Date Introduced: 27 March 1985
House: House of Representatives
Presented by: Hon. P.J. Keating, M.P., Treasurer

Short Digest of Bill

Purpose

To recover personal income tax avoided by former owners of companies that were the subject of "bottom-of-the­harbour" schemes, and to strengthen and improve the Taxation (Unpaid Company Tax) Assessment Act 1982.

Background

The Taxation (Unpaid Company Tax) Assessment Act 1982, the "Principal Act", empowers the Government to recover retrospectively company tax, including undistributed profits tax, avoided by vendor-shareholders and promoters. The "Principal Act" sets out the circumstances in which liability to recoupment tax is attracted. It is retrospective in effect as it deals only with such schemes carried out between 1 January 1972 and 4 December 1980, the date upon which the Crimes (Taxation Offences) Act 1980 made such conduct a specific criminal offence under Commonwealth law.

The accumulated and/or contingent tax liabilities of the company are reflected in the consideration received by vendor-shareholders from the sale of their shares in the company and in the fee derived by promoters. As an illustration, shareholders sell their shares in the company to a promoter and receive in cash an amount equal to the accumulated funds of the company reduced by such fee as was charged by the promoter. The accumulated funds of the company include an amount that should have been set aside as legally payable company tax. Following the sale, the promoter creates the situation whereby the company would be incapable of meeting its tax liability, namely, records are permanently lost or the tax liability is simply removed by means of a tax avoidance scheme.

The amount received by vendor-shareholders included profits which, had the target company not been sold, might have been distributed to them as dividends in the normal
course of events. Naturally such dividends would have attracted personal income tax in the hands of the former owners of the company. By receiving the profits of the target company as a capital sum rather than as a dividend, the former owners avoided paying personal income tax. Both public and private companies are involved.

The first legislative attempt to extend recoupment of tax was introduced on 18 May 1983 in the House of Representatives. The Taxation (Unpaid Company Tax) Assessment Amendment Bill 1983, together with its associated "Rates" Bill, sought to recover from the former owners of companies stripped of pre-tax profits, personal tax on the company's accumulated revenue and capital profits. The Bills were passed in the House of Representatives, but failed to gain approval in the Senate.

On 23 August 1983, the Government introduced a new Bill [No. 2] which was basically the same as the earlier Bill except that it had been modified to reflect changes in the recovery of personal income tax. Personal income tax would be assessed on the after-tax revenue (not capital) profits of those years of income where primary company tax was avoided. No liability for personal income tax would arise where the only company tax avoided was undistributed profits tax. Again, this Bill was defeated in the Senate.

A further Bill was introduced on 3 November 1983, namely the Taxation (Unpaid Company Tax) Assessment Amendment Bill 1983 [No. 4], which was essentially a watered down version of the earlier Bills. It dealt only with measures to strengthen and improve the company tax recoupment measures as originally proposed. However, the new Bill did make one important departure from the provisions contained in the earlier Bills. It sought to expand the anomalies relief provisions contained in the "Principal Act" to provide additional relief, in certain circumstances, to public company shareholders. The Bill was passed in the Senate with amendments and returned to the House of Representatives for consideration, and has since lapsed with the dissolution of Parliament in October 1984.

On 2 May 1984, a Bill, identical to the Taxation (Unpaid Company Tax) Assessment Amendment Bill 1983 [No. 2] (23 August 1983) was introduced and later was defeated in the Senate. The current Bill is identical to that Bill apart from some minor changes relating to interest on overpayments and the evidentiary provision.
The rationale underlying the amendments is that persons who have benefited from the sale of shares in companies that were stripped of pre-tax profits should not have their liability limited to the tax avoided by the companies concerned. They should also be liable for tax on the after-tax profits which, if paid as a dividend, would have been taxable in the hands of shareholders had the company continued to operate as a going concern.

The major aspects of the Bill may be summarised as -

**Liability**

Where a dividend amount exists in relation to a natural person or other "prescribed person", the company is deemed to have paid a dividend at the time of sale of shares equal to the dividend amount. In addition, where a dividend amount exists in relation to a company or trustee of a trust estate, a liability for dividend recoupment tax arises unless the individuals behind the company or trust estate elect that the relevant company be deemed to have paid them a dividend on the day of sale equal to the dividend amount.

