2002–2003

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

SENATE

TAXATION LAWS AMENDMENT BILL (No. 4) 2003

REVISED EXPLANATORY MEMORANDUM

(This memorandum takes account of amendments made by the House of Representatives to the bill as introduced)

(Circulated by authority of the Treasurer, the Hon Peter Costello, MP)
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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

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<td>A Tax System Redesigned</td>
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<td>ABN</td>
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<td>Commissioner</td>
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<td>ETP</td>
<td>eligible termination payment</td>
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<td>FBT</td>
<td>fringe benefits tax</td>
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<tr>
<td>FBTAA 1986</td>
<td><em>Fringe Benefits Tax Assessment Act 1986</em></td>
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<tr>
<td>GIC</td>
<td>general interest charge</td>
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<tr>
<td>GST</td>
<td>goods and services tax</td>
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<tr>
<td>IRU</td>
<td>indefeasible right to use an international telecommunications submarine cable system</td>
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<td>ITAA 1936</td>
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<td>PAYG</td>
<td>pay as you go</td>
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<td>RBL</td>
<td>reasonable benefit limit</td>
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<td>RCV</td>
<td>residual capital value</td>
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<td>SIS</td>
<td>simplified imputation system</td>
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<td>TAA 1953</td>
<td><em>Taxation Administration Act 1953</em></td>
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<td>TAR</td>
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General outline and financial impact

Internal roll-overs

Schedule 1 to this bill will amend the ITAA 1936 to ensure that roll-over transactions which occur wholly within the one superannuation fund or annuity provider (internal roll-overs) are treated in the same way for RBL purposes as roll-overs which occur between funds or providers (external roll-overs). This will address a problem in the current law which leads to the double counting of benefits for RBL purposes in situations involving internal roll-overs.

Date of effect: 1 July 2001.

Proposal announced: This measure was announced in Minister for Revenue and Assistant Treasurer’s Press Release No. C74/02 of 1 July 2002.

Financial impact: The revenue impact of the measure is not readily quantifiable.

Compliance cost impact: Negligible. The reporting of internal roll-overs is not expected to result in additional compliance costs for superannuation funds or annuity providers.

Summary of regulation impact statement

Regulation impact on business

Impact: This measure will potentially have implications for all providers and recipients of pensions and annuities.

Pension and annuity recipients will benefit through avoiding the double counting of benefits problem currently associated with internal roll-over transactions.

The current ETP regime requires funds to report roll-over transactions to the ATO for RBL assessment purposes. Within this existing framework, the reporting of internal roll-overs is not expected to result in additional compliance costs for superannuation funds or annuity providers.
Main points:

- The current law results in the double counting of superannuation benefits for purposes of the RBLs when a superannuation pension or annuity is commuted (stopped) and the resulting amount is rolled over within a fund.

- The changes in this bill expand the definition of ‘eligible termination payment’ to cover internal roll-over transactions and make related changes. This will allow internal roll-overs to come within the scope of the relevant RBL provisions of the income tax law. This means that when an internal roll-over occurs it will be reportable to the Commissioner and the RBL value of the pension or annuity will be reduced by the rolled over amount so as to avoid double counting of the benefit.

Uniform capital allowance system

Schedule 2 to this bill makes a number of technical corrections and amendments to the ITAA 1997 and IT(TP) Act 1997 to ensure the law operates as intended. The amendments all relate, directly or indirectly, to the uniform capital allowances system.

Date of effect: These amendments will apply from 1 July 2001, the commencement date of the uniform capital allowance system.

Proposal announced: These amendments have not been previously announced.

Financial impact: There is no revenue impact as a result of these amendments as the amendments ensure that the uniform capital allowance system operates as intended and as originally costed.

Compliance cost impact: These amendments will not involve additional compliance costs.

Non-assessable non-exempt income

Schedule 3 to this bill will improve the income tax law by clarifying, standardising and rationalising the recognition and treatment of non-assessable non-exempt income amounts. Specifically, it involves:
• establishing an explicit framework in the income tax law dealing with non-assessable non-exempt income;

• standardising related concepts by converting amounts of excluded exempt income and exempt income subject to withholding tax into non-assessable non-exempt income; and

• making a number of technical amendments to the law, including the correction of potential anomalies relating to non-assessable non-exempt income.

**Date of effect:** The amendments will generally apply to assessments for the 2003-2004 and later income years. Some amendments correcting technical errors or implementing other minor policy decisions will apply from earlier years.

**Proposal announced:** Not previously announced.

**Financial impact:** Nil.

**Compliance cost impact:** Small compliance cost saving to taxpayers through clarification of the law and removal of anomalies.

### Refundable tax offset rules

Schedule 4 to this bill makes amendments to the tax offset carry forward rules in Division 65 and the refundable tax offset rules in Division 67 of the ITAA 1997.

### Amendments to tax offset carry forward rules

The tax offset carry forward rules in the ITAA 1997 will be amended to ensure that taxpayers always receive the maximum benefit from refundable tax offsets.

**Date of effect:** The amendment will apply from 1 July 2000, when the tax offset for franked dividends became refundable.

**Proposal announced:** Not previously announced.

**Financial impact:** Nil.

**Compliance cost impact:** Nil.
Amendments to reflect of the simplified imputation system rules

Consequential amendments will be made to the refundable tax offset rules in the ITAA 1997 to reflect the SIS rules.

**Date of effect:** The amendments will apply from 1 July 2002, when the SIS rules came into effect.

**Proposal announced:** These amendments are part of the SIS, which was announced as part of the Government’s business tax reform package. The SIS was announced in Treasurer’s Press Release No. 58 of 21 September 1999 as a component of the unified entity regime.

**Financial impact:** Nil.

**Compliance cost impact:** Nil.

Preventing double refunds of the private health insurance tax offset to trustees and beneficiaries

A correction to the refundable tax offset rules in the ITAA 1997 will be made so that double claiming of the private health insurance tax offset in respect of the same private health insurance premiums by both a trustee and beneficiary will not be possible.

**Date of effect:** The amendments will apply from 1 July 2002.

**Proposal announced:** Not previously announced.

**Financial impact:** Nil. There would be a cost to revenue if these amendments were not made.

**Compliance cost impact:** Nil.

Foreign resident withholding

Schedule 5 to this bill explains amendments to the TAA 1953 that introduce new obligations to withhold from payments to foreign residents. There will also be obligations to withhold from payments received for foreign residents (i.e. by intermediaries of foreign residents). The payments to be included will be prescribed by regulations, and will be supported by the existing PAYG withholding system. The measure will improve the compliance of foreign residents with their Australian tax obligations. The measure is intended to minimise the compliance burden...
on Australian businesses by requiring withholding only for specified payments.

**Date of effect:** The new withholding arrangements will apply to payments made on or after 1 July 2003.

**Proposal announced:** Minister for Revenue and Assistant Treasurer’s Press Release C57/02 of 14 May 2002.

**Financial impact:** The legislation will have no financial impact as it establishes the framework for payments to be prescribed in the regulations. As regulations are made specifying payments, these will result in an increase to revenue.

**Compliance cost impact:** The obligation to withhold will generally only apply to entities carrying on enterprises that are already participating in the PAYG withholding system. This measure is expected to have a minimal compliance cost impact on those entities. For those entities not already using the PAYG withholding system, there will be a requirement to register for withholding, remit amounts, and provide payment summaries and annual reports if they make payments prescribed in the regulations to foreign residents.

**Summary of regulation impact statement**

**Regulation impact on business**

**Impact:** The measure is expected to have a minimal compliance cost impact on entities making payments to foreign residents. Most of these payers will already be participating in the PAYG withholding system as payers through their business activities. For those entities not already using the PAYG withholding system, there will be a requirement to register for withholding, remit amounts, and provide payment summaries and annual reports if they make payments prescribed in the regulations to foreign residents.

**Main points:**

- The measure is expected to have a minimal compliance cost impact on entities making payments to foreign residents. Most of these payers will already be participating in the PAYG withholding system as payers through their business activities.

- Foreign residents who receive payments of a kind specified by regulation will be affected by the measure. These foreign
residents will only receive the net amount of the payment, rather than the gross amount.

- Some foreign residents may find contracts in Australia less attractive under the new arrangements. This potential economic cost would be offset by the improved competitiveness of resident individuals and entities participating in the industries for which payments are prescribed.

The ATO will administer the new withholding arrangements using existing resources and administrative systems.

**PAYG withholding where no ABN is quoted**

Schedule 6 to this bill amends the ITAA 1997 and the TAA 1953 to ensure that the no ABN withholding event will apply to enterprise-to-enterprise transactions in Australia. This Schedule also amends the no ABN withholding rules to have the same geographical application as the ABN Act. This will ensure that the no ABN withholding provisions are consistent with the ABN Act, and that the original objectives of the no ABN withholding provisions are fully implemented.

*Date of effect:* The amendments will commence on Royal Assent.

*Proposal announced:* The measure has not been announced.

*Financial impact:* The financial impact of the proposal is unquantifiable but is not expected to be significant.

*Compliance cost impact:* Nil.
Worker entitlement funds

Schedule 7 to this bill amends the FBTAA 1986 to provide an FBT exemption for certain payments to approved worker entitlement funds.

This Schedule also amends the ITAA 1997 to provide a CGT roll-over to a fund that amends or replaces its trust deed in order to be approved as an approved worker entitlement fund.

**Date of effect:** The FBT exemption applies to benefits provided on or after 1 April 2003 and the CGT roll-over applies to CGT events that happen on or after 1 April 2003.

**Proposal announced:** The FBT exemption was announced in Treasurer’s Press Release No. 61 of 11 October 2002. The CGT roll-over has not been previously announced.

**Financial impact:** The FBT exemption has a cost to revenue of $1 million in 2003-2004, $6 million in 2004-2005, $10 million in 2005-2006 and $15 million in 2006-2007. The CGT roll-over has no cost to revenue.

Summary of regulation impact statement

**Regulation impact on business**

**Impact:** Some worker entitlement funds will have to apply to the Commissioner in order to determine whether they meet certain criteria. These funds must meet certain criteria before being able to be prescribed by regulation as approved worker entitlement funds.

**Main points:**

- Worker entitlement funds may be required to provide the Commissioner with information such as how the funds operate, the documentation that governs their operation and documentation relevant to their establishment.

- Prescribing the funds by regulation provides certainty to the funds, employers and workers. It is also likely to limit the compliance costs on employers as they would not have to inquire whether or not a fund has self-assessed itself as meeting the relevant criteria.

- Prescribing worker entitlement funds by regulation also minimises tax planning opportunities.
Chapter 1
Internal roll-overs

Outline of chapter

1.1 Schedule 1 to this bill will amend the ITAA 1936 to ensure that roll-over transactions which occur wholly within the one superannuation fund or annuity provider (internal roll-overs) are treated in the same way for RBL purposes as roll-overs which occur between funds or providers (external roll-overs). In doing so, the amendments will remove an anomaly in the law which leads to the double counting of benefits for RBL purposes in situations involving internal roll-overs.

Context of amendments

1.2 The ITAA 1936 requires the payment of certain benefits, such as ETPs, superannuation pensions and annuities to be reported to the ATO. The purpose of these arrangements is to allow the value of superannuation benefits to be tracked and recorded against an individual’s RBL. The RBL limits the value of concessionally taxed superannuation benefits which a person can receive over their lifetime.

1.3 Currently, the RBL reporting arrangements prevent double counting of benefits for RBL purposes in situations where pensions or annuities which have commenced are stopped and externally rolled over – that is, where the resulting ETP is either contributed back into the accumulation phase of superannuation or applied towards the provision of another pension or annuity. (Rolling over an ETP essentially allows it to be transferred within the superannuation system without triggering a tax liability.)

1.4 Double counting of benefits in these situations is avoided by reporting the rolled over ETP to the ATO. The ATO then adjusts (reduces) the value of the benefit which was reported previously when the pension or annuity commenced. In the case of external roll-overs, these arrangements ensure that the same superannuation benefit is not counted twice for RBL purposes when it is eventually paid out of the system again.
1.5 Under the current law, an internal roll-over is not an ETP and therefore cannot be reported to the ATO for RBL purposes. This is because the definition of ‘eligible termination payment’ requires an actual payment to have been made in respect of the taxpayer and no such payment is made in the case of a roll-over which occurs within a fund.

1.6 An internal roll-over can occur, for example, where a person commutes a pension which is being paid to them from a superannuation fund and returns the commutation amount to the accumulation phase within the same fund. An internal roll-over can also occur where a person rolls over the RCV of an annuity to commence another annuity with the same annuity provider.

1.7 The current inability to report internal roll-overs resulting from the commutation or RCV of a pension or annuity leads to double counting of benefits for RBL purposes. As a result, there is potential for the associated benefit to have an excessive component when it is eventually paid out of the superannuation system. The excessive amount of a superannuation benefit is the amount of the benefit in excess of the taxpayer’s RBL (in 2002-2003 these amounts are $562,195 (lump sum RBL) and $1,124,384 (pension RBL)). Where a benefit is paid as an ETP the excessive component is taxed at 48.5% (the Government has announced a measure to reduce the effective tax rate on the excessive component of an ETP from a superannuation fund). Where a benefit is paid as a pension, the excessive component is ineligible for the pension and annuity rebate which is available to superannuation income streams.

Summary of new law

1.8 This measure will ensure that internal roll-overs are treated as ETPs for purposes of the income tax law. To this end, this bill expands the definition of ‘eligible termination payment’ to cover internal roll-over transactions. Together with other amendments contained in this bill, this change will require internal roll-overs to be reported to the ATO and taken into account for RBL purposes, thereby avoiding the double counting of benefits problem which arises under the current law.

1.9 This bill inserts four new paragraphs into the definition of ‘eligible termination payment’ in subsection 27A(1) of the ITAA 1936. These paragraphs deal with the various internal roll-over situations which can arise and correspond with existing paragraphs of the definition of ‘eligible termination payment’ relating to commutation amounts and residual capital values of pensions and annuities. Amounts covered by these four new paragraphs are called internal roll-over amounts.
1.10 An internal roll-over also needs to be a *qualifying ETP* so that it can be rolled over within the superannuation system without triggering a tax liability. To achieve this, amendments are also required to subsections 27A(12), 27A(13) and section 27D of the ITAA 1936.

1.11 As a result of these amendments, an internal roll-over will come within the scope of the relevant RBL provisions of the ITAA 1936. This means that the internal roll-over will be reportable to the Commissioner and that the RBL amount of the pension or annuity can be reduced by the rolled over amount so as to avoid double counting of benefits for RBL purposes.

1.12 A number of definitional and other changes are also required to make reference to the new paragraphs in the definition of ‘eligible termination payment’ relating to internal roll-over amounts.

### Comparison of key features of new law and current law

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<th><strong>New law</strong></th>
<th><strong>Current law</strong></th>
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<tr>
<td>The definition of ‘eligible termination payment’ will be expanded to include four new paragraphs which cover internal roll-over transactions. A definition of ‘internal roll-over amount’ is inserted into subsection 27A(1). Internal roll-over amount is an ETP covered by any of the new paragraphs (daa), (ea), (gaa) or (ha) of the definition of ‘eligible termination payment’.</td>
<td>‘Eligible termination payment’ is defined in subsection 27A(1) of the ITAA 1936. The definition of ‘eligible termination payment’ does not include internal roll-overs.</td>
</tr>
<tr>
<td>Subsection 27A(12) will be amended so that an internal roll-over amount is a qualifying ETP.</td>
<td>A ‘qualifying eligible termination payment’ is defined in subsection 27A(12). The definition does not cover an internal roll-over.</td>
</tr>
<tr>
<td>Section 27D is amended so that certain details about an internal roll-over amount must be provided to the Commissioner.</td>
<td>Section 27D provides that a taxpayer who elects to roll-over a qualifying ETP must provide certain details about the ETP to the Commissioner.</td>
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Detailed explanation of new law

Eligible termination payments

1.13 Subdivision AA of Part III of Division 2 of the ITAA 1936 sets out the taxation arrangements for superannuation and termination of employment payments.

1.14 Section 27A defines a number of terms for the purposes of Subdivision AA. The definition of ‘eligible termination payment’ in subsection 27A(1) includes a list of payments that are ETPs – for example, payments to a taxpayer on termination of their employment, payments from superannuation funds and payments to a taxpayer in relation to the commutation or RCV of a pension or annuity.

Internal roll-overs

1.15 Under the current law, an internal roll-over (i.e. a roll-over which occurs within a superannuation fund or annuity provider) is not an ETP. This is because the definition of ‘eligible termination payment’ requires an actual payment to have been made in respect of the taxpayer and no such payment is made in the case of a roll-over which occurs inside a superannuation fund or annuity provider.

Reasonable benefit limits

1.16 Division 14 of Part III of the ITAA 1936 provides for a system of RBLs that generally apply to ETPs, superannuation pensions and annuities. The purpose of the RBLs is to limit the amount of concessionally taxed superannuation benefits which can be received by a person over their lifetime.

1.17 Under the existing law, an internal roll-over is not an ETP and can not therefore be reported to the Commissioner for RBL purposes. This can lead to the double counting of superannuation benefits against a taxpayer’s RBL.

Definition of ‘eligible termination payment’ to include internal roll-overs

1.18 This bill expands the definition of ‘eligible termination payment’ in subsection 27A(1) by inserting paragraphs (daa), (ea), (gaa) and (ha) to cover transactions that are internal roll-overs. The four new paragraphs cover the application of an amount resulting from the commutation or RCV of a superannuation pension or qualifying annuity.
1.19 A key feature of the transactions covered by the four new paragraphs is that they do not result in a payment; rather, they are internal transactions where the relevant amounts of money remain within the same superannuation fund or annuity provider.

1.20 New paragraph (daa) provides that where a superannuation pension is commuted (either partially or fully) and part or all of the resulting commutation amount remains in the fund or is applied immediately towards the provision of another superannuation pension by the same fund, then the amount remaining or applied is an ETP. [Schedule 1, item 3, subsection 27A(1)]

1.21 New paragraph (ea) provides that where the RCV of a superannuation pension becomes payable and part or all of the RCV remains in the fund or is applied immediately towards the provision of another pension by the same fund, then the amount remaining or applied is an ETP. [Schedule 1, item 4, subsection 27A(1)]

1.22 New paragraph (gaa) provides that where a qualifying annuity is commuted (either partially or fully) and part or all of the resulting commutation amount is applied immediately towards the provision of another qualifying annuity by the same annuity provider, then the amount so applied is an ETP. [Schedule 1, item 5, subsection 27A(1)]

1.23 New paragraph (ha) provides that where the RCV of a qualifying annuity becomes payable and part or all of the RCV is applied immediately towards the provision of another qualifying annuity by the same annuity provider, then the amount so applied is an ETP. [Schedule 1, item 6, subsection 27A(1)]

1.24 For an internal roll-over to meet the definition of ‘eligible termination payment’, it is a requirement that amounts which are applied in accordance with new paragraphs (daa), (ea), (gaa) and (ha) are attributable to the same taxpayer to whom the pension or annuity was payable. This means, for example, that an internal roll-over will not be taken to occur where an amount resulting from the commutation of a pension on the death of a taxpayer remains in the fund after the commutation.

