Tax Laws Amendment (2012 Measures No. 2) Bill 2012

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Law and Bills Digest Section

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Tax Laws Amendment (2012 Measures No. 2) Bill 2012

Date introduced: 24 May 2012
House: House of Representatives
Portfolio: Treasury
Commencement: Various dates as set out in the table in section 2 of the Bill.

Links: The links to the Bill, its Explanatory Memorandum and second reading speech can be found on the Bill’s home page, or through http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation. When Bills have been passed and have received Royal Assent, they become Acts, which can be found at the ComLaw website at http://www.comlaw.gov.au/.

Purpose

The Tax Laws Amendment (2012 Measures No. 2) Bill 2012 (the Bill) contains four schedules amending various taxation statutes for the following purposes:

• **Schedule 1** makes directors personally liable where their company’s superannuation guarantee amounts and PAYG withheld amounts remain unpaid
• **Schedule 2** implements the recommendations of the Board of Taxation, so that companies inside corporate groups do not receive tax benefits that are not available to entities outside this category.
• **Schedule 3** amends the *Income Tax Assessment Act 1997* (ITAA) to eliminate unintended retrospective benefits that arose from amendments made to the ITAA in 2010 in relation to tax cost setting rules so that tax outcomes for consolidated groups are consistent with tax outcomes for legal entities outside the consolidation regime.
• **Schedule 4** makes consequential alterations to the *Taxation Administration Act 1953* (TAA) to implement the increase in the managed investment trust (MIT) final withholding tax rate from 7.5 per cent to 15 per cent for payments related to income years on or after 1 July 2012.

This is the principle Bill in a suite of Bills that also includes:

• Pay As You Go Withholding Non-compliance Tax Bill 2012

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3. The increase of the concessional MIT final withholding tax is given effect by the Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2012.

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Committee consideration

On 24 May 2012, the House of Representatives referred all three of the Bills to the House Standing Committee on Economics (the second Economics Committee) for inquiry and report—specifically in relation to the managed investment trust withholding tax amendment and its impact on investment in Australia and the retrospective application of tax charges in the consolidation measures contained in the Bill.  

The second Economics Committee published its final report on 18 June 2012. The majority recommended that the House of Representatives pass the Bills. However, the Liberal Party members of the second Economics Committee lodged a dissenting report.

The Liberal Party members expressed the view that

... adding indiscriminate liability to all of Australia’s directors presents a considerable burden to business. These measures include: making directors personally liable for unpaid superannuation; extending director penalties that cannot be discharged by placing a company into administration; and making directors and associates liable for PAYG withholding non-compliance tax where a company has failed to pay.

Comments of the submitters will be discussed under each of the relevant Schedules to the Bill.
Schedule 1—non-compliance with PAYG withholdings, and superannuation guarantee, obligations

Schedule 1 amends the TAA in the following ways:\footnote{11}{National Intelligence and Analytical Service, *Phoenix Activities and Insolvent Trading*, Research paper 95/01, Australian Securities Commission, Brisbane, 1996, p. 12.}

- introducing personal liability to directors for company’s unpaid superannuation benefits
- preventing directors from avoiding their consequential penalties for infringing Pay As You Go (PAYG) and superannuation guarantee payment requirements (lack of payment or reporting three months after the due date) by placing their company into administration or liquidation and
- increase liability of directors and associates to include PAYG withholding non-compliance tax in circumstances where withheld amounts weren’t paid to the Commissioner.

Background

‘Phoenix’ activity

A ‘phoenix’ activity has been described by the former Australian Securities Commission (now the Australian Securities and Investments Commission as one where a company:

- fails and is unable to pay its debts
- acts in a manner which intentionally denies unsecured creditors equal access to the available assets in order to meet and pay debts and
- within 12 months of closing, another business commences which may use some or all of the assets of the former business, and is controlled by parties related to either the management or directors of the previous company.\footnote{12}{National Intelligence and Analytical Service, *Phoenix Activities and Insolvent Trading*, Research paper 95/01, Australian Securities Commission, Brisbane, 1996, p. 12.}

It has been described as an ‘abuse [of] the corporate form by dissolving one company and creating another to avoid the payment of debt’.\footnote{13}{N Coburn, *The Phoenix re-examined*, Australian Journal of Corporate Law, vol. 8, 1998, p. 322.}

The Australian Tax Office (ATO) defines the activity as ‘(t)he evasion of tax and superannuation guarantee liabilities through the deliberate, systematic and sometimes cyclic liquidation of related trading corporate entities’.\footnote{14}{Australian Taxation Office, *Strategically managing the risk posed by phoenix practices*, internal brief, Darmanin, 2010, p. 4.}

On 14 November 2009 a proposals paper was published by Treasury canvassing options to address fraudulent phoenix activity.\footnote{15}{The proposals paper contextualised the problem\footnote{16}{Australian Taxation Office, *Strategically managing the risk posed by phoenix practices*, internal brief, Darmanin, 2010, p. 4.} of phoenix activity as follows:}

\begin{itemize}
  \item \dots
  \item \dots
\end{itemize}
Tax liabilities are often left unpaid after the liquidation of a fraudulent phoenix entity. This may reflect a range of factors, including the relative benefit that a phoenix operator can obtain from non-payment of the business’ taxation liabilities and the fact that such an operator need not be concerned with maintaining a commercial relationship with the ATO.