Liability for dividend recoupment tax does not arise where -

(i) retained profits of the company in earlier years bore primary company tax;

(ii) promoters are liable to pay 100 per cent of the unpaid company tax;

(iii) vendor-shareholder's share of unpaid company tax is less than $100;

(iv) in a year of income, only undistributed profits tax was evaded;

(v) in a year of income, only capital profits existed; or

(vi) a vendor-shareholder's dependants or beneficiaries under a will are in receipt of a dividend.

**Dividend Amount**

The amount of the deemed dividend paid to former owners in relation to a year of income is calculated by
subtracting from the company's taxable income for that year (component I in the Bill) its tax liability in respect of that taxable income (component T). Component T amounts to ordinary company tax and additional tax for late payment of that tax.

The proportion of the deemed dividend attributable to each vendor-shareholder is calculated as follows -

\[
\text{consideration received by particular vendor-shareholder} = \frac{\text{deemed dividend}}{\text{total consideration for sale of shares}}
\]

Rate of Tax

For a natural person, company or trustee, the rate of tax on the deemed dividend or dividend amount will be the maximum personal rate of tax for the relevant income year. The rate ranges between 69.62 cents in the dollar for the income year commencing 1 July 1971 to 60 cents in the dollar for income year commencing 1 July 1980.

Tracing Provisions

The process of tracing from the primary to the next level and further levels (if required) will be necessary where the company or trustee to which an imputed dividend has been allocated -

(i) no longer exists;
(ii) has different shareholders or beneficiaries as a consequence of sale; or
(iii) is unlikely to pay the dividend recoupment tax and relevant prescribed persons behind the entity have not elected to be assessed on the imputed dividend.

The process is complete when it reaches

(i) a natural person or other prescribed person;
(ii) a company or trust that still exists and whose ownership has not changed.

Time for Payment

Dividend recoupment tax may be paid by instalments over a period of 12 months without attracting penalty tax, provided the liability is not contested. Arrangements in
this regard must be entered into with the Commissioner of Taxation within 30 days after the issue of a notice of assessment.

**Penalty Tax**

Failing satisfactory arrangements for payment of dividend recoupment tax over twelve months, an additional tax at the rate of 20 per cent per annum will be charged on any amount outstanding after the due date for payment.

**Main Provisions**

This Bill will come into operation on the date of Royal Assent (clause 2).

Title of the Principal Act will be changed to become "An Act relating to the assessment and collection of a tax in respect of certain unpaid income (previously company) tax" (clause 3) and will be cited as the Recoupment Tax Assessment Act 1982 (clause 4).

Sub-clause 5(g) proposes the repeal of sub-section 3(12) commonly known as the innocence clause. The repeal means that no longer will an unsuccessful post-sale tax avoidance scheme relieve a person from liability to recoupment tax or reduce such a liability.

By virtue of section 14 of the Income Tax Assessment Act 1936, the Commissioner of Taxation is required to report to Parliament annually on the working of that Act. It is now proposed to authorise the Commissioner to name in his annual report persons who fail to pay vendors or promoters recoupment tax or late payment penalty on such tax (sub-clause 6(a)).

Sub-Clause 6(c) proposes to remove the requirement of the Commissioner of Taxation (sub-section 4(5) of the Principal Act) to disclose to a former owner all known information about the stripping arrangement which had the effect of rendering a company unable to pay its tax. In addition, where the company tax payable is reduced by reason of an amended assessment, the Commissioner is empowered to refund the amount overpaid to the person or persons who paid the company tax or apply the potential refund against any recoupment tax liability of that person. Furthermore, a former owner who has paid company tax will be entitled to any interest under the Taxation (Interest on Overpayments) Act 1983, as a result of an overpayment of company tax following a successful appeal against the company assessment.
Clause 7 amends section 5 of the Principal Act to remove one of the tests of liability for recoupment tax which requires the target company to be rendered unable to pay all its company tax (sub-clauses 7(a), (b), (c) and (d)). It also will ensure that a person will not escape liability for vendors recoupment tax by reason of an unsuccessful pre-sale tax avoidance scheme (sub-clauses 7(e) and (f)).

Clause 8 proposes to insert section 5A into the Principal Act. Basically, the new section applies to vendor-shareholders in a target company who, except for any payments of company tax after 25 July 1982, would be liable to pay vendors recoupment tax in respect of ordinary company tax evaded by the stripped company. The section will also allocate a proportion of the after-tax taxable income of the stripped target company (after allowing for evaded unpaid company tax) to each of the vendor-shareholders on the same basis as allocations of the unpaid company tax was made.