1.25 A definition of ‘internal roll-over amount’ is inserted into subsection 27A(1). ‘Internal roll-over amount’ is an ETP covered by any of the paragraphs (daa), (ea), (gaa) or (ha) of the definition of ‘eligible termination payment’. [Schedule 1, item 7, subsection 27A(1)]
1.26 This bill inserts a new subsection 27A(6) which gives the Commissioner the power to specify guidelines on how an internal roll-over amount is to be determined. It is intended that, in issuing such guidelines, the Commissioner will refer to relevant industry standards. Where the Commissioner issues such guidelines, an internal roll-over amount is to be calculated in accordance with them. [Schedule 1, item 10, subsection 27A(6)]

**Qualifying eligible termination payments to include internal roll-overs**

1.27 To provide consistent treatment between internal roll-overs and external roll-overs, a number of amendments are required to ensure that no taxation liability is triggered when an internal roll-over occurs.

1.28 To this end, it is necessary that an internal roll-over is taken to be a qualifying ETP. Accordingly, subsection 27A(12) is amended so that an internal roll-over is a qualifying ETP.

1.29 A taxpayer may elect to roll-over a qualifying ETP under section 27D. Accordingly, subparagraph (ia) is inserted into subsection 27D(1) to include a reference to details about internal roll-over amounts. [Schedule 1, items 11 and 17, subsection 27A(12) and subparagraph 27D(1)(b)(ia)]

1.30 Subsection 27A(13) explains the application of section 27D. This bill amends paragraph 27A(13)(a) to ensure that an amount is rolled over if it is an internal roll-over amount. [Schedule 1, item 12, paragraph 27A(13)(a)]

1.31 As a result of these amendments, an internal roll-over will be required to be reported under section 140Q. This will enable the Commissioner to take the internal roll-over into account in determining the RBL value of an individual’s benefits.

**Example 1.1**

On 1 January 2003, Monica commences an allocated pension which has a capital value for RBL purposes of $300,000. The pension is comprised entirely of post-June 1983 amounts.

A year after commencing the pension Monica decides to accept an offer to return to work. With the salary from her new job Monica no longer needs the income from the allocated pension. She commutes the pension on 31 December 2003 and rolls over the commutation amount of $280,000 to an accumulation account with the same superannuation fund.

The internal roll-over of $280,000 is an ETP under new paragraph (daa) of the definition of ‘eligible termination payment’ in...
subsection 27A(1). It is also a qualifying ETP under subsection 27A(12). Monica’s fund must report the roll-over of the ETP to the ATO under section 140Q. Under section 140ZP, the ATO then adjusts the capital value of the commuted pension by the amount rolled over ($280,000), reducing the capital value of the pension to $20,000.

Three years later, Monica decides to give up work and commence a new allocated pension with the same super fund. With additional contributions and earnings, her accumulation account has grown to $310,000. Under section 140M, Monica’s fund reports the commencement of a new pension with a capital value of $310,000.

In determining whether the new pension is in excess of the RBL, the ATO takes account of Monica’s previously received benefits, which amount to $20,000. The total value of Monica’s benefits is now $330,000 ($310,000 plus $20,000). As this amount is below the lump sum RBL for the relevant year, the pension is not excessive and has a rebatable proportion of one.

Without the amendments contained in this bill, the commutation and roll-over of Monica’s original pension could not be reported to the ATO, and the capital value of the original pension could not be reduced under section 140ZP. At the time the second pension commenced, the total value of Monica’s benefits would therefore be $610,000 ($300,000 plus $310,000) – in other words, the same superannuation benefit would effectively have been counted twice for RBL purposes.

*Note: For simplicity, the above example assumes no indexation.*

**Other definitions**

1.32 The following amendments to definitions in Subdivision AA of Part III of Division 2 of the ITAA 1936 are required as a result of the amendments that expand the definition of ‘eligible termination payment’ to include internal roll-overs.

- Paragraphs (c) and (d) of the definition of ‘eligible service period’ in subsection 27A(1) mention ETP types relating to pensions and annuities. Amendments are made to include references to the corresponding internal roll-over ETP types (new paragraphs (daa), (eaa), (gaa) or (ha) of the definition of ‘eligible termination payment’) *[Schedule 1, items 1 and 2, subsection 27A(1)].*

- Similarly, the definition of ‘undeducted contributions’ is amended to include references to paragraphs (daa), (eaa),
(gaa) or (ha) which have been inserted into the definition of ETP [Schedule 1, items 8 and 9, subsection 27A(1)].

• Subsection 27AAAA(2) which deals with the meaning of ‘commutation ETP’ is amended to include references to paragraphs (daa), (ea), (gaa) or (ha) which have been inserted into the definition of ‘eligible termination payment’ [Schedule 1, item 13, subsection 27AAAA(2)].

• Paragraph 27AAAAA(4)(b) is amended so that it applies in relation to internal roll-overs [Schedule 1, item 14, subsection 27AAAA(4)].

• Subsection 27AB(1) includes a table which sets out the taxed element in respect of all types of ETPs. The table is amended to include references to paragraphs (daa), (ea), (gaa) or (ha) which have been inserted into the definition of ‘eligible termination payment’ [Schedule 1, items 15 and 16, subsection 27AB(1)].

Application and transitional provisions

1.33 The amendments apply to commutations of pensions and annuities, and residual capital values of pensions and annuities which become payable, on or after 1 July 2001. [Schedule 1, item 18]

REGULATION IMPACT STATEMENT

Policy objective

1.34 The policy objective is to amend the taxation laws to ensure that taxpayers are not disadvantaged when they stop a pension or annuity and roll-over the resulting commutation or residual capital value amount within the same superannuation fund or annuity provider. This can occur, for example, where a retiree commutes an allocated pension and starts accumulating superannuation again within the same fund as part of a decision to return to work or commence looking for work. It can also occur where a person rolls over the residual capital value of an annuity to start another annuity with the same annuity provider.
Assessment of impacts (costs / benefits)

1.35 The amendments contained in this bill will ensure that internal roll-overs are treated as ETPs. This change will enable these transactions to be reported to the ATO and taken into account for RBL purposes.

1.36 ‘Rolling over’ an ETP allows it to be transferred within the superannuation system (e.g. from accumulation phase to pension phase or from pension to pension) without triggering a taxing event. This treatment is allowed on the basis that the associated benefit will be subject to tax once it is paid out of the system (either as an ETP or as a pension).

1.37 Currently, internal roll-over transactions are not reportable for RBL purposes. This is because the current system is based on the reporting of ETPs and, under the current law, an ETP does not arise from a roll-over which occurs within the same superannuation fund or annuity provider. The current treatment results in the double counting of benefits for RBL purposes, with the potential for an excessive benefits situation when the benefit is eventually paid out of the superannuation system.

1.38 This measure will potentially have implications for all providers and recipients of pensions and annuities.

1.39 This measure will benefit pension and annuity recipients by avoiding the double counting of benefits problem which is currently associated with internal roll-over transactions.

1.40 The current ETP regime requires funds to report roll-over transactions to the ATO for RBL assessment purposes. Within this existing framework, the reporting of internal roll-overs is not expected to result in additional compliance costs for superannuation funds or annuity providers.

Government revenue

1.41 The revenue impact of the proposed change to the treatment of internal roll-overs is not readily quantifiable.

Administrative costs

1.42 The ATO does not anticipate the need for any major systems changes to implement this measure.
Implementation options

1.43 The double counting of benefits problem associated with internal roll-overs could be addressed in an alternative way through regulation changes to enable internal roll-overs to be reported for RBL purposes without classifying them as ETPs. However, this approach would add to the complexity of the retirement income system by introducing a new category of reportable payment falling outside the definition of ‘eligible termination payment’.

Consultation

1.44 Submissions were received from various industry stakeholders proposing that the Government take action to address the double counting of benefits problem associated with internal roll-overs under the current law.

1.45 Relevant industry and taxpayer representative groups were consulted. While there was broad agreement with the proposed legislative approach, a number of concerns of a technical nature were raised. These concerns were taken into consideration in finalising the amendments.
Chapter 2
Uniform capital allowance system

Outline of chapter

2.1 This chapter explains technical corrections and amendments made to:

- various provisions of the ITAA 1997 to ensure that the uniform capital allowance system operates as intended and ensure that the other capital allowances and CGT provisions interact appropriately with the capital allowances system; and

- various provisions in the IT(TP) Act 1997 that relate to the capital allowances system or to depreciating assets, to ensure that they apply as intended.

Context of amendments

2.2 The uniform capital allowance system was enacted with effect from 1 July 2001 and allows deductions for the cost of a depreciating asset over a period that reflects the effective life of the asset.

2.3 The technical corrections and amendments explained in this chapter ensure that the uniform capital allowance system operates as intended and interacts appropriately with other related provisions.

Detailed explanation of the amendments

Uniform capital allowance system – Division 40 of the ITAA 1997

Conversion of a mining, quarrying or prospecting right

2.4 Conversions of a mining, quarrying or prospecting right will be taken to be a continuation of that right if the right ends and the new right relates to the same area (or the difference in area is insignificant). This provision is related to the effective life rule that a mining, quarrying or prospecting right will have the same effective life as the life of the mine,
petroleum field or quarry to which that right relates (see paragraphs 2.9 to 2.12 for discussion of that rule). [Schedule 2, item 1, subsection 40-30(6)]

**Deduction for expenditure on exploration or prospecting**

2.5 Expenditure, whether capital or not, on exploration or prospecting for minerals (including petroleum) and quarry materials, is generally immediately deductible.

2.6 Subject to a number of conditions specified in section 40-80 of the ITAA 1997, the decline in value of a depreciating asset of a taxpayer (i.e. the amount deductible) is the asset’s cost if the taxpayer first uses the asset for exploration or prospecting for minerals, which includes petroleum, or quarry materials.

2.7 The first condition is that the immediate deduction is available only if the asset is not used for development drilling for petroleum, or operations in the course of working a mining property, petroleum field or quarrying property. This bill amends the first condition so that it only needs to be met when the taxpayer first uses the asset. [Schedule 2, item 2]

**What is the meaning of mining operations?**

2.8 Subsection 40-730(7) defines ‘mining operations’. This bill amends this subsection by replacing the words ‘for a taxable purpose’ with ‘for the purpose of producing assessable income’. To satisfy the definition of taxable purpose, it is sufficient that there is a purpose of exploration or prospecting. It is not necessary that there be a purpose of producing assessable income. Therefore, deductions can be claimed even if the income derived from exploration and prospecting is exempt. Under the former provisions for exploration, deductions were unable to be claimed in these circumstances. Replacing ‘for a taxable purpose’ with ‘for the purpose of producing assessable income’ will ensure that exploration expenses are not claimed where the income from the activity is exempt. [Schedule 2, item 5]

**Effective life of a mining, quarrying or prospecting right**

2.9 Paragraph 40-95(8) states that for intangible assets that qualify for write-off under Division 40, but are neither contained in the table in paragraph 40-95(7) nor IRUs, the effective life cannot be longer than the term of that intangible asset as extended by any reasonably assured extension or renewal of that term. This bill amends this subsection by removing the reference to mining, quarrying and prospecting rights. These rights will now be covered by specific references in the table in paragraph 40-95(7) of the ITAA 1997. [Schedule 2, item 3]
2.10 For a mining, quarrying or prospecting right that relates to a mine (excluding petroleum fields or quarries), the effective life of that right is the life of the mine, proposed mine, or if there is more than one mine, the life of the mine that has the longest estimated life to which the right relates. [Schedule 2, item 3, subsection 40-95(7)]

2.11 For a mining, quarrying or prospecting right that relates to a petroleum field, the effective life of that right is the life of the petroleum field or proposed petroleum field to which the right relates. [Schedule 2, item 3, subsection 40-95(7)]

2.12 For a mining, quarrying or prospecting right that relates to a quarry, the effective life of that right is the life of the quarry, proposed quarry, or if there is more than one quarry, the life of the quarry that has the longest estimated life to which the right relates. [Schedule 2, item 3, subsection 40-95(7)]

Example 2.1

Global Resources Limited obtains a right to extract a mineral for an initial term of 21 years. The right can be renewed, extended indefinitely on a 21 year basis while mining continues. Global estimates that, based on its anticipated level of production, the resource will be fully exhausted after 30 years. It could be concluded that the right, together with any reasonably assured extensions or renewals, will exist for 42 years. However, based on Global’s plans, Global or any other person is likely to use the right for 30 years only. Accordingly, Global could reasonably adopt an effective life of 30 years for the right.

Uniform capital allowance system – Division 40 of the IT(TP) Act 1997

2.13 Division 40 of the IT(TP) Act 1997 facilitates the transition of depreciable assets into the uniform capital allowance system from the various separate capital allowance regimes that operated before it. Broadly, the transitional provisions allow taxpayers to apply the new uniform capital allowance system to existing depreciable assets and certain capital expenditures. Effectively, Division 40 of the ITAA 1997 generally applies to depreciable assets after 30 June 2001.
2.14 Expenditure incurred before 1 July 2001 that was deductible under the special provisions for mining and quarrying (the former Division 330) generally retains the former treatment. This has been achieved by bringing such expenditure into Division 40 and modifying the ordinary application of the Division to ensure that the expenditure retains its concessional treatment. Accordingly, the former provisions ceased to apply from 1 July 2001.

**Mining unrecovered expenditure**

2.15 Broadly, capital expenditure other than on plant incurred on developing and operating a mine site, petroleum field or quarry (allowable capital expenditure) is deductible over the shorter of 10 years (20 years for quarrying) and the life of the project. The amount of such expenditure that remains to be deducted is unrecovered expenditure.

2.16 If a taxpayer has an amount of unrecovered expenditure at the end of 30 June 2001, the taxpayer will work out the decline in the value of that amount under Division 40 using the prime cost method, and as if it were a depreciating asset held by the taxpayer. The amount of unrecovered expenditure, that is taken to be an asset, is taken to be an asset for all purposes of Division 40.

**Disposal of property to which capital expenditure that has been completely unrecovered relates**

2.17 A note is added to subsection 40-35(1) to ensure that it is clear that subsection 40-35(6) applies, as per subsection 40-35(8), where the taxpayer does not have unrecovered expenditure at 30 June 2001.  
[Schedule 2, item 6]

2.18 A further subsection is inserted (subsection 40-35(8)) to ensure that it is clear that there is an additional decline in value of the notional asset if the underlying property is not a depreciating asset where the taxpayer:

- had completely recouped capital expenditure by 30 June 2001;
- the expenditure related to property that is not a depreciating asset; and
- the property is disposed of, lost or destroyed, or stopped being used for a taxable purpose.

[Schedule 2, item 7, subsection 40-35(8)]
2.19 This will allow a decline in the value of the notional asset where the underlying property is not a depreciating asset and the amount of unrecouped capital expenditure at 30 June 2001 is zero. For example, a balancing adjustment will occur for the notional asset where the taxpayer disposes of underlying property that is not a depreciating asset and where the mining capital expenditure related to that property has been fully deducted before 30 June 2001 under Division 330.

Merge or split of depreciating asset to which unrecouped expenditure relates

2.20 Subsection 40-35(5) applies to ensure that where the underlying property to which the unrecouped mining expenditure relates is disposed of, lost or destroyed, or ceases to be used for a taxable purpose, there is an additional decline in value of the notional asset that includes this expenditure. The amount of unrecouped expenditure that is taken to be an asset is taken to be an asset for all purposes of Division 40.

2.21 If the underlying depreciating asset or property is split, section 40-115 of the ITAA 1997 deems that the asset has stopped being held. Subsection 40-295(3) of the ITAA 1997 ensures that when a depreciating asset stops being held because it is split, a balancing adjustment event does not occur. However, under subsection 40-35(5) there is an additional decline in value for the whole of the adjustable value of the notional asset.

2.22 Paragraph 40-35(7)(a) will be inserted into the IT(TP) Act 1997 to ensure that if the underlying property is split into 2 or more depreciating assets, and the taxpayer stops holding one or more of these assets, then subsection 40-35(5) does not apply to the asset that they continue to hold. Subsection 40-35(5) does apply to the asset disposed of and an additional decline in value is available for the adjustable value of the related notional asset. [Schedule 2, item 7, paragraph 40-35(7)(a)]

2.23 Where a real asset is merged into another depreciating asset, paragraph 40-35(7)(b) will apply to ensure that section 40-125 of the ITAA 1997 does not apply while the taxpayer continues to hold both the real and depreciating assets. In this case, the original asset is not deemed to have been stopped being held, no balancing adjustment occurs under section 40-295(3) of the ITAA 1997 and there is no additional decline in value for the notional asset under subsection 40-35(5). [Schedule 2, item 7, paragraph 40-37(7)(b)]

Post 30 June 2001 mining expenditure

2.24 Capital expenditure other than on plant incurred after 30 June 2001 on developing and operating a mine site, petroleum field or
quarry (allowable capital expenditure) under a contract entered into before that day is deductible over the shorter of 10 years (20 years for quarrying) and the life of the project. [Schedule 2, item 8, subsection 40-37(1)]

2.25 The taxpayer will work out the decline in value of that amount under Division 40 using the prime cost method, and as if it were a depreciable asset held by the taxpayer. The amount of expenditure that is taken to be an asset is taken to be an asset for all purposes of Division 40, including balancing adjustments. [Schedule 2, item 8, section 40-37]

2.26 The decline in value of that asset is calculated on the following basis:

- the asset has a cost at the time the expenditure is incurred equal to the amount of the expenditure [Schedule 2, item 8, paragraph 40-37(2)(a)];
- the decline under the prime cost formula is calculated using the adjustments to the formula found in the ITAA 1997 for the year in which the expenditure is incurred. The basis for calculating the decline in the year in which the expenditure was incurred will be on the effective life and cost (to ensure that deductions are calculated in the same manner as under the former Division 330) [Schedule 2, item 8, paragraph 40-37(2)(b)];
- the asset was used for a taxable purpose when the expenditure was incurred [Schedule 2, item 8, paragraph 40-37(2)(c)]; and
- the asset had an effective life equal to the shorter of the number of years in the 10 year period for deduction (20 years for quarrying) and the life of the project [Schedule 2, item 8, paragraph 40-37(2)(d) and subsections 40-37(3) and (4)].