While the cost of fraudulent phoenix activity is difficult to measure precisely it is undoubtedly significant. The ATO estimates that the current stock of suspected phoenix cases it is monitoring poses a risk to the revenue of around $600 million. ¹⁷

Superannuation entitlements

Under the Superannuation Guarantee (Administration) Act 1992 (Superannuation Act) an employer is required to pay a minimum level of superannuation benefits in respect of each employee into a complying superannuation fund. The minimum amount of superannuation benefits that needs to be paid is nine per cent of an eligible employee’s ordinary time earnings. The payments are required to be paid a minimum of four times a year within 28 days after the end of each quarter. ¹⁸ Given the guidelines for payment frequency allow the liability to pay superannuation entitlements to be accumulated for a quarter of a year, substantial payment obligations often arise. Under current legislation, directors have no personal liability or responsibility for these unpaid superannuation obligations in respect of the employees of the corporation if the obligation remains unpaid after liquidation.

Pay as you go

The Pay As You Go (PAYG) tax system was introduced through the A New Tax System (Pay As You Go) Act 1999 (PAYG Act). Section 10-1 of the PAYG Act specifies that:

Under PAYG withholding, amounts are collected in respect of particular kinds of payments or transactions. Usually, someone who makes a payment to you is required to withhold an amount from the payment, and then to pay the amount to the Commissioner.

The withheld amount that is meant to be paid to the Commissioner of Taxation (the Commissioner) remains an outstanding debt on the books of a company which has undertaken phoenix activities. In the consequent liquidation, the debt of the company is dissolved in the absence of any assets to satisfy the debt. This leaves a liability to the Commissioner unpaid. Under current legislation,

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Directors have no personal liability or responsibility for these unpaid amounts, should a corporation go into liquidation.

Director penalty regime

Division 269 in Schedule 1 to the TAA, contains an obligation on directors to ensure the company they control meets its tax obligations. If the company is unable to pay withheld amounts to the Commissioner\(^{19}\), the directors must place the company into voluntarily administration or into liquidation. Under current legislation, the Commissioner has the ability to penalise the directors an amount equal to any PAYG withholdings that have fallen overdue; the director penalty regime makes directors personally liable.\(^{20}\) This problem is compounded, according to the Explanatory Memorandum, because:

\[\ldots\text{directors can continue to claim PAYG withholding credits (for amounts withheld from payments to them by the company) in their individual tax returns, even when the company has failed to pay some or all of its PAYG withholding liability to the Commissioner.}\(^{21}\)\]

The amendments in Schedule 1 to the Bill will expand the responsibility and scope for liability of directors by:

- expanding the director’s penalty regime to cover unpaid superannuation guarantee charge to their employees, in addition to the pre-existing liability for unpaid withheld PAYG amounts
- remedying a possible escape from liability by preventing the discharge of director’s penalties when a company is placed into liquidation and PAYG or superannuation obligations remain outstanding three months after the due date and
- imposing the obligation on directors and/or associates to pay PAYG withholding non-compliance tax on withheld PAYG amounts that have not been paid to the Commissioner. In effect, this provision will be used to counter the economic advantage gained by directors claiming credits in their personal tax returns and for using the withheld funds for other economic advantage. This is imposed by the Pay As You Go Withholding Non-compliance Tax Bill 2012.

Basis of policy commitment

This Bill is not the first attempt to expand the director penalty regime. In 2011 the Tax Laws Amendment (2011 Measures No. 8) Bill 2011\(^{22}\) and the Pay As You Go Withholding Non-compliance Tax Bill 2012.

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19. The obligations to pay withheld amounts to the Commissioner are in subdivision 16-B and division 268 of the TAA.
20. Subsection 269-20(5) of the TAA sets out the amount of the penalty.
22. Information about the Bill is available on the Bills homepage at: http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22legislation%2Fbillhome%2Fb4691%22
Tax Bill 2011\textsuperscript{23} were introduced. The Bills were referred to the House of Representatives Standing Committee on Economics (the first Economics Committee) for inquiry, and the relevant report was tabled on 3 November 2011.\textsuperscript{24} However, the director penalty provisions were withdrawn on the recommendation of the first Economics Committee on the grounds that a more in-depth investigation was needed of possible defences for innocent directors.\textsuperscript{25}

Exposure draft legislation was released on 18 April 2012 detailing the amendments planned for tax laws so as to ultimately protect tax revenue, workers’ superannuation entitlements and to expand director responsibility.\textsuperscript{26} This was a result of the proposals contained in the 2011–12 Budget in which $21.3 million was pledged for the next four years as expenditure on combating phoenix activity by the ATO.\textsuperscript{27}

The legislative changes contained in Schedule 1 to this Bill largely reflect the proposals made in 2011 but include key changes as a direct result of the first Economics Committee’s recommendations and will be discussed below.