Sections 6A to 6E are to be inserted into the Principal Act by clause 10. Proposed section 6A has the purpose of making the tracing rules contained in section 6 of the Principal Act apply, with appropriate modifications, to the tracing of dividend amounts. The primary or secondary dividend amount, in accordance with proposed section 6B, needs to be adjusted to reflect changes in ordinary company tax liability arising from an amended assessment.

Where a dividend amount exists in relation to a natural person or other prescribed person, proposed section 6C deems the company to have paid a dividend equivalent to the dividend amount and the person will become liable to pay income tax on the deemed dividend. A company or a trustee of a trust estate becomes liable for dividend recoupment tax on the dividend amount unless by virtue of the proposed section 6D the individuals behind the company or trust estate elect that the company be deemed to have paid a dividend on the day of sale equal to the dividend amount. Finally proposed section 6E will eliminate any liability on former owners for undistributed profits tax where they are liable for tax on a 'deemed dividend' amount.

Clause 11 amends section 7 of the Principal Act to amend the tests for establishing liability for promoters recoupment tax e.g. identification of the particular arrangements which rendered the target company unable to pay all its company tax.

The titles of the "Rates" Acts referred to in section 8 of the Principal Act are to be changed e.g.
Taxation (Unpaid Company Tax - Vendors) to Vendors Recoupment Tax and liability of certain companies and trustees to pay dividend recoupment tax is included (clause 12) in accordance with the provisions of the Dividend Recoupment Tax Act.

Clause 13 inserts section 9A into the Principal Act so that the liability of a company or trustee for dividend recoupment tax can be reduced by any amount paid by another company duly assessed in its own right.

Clause 19 inserts section 21A into the Principal Act to permit former owners, companies and trustees, to pay personal income tax or dividend recoupment tax respectively (where no rights of objection are exercised) to the Commissioner of Taxation by instalments over a period of 12 months free of additional tax for late payment.

Clause 21 repeals section 23 of the Principal Act and substitutes a new section 23 to overcome the constitutional doubt which has arisen about the legislation. An official certificate relating to the amount of company tax that is payable, is to be taken as conclusive evidence in an objection to an assessment. However, the certificate issued in relation to the amount of company tax that remains unpaid will be prima facie, rather than conclusive evidence.

Remarks

Under the proposed legislation, capital profits and retained earnings where company tax was not avoided are now exempt. Practical implications of the proposed legislation may be summarised as follows:-

1. The amendment assumes that retained earnings are distributed 100 per cent to shareholders. In reality, companies rarely distribute more than a sufficient distribution in order to maximise retained earnings to fund working capital, stocks, debtors, etc. Under existing taxation law a large portion of current year trading profits can be retained within the company tax free. Where a sufficient distribution is not made, additional tax (undistributed profits tax) is incurred.

This Bill seeks to tax these retained profits and hence results in an additional tax liability over and above that which would have been incurred by vendor-shareholders had the company not been sold. The additional tax liability can be illustrated as follows:
Normal Private Company  |  Position under Proposed Amendments
- $ -  | - $ -

Year ended 30 June 1980

<table>
<thead>
<tr>
<th>Description</th>
<th>Normal</th>
<th>Proposed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading Income</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Company Tax</td>
<td>A 46</td>
<td>46</td>
</tr>
<tr>
<td>Income after tax</td>
<td>54</td>
<td>54</td>
</tr>
<tr>
<td>Retention allowance</td>
<td>38</td>
<td>-</td>
</tr>
<tr>
<td>Dividend</td>
<td>16</td>
<td>54</td>
</tr>
</tbody>
</table>

Income Tax in hands of shareholders on:--
(i) normal dividend (60%)  
   - B 10  
(ii) deemed dividend (61.07%)  
   - 33  
Total Tax A + B  
   - 56  
   - 79

Increase in tax 41 per cent

In practice, shareholders in private companies may decide not to make a sufficient distribution and simply pay undistributed profits tax at 50 per cent which is considerably lower than the maximum personal rate of tax. Thus under the circumstances the tax increase in the above example would be 46 per cent. The 'Principal Act' is effective in recouping the undistributed profits tax and hence all the tax that was payable by companies sold in "bottom-of-the-harbour" schemes.