Disposal of, lost, destroyed or you stop using for a taxable purpose property to which the expenditure relates

2.27 If the underlying property, which is not a depreciable asset, to which the expenditure relates is disposed of, lost or destroyed, or it ceases to be used for a taxable purpose, there is an additional decline in value of the notional asset that includes this expenditure. [Schedule 2, item 8, subsection 40-37(5)]

2.28 Where the taxpayer disposes of the asset by sale, those sale proceeds are to be included in the taxpayer’s assessable income. If the disposal is otherwise than by sale and the taxpayer owns the asset, an
amount equivalent to the market value of the asset is included in the 
assessable income of the taxpayer. If the taxpayer does not own the asset, 
the amount included in assessable income is a reasonable amount (see the 
former Division 330 for the comparable previous rule). However, in each 
case, the amount to be included in assessable income is to be reduced so 
far as it is already included in assessable income under the rules that relate 
to a project pool (to avoid double-counting of income). In effect, the 
deductions given indirectly for the underlying property that is not a 
depreciating asset are reconciled to the actual loss in value of the property. 
[Schedule 2, item 8, subsection 40-37(6)]

Mining cash bidding payments

2.29 If a taxpayer has an amount of expenditure that would have been a mining cash bidding payment under the former Division 330 and:

- the expenditure was incurred before 30 June 2001, but the mining authority was granted after 30 June 2001; or

- the expenditure was incurred after 30 June 2001, but the mining authority was granted before 30 June 2001,

the taxpayer will work out the decline in value of that amount under Division 40 using the prime cost method, and as if it were a depreciating asset held by the taxpayer. The amount of the mining cash bidding payment that is taken to be an asset is taken to be an asset for all purposes of Division 40, including balancing adjustments. [Schedule 2, item 8, section 40-38]

2.30 The former Division 330 provided that a mining cash bidding payment was to be treated as deductible capital expenditure incurred for the purposes of Division 330. Under Division 330, the amount was deemed to be incurred at the time of payment or the grant of the mining right, whichever happened later.

2.31 The decline in value of that asset is calculated on the following basis:

- the asset comprising the mining cash bidding payment had a cost equal to the amount of the expenditure [Schedule 2, item 8, paragraph 40-38(2)(a)];

- the decline under the prime cost formula is calculated using the adjustments to the formula found in the ITAA 1997 for the year in which the mining authority is granted. The basis for calculating the decline in the year in which the mining authority is granted or the mining cash bidding payment is
made (whichever is later) will be on the effective life and cost [Schedule 2, item 8, paragraph 40-38(2)(b)];

- the asset was used for a taxable purpose at the time which the mining authority was granted or the mining cash bidding payment is made (whichever is later) [Schedule 2, item 8, paragraph 40-38(2)(c)]; and

- the asset had an effective life equal to the shorter of 10 years or the life of the project [Schedule 2, item 8, paragraph 40-38(2)(d) and subsections 40-38(3) and (4)].

Disposal of, lost, destroyed or you stop using for a taxable purpose property to which the mining cash bidding payment relates

2.32 If the underlying property, the depreciating asset, to which the mining cash bidding payment relates is disposed of, lost or destroyed, or it ceases to be used for a taxable purpose, there is an additional decline in value of the notional asset that includes this expenditure. The additional decline in value is that part of the notional asset’s adjustable value that relates to the underlying property and that was not taken into account in working out the balancing adjustment for the disposal of the depreciating asset. [Schedule 2, item 8, subsection 40-38(5)]

Merge or split of depreciating asset to which unrecouped expenditure relates

2.33 If the underlying property is split into 2 or more depreciating assets, and the taxpayer stops holding one or more of these assets, then subsection 40-38(5) does not apply to the asset that they continue to hold. Subsection 40-38(5) does apply to the asset disposed of and an additional decline in value is available for the adjustable value of the related notional asset. [Schedule 2, item 8 inserts paragraph 40-38(6)(a)]

2.34 Where a real asset is merged into another depreciating asset, paragraph 40-38(6)(b) applies to ensure that section 40-125 of the ITAA 1997 (merging depreciating assets) does not apply while the taxpayer continues to hold both the real and depreciating assets. In this case, the original asset is not deemed to have been stopped being held, no balancing adjustment occurs under section 40-295(3) of the ITAA 1997 and there is no additional decline in value for the notional asset under subsection 40-38(5). [Schedule 2, item 8, paragraph 40-38(6)(b)]

Transport capital expenditure

2.35 Broadly under former Subdivision 330-H, capital expenditure on certain facilities used primarily and principally in the transport of
minerals, including petroleum, and quarry materials, away from the place of extraction, is evenly deductible over 10 years (20 years for quarry materials). The deduction commences in the year the facility is so used.

2.36 A taxpayer who deducted or was entitled to deduct an amount for transport capital expenditure in respect of a transport facility before 30 June 2001 can continue to deduct that expenditure under Division 40 of the ITAA 1997.

Merge or split of depreciating asset to which unrecouped expenditure relates

2.37 Subsection 40-40(4) applies to ensure that where the underlying property to which the unrecouped mining expenditure relates is disposed of, lost or destroyed, or ceases to be used for a taxable purpose, there is an additional decline in value of the notional asset that includes this expenditure.

2.38 If the underlying depreciating asset or property is split, section 40-115 of the ITAA 1997 deems that the asset has stopped being held. Subsection 40-295(3) of the ITAA 1997 ensures that when a depreciating asset stops being held because it is split a balancing adjustment event does not occur, however, under subsection 40-40(4) there is an additional decline in value for the whole of the adjustable value of the notional asset.

2.39 If the underlying property is split into 2 or more depreciating assets, and the taxpayer stops holding one or more of these assets, then subsection 40-40(4) does not apply to the asset that they continue to hold. Subsection 40-40(4) does apply to the asset disposed of and an additional decline in value is available for the adjustable value of the related notional asset. [Schedule 2, item 9 will insert paragraph 40-40(6)(a)]

2.40 Where a real asset is merged into another depreciating asset, paragraph 40-40(6)(b) will apply to ensure that section 40-125 of the ITAA 1997 does not apply while the taxpayer continues to hold both the real and depreciating assets. In this case, the original asset is not deemed to have been stopped being held, no balancing adjustment occurs under section 40-295(3) of the ITAA 1997 and there is no additional decline in value for the notional asset under subsection 40-40(4). [Schedule 2, item 9, paragraph 40-40(6)(b)]

Post 30 June 2001 transport expenditure

2.41 A taxpayer who incurs expenditure after 30 June 2001 under a contract entered into before that day where that expenditure would have been transport capital expenditure in respect of a transport facility under
the former Division 330, can deduct that expenditure under Division 40 of the ITAA 1997. \[Schedule 2, item 10, subsection 40-43(1)\]

2.42 The capital expenditure is treated as a depreciating asset and the decline in value of that asset is calculated using the prime cost method on the following basis:

- the cost of this asset is equal to the amount of the expenditure incurred \[Schedule 2, item 10, paragraph 40-43(2)(a)\];

- the decline under the prime cost formula is calculated using the adjustments to the formula found in Division 40 of the ITAA 1997 for the year in which the expenditure is incurred. The basis for calculating the decline in the year in which the expenditure is incurred will be on the effective life and cost (to ensure that deductions are calculated in the same manner as under the former Division 330) \[Schedule 2, item 10, paragraph 40-43(2)(b)\];

- the asset was used for a taxable purpose at the time the expenditure was incurred \[Schedule 2, item 10, paragraph 40-43(2)(c)\]; and

- the asset had an effective life equal to the years remaining in the 10 year period for deduction (20 years for quarrying) \[Schedule 2, item 10, paragraph 40-43(2)(d) and subsection 40-43(3)\].

**Disposal of, lost, destroyed or you stop using for a taxable purpose property to which transport capital expenditure relates**

2.43 If the underlying property, which is not a depreciating asset, to which the transport expenditure relates is disposed of, lost or destroyed, or it ceases to be used for a taxable purpose, there is an additional decline in value of the notional asset that represents this expenditure. That decline in value is that part of the notional asset’s adjustable value that relates to the underlying property that was not taken into account in working out the balancing adjustment for the disposal of the underlying property. \[Schedule 2, item 10, subsection 40-43(4)\]

**No additional decline in certain cases**

2.44 Section 40-340 of the ITAA 1997 provides roll-over relief where depreciating assets are transferred between companies in the same wholly-owned group or where there are variations in the interests of partners or joint venturers. The roll-over relief prevents an amount from being included in the transferor’s assessable income. Under subsection 40-340(1) roll-over relief is automatic if there is a transfer and
where CGT roll-over relief is available. If there is a variation in the interests of a partnership, roll-over relief under subsection 40-340(3) is elective. ¹

2.45 Where a taxpayer transfers a depreciable asset to another company in the same wholly-owned group and roll-over relief under subsection 40-340(3) is chosen, subsection 40-44(1) ensures that there is no additional decline in the value of the related notional asset. [Schedule 2, item 10, subsection 40-44(1)]

2.46 The cost to the transferee of the depreciable asset on disposal is the sum of the adjustable value of the real asset and the adjustable value of the notional asset just prior to the disposal. [Schedule 2, item 10, subsection 40-44(2)]

Mining, quarrying or prospecting rights

Extension, renewal or conversion of mining, quarrying or prospecting rights

2.47 The IT(TP) Act 1997 provides for mining, quarrying and prospecting rights that the taxpayer held before 1 July 2001 to remain subject to the CGT provisions contained in the ITAA 1997 instead of being subject to the balancing adjustment rules of the uniform capital allowance system. The uniform capital allowance system does not apply to a mining, quarrying or prospecting right that the taxpayer held before 1 July 2001. Costs incurred on those rights on or after 1 July 2001 can only be used in the calculation of the taxpayer’s capital gain or loss under the CGT provisions.

2.48 Subsection 40-77(1A) ensures that the renewal or extension of a mining, quarrying or prospecting right on or after 1 July 2001 will be taken to be a continuation of that right and therefore Division 40 of the ITAA 1997 will continue not to apply. Instead, the renewed or extended right will remain subject to the CGT provisions. [Schedule 2, item 11, subsection 40-77(1A)]

2.49 In addition, if a taxpayer acquired a mining, quarrying or prospecting right before 1 July 2001 and that right ends on or after 1 July 2001 and is replaced by a new right that relates to the same area (or the difference in area is insignificant), then Division 40 of the ITAA 1997 will continue not to apply and the new right remains subject to the CGT provisions contained in the ITAA 1997 instead of being subject to the balancing adjustment rules of the uniform capital allowance system. [Schedule 2, item 11, subsection 40-77(1B)]

¹ Roll-over relief will be unavailable for wholly-owned groups from 1 July 2003 that do not choose to consolidate.
Transfer of mining, quarrying or prospecting right to a member of the same wholly owned group

2.50 If a taxpayer acquired a mining, quarrying or prospecting right before 1 July 2001 and that right is transferred on or after 1 July 2001 to another member of the same wholly-owned group, Division 40 of the ITAA 1997 does not apply and the right remains subject to the CGT provisions contained in the ITAA 1997 instead of being subject to the balancing adjustment rules of the uniform capital allowance system. [Schedule 2, item 11, subsection 40-77(1C)]

2.51 Where a taxpayer disposes of a mining, quarrying or prospecting right that they held before 1 July 2001 to an associate (except where the associate is also a member of the same wholly-owned group), or enters into arrangements where in-substance ownership or use is retained, the cost of the asset to the purchaser is capped at the amount that would have been deductible under the former Division 330. [Schedule 2, item 12, paragraph 40-77(2)(a)]

Disposal of, lost, destroyed or you stop using for a taxable purpose mining, quarrying and prospecting rights

2.52 Under the IT(TP) Act 1997, mining, quarrying and prospecting rights held before 1 July 2001 are subject to the CGT provisions contained in the ITAA 1997. The rights are not subject to the balancing adjustment rules of the uniform capital allowance system. In effect, there is no balancing adjustment to include in assessable income amounts deducted under the former Division 330.

2.53 If a taxpayer held a mining, quarrying or prospecting right before 1 July 2001 and disposes of (or otherwise stops holding) that right after 1 July 2001 and they have deducted an amount for it under the former Division 330, then an amount equal to the amount the taxpayer has deducted or can deduct must be included in assessable income. [Schedule 2, item 13, subsection 40-77(4)]

2.54 Similarly, if a taxpayer disposes (or otherwise stops holding) a mining, quarrying or prospecting right after 1 July 2001 that they started to hold before 1 July 2001 and they were entitled to deduct an amount for a notional asset under subsection 40-35(5), then the amount the taxpayer has deducted or can deduct must be included in assessable income. [Schedule 2, item 13, subsection 40-77(5)]

2.55 A new subsection is inserted (subsection 40-77(6)) to ensure that amounts included in assessable income under subsections 40-77(4) and (5) are included in the CGT cost base of the asset. [Schedule 2, item 13, subsection 40-77(6)]
Mining, quarrying or prospecting rights acquired from an associate

2.56 Where a taxpayer disposes (or otherwise stops holding) a mining, quarrying or prospecting right that they acquired from an associate (except where the associate is also a member of the same wholly-owned group) after 1 July 2001, and the associate started to hold the right before 1 July 2001, then the taxpayer must reduce the amount that would be included in assessable income under subsection 40-285(1) of the ITAA 1997. [Schedule 2, item 13, subsection 40-77(7)]

2.57 The amount included in assessable income under subsection 40-285(1) of the ITAA 1997 is reduced (but not below zero) by the difference between the cost incurred in acquiring the asset and the amount to which the cost is limited under subsection 40-77(2) of the IT(TP) Act 1997. [Schedule 2, item 13, subsection 40-77(8)]

Example 2.2

Able Resources Ltd (Able Resources) acquired a mining right on 15 June 2000 for $10 million. The amount of $3 million was deductible under the former Division 330.

In August 2001 the right is transferred to Brad Resources Ltd (Brad Resources) for its market value of $10 million. Able Resources and Brad Resources are members of the same wholly-owned group. The mining right is now subject to Division 40 and its cost (for CGT purposes) is capped at $3 million by subsection 40-77(2) IT(TP) Act 1997. Brad Resources claims deductions of $1 million for the decline in value of the right and then disposes of the mining right to Cain Resources Ltd (Cain Resources) for $30 million. Cain Resources is neither a member of the same wholly-owned group nor an associate of Brad Resources.

Brad Resource’s disposal of the mining right is a balancing adjustment event under section 40-285 of the ITAA 1997. The termination value of the right is $30 million. The adjustable value of the mining right is $2 million ($3 million – $1 million). Brad Resources must include the difference between the termination value and the adjustable value ($28 million) in its assessable income.

In addition, Brad Resources must reduce its assessable income by $7 million, which is the difference between the capital cost of the right ($10 million) and the amount to which the cost of the right was limited under subsection 40-77(2) ($3 million). In effect, Brad Resources will include $21 million in assessable income.
2.58 If a taxpayer splits plant into one or more depreciating assets on or after 1 July 2001 where the plant was:

- acquired, entered into a contract to acquire, or started to construct plant before 11.45 am, by legal time in the Australian Capital Territory, on 21 September 1999 [Schedule 2, item 14, paragraph 40-95(1)(a)]; and
- held the plant at the end of 30 June 2001 [Schedule 2, item 14, paragraph 40-95(1)(b)],

while the taxpayer continues to hold the assets, section 40-115 of the ITAA 1997 applies as if the taxpayer had acquired the assets before 11.45am on 21 September 1999 [Schedule 2, item 14, subsection 40-95(2)].

2.59 Similarly, if a taxpayer on or after 1 July 2001 merges plant with another depreciating asset, section 40-125 of the ITAA 1997 does not apply to the asset, or to the taxpayer’s interest in the asset, into which it is merged while the taxpayer continues to hold it. [Schedule 2, item 14, subsection 40-95(3)]

Disposal of pre-1 July 2001 mining depreciating asset to associate

2.60 If a taxpayer started holding a depreciating asset before 1 July 2001 and transfers that asset to a company that is a member of the same linked group and the amount included in assessable income for the real asset is greater than the amount the taxpayer can deduct for the related notional asset then subsections 40-35(5), 40-38(5) or 40-40(4) do not apply. ‘Linked group’ is defined in section 170-260 of the ITAA 1997. [Schedule 2, item 15, subsections 40-287(1) and (2)]

2.61 Instead, the amount that the taxpayer would have been able to deduct for the related notional asset under subsection 40-35(5), 40-38(5) or 40-40(4) reduces the amount included in assessable income for the real asset under subsection 40-285(1). [Schedule 2, item 15, subsection 40-287(3)]

Disposal of pre-1 July 2001 mining non-depreciating asset to associate

2.62 If a taxpayer started holding property that is not a depreciating asset before 1 July 2001 and transfers that property to a company that is a member of the same linked group and the amount received in respect of the disposal is greater than the amount the taxpayer can deduct for the related notional asset then there is no additional decline in value of the notional asset under subsections 40-35(5), 40-37(5), 40-40(4) or 40-43(4).
‘Linked group’ is defined in section 170-260 of the ITAA 1997. [Schedule 2, item 15, subsections 40-288(1) and (2)]

2.63 Instead, the amount that the taxpayer would have been able to deduct for the related notional asset under subsection 40-35(5), 40-37(5), 40-40(4) or 40-43(4) reduces the amount included in assessable income for the property under subsection 40-35(6), 40-37(6), 40-38(6), 40-40(5) or 40-43(5) of the IT(TP) Act 1997, or subsections 40-830(6) of the ITAA 1997. [Schedule 2, item 15, subsection 40-288(3)]

Involuntary disposals

2.64 Under section 40-365 of the ITAA 1997, where the taxpayer involuntarily disposes of a depreciating asset they can choose whether or not to include a balancing adjustment in assessable income. The taxpayer may instead decide to use some or all of the amount that would otherwise be a balancing adjustment as a reduction in the cost, or in the base value, or one or more replacement assets.

2.65 Section 40-365 of the IT(TP) Act 1997 will ensure that section 40-365 of the ITAA 1997 applies when the taxpayer:

- ceases holding a depreciating asset because the asset is lost or destroyed; compulsorily acquired by an Australian government agency; or disposed of to an Australian government agency after compulsory negotiations before 1 July 2001 [Schedule 2, item 16, paragraph 40-365(a)];
- commences holding a replacement asset after 1 July 2001 [Schedule 2, item 16, paragraph 40-365(b)]; and
- satisfies the conditions in subsections 40-365(3) and (4) of the ITAA 1997 [Schedule 2, item 16, paragraph 40-365(c)].

Application provision

2.66 The amendments made by Schedule 2 to the bill apply to assessments for the income year in which 1 July 2001 occurred and later income years. [Schedule 2, item 17]

2.67 The majority of these amendments are beneficial to taxpayers. The remaining amendments are required to maintain the integrity of the tax system.
Chapter 3

Non-assessable non-exempt income

Outline of chapter

3.1 The amendments contained in Schedule 3 to this bill improve the income tax law by clarifying, standardising and rationalising the concept of non-assessable non-exempt income.