**Financial implications**

The Explanatory Memorandum notes that the amendments in Schedule 1 to the Bill are expected to generate $10 million of revenue due to increased compliance and a decrease in financial obligation evasion for 2011–12. A further $290 million is expected to be secured between 2012–16.\textsuperscript{28}

**Key provisions**

**Defences**

As already stated, Division 269 in Schedule 1 to the TAA, contains an obligation on directors to ensure the company they control complies with its tax obligations. Where a company director fails to do so, penalties can be applied.

\begin{itemize}
\item \textsuperscript{23} Information about the Bill is available on the Bills home page at: http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22legislation%2Fbillhome%2Fr4690%22
\item \textsuperscript{24} Information about the inquiry, the terms of reference, submissions and the final report House of Representatives Standing Committee on Economics is available at: http://www.aph.gov.au/Parliamentary_Business/Committees/House_of_Representatives_Committees?url=economicstaxlaws/index.htm
\item \textsuperscript{26} Details of the exposure draft and accompanying explanatory memorandum are available at: http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Amendments-to-the-director-penalty-regime
\item \textsuperscript{28} Explanatory Memorandum, p. 3.
\end{itemize}

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**Item 2** repeals subsections 269-35(1)–(4) and inserts proposed subsections 269-35(1)–(4A) into the TAA to update the defences against an action by the Commissioner to recover those penalties:

- First, proposed subsection 269-35(1) provides that a director is exempt from a penalty if, as a result of illness or some other good reason it would have been unreasonable to expect the director to take part in the management of the company.
- Second, proposed subsection 269-35(2) provides that a director is exempt from a penalty if the director took all ‘reasonable steps’ to make sure all other directors complied with the obligations surrounding the winding up of the company, or that there were no reasonable steps that the director could have taken to make sure those things happened.

Proposed subsection 269-35(3) sets out matters to be considered in deciding what those ‘reasonable steps’ would be. These include the duration of tenure of company management and other relevant circumstances. This section provides a defence for directors against which a penalty is sought in court. For claims by the Commissioner recovering penalties this defence cannot be relied upon unless the director provided information to the Commissioner regarding the incapacity within 60 days of the penalty notice: proposed subsection 269-35(4A).

**Retrospective effects**

All the directors of a company have a duty to ensure the company fulfils its legal obligations. **Item 4** of Part 1 of Schedule 1 to the Bill is an applications provision. It operates so that the amendments in Division 1 of Part 1 of Schedule 1 to the Bill apply to all penalties due once the Bill has commenced—that is on the day of Royal Assent—and those payable before the commencement of the Bill to the extent that they have not already been paid, remitted or discharged before commencement.

Importantly existing section 269-25 of the TAA provides that the Commissioner must issue a director penalty notice to a director and wait 21 days before commencing recovery proceedings. **Item 3** inserts proposed section 269-52 to allow the Commissioner also to issue a director penalty notice to a director’s registered tax agent. If the company complies with the obligations, or commences winding up/liquidation, the director penalty is passed to the company debt. If after three months, the debt remains, the penalty obligation remains on the directors.

**Items 5 and 6** apply to those persons who become directors of a company on or after the day of Royal Assent (new directors). The amendments to section 269-20 of the TAA provide that a new director will be liable for a director penalty if:

- the person became a director after the due day for the company to meet its obligations and
- 30 days after becoming a director of the company those obligations have still not been met.

**Credits**

**Items 12–15** of Part 2 of Schedule 1 to the Bill amend the TAA.

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**Item 14** inserts new **Subdivision 18-D** into Division 18 into Schedule 1 of the TAA. The object of new Subdivision 18-D, set out in **proposed section 18-120**, is the reversal of any economic benefit gained through tax credits for recipients of withholding payments if the company does not comply with its obligation to pay withheld amounts of PAYG to the Commissioner. The director will generally be eligible to a credit in the personal tax realm if the company has withheld an amount. **Proposed section 18-125** provides that any individual is liable to pay PAYG withholding non-compliance tax if:

- they were a director of a company within the meaning of the Corporations Act 2001
- the company was required to pay the Commissioner and
- the company failed to pay these amounts to the commissioner before the last day (or the day of non-compliance).

The obligation will apply to a person who became a new director after the ‘payment day’

29. Section 16-70 of Schedule 1 to the TAA requires an entity to pay withheld amounts to the Commissioner. The ‘payment day’ is worked out by reference to the table in section 16-75 of Schedule 1 to the TAA.

**Proposed section 18-135** of Part 2 of Schedule 1 to the Bill outlines the liability of associates of directors to pay PAYG withholding non-compliance tax if reasonable steps were not taken to ensure compliance and the associate knew, or could reasonably have been expected to know, of the obligation.