Further, because the Bill deems a dividend to be paid at the time of sale of the shares, personal tax at a higher rate will be imposed on the 'deemed dividend' than if the dividend had been paid in the normal manner, usually by 30 April of the following year. This is due to the gradual reduction in the maximum personal marginal rate of tax (69.62 cents to 60 cents in the dollar) during the period covered by the legislation.

2. Directed at companies sold with current year profit component (Wet Slutzkins). Companies sold to the same promoters with only retained earnings
from past years (Dry Slutzkins) escape the new tax as do companies which paid their company tax but avoided their Division 7 undistributed profits tax. However, when the current year profit companies have paid their company tax and Division 7 tax under the 'Principal Act' they are no different to the Dry Slutzkin companies which have been excluded.

3. Retained profits of earlier years

Another implication of the Bill is that retained profits of earlier years can be caught by the proposed legislation and deemed to be paid as a dividend to vendor-shareholders even where there was not an intended avoidance of company tax. This could arise where a company was sold with only the company tax liability of the year of sale outstanding but subsequently, for any reason, an amended assessment is issued in relation to an earlier year resulting in an increase in the company's ordinary tax liability for that year.

4. Bottom-of-the-harbour - colloquialism

The Bill treats all companies in the same manner as if they had all been sent to the "bottom-of-the-harbour" given that the innocence clause contained in sub-section 3(12) of the Taxation (Unpaid Company Tax) Assessment Act 1982 is to be abolished. Not all companies sold under these schemes were dumped. Some companies met all the requirements under existing tax and company law and the shareholders related to these companies will be unduly penalised by the abolition of the innocence clause.

5. Crimes (Taxation Offences) Act 1980

The proposed deletion of the so-called innocence clauses in the Taxation (Unpaid Company Tax) Assessment Act makes the provisions in that Act harsher than the Crimes (Taxation Offences) Act 1980 (CTO). For example -

(i) it deprives a vendor-shareholder of the right to be relieved of that part of the recoupment tax liability where it can be shown that before the sale of shares that person reasonably believed that the relevant company did not have that marginal tax liability;
(ii) it places an absolute primary liability on vendor-shareholders who, had they carried out the same sale transaction under the CTO Act, might avoid liability because they can demonstrate reasonable belief; and

(iii) it penalises those vendor-shareholders who can demonstrate that after the share sale the company was placed into an arrangement which, under the law, could reasonably be expected to avoid a tax liability arising in the company.

6. Tax Neutrality

(i) Time Scale

By retrospective withdrawal of the 'innocence clauses' the situation could arise whereby, as a result of identical actions, one taken before 4 December 1980 and the other after 4 December 1980, far greater tax will be payable under the retrospective legislation than under the current legislation.

(ii) Successful and Unsuccessful Avoidance

The removal of the so-called "innocence clauses" discriminates between vendor-shareholders who managed to obtain a promoter who successfully avoided tax and vendor-shareholders with promoters who unsuccessfully avoided tax. The former shareholders would not be liable for recoupment tax, under the legislation whether or not the "innocence clauses" remain.

7. Legal Action

The Commissioner will contest the use of the so-called "innocence clauses" in the courts.

It could be argued that vendor-shareholders might find it difficult to succeed with action in courts of law based on grounds of innocence. How could a court of law differentiate easily between action
taken to avoid tax and action to strip the company? No doubt such arrangements would be made concurrently.

8. Annual Report

The Bill provides for the naming of non-payers in the public annual report of the Commissioner of Taxation. Non-payers in similar circumstances under other sections of the Income Tax Assessment Act 1936 (ITAA) are not named publicly. Taxpayers listed in the annual report are those who have been charged additional tax under sub-section 226(1) and/or sub-section 226(2) of ITAA and where the amount of the statutory additional tax exceeds $1500 and the total additional tax is more than 25 per cent of the increased tax. Furthermore, the taxpayer would need to have exhausted all rights of objection and appeal.

9. Loss of Revenue

Even where the so-called "innocence clauses" are being used, most taxpayers would have paid the tax liability subject to the ultimate outcome. Therefore there would be no immediate loss of revenue to the Government.

10. Share Market

Investor confidence in the share market will be affected by the proposed legislation simply because of the potential liability which some companies might face. The proposed legislation also threatens the concept of limited liability.

For further information, if required, contact:

4 April 1985

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