3.2 There are 3 broad categories of amendments in this measure:

- amendments to establish an explicit framework in the income tax law dealing with non-assessable non-exempt income;

- amendments to standardise the concept of non-assessable non-exempt income by converting amounts of excluded exempt income and exempt income subject to withholding tax into non-assessable non-exempt income amounts; and

- technical amendments broadly relating to non-assessable non-exempt income, including the correction of anomalies in the law.

Context of amendments

3.3 Non-assessable non-exempt income is a third category of income recognised by the income tax law. The two better known categories are assessable income and exempt income.

3.4 As non-assessable non-exempt income is not assessable income, it is not taken into account in working out a taxpayer’s taxable income for an income year. As the amount is also not exempt income, it is not taken into account in working out a taxpayer’s tax loss for an income year or in working out how much of a prior year tax loss is deductible in an income year.
3.5 A non-assessable non-exempt income amount was first explicitly recognised in the income tax law in 1992. These amounts were still rare at the time the ITAA 1997 was first enacted. As a consequence, non-assessable non-exempt income was only referred to in non-operative material contained in that Act.

3.6 However, in recent years, the number of non-assessable non-exempt income amounts recognised by the law has grown to approximately 15. Perhaps the most significant of these is GST on taxable supplies.

3.7 In addition, the existing concepts of excluded exempt income and exempt income subject to withholding tax broadly duplicate the non-assessable non-exempt income treatment. This duplication is unnecessary and increases the risk that comparable amounts will be subject to inconsistent treatment under the law.

3.8 There are also amounts that should, as a matter of policy, be subject to non-assessable non-exempt income treatment but are currently treated by the law in a different way. Most commonly these amounts are simply treated as exempt income, so they are taken into account in working out and applying losses.

**Summary of new law**

3.9 The core component of this measure establishes an explicit framework for non-assessable non-exempt income in the income tax law. It has these elements:

- operative rules outlining how non-assessable non-exempt income is provided for in the law;
- operative rules clarifying the major facets of non-assessable non-exempt income treatment – that the amounts are not included in assessable income and are not included in exempt income;
- a checklist of amounts of non-assessable non-exempt income as a reference point for users of the law; and
- an area of the law established as a repository for miscellaneous non-assessable non-exempt income amounts.

3.10 The concepts of excluded exempt income and exempt income subject to withholding tax will be removed from the law. Amounts falling
under these concepts are intended to be treated in the same way as non-assessable non-exempt income. Amounts that are excluded exempt income or exempt income subject to withholding tax will be converted into non-assessable non-exempt income to ensure a single standardised treatment.

3.11 Apart from these amounts, some other new amounts are to become non-assessable non-exempt income. These amounts are predominantly treated as exempt income by the current law and include:

- certain amounts received by life insurance companies; and
- amounts that should be treated as non-assessable non-exempt income because they have previously been taxed or are never effectively received.

3.12 Finally, technical amendments are to be made to ensure the law reflects other intended outcomes. This includes recognising non-assessable non-exempt income in cases where the law was intended to cover any income that is not assessable income but only explicitly mentions exempt income.

### Comparison of key features of new law and current law

<table>
<thead>
<tr>
<th>New law</th>
<th>Current law</th>
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<tr>
<td>There will be an explicit framework in the income tax law supporting the concept of non-assessable non-exempt income.</td>
<td>Non-assessable non-exempt income amounts exist but without any supporting framework.</td>
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<tr>
<td>A single standardised concept of non-assessable non-exempt income will cover amounts of ordinary or statutory income that are neither assessable nor exempt.</td>
<td>Multiple concepts effectively cover amounts of ordinary or statutory income that are neither assessable nor exempt – non-assessable non-exempt income, deemed non-income, excluded exempt income and exempt income subject to withholding tax.</td>
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<tr>
<td>These amounts will become non-assessable non-exempt income:</td>
<td>Those amounts are currently exempt income.</td>
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<td>• private company dividends set off against shareholder loans treated as notional dividends;</td>
<td></td>
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New law | Current law
---|---
- amounts subject to family trust distributions tax; |  
- mining payments for the benefit of Aboriginals that are subject to withholding tax; |  
- refunded amounts subject to franchise fees windfall tax or Commonwealth places windfall tax; |  
- amounts derived by life insurance companies from segregated exempt assets; |  
- amounts derived by life insurance companies from disposing of units in a pooled superannuation trust; |  
- the non-resident portion of certain foreign source income derived by life insurance companies that is attributable to policies issued by foreign permanent establishments; |  
- income derived by friendly societies that carry on a life insurance business attributable to income bonds, funeral policies and certain scholarship plans issued before 1 January 2003; and |  
- one third of certain management fees derived by life insurance companies before 1 July 2005 on life insurance policies issued before 1 July 2000. |  

**Detailed explanation of new law**

3.13 The non-assessable non-exempt income measure is intended to formally explain an increasingly common building block in the income tax law and to standardise the way it is used. The measure is explained here in 3 parts, one for each of the measure’s different components:

- establishing a framework for non-assessable non-exempt income;
Non-assessable non-exempt income

- standardising the non-assessable non-exempt income concept; and

- technical amendments.

Establishing a non-assessable non-exempt income framework

The existing income framework in the income tax law

3.14 The ITAA 1997 deals with 2 types of income:

- ordinary income; and

- statutory income.

3.15 ‘Ordinary income’ is defined in subsection 6-5(1) of the ITAA 1997 as ‘income according to ordinary concepts’. Salary and wages, interest and rent are typical examples of ordinary income.

3.16 ‘Statutory income’ is defined in subsection 6-10(2) as ‘amounts that are included in assessable income by provisions about assessable income’. That is, statutory income is amounts that are not income according to ordinary concepts but are nevertheless intended to be taxed as income, so the law specifically includes them. The most obvious example is net capital gains.

3.17 Each of those types of income is divided by the law into 3 categories:

- assessable income;

- exempt income; and

- non-assessable non-exempt income.
3.18 The relationship between the different types and categories of income is illustrated by Diagram 3.1 (taken from section 6-1 of the ITAA 1997).

**Diagram 3.1**

- Assessable income
- Ordinary income
- Statutory income
- Non-assessable, non-exempt income
- Exempt income

3.19 Assessable income is income (whether ordinary or statutory) that is counted in working out the amount of taxable income that is subject to tax.

3.20 Exempt income is *not* counted directly in working out taxable income. However, it *is* counted in reducing prior year tax losses that can be deducted in the current year and in reducing tax losses carried forward to later years.

3.21 Non-assessable non-exempt income is also not counted in working out taxable income. Unlike exempt income though, it has no effect on tax losses. Non-assessable non-exempt income truly has no effect on the income tax system.

3.22 Assessable income and exempt income are each dealt with in considerable detail by the operative provisions in Division 6 of the ITAA 1997. However, there are no operative provisions dealing with non-assessable non-exempt income, even though there are now quite a number of amounts in the law that are neither assessable income nor exempt income. Amendments contained in this bill will fill that gap.
The non-assessable non-exempt income framework

3.23 The preceding paragraphs consider the existing legislative framework for assessable income and exempt income. No such framework currently exists for non-assessable non-exempt income. With the number of non-assessable non-exempt amounts in the law growing in recent years to about 15, the need to establish such a framework has become more pressing.

3.24 Establishing that framework will put the rules for non-assessable non-exempt income on the same footing as those for other core income tax concepts such as taxable income, assessable income, exempt income, deductions and tax offsets. There are 4 significant parts of the framework.

Definition of ‘non-assessable non-exempt income’

3.25 The most obvious part of the framework is a definition. Non-assessable non-exempt income is ordinary or statutory income that is expressly made neither assessable income nor exempt income. That express provision can be in the ITAA 1997, the ITAA 1936 or in any other Commonwealth law. [Schedule 3, items 1, 56 and 131, subsection 6(1) of the ITAA 1936, section 6-23 and subsection 995-1(1) of the ITAA 1997]

3.26 An important point to note is that there must be an express provision to make an amount non-assessable non-exempt income. Unlike exempt income, it is not enough that the amount is excluded from assessable income. If it were, it would not be clear whether the amount became exempt income or non-assessable non-exempt income. The express provision does not have to be in the income tax law, although that would commonly be the case.

3.27 The definition establishes a strict dichotomy between amounts of income. Each of them will be assessable, exempt or non-assessable non-exempt.

No overlaps between types of income

3.28 The second part of the framework prevents any overlap between the 3 types of income. An amount that is non-assessable non-exempt income cannot be assessable income [Schedule 3, item 51, subsection 6-15(3) of the ITAA 1997]. Similarly, it cannot be exempt income [Schedule 3, item 55, subsection 6-20(4) of the ITAA 1997]. These rules complement the existing rule in subsection 6-15(2) of the ITAA 1997 that prevents an overlap between assessable income and exempt income. With the new provisions, the demarcation between the 3 types of income is complete; if an amount is one type of income, it cannot be either of the other 2 types. The
amendments add some guide material to the same effect [Schedule 3, item 49, subsection 6-1(5) of the ITAA 1997].

How to categorise an amount

3.29 An amount that is not ordinary income or statutory income cannot be assessable income, exempt income or non-assessable non-exempt income.

3.30 An amount of ordinary or statutory income will be assessable income unless it is exempt income or non-assessable non-exempt income.

3.31 An amount of ordinary income will be exempt income if:

- a provision (whether in the ITAA 1997, the ITAA 1936 or any other Commonwealth law) says that the amount is exempt income; or
- the ITAA 1997 or the ITAA 1936 excludes it from being assessable income (whether expressly or by implication).

3.32 An amount of statutory income will only be exempt income if a provision (whether in the ITAA 1997, the ITAA 1936 or any other Commonwealth law) says that the amount is exempt income.

3.33 An amount of ordinary or statutory income will only be non-assessable non-exempt income if a provision (whether in the ITAA 1997, the ITAA 1936 or any other Commonwealth law) says that the amount is non-assessable non-exempt income.

A place for miscellaneous non-assessable non-exempt income amounts

3.34 Many provisions that make amounts assessable income, exempt income or non-assessable non-exempt income are dealt with as part of a larger legislative regime because it is appropriate to keep all the provisions about a particular subject matter in the one place.

3.35 However, there are miscellaneous amounts of each type of income that are not part of a broader subject area. Division 15 of the ITAA 1997 includes all of that Act’s miscellaneous provisions about assessable income. Divisions 51 and 53 contain its miscellaneous provisions about amounts that are exempt income. The third part of the framework adds Division 59 as a repository for the miscellaneous amounts of non-assessable non-exempt income. [Schedule 3, items 89 and 90, sections 59-1, 59-5, 59-10, 59-15, 59-20, 59-25 and 59-30 of the ITAA 1997]
3.36 Apart from the guide to the new Division, each of its sections replaces one or more existing provisions of the income tax law. The existing provisions are repealed. [Schedule 3, items 6, 73 and 83 to 87, paragraph 23(jd) of the ITAA 1936 and sections 22-1, 22-5, 51-25, 51-45, 51-48, 51-49 and 52-130 of the ITAA 1997]

Checklist of non-assessable non-exempt income

3.37 The final part of the framework adds a checklist of amounts that are non-assessable non-exempt income. The checklist is guide material intended to make it easier for readers to locate provisions that make amounts non-assessable non-exempt income. [Schedule 3, item 70, section 11-55 of the ITAA 1997]

3.38 The new checklist is added to Division 11, which currently houses the checklists for items of exempt income and exempt entities. The existing exempt income checklists are grouped into Subdivision 11-A and the checklist for non-assessable non-exempt income is in Subdivision 11-B. [Schedule 3, items 60, 61 and 70, Subdivision 11-A, section 11-1A, Subdivision 11-B and sections 11-50 and 11-55 of the ITAA 1997]

3.39 Most of the items in the new checklist replace references in existing checklists. Those existing checklist references are removed. [Schedule 3, items 58 and 62 to 69, checklist references in sections 10-5, 11-10 and 11-15 of the ITAA 1997]

Standardising the non-assessable non-exempt income concept

3.40 The income tax law already recognises the concept of amounts that do not reduce tax losses but otherwise have the same effect as exempt income. However, there is no uniformity in the way the concept is applied to particular amounts. Some are made neither assessable income nor exempt income; some are treated as not being income at all, and some are categorised as excluded exempt income or exempt income subject to withholding tax (which are disregarded when exempt income reduces losses).

3.41 The amendments ensure that all amounts of non-assessable non-exempt income are specifically described as neither assessable income nor exempt income.

3.42 Division 36 of the ITAA 1997, which works out how losses are reduced by ‘net exempt income’, starts with exempt income and disregards excluded exempt income and exempt income subject to withholding tax. As amounts that are excluded exempt income or exempt income subject to withholding tax will no longer be exempt income, but will be non-assessable non-exempt income instead, they will no longer
have to be disregarded. The amendments remove the now unnecessary references to those amounts [Schedule 3, items 76 and 77, subsection 36-20(1) and paragraphs 36-20(2)(a) and (b) of the ITAA 1997]. They also remove the definitions of excluded exempt income and exempt income subject to withholding tax, which will no longer appear in the income tax law [Schedule 3, items 78, 129 and 130, subsections 36-20(3), 36-20(3A), 36-20(4) and 995-1(1) of the ITAA 1997].

3.43 As a result of removing excluded exempt income and exempt income subject to withholding tax, a number of amendments are needed to preserve the treatment of amounts that are currently exempt income but don’t reduce losses. These amendments reflect the non-assessable non-exempt income terminology. [Schedule 3, items 8, 9, 11 to 13, 15 to 18, 20 to 22, 27, 32 and 35, subsection 23AH(2), paragraphs 23AH(3)(d), 23AH(9)(d), 23AI(1)(c), 23AI(1)(d) and 23AI(1)(g), subsection 23AJ(1), paragraphs 23AK(1)(c), 23AK(1)(d), 23AK(1)(g), 23AK(1)(h) and 23AK(1)(i), subsections 59(2AAA) and 99B(2A) and section 128D of the ITAA 1936]

3.44 Some of those amendments involve more than just a simple wording change because the amended provisions cover several types of amounts, not all of which are affected by the measure. In those cases, the amendments split the provisions into 2, one covering the unaffected amounts and one covering the amounts affected by the non-assessable non-exempt concept. [Schedule 3, items 14, 19 and 25, paragraphs 23AI(1)(e), 23AK(1)(e) and 23AK(1)(ea) and subsections 23L(1) and (1A) of the ITAA 1936]

3.45 A few amendments change provisions that treat an amount as not being income into provisions that make the amount non-assessable non-exempt income. This is a change in terminology rather than a change in substance. The result is still that the amount has no tax effect. [Schedule 3, items 23 and 24, subsections 23E(1) and 23J(1) of the ITAA 1936]

3.46 Other amendments change references to ‘exempt income’ to also cover non-assessable non-exempt income. For example, subsection 8-1(2), which currently prevents deductions for amounts incurred in gaining or producing exempt income, will now also prevent deductions for amounts incurred in gaining non-assessable non-exempt income. The amendments reflect the originally intended outcomes in the law. [Schedule 3, items 57, 79, 80, 97, 102, 103, 105 to 108, 111 to 122 and 139, paragraph 8-1(2)(c), subsections 40-100(4) and 40-105(1), paragraph 104-185(1)(e), note 2 to subsection 207-15(3) and note 2 to section 207-30, paragraphs 207-110(1)(c), 207-110(2)(c), 207-110(3)(c) and 207-110(4)(c), subsection 208-5(1), paragraphs 208-5(2)(b), 208-40(1)(b), 208-40(2)(b), 208-40(3)(b) and 208-40(4)(b), items 2 and 3 of the table in section 208-115 and items 2, 3, 5 and 6 of the table in section 208-130 of the ITAA 1997 and paragraph 360-140(2)(a) in Schedule 1 to the TAA 1953]

3.47 Particular examples of that type of amendment occur in the partnership and trust provisions. Sections 92 and 97 of the ITAA 1936
Non-assessable non-exempt income

apportion, for partners and beneficiaries respectively, the partnership’s or trust’s net income and its exempt income. There is no provision to apportion income amounts that are neither assessable income nor exempt income. The amendments ensure that the non-assessable non-exempt income of the partnership or trust is apportioned between the partners and beneficiaries in the same way. [Schedule 3, items 28 to 31, section 90, subsections 92(4) and 95(1) and paragraph 97(1)(c) of the ITAA 1936]

There are also some substantive changes

3.48 There are 3 reasons why an amount is made non-assessable non-exempt income:

- a specific policy decision was made to prevent the amount from having any tax effect for the taxpayer, whether they have a taxable income or a tax loss;

- the amount is otherwise subject to income tax, or a substitute for income tax, so any further tax effect would effectively be double taxation; or

- the amount has the form of income but does not really represent a gain to the taxpayer.

3.49 An example of a specific policy decision to prevent an amount having any tax effect is the treatment of compensation paid under firearms surrender arrangements. To promote maximum compliance with the gun buyback initiative, compensation payments were made excluded exempt income to protect tax losses.

3.50 An example of an amount otherwise being subject to income tax is the actual price earned for selling trading stock outside the ordinary course of business. In that case, the sale is treated as having occurred at market value and that market value is taxed. To allow the actual sale price to also have a tax effect would amount to double taxation. An example of an amount being subject to a substitute for income tax would be fringe benefits. In that case, the employer pays fringe benefits tax as a replacement for the employee paying income tax on certain employment benefits.

3.51 An example of an amount that is not really a gain to a taxpayer is the GST payable on goods and services the taxpayer supplies. The taxpayer on-pays the GST to the Commonwealth, so it is not a gain to the taxpayer. Therefore, it should not have any income tax effect.