**Proposed section 18-140** outlines the terms of the notice the Commissioner must give before commencing proceedings to recover the PAYG withholding non-compliance tax. The Commissioner may only request payment in writing after the non-compliance day when the Commissioner is satisfied, on the basis of available information, that it is fair and reasonable for the individual to pay the PAYG withholding non-compliance tax... If the PAYG non-compliance tax is not paid by the due date a general interest charge on the unpaid amount will apply: **proposed section 18-150**.

**Superannuation guarantee charge**

**Items 36–47** amend Division 268 of Schedule 1 to the TAA which currently relates to estimates and recovery of PAYG withholding liabilities. **Item 37** expands the Commissioner’s powers in regards to making estimates for liabilities not paid. The guide to Division 268 is amended to enable the Commissioner to make an estimate of:
(a) amounts not paid as required by Part 2-5 of this Act (pay as you go (PAYG) withholding); or

(b) unpaid superannuation guarantee charge;

and to recover the amount of the estimate.

**Items 38–42** make the necessary insertions into Division 268 of Schedule 1 to the TAA to ensure that amounts owing under the *Superannuation Guarantee (Administration) Act 1992* are captured by the Division. The object of the division is amended by repealing and replacing section 268-5 so that all estimated PAYG withheld amounts and unassessed estimated unpaid superannuation guarantee charges can be recovered. **Proposed subsections 268–10(1) and (1A)** allow the Commissioner to estimate the amounts of unpaid and overdue liability, leaving the company less time to fraudulently move company assets. The estimate is payable on the day the superannuation guarantee is short for the quarter when it should have been issued to the Commissioner in a superannuation guarantee statement.

**Item 45** inserts **proposed subsection 268–90(2A)** into Schedule 1 of the TAA to outline the procedure that a director must follow once a notice of estimate has been received in regards to a liability to pay a superannuation guarantee charge. An affidavit must be supplied verifying the name, address, employee details, amount of the shortfall and consequent actions that have been taken to satisfy the obligation to the Commissioner. In some cases where the employee to whom the superannuation guarantee relates is not yet identified, the money will be held in consolidated revenue until clarification is acquired.

**Items 24–34** make consequential amendments to the *Corporations Act 2001* (Corporations Act). Existing section 553AB of the Corporations Act deals with superannuation debts in the event of a winding up. **Items 24–27** amend section 553AB of the Corporations Act to allow for the amount of an estimate liability under Division 268 in Schedule 1 to the TAA (as amended by items 36–47 above) also to be taken into account.

Existing section 556 of the Corporations Act sets out those payments which must be given priority over other unsecured debts and claims. **Items 28–33** amend section 556 to specifically include liabilities to pay the amount of estimates under Division 268 in Schedule 1 to the TAA and liability to pay the amount of an estimate of a superannuation guarantee charge.

**Items 49–51** amend Division 269 of Schedule 1 to the TAA to provide that directors of a company registered under the Corporations Act will be held personally liable to meet the superannuation guarantee obligations. **Item 52** inserts **proposed subsection 269–10(3)** to make clear that, for the purpose of the director penalty regime, the superannuation guarantee charge is payable on the lodgement date for the quarter to the Commissioner.

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Comments

The Australian Institute of Company Directors has been particularly critical of Schedule 1 to the Bill on the grounds that it does not go far enough to protect new directors. At issue for the Australian Institute of Company Directors is that:

- the Bill applies to all directors of Australian companies—not just to directors of companies suspected of phoenix activity
- the Bill makes directors personally liable for a company’s unpaid superannuation guarantee amounts regardless of the directors’ culpability
- the Bill makes new directors personally liable for the actions of the company even when the person was not a director at the time of the company’s breach which is inconsistent with the defence of illness and
- the defences for directors are limited and difficult to prove.

In the Advisory report on the Tax Laws Amendment (2011 Measures No. 8) Bill 2011 (the Report), the first Economics Committee acknowledged a need for the proposed provisions to be implemented in order to ensure the efficiency of the PAYG system. Phoenix operators were evading the existing legislation due to the requirement for the Australian Taxation Office (ATO) to issue a 21 day penalty notice before legal actions were commenced, hastily submitting to voluntary administration during the 21 day period. The first Economics Committee received submissions from stakeholders arguing that the legislation must provide a safeguard against capturing honest directors who act in good faith and for the best interests of the company, who are liable under the legislation. To that end, the first Economics Committee recommended that the Government should investigate ways to expand the defences in the Bill.

This concern is addressed somewhat by this Bill, increasing the period before which a new director will be liable for penalties from 14 days to 30 days after becoming a director. This amendment also takes into consideration that new directors will have more information to consider, given the inclusion of liability with regard to superannuation guarantee charges.

The retrospective aspects of the amendments in Schedule 1 to the Bill were criticised by the Law Council of Australia, the Business Council of Australia and the Tax Institute in submissions to the

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31. Ibid., pp. 1–2.

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first Economics Committee in regard to the predecessor Bills. Despite these concerns, the retrospective effect of the amendments has been retained in this Bill.

