorandum, ibid, p. 132.

59. Explanatory Memorandum, ibid, p. 139.

60. Explanatory Memorandum, ibid, p. 150.


63. Explanatory Memorandum, ibid, p. 9.

64. CCH, ibid, Topic 21-100 ‘Conduit foreign Income’.

65. Explanatory Memorandum, ibid, p. 169.


67. Explanatory Memorandum, ibid, p. 169.

68. Explanatory Memorandum, ibid, p. 197.


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73. Explanatory Memorandum, ibid, p. 9.
74. CCH, ibid, Topic 13-725 – Taxable Australian Property.
75. Explanatory Memorandum, ibid pp, 177 to 183.
76. Explanatory Memorandum, ibid, p. 185.

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