3.52 There are some amounts in the existing law that are currently only exempt income when one of those reasons should have led to them
being non-assessable non-exempt income. The amendments correct those cases:

- **private company dividends** – section 109ZC of the ITAA 1936 makes a private company dividend exempt income if it is set off against a loan or other benefit previously treated as a notional dividend. The aim is to avoid double taxing the dividend but, if the shareholder has tax losses, the dividend will reduce them and, in effect, double tax the amount [Schedule 3, item 34, subsection 109ZC(3) of the ITAA 1936];

- **family trust distributions tax** – section 271-105 of Schedule 2F to the ITAA 1936 exempts amounts subject to family trust distributions tax. If they were to reduce losses, there would also effectively be double tax [Schedule 3, item 48, subsection 271-105(3) of Schedule 2F to the ITAA 1936];

- **mining payments** – sections 51-25 and 51-45 of the ITAA 1997 exempt payments made by mining companies for the benefit of Aboriginals or Aboriginal representative bodies. As the payments are subject to a final withholding tax in the hands of the mining company, there is the potential for double taxation if the recipient has losses. The amendments will make the treatment of these withholding cases the same as the treatment of dividend, interest and royalty withholding cases [Schedule 3, item 89, section 59-15 of the ITAA 1997];

- **windfall taxes** – sections 51-48 and 51-49 of the ITAA 1997 exempt amounts refunded to taxpayers by the States that are taxed at 100% under the franchise fees windfall tax or the Commonwealth places windfall tax. Since the taxpayer does not gain from the refund, the amounts are exempt income but any losses the taxpayer has would be inappropriately reduced by the amount [Schedule 3, item 89, sections 59-20 and 59-25 of the ITAA 1997];

- **capital gains on trust distributions** – CGT event E4 provides for a capital gain if a trust distributes an amount that is not assessable income. Section 104-71 of the ITAA 1997 disregards distributions of excluded exempt income and exempt income subject to withholding tax. In replacing those terms with ‘non-assessable non-exempt income’, the range of things disregarded for CGT event E4 is slightly widened. Each of the amounts newly included within that range falls within one of the 3 cases where an amount should not
have any tax effect (see paragraph 3.48) and so is properly excluded from being counted towards a capital gain [Schedule 3, item 96, paragraphs 104-71(1)(a) and (b) of the ITAA 1997];

- *capital gains and losses on assets producing non-assessable income* – subsection 118-12(1) disregards capital gains and losses made on an asset used solely to produce exempt income. However, that rule does not apply if the amounts the asset is producing are *excluded exempt income* or *exempt income subject to withholding tax*. Those terms will be replaced by a slightly different list of amounts. The criterion used for inclusion on the list is whether the amount was made non-assessable non-exempt to prevent double taxation. If it was, the amount is obviously intended to be taxed at some point, so there is no policy justification for disregarding gains and losses on assets used to produce it [Schedule 3, item 98, section 118-12 of the ITAA 1997].

**Amendments relating to life insurance companies**

3.53 Section 320-35 of the ITAA 1997 exempts from tax certain income received by life insurance companies (including friendly societies that carry on a life insurance business).

3.54 The amendments will change some of the income that is exempt from tax under section 320-35 into non-assessable non-exempt income.

3.55 The non-assessable non-exempt income of life insurance companies will include:

- amounts derived from ‘segregated exempt assets’ (broadly, these are assets supporting immediate annuity and current pension businesses);

- amounts derived from the disposal of units in a pooled superannuation trust;
• the non-resident portion of certain foreign source income assets that are attributable to policies issued by foreign permanent establishments; and
• income derived by friendly societies that carry on life insurance businesses that are, broadly, attributable to income bonds, funeral policies and certain scholarship plans issued before 1 January 2003.

[Schedule 3, item 126, section 320-37 of the ITAA 1997]

3.56 The effect of treating those amounts as non-assessable non-exempt income is that life insurance companies will not have to apply them to reduce losses.

3.57 Amounts derived from segregated exempt assets and amounts derived by friendly societies that are attributable to income bonds, funeral policies and certain scholarship plans issued before 1 January 2003 will be treated as non-assessable non-exempt income because those amounts are derived by life insurance companies or friendly societies on behalf of particular groups of policyholders. It would be inequitable to use those amounts to reduce losses that relate to different groups of policyholders or to shareholders.

3.58 Amounts derived from disposing of units in a pooled superannuation trust will be treated as non-assessable non-exempt income because the trust has already been taxed at the appropriate rate on any gains in the value of the units. Therefore, to reduce the losses of the life insurance company by these amounts effectively results in double taxation.

3.59 The non-resident portion of certain foreign source income that is attributable to policies issued by foreign permanent establishments will be treated as non-assessable non-exempt income because it is equivalent to the foreign branch income of ordinary companies that section 23AH of the ITAA 1936 treats as non-assessable non-exempt income.

3.60 The amounts currently covered by section 320-35 that will stay exempt income of life insurance companies will include:

• amounts accrued before 1 July 1988 that were derived from assets that have become ‘virtual pooled superannuation trust assets’ (broadly, those are assets that support complying superannuation businesses); and
• amounts credited to retirement savings accounts that are paying out annuities.

[Schedule 3, item 126, section 320-35 of the ITAA 1997]
3.61 Life insurance companies are also exempt from tax on one third of certain management fees they derive before 1 July 2005 on life insurance policies issued before 1 July 2000 (see section 320-40 of the ITAA 1997). To ensure that life insurance companies will not have to apply this income to reduce losses, that currently exempt income will also be changed to be non-assessable non-exempt income. [Schedule 3, items 127 and 128, subsections 320-40(1) and (8) of the ITAA 1997]

3.62 The exemption of one third of those management fees was a transitional measure associated with the implementation of the recommendations of A Tax System Redesigned that broadened the tax base of life insurance companies. The benefits of the transitional measure would be eroded if losses were reduced by the exempt amount. Therefore, the currently exempt income will be changed to non-assessable non-exempt income.

3.63 Under the imputation system, life insurance companies are entitled to a tax offset for franking credits on distributions that are exempt income relating to their segregated exempt assets. In addition, a tax offset is available for franking credits on distributions derived by friendly societies that carry on life insurance business where those distributions are exempt income relating to certain income bonds, funeral policies and scholarship plans.

3.64 Consequential amendments will ensure that those tax offsets continue to apply. In addition, tax offsets for franking credits on distributions derived by friendly societies that carry on life insurance business will be extended to all distributions that are non-assessable non-exempt income relating to income bonds, funeral policies and certain scholarship plans. [Schedule 3, items 41 to 45, 109 and 110, paragraphs 160AQT(4)(b), 160AQU(2)(b) and 160AQWA(1)(b) and subparagraphs 160AQZB(1)(c)(ii) and 160AQZC(1)(c)(ii) of the ITAA 1936 and paragraphs 207-120(1)(b) and (2)(b) of the ITAA 1997]

Technical amendments

3.65 Subsection 23AH(4) of the ITAA 1936 is repealed. This subsection aims to ensure that capital gains are reduced by amounts of exempt foreign branch income earned by Australians. However, the same work is already done by section 118-20 of the ITAA 1997, which reduces capital gains by amounts included in assessable income, exempt income or non-assessable non-exempt income. Therefore, subsection 23AH(4) is redundant. [Schedule 3, item 10, subsection 23AH(4) of the ITAA 1936]
3.66 As an aid for readers, the note to subsection 6-15(2) of the ITAA 1997 explains the effects of an amount being exempt income. The note is expanded to also include the capital gains effect for assets used to produce exempt income. [Schedule 3, item 50, note to subsection 6-15(2) of the ITAA 1997]

3.67 ‘Commonwealth law’ is a defined term in the ITAA 1997. Defined terms are usually marked with an asterisk to draw readers’ attention to the fact that the term is given a particular meaning. The amendments add asterisks missing from some instances of that term. [Schedule 3, items 52 and 54, subsections 6-20(1) and (3) of the ITAA 1997]

3.68 Paragraph 17-5(c) of the ITAA 1997 makes GST increasing adjustments non-assessable non-exempt income if they arise in circumstances that also give rise to an assessable recoupment. ‘Assessable recoupment’ is a defined term that does not cover all appropriate cases. For example, there would be a GST increasing adjustment if a business were refunded part of the purchase price of its trading stock. The refund could be ordinary income and therefore not an ‘assessable recoupment’. The amendment resolves the problem by replacing the defined term with words that capture the intended idea. [Schedule 3, item 71, subparagraph 17-5(c)(ii) of the ITAA 1997]

3.69 The amount of carry-forward tax offsets are currently reduced by 34% of any net exempt income. The amendments change the reduction to 30% to match the second lowest rate of personal tax to which it has always been pegged. [Schedule 3, items 91 and 94, section 65-30 and subsection 65-35(3) of the ITAA 1997]

3.70 The amendments correct a misalignment between the way carry-forward tax offsets are reduced in the initial year and the way they are reduced in later years. In the initial year, the amount of carry-forward tax offsets is reduced by a percentage of net exempt income (i.e. exempt income less any outgoings incurred in earning it). However, for later years, it is simply reduced by exempt income. The amendments correct this by also reducing the offsets in those later years by net exempt income. [Schedule 3, items 92, 93 and 95, subsection 65-35(3) of the ITAA 1997]

3.71 Subsection 152-110(2) of the ITAA 1997 makes amounts of ‘income’ derived from certain CGT events neither assessable income nor exempt income. The amendments remove any doubt about the scope of the provision by making it clear that ‘income’ means both ordinary income and statutory income. [Schedule 3, item 101, subsection 152-110(2) of the ITAA 1997]
Application and transitional provisions

General application rule

3.72 With a few exceptions, the amendments will apply to assessments for the 2003-2004 income year and to later income years.
[Schedule 3, subitem 140(1)]

Special application rules

3.73 The exceptions to the general application rule are:

- the technical amendment to fix the incorrect use in section 17-5 of the ITAA 1997 of the defined term ‘assessable recoupment’ (see paragraph 3.68), will apply to things done on or after 1 July 2000. This is the date on which section 17-5 first applied [Schedule 3, subitem 140(2)];

- the technical amendments to subsection 65-35(3) of the ITAA 1997 that replace ‘exempt income’ with ‘net exempt income’ (see paragraph 3.70) apply to assessments for the 1997-1998 income year and later income years. The 1997-1998 income year is the first income year subsection 65-35(3) applied to [Schedule 3, subitem 140(3)];

- the technical amendments that change the rate at which net exempt income reduces carry-forward tax offsets from 34% to 30% (see paragraph 3.69) apply to assessments for the 2000-2001 income year and later income years. The 2000-2001 income year is the income year for which the second lowest rate of personal income tax changed from 34% to 30% [Schedule 3, subitem 140(4)];

- the amendments that make certain amounts received by life insurance companies and friendly societies neither assessable income nor exempt income (see paragraphs 3.53 to 3.64) apply to amounts derived on or after 1 July 2000. That is the date on which the life insurance provisions in Division 320 of the ITAA 1997 began to apply. This application rule also covers amendments that make changes consequential on the life insurance changes [Schedule 3, subitem 140(5)];
• the amendments to paragraphs 207-120(1)(b) and 207-120(2)(b) in the new imputation provisions of the ITAA 1997 reflect changes made to the life insurance provisions they refer to. Those amendments apply to events that occur on or after 1 July 2002, the time at which the new imputation provisions began to apply. This is necessary because the life insurance changes will already be applying at that time (see previous dot point) [Schedule 3, subitem 140(6)];

• the amendment to correct a reference in paragraph 177EA(15)(b) of the ITAA 1936 applies to distributions that are made or flow indirectly after 30 June 2002. That paragraph will be added to the law if the New Business Tax System (Consolidation and Other Measures) Bill (No. 2) 2002 is enacted and will apply to such distributions from that time [Schedule 3, subitem 140(7)];

• the amendments to correct references in paragraphs 15-60(3)(b) and 320-112(3)(b) of the ITAA 1997 apply to assessments for the income year that includes 1 January 2003 and later years. Those provisions will be added to the law if the Taxation Laws Amendment Bill (No. 6) 2002 is enacted and will apply to assessments for those income years [Schedule 3, subitem 140(8)].

Transitional life insurance provision

3.74 Some of the amendments needed to make the life insurance amendments (paragraphs 3.53 to 3.64) apply correctly in relation to the imputation provisions will have to apply from the same time as the life insurance amendments. The amendments to the relevant old imputation provisions will apply for the period from 1 July 2000 until 30 June 2002 (see the fourth dot point in paragraph 3.73). The new imputation provisions in Division 207 of the ITAA 1997 began to apply from 1 July 2002, and the relevant amendments to those provisions apply from that date (see the fifth dot point in paragraph 3.73). However, those amendments to the new imputation provisions refer to ‘non-assessable non-exempt income’, a concept that will not appear in the law until the 2003-2004 income year. Therefore, a transitional provision applies for the period from 1 July 2002 until the start of that year to treat the references to an amount being ‘non-assessable non-exempt income’ as references to it being neither assessable income nor exempt income. [Schedule 3, subitem 141(1)]

3.75 The amendments to paragraphs 15-60(3)(b) and 320-112(3)(b) of the ITAA 1997 will also refer to ‘non-assessable non-exempt income’
for periods that may be before that concept appears in the law. Therefore, a transitional provision will treat those references as being to an amount being neither assessable income nor exempt income during those periods. 

[Schedule 3, subitem 14(2)]

**Special commencement provision**

3.76 A number of the amendments relate to an amount that is made non-assessable non-exempt income because it is repaid in a later year.

[Schedule 3, items 46, 58, 72, 73, 90 and 133, subsection 170(10AB) of the ITAA 1936, sections 10-5 and 20-160, Division 22 and section 59-30 of the ITAA 1997 and Division 22 of the IT(TP) Act 1997]

3.77 The provisions that make such amounts non-assessable non-exempt income, and make certain consequential amendments to the law, are in Schedule 3 to the Taxation Laws Amendment Bill (No. 7) 2002 (which, if enacted, will be the *Taxation Laws Amendment Act* (No. 2) 2003).

3.78 The amendments cannot operate until after the provisions in that bill become law. Therefore, the amendments commence on the later of:

- the commencement of Schedule 3 to this bill (which contains these amendments); and

- the commencement of Schedule 3 to the *Taxation Laws Amendment Act* (No. 2) 2003.

[Subclause 2(1), items 5, 7, 9, 11 and 13 in the table]

3.79 Similarly, some amendments change provisions that will only appear in the law when the bills they are in are enacted ([Schedule 3, items 46A, 70A and 128A, paragraph 177EA(15)(b) of the ITAA 1936 and paragraphs 15-60(3)(b) and 320-112(3)(b) of the ITAA 1997]. The amendments cannot operate until those provisions become law, so they commence when those provisions commence, which is:

- for item 46A – immediately after Schedule 27 to the *New Business Tax System (Consolidation and Other Measures) Act* 2003 commences; and

- for items 70A and 128A – immediately after Schedule 3 to the *Taxation Laws Amendment Act* (No. 1) 2003 commences.

[Subclause 2(1), items 5A, 8A and 12A in the table]
Consequential amendments

3.80 Many of the amendments are consequential amendments that are needed because the non-assessable non-exempt income concept has been created or because provision numbers have changed.

3.81 Some of these amend references to amounts of exempt income that now also cover amounts of non-assessable non-exempt income or have been changed to only cover amounts of non-assessable non-exempt income. [Schedule 3, items 2 to 5, 26, 36 to 40, 47, 70A, 75, 100, 123 to 125, 128A, 134 and 136 to 138, subparagraphs 6AB(2)(b)(iv) and 6AB(2)(b)(vi), paragraphs 6AB(3A)(b) and 6AB(3A)(c), subparagraph 47A(7)(b)(i), paragraphs 128TA(1)(a), 128TA(2)(a) and 128TA(2)(b), sections 160AFCD and 160AFCJ and subparagraph 530(1)(d)(i) of the ITAA 1936, paragraphs 15-60(3)(b) and 25-90(b), subsection 118-20(6), section 320-1, paragraph 320-5(2)(a), section 320-10 and paragraph 320-112(3)(b) of the ITAA 1997, paragraph 360-65(1)(da), item 45 of the table in section 360-75, section 360-77 and paragraph 360-100(1)(ea) in Schedule 1 to the TAA 1953]

3.82 One of these replaces references to income that is neither assessable income nor exempt income with references to income that is ‘non-assessable non-exempt income’. [Schedule 3, item 99, paragraphs 118-20(4)(a) and (b) of the ITAA 1997]

3.83 Some of these amend references to provisions that have been moved. The references will instead refer to the new provision. [Schedule 3, items 7, 41 to 46A, 70A, 109, 110, 128A and 135, note to subsection 23AE(1A), paragraphs 160AQST(4)(b), 160AQUP(2)(b) and 160AQWA(1)(b), subparagraphs 160AQZB(1)(c)(ii) and 160AQZC(1)(c)(ii), subsection 170(10AB) and paragraphs 160AQZB(1)(c)(ii) and 160AQZC(1)(c)(ii), subsection 170(10AB) and paragraph 177EA(15)(b) of the ITAA 1936, paragraphs 15-60(3)(b), 207-120(1)(b), 207-120(2)(b) and 320-112(3)(b) of the ITAA 1997 and paragraph 360-75(a) in Schedule 1 to the TAA 1953]

3.84 There are also amendments tidying up assorted headings, notes and other things that need to be removed or changed because of the creation of the non-assessable non-exempt income framework. [Schedule 3, items 33, 53, 59, 74, 81, 104 and 133, paragraph 102AAZB(a) of the ITAA 1936, note to subsection 6-20(2) and headings to Division 11, section 25-90, Part 2-15 and section 207-110 of the ITAA 1997 and Division 22 of the IT(TP) Act 1997]

3.85 Some link notes are amended, added or removed as a result of the amendments. Link notes are signposts that point readers to the next Division (e.g. “The next Division is Division 25”) so they aren’t confused when the Divisions don’t follow a standard numerical sequence. [Schedule 3, items 72, 82, 88 and 132, sections 20-160, 51-15 and 58-90 of the ITAA 1997 and section 20-115 of the IT(TP) Act 1997]
Chapter 4
Refundable tax offset rules

Outline of chapter

4.1 Schedule 4 to this bill will amend the tax offset carry forward rules in Division 65 and the refundable tax offset rules in Division 67 of the ITAA 1997.

4.2 The amendments will:

- make a minor change to the tax offset carry forward rules to ensure that taxpayers will always receive the maximum benefit from refundable tax offsets;
- make changes to the refundable tax offset rules to reflect the new SIS rules; and
- make a correction to the refundable tax offset rules so that double claiming of the private health insurance tax offset in respect of the same private health insurance premiums by both a trustee and beneficiary will not be possible.

Context of amendments

Amendment to tax offset carry forward rules

4.3 Tax offsets reduce the amount of income tax a person has to pay. If certain tax offsets exceed a person’s tax liability for an income year, the tax offsets may be carried forward to the next income year or refunded. The order in which tax offsets are applied determines whether any tax offsets may be carried forward or refunded.

4.4 The current ordering rules set out in Division 65 do not apply correctly in relation to a number of refundable tax offsets, namely the tax offsets that arise for excess imputation credits, private health insurance, films, research and development and the ‘first child’. An amendment is required to maximise the benefit of refundable tax offsets to taxpayers.
Amendments to reflect the simplified imputation system rules

4.5 Amendments to the refundable tax offset rules in ITAA 1997 are required to reflect the new SIS rules, which replaced the former imputation rules in Part IIIAA of the ITAA 1936 from 1 July 2002.