Schedule 2—Consolidation and Taxation of Financial Arrangements

Background

The Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009 (TOFA Act) \(^{36}\) commenced on 26 March 2009 putting into place the third and fourth tranches of changes to the taxation of financial arrangements \(^{37}\) which were initially recommended by the Review of Business Taxation (known as the Ralph Review). \(^{38}\) The provisions in the TOFA Act were implemented to ‘create compliance cost savings by more closely aligning tax treatment with accounting standards.’ \(^{39}\)

The purpose of the TOFA consolidation interaction provisions is to allow a TOFA taxpayer to elect to apply the provisions to pre-existing financial arrangements so that one set of tax provisions can be used. Upon election to employ the TOFA provisions, balancing adjustments must be made to existing financial arrangements so as to conform to the TOFA guidelines. \(^{40}\) As a result of this rebalance there will be a positive or negative outcome that will either be added to, or used as an offset to, the taxpayer’s assessable income evenly quartered over the next four years.

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40. The primary method is contained in subitem 104(13) of the TOFA and the alternative method is contained in subitems 104(14) and 104(15). All of these items are contained in the applications provisions of the TOFA.

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Basis of policy commitment

On 25 November 2011, the Assistant Treasurer and Minister for Financial Services and Superannuation, Mr Shorten announced that the Government would ‘introduce changes to income tax law affecting consolidated groups’. 41

An attachment to the media release provided the Government’s response to the Board of Taxation’s Report on the Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules 42 which provides the following background to the changes in Schedules 2 and 3 to the Bill:

The consolidation regime was introduced from 1 July 2002. In December 2005, the then government announced technical changes to the consolidation provisions, including changes to the residual tax cost setting rule, to ensure the legislation had its intended effect. A further package of changes was announced by the former government in 2007. The present Government re-committed to the whole package of 22 consolidation measures in the 2008-09 Budget.

When a Bill containing the 22 consolidation measures was introduced into the House of Representatives in February 2010, the revenue impact of the package of changes was stated as formally unquantifiable, but not expected to be significant. However, while the Bill was in the Parliament, the Australian Taxation Office identified revenue risks arising from the measure changing the residual tax cost setting and rights to future income rules. As a result, the Bill was amended in the Senate to reduce the cost of this measure, and the statement of the revenue impact for the measure was changed to ‘significant’. The Bill was passed by the Parliament on 12 May 2010 and assented to on 3 June 2010...

On 30 March 2011 the Assistant Treasurer asked the Board of Taxation to examine the operation of the residual tax cost setting and rights to future income rules. The Board concluded that the scope of the rules, as enacted, appeared to be broader than was intended at the time of their announcement in 2005. These rules, combined with the effect of other long-standing elements of the consolidation regime, could allow consolidated groups to access deductions that are not available to taxpayers outside the consolidation regime. Consequently, the revenue impact of the rules was likely to be significantly larger than expected.

Changes to the operation of the residual tax cost setting and rights to future income rules are necessary to protect a significant amount of revenue that would otherwise be at risk, and to

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make the tax outcomes for consolidated groups more consistent with those for entities outside consolidation. 43

Financial implications

The Explanatory Memorandum notes that the amendments in Schedule 2 to the Bill are expected to protect a significant amount of revenue over the forward estimates and generate a revenue gain of $253 million over that period. 44

Key provisions

Schedule 2 to the Bill does two things being:

- it amends the taxation of financial arrangements consolidation interaction provisions in the *Income Tax Assessment Act 1997* (ITAA) and
- it amends the transitional provisions in the TOFA Act.

*Items 1–4* of Schedule 2 to the Bill amend section 715-375 of the ITAA so as to ensure the head company is recognised as having acquired an amount for taking an accounting liability that constitutes part of a joining/consolidation event.

*Item 2* of the Bill repeals and replaces paragraph 715-375(1)(c) so that the liability acquired by the head company must be a Division 230 financial arrangement under the TOFA Act regardless of the associated entity’s TOFA status. *Proposed paragraph 715-375 (1)(c)* operates from the head company’s perspective so as to allow the application of *proposed subsection 715-375(2)*.

*Item 3* of Schedule 2 to the Bill repeals existing subsections 715-375(2)–(4) and inserts *proposed subsection 715-375(2)* which deems the head company of a group to have received a payment for starting to have the joining entities liabilities at the joining time. The amendments seek to achieve the policy intent in the TOFA Act so as to ensure that:

For liabilities that are or form part of financial arrangements that are subject to the fair value, foreign exchange retranslation, or reliance on financial reports method, the head company applies Division 230 as if the liability were assumed at the time of joining for an amount equal to the liability’s Division 230 starting value. 45

This will ensure that no tax outcomes for gains or losses accrued during the period prior to the merger can be exploited. *Item 4* inserts *proposed section 715-378* which deems the head company

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44. Explanatory Memorandum, p. 5.

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to have the obligation transferred from the merged company to either provide, or to receive, the payment attached to the transferred obligation.

