Date Introduced: 2 May 1984
House: House of Representatives
Presented by: Hon. C.J. Hurford M.P., Acting Treasurer

Short Digest of Bill

Purpose

To enable the Government to recover personal income tax avoided by former owners of companies that were subjected to "bottom-of-the-harbour" schemes, and to strengthen and improve in several identified areas 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 accumulated and/or contingent tax liabilities of the company were 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 would 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 included an amount that ought to have been set aside as legally payable company tax. Following the sale, the promoter created the situation whereby the company was incapable of meeting its tax liability and the records were permanently lost or the tax liability was simply removed by means of a tax avoidance scheme.

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 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.

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 was now 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 was to arise where the only company tax avoided was undistributed profits tax. Again, this Bill was defeated in the Senate.

Basically, the Bills were designed to enable the Government to recover personal income tax avoided by former owners of companies that were subjected to "bottom-of-the-harbour" schemes. In addition, the Bills aimed to strengthen and improve the "Principal Act" in several identified areas, and were applicable to both public and private companies.

A further Bill was introduced on 3 November 1983, namely the Taxation (Unpaid Company Tax) Assessment Amendment Bill 1983 [No. 3], 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.
The current Bill is identical to the Taxation (Unpaid Company Tax) Assessment Amendment Bill 1983 [No. 2] introduced on 23 August 1983. Personal income tax will 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 will arise where the only company tax avoided was undistributed profits tax.

The rationale underlying the current 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.

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) 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 -

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

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 1972 to 60 cents in the dollar for income year 1981.

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

The amending Act is to come into operation on the day on which it receives 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).

Paragraph (g) of clause 5 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 (clause 6(a)).

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.

Clause 7 intends 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
(paragraphs (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 (paragraphs (e) and (f)).

Clause 8 proposes to insert a new section - 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.

A number of technical amendments to section 6 of
the Principal Act are to be effected by clause 9.

Five new sections - sections 6A to 6E - are to be
inserted into the Principal Act (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 intends 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 proposes to insert a new section - 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 will 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 will replace section 23 of the Principal Act to overcome the constitutional doubt which has arisen about the legislation. The certificate issued under the section will be prima facie, rather than conclusive evidence. The prima facie rule will revert to a conclusive evidence rule on a date to be fixed by proclamation.

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:

<table>
<thead>
<tr>
<th>Normal Private Company Situation $</th>
<th>Position under Proposed Amendments $</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year ended 30 June 1980</strong></td>
<td></td>
</tr>
<tr>
<td>Trading Income</td>
<td>100</td>
</tr>
<tr>
<td>Company Tax</td>
<td>A 46</td>
</tr>
<tr>
<td>Income after tax</td>
<td>54</td>
</tr>
<tr>
<td>Retention allowance 70%</td>
<td>38</td>
</tr>
<tr>
<td>Dividend</td>
<td>16</td>
</tr>
<tr>
<td>Income Tax in hands of shareholders on:</td>
<td></td>
</tr>
<tr>
<td>(i) normal dividend (60%)</td>
<td>B 10</td>
</tr>
<tr>
<td>(ii) deemed dividend (61.07%)</td>
<td></td>
</tr>
<tr>
<td>Total Tax A + B</td>
<td>56</td>
</tr>
<tr>
<td><strong>Increase in tax</strong></td>
<td>41 per cent</td>
</tr>
</tbody>
</table>

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 it is the shareholders related to these companies who 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 get with 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 are not named publicly. Taxpayers listed in the annual report are those that have been charged additional tax under sub-section 226(1) and/or sub-section 226(2) of the Income Tax Assessment Act 1936 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. Further, 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. **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:

24 May 1984

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