Removal of scope for double refunds of the private health insurance tax offset to trustees and beneficiaries

4.6 Due to a defect in the current law, both a trustee and a beneficiary may be entitled to a refund of the private health insurance tax offset in respect of the same private health insurance premiums. This may occur, for example, where a trustee is assessed in respect of trust income under section 98 of the ITAA 1936 because a beneficiary is a minor, and therefore under a legal disability, and the beneficiary is a beneficiary in another trust estate or has income from other sources.

Summary of new law

Amendment to tax offset carry forward rules

4.7 The tax offset carry forward rules in Division 65 of the ITAA 1997 will be amended so that tax offsets that are subject to the refundable tax offset rules will always be the highest priority tax offset for the purposes of calculating the amount of a tax offset that is carried forward.

Amendments to reflect the simplified imputation system rules

4.8 The refundable tax offset rules in Division 67 of the ITAA 1997 will be amended to reflect the new SIS rules. In particular, a corporate tax entity will generally not be entitled to a refund of excess imputation credits.

Removal of scope for double refunds of the private health insurance tax offset to trustees and beneficiaries

4.9 The refundable tax offset rules in Division 67 of the ITAA 1997 will be amended so that double claiming of a private health insurance tax offset in respect of the same private health insurance premiums by both a trustee and a beneficiary will not be possible.
Detailed explanation of new law

Amendment to tax offset carry forward rules

4.10 The tax offset carry forward rules in Division 65 of the ITAA 1997 will be amended so that tax offsets that are subject to the refundable tax offset rules in Division 67 will always be the highest priority tax offset for the purposes of calculating the amount of a tax offset that is carried forward. This amendment will maximise the benefit of these refundable tax offsets to taxpayers. [Schedule 4, item 1, subsection 65-25(2), item 1A in the table]

Amendments to reflect the simplified imputation system rules

4.11 Division 67 of the ITAA 1997 outlines the tax offsets that are subject to the refundable tax offset rules; when a taxpayer is entitled to a refund of a tax offset; and the amount of the refund.

4.12 Division 67 will be amended to reflect the new SIS rules. The amended provisions will provide the same outcome as the former rules. [Schedule 4, item 2, subsections 67-25(1) to (1E)]

4.13 A corporate tax entity will generally not be entitled to a refund of excess imputation credits. Under the SIS rules, the intercorporate dividend rebate has been replaced by a tax offset for franked distributions. Only individuals, complying superannuation entities and certain charities and gift deductible organisations are entitled to refunds of excess imputation credits.

4.14 However, consistent with the former rules, a corporate tax entity that is a life insurance company will be eligible for a refund. Certain charities and gift deductible organisations will also continue to be eligible for a refund. [Schedule 4, item 2, subsections 67-25(1C) to (1E)]

Removal of scope for double refunds of the private health insurance tax offset to trustees and beneficiaries

4.15 Subsection 67-25(2) of the ITAA 1997 will be amended so that the private health insurance tax offset allowable to a trustee under subsection 61-335(4) will not be refundable where a trustee is liable to be assessed under section 98. Beneficiaries will continue to be eligible for refunds of the private health insurance tax offset. This amendment will remove the scope for double refunds of that tax offset. [Schedule 4, items 3 and 4, subsection 67-25(2)]
Application and transitional provisions

Amendment to tax offset carry forward rules

4.16 The amendment to the tax offset carry forward rules in Division 65 of the ITAA 1997 will apply from 1 July 2000, when the tax offset for franked dividends became refundable.

Amendments to reflect the simplified imputation system rules

4.17 The amendments to the refundable tax offset rules in Division 67 of the ITAA 1997 will apply from 1 July 2002, when the SIS rules came into effect.

Removal of scope for double refunds of the private health insurance tax offset to trustees and beneficiaries

4.18 The amendments to subsection 67-25(2) of the ITAA 1997 will apply from 1 July 2002.
Chapter 5
Foreign resident withholding

Outline of chapter

5.1 Schedule 5 to this bill amends the TAA 1953 introduce new obligations to withhold from payments, to be prescribed by regulation, that are made to foreign residents.

5.2 References in this chapter are references to provisions in Schedule 1 to the TAA 1953 unless stated otherwise.

Context of reform

5.3 The Review of Business Taxation (Ralph Review) concluded that there are high levels of non-compliance by foreign residents who do not have a permanent presence in Australia with their Australian income tax obligations. The Ralph Review recommended the introduction of a uniform withholding regime on all taxable Australian source income and capital gains derived by foreign residents.

5.4 In the Minister for Revenue and Assistant Treasurer’s Press Release C57/02 of 14 May 2002, the Government announced a modified approach under which new PAYG withholding obligations will apply to certain payments to foreign residents.

5.5 The new PAYG withholding obligations will minimise the compliance burden on Australian businesses by requiring withholding only for certain payments. The payments from which amounts must be withheld will be prescribed by regulations. These regulations will be made where there is a demonstrated compliance risk and after consultation with affected taxpayer groups. The new withholding obligations will be supported by the existing PAYG withholding system.

Summary of new law

5.6 The new withholding obligations will apply to certain payments made to foreign residents, to be prescribed by regulation. Amounts withheld will be available as a credit against an assessment of income tax.
5.7 The new provisions set out the circumstances when withholding will be required and from whom a payer will be required to withhold. There is also a provision that requires withholding by an intermediary who receives an amount on behalf of a foreign resident.

5.8 The existing generic withholding rules will cover such things as when the withheld amount must be paid to the Commissioner (Subdivision 16-B), entitlement of the recipient to a credit for the amount withheld (Subdivision 18-A) and offences (Subdivision 20-B).

5.9 The new withholding requirements will not affect the existing tax obligations of foreign residents such as the requirement to lodge a tax return. They will also not affect the assessment of a foreign resident’s tax return other than to allow credits for amounts withheld.

Detailed explanation of new law

5.10 Schedule 5 to this bill inserts Subdivision 12-FB into Schedule 1 to the TAA 1953. This Subdivision creates two new withholding obligations in respect of foreign residents.

5.11 The new withholding obligations will require withholding in two different circumstances where payments are prescribed by regulation:

- where the payment is made to a foreign resident; and
- where the payment is received for a foreign resident.

Requirement to withhold where the payment is made to a foreign resident

5.12 The new obligation to withhold from a payment to a foreign resident is set out in section 12-315. [Schedule 5, item 6, section 12-315]

Payments made in carrying on an enterprise

5.13 Withholding will be required only where the entity making the payment (the payer) does so in carrying on an enterprise. This will exclude, from the scope of withholding payments, activities that are of a private or domestic nature for the payer. This is consistent with the scheme of the existing PAYG withholding system that generally does not require individuals and households to withhold. [Schedule 5, item 6, subsection 12-315(1)]
Who is subject to withholding?

5.14 Withholding will be required where the recipient is a foreign resident. This rule will address circumstances where the payer knows the status of the recipient as a foreign resident. [*Schedule 5, item 6, paragraph 12-315(2)(a)*]

5.15 There are also situations where the payer will not know whether the payee is a foreign resident. Residency can be a complex question of fact and degree, even if the payer knows all the relevant primary facts – which they often will not. To overcome this difficulty for payers, additional tests to determine when amounts should be withheld have been included.

5.16 One of these tests is where the payer has no reasonable grounds to believe that the recipient is an Australian resident and either:

- the recipient has an address outside Australia according to any record that is in the payer’s possession, or is kept and maintained on the payer’s behalf, about a transaction to which the payment relates; or

- the payer is authorised to make the payment at a place outside Australia (whether to the recipient or to anyone else).

[*Schedule 5, item 6, paragraph 12-315(2)(c)*]

5.17 This test will ensure that where there are reasonable grounds to believe that the recipient is an Australian resident, withholding will not be required, even if an amount is paid outside Australia, or the recipient has an address outside Australia.

5.18 However, if there are no reasonable grounds to believe that the recipient is an Australian resident, and the amount is to be paid outside Australia, or the recipient has a foreign address, withholding will be required.

5.19 Whether or not there are reasonable grounds to believe that a recipient is an Australian resident will be considered on an objective basis. The question is whether a reasonable person in the shoes of the payer would have thought that there were reasonable grounds to believe that the recipient of the payment is an Australian resident.

5.20 The two tests specified in paragraph 12-315(2)(c) are not by themselves sufficient to perform the intended compliance function of the new withholding obligations. It is relatively easy for a non-resident to obtain an Australian address and bank account. To address this risk withholding will also be required where the payer believes, or has
reasonable grounds to believe, that the recipient is a foreign resident. Once again this will be taken from the objective point of view of a reasonable person standing in the shoes of the payer. [Schedule 5, item 6, paragraph 12-315(2)(b)]

5.21 The entities subject to withholding will include a recipient with a connection outside Australia of a kind prescribed in the regulations. This will permit a regulation detailing a specific connection for a particular type of payment covered by the withholding obligation. For example, if the existing conditions in subsection 12-315(2) prove to be insufficient to prevent avoidance of the withholding obligations, additional conditions may be made by regulation to ensure the integrity of the withholding system. [Schedule 5, item 6, paragraph 12-315(2)(d)]

5.22 This chapter refers to ‘foreign resident’ as a shorthand term for the entity that is the ultimate recipient of payments subject to withholding. In some cases the entity may not be a foreign resident. For example, a payer may withhold an amount from a payment to an entity because they believe that the conditions in paragraph 12-315(2)(c) are satisfied, but it turns out that the entity was in fact a resident of Australia. In such circumstances the resident will receive a credit for this amount in a subsequent assessment.

Which payments are subject to withholding?

Payments to be prescribed in the regulations

5.23 Withholding will be required from payments of a kind that are prescribed in the TAR 1976. This will enable payments to be prescribed progressively after consultation with affected groups as they are identified as presenting a compliance risk. [Schedule 5, item 6, paragraph 12-315(1)(b)]

Payments that are excluded

5.24 Withholding is not required from payments to the extent that the payment is a living-away-from-home allowance benefit or an expense payment benefit. These payments are excluded from withholding because they are subject to the fringe benefits tax and do not give rise to an income tax liability for the recipient. [Schedule 5, items 2 and 3, subsections 12-1(2) and (3)]

5.25 A number of specific types of payments are excluded from the scope of the new withholding obligations. Existing withholding provisions already cover these payments. However, in some cases the existing withholding includes carve-outs and there is no intention to use these new withholding provisions to pick up those carve-outs.
5.26 The payments specifically excluded are:
- payments of dividends, interest and royalties;
- departing Australia superannuation payments;
- natural resource payments; and
- mining payments.

[Schedule 5, item 6, paragraph 12-315(1)(c)]

Procedural requirement when making regulations

5.27 Regulations made under these provisions prescribing payments to which withholding applies can only be made where the Minister is satisfied the payment could reasonably be related to assessable income of foreign residents. This requirement relates to the nature of the payment itself, not the characterisation of the payment in the hands of a particular recipient. [Schedule 5, item 6, subsection 12-315(3)]

5.28 For example, some payments are exempt income regardless of who receives them, such as interest on a judgment debt. However, some payments are exempt income if they are derived by particular entities, such as pay and allowances paid to a Defence Force member performing duties in operational areas. This second type of payment (for pay and allowances) could reasonably be related to assessable income, despite the fact that in the hands of particular recipients it is not.

5.29 Similarly, payments that are reasonably related to CGT events that happen could reasonably be related to the assessable income of foreign residents, despite the fact that in certain cases no capital gain will arise.

Requirement to withhold where payment is received for a foreign resident

5.30 The new withholding regime for payments to foreign residents will also apply where a payment is received by an entity on behalf of a foreign resident. The withholding obligation will prevent the deferment or avoidance of withholding by a foreign resident having an Australian resident entity, for example a nominee company, receiving and accumulating the relevant monies in Australia on behalf of the foreign resident. [Schedule 5, item 6, section 12-317]

5.31 The obligation to withhold will apply where an entity (the intermediary) receives a payment that meets the requirements of paragraph 12-315(1)(b) (it is of a kind set out in the regulations) and paragraph 12-315(1)(c) (it is not one of the listed payments) on behalf of a foreign resident. [Schedule 5, item 6, subsection 12-317(1)]
5.32 The obligation to withhold arises only if the intermediary is a person in Australia or an Australian government agency and a foreign resident is or becomes entitled:

- to receive the payment (or part of it) from the intermediary, or to receive the amount of the payment (or part of it) from the intermediary; or

- to have the intermediary credit to the foreign resident, or otherwise deal with on the foreign resident’s behalf or as the foreign resident directs, the payment or part of it, or the amount of the payment or part of it.

[Schedule 5, item 6, paragraphs 12-317(1)(a) and (b)]

5.33 The intermediary must withhold the amount:

- if the foreign resident is so entitled when the intermediary receives the payment – just after receiving the payment; or

- if the foreign resident becomes entitled after the intermediary receives the payment – just after the foreign resident becomes entitled to the payment.

[Schedule 5, item 6, subsection 12-317(2)]

5.34 Tests similar to those in subsection 12-315(2), which describe the entities from whom withholding is required, are included in this provision. In many cases an intermediary may know whether the other party is a foreign resident, but this may not always be the case. Therefore, these tests are also appropriate here to assist the intermediary to know when to withhold. [Schedule 5, item 6, subsection 12-317(3)]

Exemption from withholding

5.35 The Ralph Review recommended an exemption for non-residents that have a permanent presence in Australia on the basis that there is an ongoing business or there are business assets sufficient to meet Australian tax liabilities. This recommendation is unsuitable for a self-assessed withholding obligation because the payer will generally not know enough about the payee’s activities and assets to know whether they would be sufficient to meet their tax liabilities.
5.36 Instead the amendments provide that the Commissioner may grant an exemption from withholding if the Commissioner is satisfied that the entity has an established history of compliance with its obligations under taxation laws, and that the entity is likely to continue to comply with those obligations. This reflects the Ralph Review’s recommendation that withholding not apply to non-residents with a permanent presence in Australia. According to the Review, these were a lower risk group of non-residents as they were more likely to comply with their Australian tax obligations. [Schedule 5, item 6, section 12-319]

5.37 The Commissioner will grant the exemption for a specific period that will be stated in the exemption notice. [Schedule 5, item 6, subsection 12-319(2)]

5.38 While not limiting the matters that the Commissioner may have regard to, the Commissioner may have regard to the following matters in deciding whether to grant an exemption:

- whether in the current income year and in the two previous income years the foreign resident is or was liable to pay a PAYG instalment;

- the amount of any tax-related liabilities of the foreign resident that are currently due and payable; and

- the record of the foreign resident (and its associates) in meeting its Australian tax obligations in the current income year and previous two income years.

[Schedule 5, item 6, subsection 12-319(3)]

5.39 The intention is that an exemption will not be granted to those entities who have no history of compliance with Australian taxation obligations, including with the PAYG instalments system.

5.40 The record of the foreign resident and its associates in meeting Australian taxation obligations in the past two years would include consideration of things such as:

- whether the foreign resident and associates have complied with all obligations under the PAYG instalments system;

- whether the foreign resident is liable to general interest charge, or to an administrative penalty or has committed a taxation offence in respect of the two immediately preceding income years; and
• if the foreign resident has employees, whether they have complied with taxation obligations in respect of them, such as PAYG withholding or superannuation guarantee charge.

5.41 The Commissioner must give a copy of the notice to the entity to which it relates. However, failure to provide the notice to the entity does not affect the validity of the exemption. [Schedule 5, item 6, subsections 12-319(4) and (5)]

5.42 In many cases an exemption from withholding will mean that the payments are subject to the PAYG instalments system. Foreign residents who are granted an exemption from withholding are still expected to comply with their obligations under the PAYG instalments system.

Withholding from payments to partnerships and other joint entities

5.43 The new withholding obligation will apply to a payment to a partnership if one or more of the partners in the partnership satisfy the conditions specified in subsection 12-315(2). Similarly, the measure will apply to a joint venture if one or more of the persons in the joint venture satisfies one of the conditions. The withholding rules will apply in this way to ensure that foreign residents may not avoid withholding by entering into partnerships or joint ventures with residents.

5.44 This is achieved by the use of the phrase “...to another entity, or to other entities jointly”. [Schedule 5, item 6, subsection 12-315(1)]

5.45 However, these words have not been used in section 12-317, which requires withholding where an amount is received for a foreign resident. If an entity receives an amount on behalf of a partnership or joint venture the entity receives the amount for each and every one of the partners or joint venturers. Therefore, if one or more of the partners or joint venturers satisfies any of the tests in paragraph 12-317(1)(c) the entity receiving the amount on their behalf must withhold in accordance with section 12-317.

Distributions from trusts

5.46 Subsections 98(3) and (4) of the ITAA 1936 relate to trust estates where a beneficiary is a non-resident at the end of the year of income. In these cases the trustee is liable, and will be assessed on that share of the trust income that is:

• attributable to the period when the beneficiary was a resident; and
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- attributable to the period when the beneficiary was a non-resident and the income was from sources in Australia.

5.47 These existing provisions will continue to apply to distributions from trust estates to non-resident beneficiaries.

Exempt income

5.48 The new withholding provisions have not been included in the general exception from withholding for exempt income in subsection 12-1(1). Therefore withholding from prescribed payments to foreign residents will be required regardless of whether the amount is exempt income.

5.49 However, the foreign resident may apply to the Commissioner for a variation of the amount withheld under the existing variation provisions in section 15-15 (including a variation to nil), on the basis that the income is exempt (e.g. because of a double tax agreement). Where the income is exempt the amount withheld will not reflect the ultimate tax liability of the foreign resident and a variation under subsection 15-15(1) can be made based on the special circumstances of the particular foreign resident.

Priority rules

5.50 The current PAYG withholding obligations in Part 2-5 will have priority over the new foreign resident withholding obligations, except for the voluntary agreements provision (section 12-55). The reason for this is that if withholding is already required by an existing provision then the desired outcome, for withholding to occur, is already achieved. The new obligations will only apply to payments that fall outside the existing PAYG withholding system. The table in subsection 12-5(2) is amended to ensure that all the withholding provisions in Division 12 apply in priority to the new withholding obligations. It is not necessary to mention the voluntary agreements withholding obligation because the note after the table explains that it covers a payment only if no other provision requires the payer to withhold. [Schedule 5, items 4 and 5]

5.51 The new withholding obligations will have priority over the voluntary agreements withholding obligation, which is designed so that payees who are not otherwise covered by withholding can ‘volunteer’ into withholding, if they and the payer agree. The voluntary agreements withholding obligation only operates if no other provision in Division 12 requires the paying entity to withhold an amount from the payment (paragraph 12-55(1)(b)). Consequently, no amendment is needed to give
these new withholding obligations for foreign residents priority over the voluntary agreements withholding provision.