**Items 5 and 6** of Schedule 2 to the Bill amend the TOFA Act to\(^\text{46}\):

- ensure the TOFA consolidation interaction provisions apply to a joining/consolidation event, prior to the merged entity commencing application of the TOFA provisions if the head company has made a intermediary determination to apply the TOFA provisions to its existing financial arrangements
- quarantine transitional balancing adjustments, that involve tax deferred amounts derived from the head company’s financial reports being used to transition existing financial agreements acquired as part of a pre-TOFA joining and
- for assets acquired as part of a pre-TOFA merger when a transitional determination has been made, the disparity between the tax cost setting amount and the opening value for TOFA purposes is spread over four years from the parent company’s first income year.

**Item 5** inserts proposed sections **104B** and **104C** into the TOFA Act to provide that:

- the parent company cannot use the alternative method to work out TOFA transitional balancing adjustments for the assets and liabilities of joining entities other than chosen transitional entities
- for assets existent pre-TOFA formation being transitioned into TOFA, the discrepancy between the tax cost setting amount and the Division 230 starting value is to be spread over the following four years
- for liabilities existent pre-TOFA formation, the recognised payment amount will be one that would result in no tax consequence for the merging company should it extinguish the liability at the joining date. Under proposed section **104B** the single entity rule specifies that after joining, the entities are to be considered as a single entity for taxation purposes and
- the alternative methods outlined in subsections 104(14) and (15) of the TOFA Act are not allowed to be used in establishing the transitional balancing adjustments for assets and liabilities acquired pre-TOFA formation.

The amendments contained in proposed section **104B** do not apply, in accordance with the exceptions in proposed paragraphs **104C(1)(a) and (b)**, to assets that are subject to any prior private ruling or written advice under an Annual Compliance Arrangement which is issued by the Commissioner.

**Retrospectivity**

The amendments contained in Schedule 2 to the Bill are proposed to commence from 26 March 2009. The Parliament has the power to pass legislation retrospectively.\(^\text{47}\) Generally though,

\(^{46}\) Explanatory Memorandum, p. 67.
\(^{47}\) The constitutional validity of retrospective legislation was affirmed by the High Court in *Polyukhovich v Commonwealth* (1991) 172 CLR 501.

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governments must justify the need for retrospective operation and ensure that the legislation does not unduly impinge on a person’s rights or responsibilities. The retrospective operation of this amendment is intended to protect a significant amount of revenue that would otherwise be at risk, and to make the tax outcomes for consolidated groups more consistent with those for entities outside consolidation.

Comments

It is the retrospective effect of the amendments in Schedule 2 to the Bill which caused submitters to the second Economics Committee the most concern. Greenwoods and Freehills expressed their lack of understanding about why the TOFA/consolidation provisions are to be applied to corporate acquisitions that took place prior to the commencement of the TOFA, and why the change of law should only apply to a limited class of taxpayers.48

Deloitte also sought to:

emphasise the not inconsiderable concern of taxpayers, their advisors and the various professional bodies representing these groups regarding the retrospective application of the amendments contained in Schedule 2.49

Schedule 3—Consolidation

Background

Schedule 3 to the Bill seeks to amend the ITAA to improve uniformity in the tax outcomes for consolidated groups when compared to outcomes achieved outside the consolidation system. In some circumstances it may be cost effective for a wholly owned Australian resident company, comprised of many constituent companies to lodge a single tax return. This is often more efficient from a compliance perspective also.

Financial implications

The Explanatory Memorandum notes that the amendments in Schedule 3 to the Bill are will have a nil revenue impact. However, amendments will protect a significant amount of revenue that otherwise would be at risk over the forward estimates period.50


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Key provisions

When a company joins a consolidated group, or is effectively taken over, generally all shares in the first company are purchased and extinguished. The ownership of the assets of the first company is acquired by the head company. The value of these assets must be assessed and this is done under the tax cost setting rules which are set out in section 701-55 of the ITAA. If the asset does not fall within the provisions listed in that section, the residual tax cost setting rule applies.51

The amendments in Schedule 3 to the Bill seek to minimise any potential for taxpayers engaged in the consolidated regime to access deductions that are not available to other ordinary tax payers and to ultimately protect revenue. There are three sets of changes, which will apply in different circumstances with regard to the times that the acquisition took place. These are as follows:

- acquisitions that took place prior to 12 May 2010 (pre-rules will apply)
- acquisitions that took place between 12 May 2010 and 30 March 2011 (interim rules will apply) and
- acquisitions taking place on or post 31 March 2011 (prospective rules apply).

Pre-rules

The provisions of Part 1 of Schedule 3 to the Bill—that is, the pre-rules—commence on the day of Royal Assent.

Amendments were made to the ITAA in 2010 by the Tax Law Amendment (2010 Measures No. 1) Act 2010 in which the scope of the residual cost setting rule was broadened, and the right to future income rule was introduced by inserting subsection 701-55(5C into the ITAA. The 2010 amendments operated retrospectively back to 1 July 2002 in an effort to replicate the original policy intent.