**Amount to be withheld under the new withholding obligations**

5.52 The amount to be withheld under the new obligations will be specified in the regulations.

5.53 This is achieved by including the new withholding obligations within the scope of subsection 15-10(2), which allows regulations to be made specifying the rate at which amounts are to be withheld. Subsection 15-10(2) is amended to include a reference to Subdivision 12-FB. [Schedule 5, item 7]

5.54 Rates of withholding will be determined as regulations are developed.

**Penalties and offences**

*Failure to withhold – civil penalty*

5.55 The existing civil penalty for failure to withhold by an entity other than an exempt Australian government agency, specified in section 16-30, will apply for the new withholding provisions. No amendment is required. This is because section 16-30 imposes a penalty where there is a failure to withhold as required by Division 12, and the new withholding obligations created by these amendments are inserted into Division 12.

5.56 There are existing civil penalties for failure to withhold by an exempt Australian government agency. These are specified in section 16-35 for a payment other than of a dividend, interest or a royalty and in section 16-40 for payments that are dividends, interest and royalties. The penalty specified in section 16-35 will not apply where there is a failure to withhold from a payment to a foreign resident under Subdivision 12-FB. [Schedule 5, item 10]

5.57 Instead, a new civil penalty provision for exempt Australian government agencies will mirror the existing penalty in section 16-40 for failure to withhold from a dividend interest or royalty payment. The amount of the penalty is the amount that the exempt Australian government entity failed to withhold, and is due at the time when the agency would have had to pay to the Commissioner the amount required to be withheld. [Schedule 5, item 13, section 16-43]

5.58 Amendments are made to include references to new section 16-43 in the following provisions:
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- the notes following subsections 16-25(1) and (2) [Schedule 5, items 8 and 9];
- section 16-45 (about remission of penalties) and section 16-50 (about GIC on unpaid penalty amounts) [Schedule 5, items 14 to 16]; and
- subsection 250-10(2) (list of tax related liabilities) [Schedule 5, item 29].

Offences

5.59 The offence provision of section 20-35 will apply to the new withholding obligations.

5.60 References to the new withholding provision where an amount is received for a foreign resident are inserted into paragraphs 20-35(2)(a) and 20-35(2)(b) to ensure that it will not be an offence for a foreign resident to claim a credit for amounts withheld on their behalf under section 12-317. [Schedule 5, items 26 and 27]

Annual reports about withholding payments

5.61 The existing annual reporting requirements specified in section 16-153 will apply to payments from which withholding is required by sections 12-315 or 12-317. The requirements will be the same as those for payments covered by dividend, interest and royalty withholding, no ABN withholding, mining withholding and natural resource payment withholding. Accordingly, the entity affected (generally the payer) will give a report to the Commissioner in the approved form not later than 31 October after the end of the financial year.

5.62 Paragraphs 16-153(1)(a) and (b) are amended to refer to the new withholding obligation for payments to foreign residents. Paragraphs 16-153(1)(c) and (d) are amended to refer to the new withholding obligation where an amount is received for a foreign resident. [Schedule 5, items 17 to 20]

Payment summaries

5.63 Payers will be required to provide annual payment summaries, and part-year payment summaries where requested, in the approved form in relation to amounts withheld from payments to foreign residents under the new withholding obligations. Paragraph 16-155(1)(a) (that explains when it is necessary for a payer to provide an annual payment summary to a recipient) is amended and paragraph 16-155(1)(baa) is inserted, to
include references to the new withholding provisions. [Schedule 5, items 21 to 22]

5.64 Many foreign residents will only have short term or one-off payments for which a payee may want a part-year payment summary. Paragraph 16-160(1)(a) is amended and paragraph 16-160(1)(ba) is inserted, to include references to the new withholding provisions. [Schedule 5, items 23 to 24]

Credits for amounts withheld

5.65 The recipient of a payment from which an amount is withheld under the new withholding obligations will be entitled to a credit for the amounts withheld. The entitlement to a credit arises when the Commissioner makes an income tax assessment (or determines that no income tax is payable) for the income year.

5.66 No amendment is necessary for the crediting of amounts withheld under section 12-315 from payments to foreign residents because Subdivision 18-A (crediting amounts against liability for income tax, withholding tax or mining withholding tax) can already achieve the desired result. The main crediting provision would be section 18-15, with section 18-20 applying where the recipient is a partnership and section 18-25 where the recipient is a trust.

5.67 The crediting rules will also apply to amounts withheld where an amount is received for a foreign resident. An amendment is necessary to enable this to occur. Subsection 18-10(2) is inserted to provide that if an amount is withheld under section 12-317, sections 18-15, 18-20 and 18-25 are applied in the same way as if the payment has been made to the likely foreign recipient. This rule will ensure that the foreign resident may obtain a credit for the amount withheld. [Schedule 5, item 25]

5.68 Division 3 of Part IIB of the TAA 1953 sets out how the Commissioner must treat a credit. These generic rules will apply to credits for amounts withheld under the new withholding events.

Recovery, through estimates and director penalties, of amounts withheld but not remitted

5.69 There are rules in Division 8 of Part VI of the ITAA 1936 that facilitate the recovery of amounts that have been withheld under Division 12 but not remitted to the Commissioner. The rules empower the Commissioner to make an estimate of the amount and recover the amount of the estimate. Division 9 of Part VI of the ITAA 1936 deals with penalties for directors of companies that fail to remit amounts to the
Commissioner as required by the PAYG withholding system. These rules will also apply for the recovery of amounts withheld but not remitted under the new withholding obligations for payments to foreign residents. No amendment is required because the rules currently apply for the recovery of amounts withheld under Division 12.

Reviewable decision

5.70 A reference to subsection 12-319(1) is inserted as new item 1A into the table in section 20-80 to ensure that the decision not to grant an exemption from withholding is one which can be objected to under Part IVC of the TAA 1953. [Schedule 5, item 28]

Application and transitional provisions

5.71 The new withholding arrangements will apply to payments made on or after 1 July 2003. Due to the nature of withholding, the new obligations will only apply prospectively. [Schedule 5, item 30]

Consequential amendments

5.72 The table in section 10-5 of Schedule 1 to the TAA 1953 provides a summary of the withholding payments that are covered by the PAYG withholding system. References to the two new withholding events, sections 12-315 and 12-317, that will apply to payments to foreign residents are inserted. [Schedule 5, item 1, section 10-5, items 22B and 22C in the table]

5.73 A consequential amendment is made to subsection 16-40(2) and the note following to amend the reference to ‘entity’ to ‘exempt Australian government agency’. [Schedule 5, items 11 to 12]

REGULATION IMPACT STATEMENT

Policy objective

5.74 The objective of this measure is to improve the compliance of foreign residents with their Australian tax obligations through the use of withholding arrangements that can be tailored to address risks of non-compliance.
Background

5.75 The Review of Business Taxation concluded that there are high levels of non-compliance by non-residents without a permanent presence in Australia, with their Australian income tax obligations. Recommendation 21.6 of *A Tax System Redesigned* recommended a new withholding systems for collecting tax from non-residents in respect of Australian source income and gains on the disposal of assets.

5.76 On 14 May 2002 the Minister for Revenue and Assistant Treasurer announced that the Government had decided to adopt a modified approach to the Review of Business Taxation recommendation. The approach minimises the compliance burden on Australian businesses by allowing withholding obligations to be developed as required for specific payments.

5.77 The proposed measure is designed to address non-compliance by foreign residents in a manner that is proportionate to specific areas of non-compliance and that recognises the need to minimise the impact of those measures on Australian and foreign resident taxpayers who do meet their obligations.

5.78 The measure is intended to improve the overall compliance of foreign residents, reaching a balance between revenue protection and costs of compliance.

Implementation options

5.79 The proposed measure will introduce new withholding obligations to apply to certain payments made to foreign residents, that will be prescribed by regulation. A regulation to specify a particular payment to which withholding will apply would be made where there is non-compliance with Australian tax obligations and after consultation with affected parties. Foreign residents for whom an amount has been withheld will be entitled to a credit on assessment for the amount withheld. This measure is considered to be the only feasible method of achieving the objective of collecting tax from foreign residents in receipt of certain payments and ensuring that they comply with their obligations under Australian tax law.

5.80 The new withholding obligations will be supported by the existing PAYG withholding system. The existing generic withholding rules will cover such things as when the withheld amount must be paid to the Commissioner (Subdivision 16-B of Schedule 1 to the TAA 1953), entitlement of the recipient of the payment to a credit for the amount
withheld (Subdivision 18-A of Schedule 1 to the TAA 1953) and offences (Subdivision 20-B of Schedule 1 to the TAA 1953).

5.81 The new PAYG withholding obligations will provide for amounts to be withheld from payments derived in Australia by foreign residents. It will not cover interest, dividend and royalties. These are already subject to withholding under specific provisions of the current law.

Assessment of impacts

Impact group identification

5.82 The measure will introduce obligations to withhold from certain payments to foreign residents, and from payments received for foreign residents, that are prescribed in the regulations. The broad impact groups who may be affected by the measure include:

- Australian resident payers, and residents in receipt of amounts for foreign residents;
- foreign residents who receive payments prescribed in the regulations; and
- the ATO, who will administer the new arrangements.

Analysis of costs / benefits

Compliance costs

Australian resident payers

5.83 Australian resident individuals and entities who make payments to foreign residents of the kind to be prescribed in the regulations will have new obligations under the measure. These payers will be required to withhold from the payments for which there is not currently a requirement to withhold. They will then be required to pay the amounts to the Commissioner. The new withholding obligations are accompanied by requirements to provide payment summaries to the payee and annual reports to the ATO. These obligations will increase the work required by these entities to comply with the law. However, it is expected that most of these resident entities will have existing obligations under the PAYG withholding system, for example, to withhold from payments of
salary or wages to their employees. Therefore the increase in work is expected to be minimal in most cases.

5.84 There is expected to be a compliance impact on the small number of payers who are not currently payers in the withholding system. The payers will need to familiarise themselves with the new requirements and register as withholders. They will then have to withhold, pay amounts to the Commissioner and report. This will moderately increase their costs of compliance.

5.85 There will also be new obligations to withhold by those residents who receive payments for foreign residents of the kind prescribed in the regulations on behalf of foreign residents. These obligations are the same as those for the resident payers, including the requirement to provide payment summaries and annual reports.

5.86 Payments will only be regulated where there is a risk of non-compliance. The targeting of specific payments is intended to ensure that there is no unnecessary burden placed on Australian businesses in instances where foreign residents are already meeting their Australian tax obligations.

Foreign residents who receive payments specified in the regulations

5.87 Foreign residents who receive payments of a kind specified by regulation will be affected by the measure. These foreign residents will only receive the net amount of the payment, rather than the gross amount. In order to claim a credit for the amount withheld they will need to lodge a tax return in Australia. The obligation to lodge the return already exists under Australian income tax law for those foreign residents who derive income that is taxable in Australia. There will be an increased compliance burden only for these foreign residents who are not meeting their existing obligations.

5.88 Foreign entities will be able to apply for a variation to the amount to be withheld, including to nil, if the rate specified in the regulations is unlikely to reflect the taxpayers’ ultimate tax liability. Foreign residents who have an established record of compliance with the PAYG instalments system and their other tax obligations in Australia will also be able to apply to be exempt from withholding. The process of applying for the variation or exemption will be similar to that currently in place under the PAYG withholding system.

5.89 Withholding may, in some cases, occur from payments to foreign residents who will ultimately have no tax liabilities in Australia, usually due to the operation of a Double Tax Agreement. These foreign residents may apply for a variation to nil. If they do not do this then
amounts that are withheld can be claimed by lodging an income tax return.

5.90 The key benefit of the measure is the facilitation of the collection of tax from certain payments to foreign residents through withholding, and the resulting increase in compliance of those foreign residents with their income tax obligations in Australia.

Administrative costs

Australian Taxation Office

5.91 The ATO will be responsible for the administration of the new arrangements. The ATO administers the existing PAYG withholding systems and will administer the new obligations using existing resources and administrative systems. A new variation processing system is being developed which includes internet based applications.

5.92 There will also be an initial increase in the ATO’s workload. The approach of regulating specific payments will allow for focused support and education by the ATO to be directed to those who fall within the regime in an industry specific manner.
5.93 There will be an initial increase in the administrative work of the ATO due to an increased number of applications for exemptions and variations from foreign residents who claim to either have established a history of compliance with the PAYG instalment system in Australia or feel that the rate of withholding will not accurately reflect their final tax liability.

**Government revenue**

5.94 The proposal will increase revenue collections by increasing the compliance of foreign residents with Australian tax laws. The magnitude cannot be estimated until the specific payments to be covered by the measure have been determined.

**Economic costs**

5.95 The new withholding obligations are a means of tightening current collection arrangements, and are not a new tax. However, some foreign residents may find contracts in Australia less attractive under the new arrangements. This would be offset by the improved competitiveness of resident individuals and entities participating in the industries for which payments are prescribed. The new withholding requirements will remove the advantage that some foreign residents currently have from lower costs through not paying tax in Australia compared to the costs of residents.

**Consultation**

5.96 Consultation on the framework legislation took place on 28 November 2002. Representatives attended the consultation from Treasury, the ATO and the tax professional bodies. Consultation will also take place with affected parties throughout the regulation making process. Once sectors are identified as a compliance problem consultation will take place to determine how to best support affected parties in meeting their tax obligations.

**Conclusion and recommended option**

5.97 The proposal put forward is considered to be the only method for achieving the objective that foreign residents understand and meet their Australian tax obligations. Use of the existing PAYG arrangements will minimise implementation costs for Australian businesses and the ATO.
5.98 The proposal will also protect the revenue by implementing a collection mechanism that is particularly suited to foreign-resident taxpayers. Withholding is particularly suitable because the tax is collected from the resident payer in Australia before it is paid offshore. This contrasts with other collection systems, including the PAYG instalment system, which rely on the foreign resident to pay the tax from outside Australia.

5.99 The annual reporting will facilitate the collection of complete and up to date information on foreign resident taxpayers which will allow the ATO to better support this group in meeting their tax obligations.
Chapter 6
PAYG withholding where no ABN is quoted

Outline of chapter

6.1 Schedule 6 to this bill amends the ITAA 1997 and the TAA 1953 to ensure that the PAYG no ABN withholding event will apply to enterprise-to-enterprise transactions in Australia.

Context of amendments

6.2 At present, the PAYG no ABN withholding provision, section 12-190 of Schedule 1 to the TAA 1953, only applies to supplies that a supplier makes ‘in the course or furtherance of an enterprise carried on in Australia’ (paragraph 12-190(1)(a)). In addition, there is an exemption for ‘payments made otherwise than in the course or furtherance of an enterprise carried on in Australia by the payer’ (paragraph 12-190(4)(a)).

6.3 The PAYG no ABN withholding is intended to complement the GST and ABN arrangements and apply to enterprise-to-enterprise transactions. However, the definition of ‘carried on in Australia’ in the ITAA 1997 only covers businesses. This is because this definition links to the definition of ‘permanent establishment’, which is a place where a person carries on a business. This means that it is arguable that section 12-190 only applies to business-to-business transactions. As a result of this unintentionally narrow definition non-business enterprises, such as governments and non-profit organisations, are not required (or able) to withhold from their payments when a supplier fails to quote its ABN. This is contrary to the policy intention of the PAYG no ABN withholding event.
6.4 The geographical application of the no ABN withholding rules is currently inconsistent with the concept of ‘Australia’ as defined in the ABN Act. The ABN Act definition is narrower as it does not include any external Territory, but does include certain installations. Section 12-190 needs to be amended to have the same geographical operation as the ABN Act.

6.5 The amendments will ensure that the original objectives of the no ABN withholding provisions are fully implemented.

Summary of new law

6.6 The amendments will remove the definition of ‘carried on in Australia’ from the ITAA 1997. This will mean the expression will have its ordinary meaning and the operation of the no ABN withholding event will not be restricted in its operation to just business-to-business transactions.

6.7 The no ABN withholding event will have the same geographical application as the ABN law.

Detailed explanation of new law

6.8 The amendments remove the definition of ‘carried on in Australia’ from section 995-1 of the ITAA 1996. Section 12-190 is the only provision in which this definition is used. The expression will then have its ordinary meaning. [Schedule 6, item 1]

6.9 Section 12-190 is amended to have the same geographical operation as the ABN Act by inserting new subsection 12-190(7). The new subsection provides that in working out whether an enterprise is carried on in Australia for the purposes of applying section 12-190, external Territories of Australia are ignored. Installations that are deemed to be part of Australia by section 5C of the Customs Act 1901 will be part of Australia for the purposes of the no ABN rules. This amendment will ensure that an enterprise is to be treated as carried on in Australia only where it would be treated as carried on in Australia under the ABN Act. [Schedule 6, item 2, subsection 12-190(7)]
Application and transitional provisions

6.10 The amendments will apply to payments made after Royal Assent. [Schedule 6, item 3]
Chapter 7
Worker entitlement funds

Outline of chapter

7.1 Schedule 7 to this bill inserts sections 58PA and 58PB into the FBTAA 1986 and amends subsection 136(1) of the FBTAA 1986. These amendments provide an FBT exemption for certain payments to approved worker entitlement funds.

7.2 This Schedule also amends sections 112-50 (item 6 in the table) and 126-125 of the ITAA 1997 and inserts subsection 126-130(2) into the ITAA 1997. These amendments provide an automatic CGT roll-over to a fund that amends or replaces its trust deed in order to be approved as an approved worker entitlement fund under subsection 58PB(2) of the FBTAA 1986.

Context of amendments

Fringe benefits tax

7.3 Taxation Ruling TR 1999/5, which was issued by the Commissioner on 19 May 1999, ruled on the FBT treatment of certain payments to trusts by employers. The ruling is considered to apply to payments to worker entitlement funds. The ATO has stated that employers contributing to worker entitlement funds have until 1 April 2003 to comply.

7.4 However, payments made by a worker entitlement fund to an employee are also taxable in the hands of the employee as either ETPs or as salary or wages.

7.5 As a result, payments into worker entitlement funds for employees would be effectively taxed twice – once as a fringe benefit when paid into the fund and once when paid out of the fund.

7.6 An FBT exemption for certain payments to approved worker entitlement funds ensures that these payments are not taxed twice.
Capital gains tax

7.7 Funds may be required to change their trust deeds in order to satisfy the Commissioner that the criteria in the legislation is met. Satisfying the criteria is necessary before a fund can be prescribed for the purposes of the FBT exemption. A CGT event may occur as a result of such a change to a trust deed.

7.8 A CGT roll-over for a fund that amends or replaces its trust deed in order to be approved as an approved worker entitlement fund under subsection 58PB(2) of the FBTAA 1986 ensures that the fund does not incur a CGT liability as a result of complying with the criteria for the FBT exemption.

Summary of new law

Fringe benefits tax

7.9 The amendments will provide an FBT exemption for certain payments to approved worker entitlement funds.

7.10 The FBT exemption is designed to apply only to those payments where the use of a separate fund is necessary in order to provide for the protection and portability of employee entitlements.

7.11 In order for the FBT exemption to apply, the payments into an approved worker entitlement fund must be required under an industrial instrument and be for the purpose of making leave payments or payments when an employee ceases employment.

7.12 For the FBT exemption to apply, contributions must be made to an approved worker entitlement fund. Before a fund can be approved as an approved worker entitlement fund it will have to meet criteria concerning the level of employer control, the use of fund assets, the types of payments that the fund can make and the maintenance of worker entitlement accounts.

7.13 The Commissioner will be responsible for advising the Government and the Governor-General on whether funds meet the required criteria prior to the fund being prescribed by regulation.
7.14 Long service leave funds established and operating by or under Commonwealth, State or Territory legislation are taken to be approved worker entitlement funds without the need for them to be prescribed by regulation.

Capital gains tax

7.15 The amendments will provide an automatic CGT roll-over for a fund that amends or replaces its trust deed in order to be approved as an approved worker entitlement fund under subsection 58PB(2) of the FBTAA 1986.

7.16 CGT event E1 or E2 may occur in relation to a CGT asset when a trust deed of a fund is amended or replaced. This amendment provides CGT relief if the trust deed of a fund is amended or replaced for the purpose of having the fund approved as an approved worker entitlement fund under subsection 58PB(2) of the FBTAA 1986. The CGT roll-over is only provided if the assets and members of the fund do not change as a consequence of the amendment or replacement.

Comparison of key features of new law and current law

<table>
<thead>
<tr>
<th>New law</th>
<th>Current law</th>
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<tbody>
<tr>
<td>From 1 April 2003, FBT does not apply to payments to an approved worker entitlement fund for leave entitlements or for entitlements when an employee ceases employment, where the payments are required under an industrial instrument.</td>
<td>FBT applies to payments to worker entitlement funds.</td>
</tr>
<tr>
<td>From 1 April 2003, a CGT liability does not arise when a trust deed is changed for the purpose of having the fund approved as an approved worker entitlement fund under subsection 58PB(2) of the FBTAA 1986.</td>
<td>A CGT liability may arise when a trust deed is changed for the purpose of having the fund approved as an approved worker entitlement fund under subsection 58PB(2) of the FBTAA 1986.</td>
</tr>
</tbody>
</table>
Detailed explanation of new law

Fringe benefits tax

7.17 This amendment will provide an FBT exemption for certain payments made to approved worker entitlement funds.

7.18 The exemption is provided to certain payments into approved funds to ensure that it applies only to payments where the use of a separate fund is necessary in order to provide for the protection and portability of employee entitlements.

7.19 Before a fund can be prescribed by regulation it will have to satisfy certain criteria. The Commissioner will be responsible for determining whether or not worker entitlement funds meet the criteria.

What payments to approved worker entitlement funds will be exempt from fringe benefits tax?

7.20 A contribution to an approved worker entitlement fund must be required to be made under an industrial instrument. An industrial instrument, as defined in the FBTAA 1986, is a law of the Commonwealth or of a State or Territory or an award, order, determination or industrial agreement in force under any such law. This includes registered AWAs, an award or legislation. [Schedule 7, item 1, paragraph 58PA(b)]

7.21 The FBT exemption will not apply to payments made above those required under an industrial instrument. For example, if an AWA requires that the employer contribute $80 per week into an approved employee entitlement fund, but the employer contributes $100 per week, the FBT exemption will apply only to $80. FBT may be payable on the extra $20 contribution.

7.22 The contribution must also be required for the purposes of making leave payments or payments in lieu of leave or payments when an employee ceases employment. Contributions can also be made for the reasonable administrative costs of the fund. Reasonable administrative costs include the reasonable costs of administering the fund, but do not include payments by the fund for the purposes of providing goods or services to workers (other than a fund’s own employees), contributors, beneficiaries of the fund or their associates [Schedule 7, item 1, paragraph 58PA(c)]
When is a fund an approved worker entitlement fund?

7.23 A fund will be an approved worker entitlement fund when it is:

- a long service leave fund established and operating by or under a law of the Commonwealth, State or Territory; or
- prescribed by regulation but not disallowed by the Treasurer.

[Schedule 7, item 1, section 58PB]

Long service leave funds established under a law of the Commonwealth, State or Territory

7.24 Funds established and operating by or under a law of the Commonwealth, State or Territory for the purposes of ensuring long service leave is paid will be approved worker entitlement funds.

[Schedule 7, item 1, subsection 58PB(1)]

Other funds

7.25 Funds other than those established under a law of the Commonwealth, State or Territory for the purposes of ensuring long service leave is paid will be an approved worker entitlement fund if the fund is prescribed by regulation. Even if the fund has been prescribed, it will not be an approved worker entitlement fund if the Treasurer has declared, in writing, that it is not prescribed.

[Schedule 7, item 1, subsection 58PB(2)]. The declaration will be a disallowable instrument [Schedule 7, item 1, subsection 58PB(3)].

Criteria that funds must meet before they can be prescribed as an approved worker entitlement fund

7.26 Before a fund can be prescribed by regulation the Commissioner must be satisfied that it meets certain criteria.

[Schedule 7, item 1, subsection 58PB(4)]

Level of contributor control

7.27 The management of the worker entitlement fund and the management of the investments of the fund must be at arm’s length from the contributors to the fund and their associates.

[Schedule 7, item 1, paragraph 58PB(4)(a)]
Use of fund assets

7.28 Under the fund’s constituting documents, no more than 5% of the total assets of the fund are to be invested in an entity controlled by a contributor or an associate of a contributor. The constituting documents must also specify that the fund cannot provide or facilitate a loan or any other form of financial assistance to contributors or their associates or to those for whom contributions are made or their associates. [Schedule 7, item 1, paragraph 58PB(4)(b)]

Payments from the fund

7.29 A fund’s constituting documents must limit payments from the fund. The limitations on the payments from the fund are to ensure that the main purpose of the fund is the protection and portability of worker entitlements. The fund will be able to make payments necessary to ensure the proper administration of the fund.

Payments from the contributions to the fund

7.30 Under the fund’s constituting documents, payments from contributions to the fund can only be made for the following purposes:

- to pay worker entitlements to persons in respect of whom contributions are made;

- to make investments to generate income from the assets of the fund;

- to reimburse contributors who have paid entitlements directly to persons in respect of whom contributions are made;

- to return contributions to contributors;

- to pay, for the benefit of a person in respect of whom contributions are made, an ETP (within the meaning of section 27A of the ITAA 1936) into:
  - a complying superannuation fund (within the meaning of section 45 of the Superannuation Industry (Supervision) Act 1993);
  - a complying approved deposit fund (within the meaning of section 47 of the Superannuation Industry (Supervision) Act 1993); or
Worker entitlement funds

- a retirement savings account (within the meaning of the Retirement Savings Account Act 1997);

- to transfer contributions to another approved worker entitlement fund;

- to pay the reasonable administrative expenses of the fund;

- to pay amounts to a contributor’s external administrator that would otherwise be payable as a reimbursement to contributors who have paid entitlements directly to persons in respect of whom contributions are made or to return contributions to contributors; or

- to pay interest on, or to repay, money lent to the fund.

[Schedule 7, item 1, paragraph 58PB(4)(c)]

7.31 Payments to pay worker entitlements to persons in respect of whom contributions are made includes contributions made as required entitlement contributions and to which the FBT exemption will apply if made to an approved employee entitlement fund. It also includes other contributions to which the FBT exemption does not apply and which are subject to FBT when they are made into the fund. [Schedule 7, item 1, subparagraph 58PB(4)(c)(i)]

7.32 The funds also need to be able to undertake investments in order to generate income. As discussed in paragraph 7.28 there are limitations on the investments that the fund can undertake. [Schedule 7, item 1, subparagraph 58PB(4)(c)(ii)]

7.33 The funds will be able to reimburse contributors. Funds may choose to operate in such a way that contributors make contributions to the fund for leave entitlements or for payments when an employee ceases employment but retain the responsibility to pay such entitlements to employees when they fall due. The fund may then reimburse to the contributor the contributions made in respect of those entitlements. Funds will also be able to return contributions to contributors. For example, a contributor may mistakenly make a contribution in excess of that required and the fund will be able to return any excess. Another example may be where a fund makes a reimbursement to a contributor where it is no longer necessary to hold the entitlement because it will never fall due. Where a contributor appoints an external administrator, funds may make reimbursements of or return the contributor’s contributions to the external administrator. [Schedule 7, item 1, subparagraphs 58PB(4)(c)(iii), (iv) and (viii)]
7.34 Funds will be able to transfer contributions to an approved worker entitlement fund. This may occur if a fund is wound up. The fund can also pay an ETP (within the meaning of section 27A of the ITAA 1936) in respect of a worker directly to a complying superannuation fund, complying approved deposit fund or a retirement savings account rather than directly to the employee. [Schedule 7, item 1, subparagraphs 58PB(4)(c)(v) and (viii)]

7.35 Payments can also be made for the reasonable administrative costs of the fund. Reasonable administrative costs include the reasonable costs of administering the fund, but do not include payments by the fund for the purposes of providing goods or services to workers (other than a fund’s own employees), contributors, beneficiaries of the fund or their associates. [Schedule 7, item 1, subparagraph 58PB(4)(c)(vii)]

Payments from the income of the fund

7.36 Under the fund’s constituting documents, payments from the income of the fund can only be made for certain purposes. These purposes are:

- to make payments for the same purposes as payments made from contributions to the fund (other than the payment of worker entitlements);
- to make payments to contributors to the fund; or
- to make payments to other persons where the payment is specified in subsection 58PB(5).

[Schedule 7, item 1, paragraph 58PB(4)(d)]

7.37 Any income generated by the fund will be able to be used to supplement contributions in order to make payments that would otherwise be made from the contributions. Payments of worker entitlements from the income of the fund is, however, limited (see paragraphs 7.38 to 7.39). [Schedule 7, item 1, subparagraph 58PB(4)(d)(i)]

7.38 The fund can make payments out of the income of the fund to persons in respect of whom contributions to the fund have been made and where the contribution would be an exempt benefit under section 58PA if the fund were an approved worker entitlement fund. The payment can either be a payment of a worker entitlement where the contribution for that payment would be an exempt benefit under section 58PA if the fund were an approved worker entitlement fund or a payment of some kind other than a worker entitlement. That is, if an employer has placed an employee entitlement into an approved worker entitlement fund of a kind
that receives the FBT exemption under section 58PA, then payments can be made out of the fund income to that employee for such FBT exempt worker entitlements or for reasons other than a worker entitlement. For example, the income of the fund can be distributed to that worker. Other worker entitlements, for example a fringe benefit that is not exempt under section 58PA, cannot be paid out of the income of the fund. [Schedule 7, item 1, subparagraphs 58PB(4)(d)(ii) and (iii)]

7.39 It is considered that a worker entitlement would include payments agreed between an employer and a worker in compensation for services rendered by the worker or payments to a worker stipulated in an industrial instrument. A worker entitlement would also include any benefit to be provided to the worker which has been agreed between an employer and a worker entitlement fund. However, an ex gratia distribution of income from the fund would not be considered to be a worker entitlement.

Record keeping

7.40 Before being able to be prescribed, a worker entitlement fund will have to meet criteria on fund records. Under its constituting documents, an account must be kept for each person in respect of whom contributions to the fund are made and the account must be kept in a manner that enables entitlements in respect of the person to be calculated. [Schedule 7, item 1, paragraph 58PB(4)(e)]

Definitions

7.41 The amendments to the FBTAA 1986 have required, as a consequence, new definitions of ‘approved worker entitlement fund’, ‘entity’ and ‘external administrator’ to be inserted into subsection 136(1) of the FBTAA 1986. [Schedule 7, items 2, 3 and 4]

Capital gains tax

7.42 This amendment provides a CGT roll-over to a fund that changes or replaces its trust deed for the purpose of having the fund approved as an approved worker entitlement fund under subsection 58PB(2) of the FBTAA 1986 if the assets and members of the fund do not change as a result of the amendment or replacement. [Schedule 7, items 6 to 8, subsection 126-130(2) of the ITAA 1997]
7.43 CGT event E1 (creating a trust over a CGT asset) or E2 (transferring a CGT asset to a trust) can happen in relation to a CGT asset where a trust deed of a fund is amended or replaced. This amendment ensures that no CGT liability arises where a fund amends or replaces its trust deed for the purpose of having the fund approved as an approved worker entitlement fund under subsection 58PB(2) of the FBTAA 1986. This requires that the assets and members of the fund do not change as a consequence of the amendment or replacement.

Application provisions

7.44 The FBT exemption applies to benefits provided on or after 1 April 2003 and the CGT roll-over applies to CGT events that happen on or after 1 April 2003. [Schedule 7, items 5 and 9]

REGULATION IMPACT STATEMENT

Policy objective

7.45 To remove FBT from payments to worker entitlement funds where it is necessary for the payments to be made to the fund in order to provide for the protection or portability of employee entitlements.

7.46 Taxation Ruling TR 1999/5, which was issued by the Commissioner on 19 May 1999, ruled on the FBT treatment of certain payments to trusts by employers. The ruling is considered to apply to payments to worker entitlement funds. The ATO has stated that employers contributing to worker entitlement funds have until 1 April 2003 to comply.

Implementation options

Option 1

7.47 Provide an FBT exemption for certain payments into approved worker entitlement funds.

7.48 Under this option the FBT exemption applies to certain payments into approved worker entitlement funds. A fund will be approved if it is prescribed by regulation. Before a fund can be prescribed the Commissioner must be satisfied that the fund meets the criteria set out in the legislation. The criteria cover the level of employer control, the use
of fund assets, payments from the fund and maintenance of worker entitlement accounts.

7.49 Long service leave funds that are established and operating by or under a law of the Commonwealth, a State or a Territory will be taken to be approved worker entitlement funds without the need to be prescribed by regulation.

7.50 Only certain payments to approved worker entitlement funds will be covered by the FBT exemption. The FBT exemption will apply to payments made to approved worker entitlement funds that are required under an industrial instrument (as already defined in the FBTAA 1986) and are for the purposes of ensuring that an obligation to make leave payments or payments when an employee ceases employment is met.

**Option 2**

7.51 Provide an FBT exemption for certain payments into worker entitlement funds that meet relevant criteria, without the need for the funds to be specifically prescribed in regulations.

7.52 Under this option the funds would self-assess whether or not they were covered by the exemption.

**Assessment of impacts**

**Impact group identification**

7.53 The groups affected by this measure are worker entitlement funds and employers who contribute to worker entitlement funds.

7.54 It is estimated that there are currently around 30 to 40 worker entitlement funds that, under option 1, may apply to the ATO in order to satisfy the Commissioner that the certain criteria for the FBT exemption are met. Under option 2 there would be no requirement that these funds be prescribed, so they would have to self-assess.

7.55 It is estimated that there are around 10,000 employers currently ‘active’ in respect of worker entitlement funds in the building and related industries. Employers would have to self-assess under both options as to whether the payments they are making into approved worker entitlement funds qualify for the FBT exemption.
7.56 Workers whose entitlements are provided for by payments into worker entitlement funds are also affected by this measure. Without the FBT exemption it is expected that employers would seek to cease contributing to such worker entitlement funds from 1 April 2003 because of the increased cost due to the imposition of FBT.

Assessment of costs

Compliance costs

7.57 Under option 1 there will be some compliance costs involved for the worker entitlement funds that apply to be prescribed for the purposes of the FBT exemption. The funds may be required to provide the ATO with information such as how the funds operate, the documentation that governs their operation and documentation relevant to their establishment. For example, the funds may have to provide the ATO with copies of their trust deeds.

7.58 There would also be compliance costs for the funds associated with self-assessment under option 2, although the costs are likely to be smaller than under option 1. There may also be compliance costs on employers as they would have to inquire whether or not a fund has self-assessed itself as meeting the relevant criteria.

7.59 Option 2 would also provide less certainty to the funds in ascertaining whether or not they meet the criteria for the purposes of the FBT exemption. Option 1 provides certainty for the funds by naming them by regulation. The certainty provided by option 1 is also likely to limit the compliance costs on employers as they may not have to inquire whether or not a fund has self-assessed itself as meeting the relevant criteria.

7.60 Under both options, some funds may be required to change their constituting documents in order that certain payments into them qualify for the FBT exemption.

Administration costs

7.61 Option 1 is estimated to impose a small one-off administration cost on the ATO as the Commissioner will have to determine whether or not funds meet the relevant criteria before they are able to be prescribed by regulation. Option 1 will also involve some minor ongoing costs for the ATO in assessing future funds that may apply and in ensuring that those funds prescribed do not change their arrangements.

7.62 There could also be administration costs under option 2 as a result of funds and/or employers seeking certainty through the ATO
that is, funds may still seek certainty from the ATO by applying for a class ruling or sponsoring an employer in applying for a private binding ruling. The administration costs of option 2 would be reflective of how many funds sought rulings. If each fund sought a ruling the administration costs of option 2 would approach those of option 1.

7.63 Under both options there may be administration costs involved with employers seeking certainty through the ATO rulings system. That is, employers may seek private binding rulings to determine whether the payments they make to an approved worker entitlement fund satisfy the requirements for the FBT exemption.

**Government revenue**


**Assessment of benefits**

7.65 Option 1 provides certainty to the funds, employers and workers through setting out by regulation which funds are prescribed for the purposes of the FBT exemption. The certainty provided by option 1 is likely to reduce the compliance costs on employers as they may not have to inquire of a fund as to whether or not it has self-assessed itself as meeting the relevant criteria.

7.66 Prescribing the fund by regulation will also help to minimise the scope for tax planning opportunities to be undertaken. Without such prescription, that is if option 2 were adopted, there would be more scope for such tax planning opportunities as funds would be able to self-assess.

7.67 The benefit of both options is that they will ensure that the costs to employers in placing certain worker entitlements into approved worker entitlement funds will not increase as a result of the imposition of FBT.

**Consultation**

7.68 Consultation on the criteria that the funds would have to meet before being able to be prescribed was undertaken with representatives of worker entitlement funds. As a result of that consultation a number of technical amendments were made to the criteria.
Conclusion and recommended option

7.69 Option 1 is preferred given that the prescription of certain funds by regulation will provide certainty to funds and employers and will minimise the scope for tax planning opportunities.

7.70 It is considered that the possible advantages of the lower compliance costs offered by option 2 due to self-assessment are outweighed by the compliance costs involved with the lower certainty for worker entitlement funds and employers ascertaining whether or not a fund is able to access the FBT exemption.
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