The amendments in Schedule 3 to the Bill seek to restore the original cost setting rule and limit the deductions created under the right to future income rule for unbilled income assets. The Pre-rules will amend the operation of the current law for acquisitions that took place before 12 May 2010. Item 2 of Schedule 3 to the Bill seeks to return the residual tax cost setting rule and consequently quarantine the unjust tax advantages currently available. Essentially the tax cost setting rule will effectively reset the asset’s cost base should it not be covered by the current provisions.

The amendments in 2010 regarding the rights to future income rules allowed consolidated groups to deduct the reset cost for a right to future income asset over the lesser of the period relevant to the contract or ten years. The amendments contained in this Bill seek to limit the deductions only to unbilled income assets (anything else is considered a non-deductible right to future income). Item 1 repeals and replaces subsection 701–55(5C) and inserts proposed subsection 701–55(5D) to grant the consolidated group, holding an unbilled income asset acquired from a merged entity, the ability

50. Explanatory Memorandum, p. 6.
51. Subsection 701–55(6), ITAA.

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to deduct the reset tax cost under section 716-405 of the ITAA. Item 6 inserts proposed section 701-63 into the ITAA which contains three important terms.

First, proposed subsection 701–63(5) defines a ‘right to future income’ as a valuable right to receive an amount for the performance of work or services or the provision of goods if it forms part of a contract or agreement, and the market value of the valuable right is greater than nil, and it is not in whole or in part a Division 230 financial arrangement (that is, a TOFA).

Second, proposed subsection 701–63(6) specifies a right to future income is an ‘unbilled income asset’ if the asset is:

- work that has been performed (wholly or partially) and the recoverable debt has not yet arisen in respect of that work, before the joining time or
- goods or services that have been provided where a recoverable debt has not yet arisen in respect of that supply, before the joining time.

Third, proposed subsection 701–63(4) provides that a ‘non-deductible right to future income’ is a right to future income that is not an unbilled income asset.

Under proposed subsection 701-55(5C), if an entity joins a consolidated group with assets that are not a ‘non-deductible right to future income’, the consolidated group will be entitled to an allowable deduction. Item 9 repeals and replaces section 716–405 of the ITAA to clarify that if a member of the consolidated group leaves, and is entitled to the right to future income asset and hence the deduction, it is to remain with the departing member: proposed subsection 716-405(5).

Proposed subsection 716–405(2) provides that if a recoverable debt is expected to arise within 12 months of the merger, the head company can include it in the income year.

Assets treated as goodwill

Proposed section 701–73 allows for the treatment of certain assets held by the joining company to be joined to the goodwill of the consolidated group. Goodwill is treated as a Capital Gains Tax (CGT) item for the purposes of taxation under Taxation Ruling TR 1999/16 and the tax costs allocated to these assets will only be recognised in certain situations, including but not limited to, the departure of the subsidiary group to whom the goodwill belongs, the goodwill is sold, or the goodwill ceases to exist. Under proposed subsection 701–63(3) an ‘asset forming part of goodwill’ is an asset which:

- is intangible and the value is derived from projected inflows of any insurance policies or
- is a customer relationship asset or industry knowhow or any other intangible asset that is not a CGT asset, revenue asset, depreciating asset, trading stock, a Division 230 financial arrangement, goodwill or an asset that is excluded because of section 705-30(2).


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Interim rules

The purpose of the interim rules is to modify the current legislation as amended by the pre-rules for the period 12 May 2010 to 30 March 2011. Essentially, these laws are introduced so as to ensure no injustice is done to taxpayers who relied on the law as it existed before the Board of Taxation Review concluded.

The interim rules restore the rights that were extinguished by the introduction of the pre-rules through amendments in items 15–21, 23 and 24.

Item 22 inserts proposed section 705–56A into the ITAA to quarantine any value being ascribed to certain rights to future income. This applies in the circumstances that the merging entity holds an asset and attached to that is a right to future income that is a non-deductible right to future income. The reset cost value for the right to future income will depend on whether there is a recognisable market value of the right to future income. If there is, this value will be used for the purposes of working out the reset tax cost for the right to future income under existing section 705-35 (tax cost setting amount for reset cost base assets).

Prospective Rules

The prospective rules amend the operation of present law taking into account the modifications created by the pre-rules and interim rules. These rules will apply on a prospective basis from the 30 March 2011. Essentially the rules will seek to:

- restrict the cost setting rules to CGT assets, revenue assets, depreciating assets, trading stock and Division 230 financial arrangements thus increasing integrity of the consolidation tax regime: proposed section 701–67, inserted by item 34
- force a business acquisition approach to the residual cost setting rule. This will cause the acquisition to be done on capital account so as to prevent giving rise to immediate revenue deductions: proposed subsections 701–56(1) and (2) inserted by item 31
- ensure reset tax costs for rights to future income that are work in progress amounts and consumable stores are deductible: proposed subsection 701–55(5C) inserted by item 28 treat all other rights to future income as retained cost base assets which will prevent increasing tax costs of these assets: proposed subsections 701–63(5) and (6) inserted by item 33 and
- make consequential amendments to remove some rules that are brought into existence under the interim rules.

53. Note that the residual tax cost setting rule inserted by proposed subsection 701–55(6) in the interim rules (at item 16 of Part 2 to Schedule 3 to the Bill) will be retained.

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Comments

As with the amendments in Schedule 2 to the Bill, submitters were concerned about the retrospective effect of the proposed amendments in Schedule 3. The Tax Institute expressed its disquiet about:

... the retrospective nature of the amendments to the consolidation provisions that interact with the TOFA provisions. The primary consequence of these changes is to retrospectively deny a number of taxpayers deductions in relation to certain liabilities while, at the same time, allowing other taxpayers to still obtain deductions in relation to the same liabilities. As the distinction between taxpayers affected and taxpayers not affected is based on whether they made a compliance related election (and they were unaware of these potential consequences when they made the election), we cannot see any basis on which this change should be applied on a retrospective basis.\(^{54}\)

Schedule 4—MIT withholding tax rate

Background

Foreign direct investment (FDI) provides a significant amount of revenue to Australia and the sector’s growth has been strong over the past couple of years. FDI into Australia increased by 11.1 per cent in 2009 and was followed by an expansion of 7.5 per cent to a total of $474 billion in 2010.\(^{55}\) Although the global financial crisis did have a significant negative effect on levels of FDI into Australia, given the strength and resilience of the Australian economy, these levels have returned to positive growth due to investor confidence.\(^{56}\)

The current tax rate of 7.5 per cent applies to all distributions that are paid from Managed Investment Trusts (MITs) to residents of countries that have an active tax information exchange agreement with Australia\(^ {57}\); otherwise the withholding tax rate is 30 per cent.

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57. The Australian Taxation Office publishes a list of those countries that have a tax information exchange agreement with Australia at: [http://www.ato.gov.au/businesses/content.aspx?doc=/content/00161158.htm](http://www.ato.gov.au/businesses/content.aspx?doc=/content/00161158.htm)

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Basis of policy commitment

As part of the Australian Labor Party’s (Labor) 2007 election campaign, it promised to reduce the withholding tax rate on MITs payments to foreign residents from the then current rate of 30 per cent to 15 per cent.

Further, forming part of the 2008–09 Budget, the Labor Government declared that the effective rate would be reduced more significantly than originally proposed, to 7.5 per cent, but that it would be done in the following three steps:\(^{58}\)

- 22.5 per cent for certain distributions in relation to the first income year after the enabling legislation receives Royal Assent
- 15 per cent final withholding tax for fund payments in the second income year and
- 7.5 per cent final withholding tax for fund payments of third and later income years.

The *Income Tax (Managed Investment Trust Withholding Tax) Act 2008* (MITW Act) received the Royal Assent on 23 June 2008. The rate of 7.5 per cent has applied to distributions made from the 2010–11 financial year.

This Bill operates to increase that rate to 15 per cent. This measure was announced as part of the 2012–13 Budget.

Financial implications

The Explanatory Memorandum notes that the amendments in Schedule 4 to the Bill are expected to generate approximately $260 million, in revenue, over the forward estimates.\(^{59}\)

Key provisions

Schedule 4 to the Bill amends the TAA by increasing the MIT withholding tax rate from 7.5 per cent to 15 per cent with effect from 1 July 2012.

In addition, the *Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2012* amends subparagraph 4(1)(a)(ii) of the *Income Tax (Managed Investment Trust Withholding Tax) Act 2008* so the rate of income tax imposed by the MITW Act if the entity is a resident of an information exchange country is 15 per cent for fund payments starting on or after 1 July 2012.

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58. W Swan (Treasurer) and C Bowen (Assistant Treasurer), *Establishing Australia as a regional financial hub*, joint media release, 13 May 2008, viewed 17 June 2012, [http://parlinfo.aph.gov.au/parlinfo/search/display/display.w3p;query=Id%3A%22media%2Fpressrel%2FWKKG6%22](http://parlinfo.aph.gov.au/parlinfo/search/display/display.w3p;query=Id%3A%22media%2Fpressrel%2FWKKG6%22)


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Comments

Ernst & Young submitted that this measure ‘makes foreign investors in Australia nervous and some major investors will rethink their Australian investment plans’. In particular, Ernst & Young stated:

Australia is competing, currently, for global capital investment with other countries. We have seen global asset manage interest in investing into the USA and UK given their lower currency exchange rates and greater turnaround prospects from the global financial crisis and thus potential for higher capital growth. Overseas investors have been prepared to accept slightly lower yields from Australian asset investments given the stability and transparency of our legal, tax and regulatory system. [This measure] ... affects the perception of Australia by global investors.

This view is shared by commentators. It has been reported that:

Singapore’s Mapletree Logistics Trust is understood to have withdrawn from negotiations to buy Stockland’s $822 million industrial portfolio in response to the government’s move to double the tax imposed on overseas investors.

And:

The federal government’s decision to double withholding tax for foreign investors in managed investment trusts, in tandem with the high Australian dollar, could curtail burgeoning Chinese investment in Australia real estate.

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61. Ibid., p. 1.


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