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Tax Laws Amendment (2006 Measures No. 4) Bill 2006

Thomas John
Law and Bills Digest Section

Contents

Abbreviations

CGT	capital gains tax
ITAA 1997	*Income Tax Assessment Act 1997*
ITAA 1936	*Income Tax Assessment Act 1936*
OECD	Organisation for Economic Co-operation and Development
OECD Convention	*OECD Model Tax Convention on Income and on Capital*

Tax Laws Amendment (2006 Measures No. 4) Bill 2006

Date introduced: 22 June 2006

House: House of Representatives

Portfolio: Treasury

Commencement: The operative provisions of the Tax Laws Amendment (2006 Measures No. 4) Bill 2006 commence on receiving Royal Assent. Schedules 1, 2 and 4 as well as Schedule 3, items 1 and 2, will also commence upon the Bill receiving Royal Assent. Schedule 3, items 3 to 5 will commence retrospectively on 13 December 2005.

Purpose

The Tax Laws Amendment (2006 Measures No. 4) Bill 2006 (Bill) is an omnibus bill with each of the Schedules having its own purpose. They are set out as part of the analysis of each of the four Schedules below.

Background

The Backgrounds to the respective Schedules will be, where necessary, discussed as part of the analysis of each of the Schedules below.

Schedules of the Bill

The following Part only provides a brief discussion of the individual schedules. To avoid duplication between the Bills Digest and the Explanatory Memorandum, the reader may be referred to specific passages in the Explanatory Memorandum, for example, where examples highlight the operation of the proposed new laws.

Schedule 1—Marriage breakdown roll-over

Background

Schedule 1 will make modifications to the provisions regulating capital gains tax (CGT) implications applying to asset disposals triggered by marriage breakdowns. Where a capital gain or loss applies to an asset disposal arsing as a consequence of a marriage breakdown, it can be ignored. With respect to the current arrangements, the *CCH Australian Tax Master Guide 2006* notes that:

> A compulsory same-asset roll-over happens if a CGT event involves an individual (the transferor) disposing of an asset to, or creating an asset in, his/her spouse or former spouse (the transferee) because of: (a) a court order under the *Family Law Act 1975* or a corresponding foreign law; (b) a court-approved maintenance agreement or a similar agreement under a foreign law; or (c) a court order under the State Territory or for a law relating to an de facto marriage breakdowns (s 126-5).[1]

The changes contained in this Bill were announced by the then Minister for Revenue and Assistant Treasurer, the Hon. Mal Brough, in 2005.[2]

Main provisions

Items 1 and **2** propose changes to Subdivision 118B of the ITAA 1997. Subdivision 118B provides a framework under which certain capital gains or losses arising from a CGT event affecting a taxpayer's main residence may be ignored. Section 118-110 provides for the so-called *basic case*, subsequent sections provide expansions and limitations of the *basic case* exemption.[3]

Item 1 inserts proposed **section 118-75** concerning marriage breakdown settlements. It will provide that a capital gain or loss can be disregarded if there is a direct link between the gain on loss and an asset disposal arising as a result of the breakdown of a marriage. The provision also requires that it is reasonably likely that the breakdown is permanent. Whether separation has occurred, is to be determined under the provisions of the *Family Law Act 1975*.

Item 2 inserts proposed **section 118-178** which will provide a limitation to the *basic case* exemption where the CGT event occurs as the result of a marriage breakdown rollover pursuant to Subdivision 126A ITAA 1997.

Items 3 and **7** add additional subsections to sections 126-5 and 126-15 of the ITAA 1997. Proposed **subsection 126-5(3A)** and **126-15(5)** ensure that not only court-ordered CGT events come within the ambit of the marriage breakdown roll-over provisions, but also those which are the result of an arbitral award or certain written agreements. However, the CGT events triggered by arbitral awards and certain written agreements will only benefit from the marital breakdown roll-over exemptions if certain conditions can be fulfilled (**items 4** and **8**). The conditions will be set out in **item 9**, proposed **section 126-25** and include that:

- the couple has separated
- the separation is reasonably likely to be permanent, and

- the CGT trigger event is directly connected with the breakdown of the marriage of the fact of marriage.

Application and costs

The measures is this Schedule will apply after this law receives Royal Assent. According to the Explanatory Memorandum, the financial impact and the compliance costs are expected to be minimal.[4]

Comment

The proposed new law will allow the marriage breakdown roll-over provisions to apply in situations where the transfer of assets is the result of out-of-court settlements rather than court orders. The out-of-court settlements contemplated in this measure are arbitral awards and certain written or financial binding agreements. Parliament may note that the measure will make no changes to availability of the roll-over relief: only heterosexual couples, married or in *de-facto* relationships, will benefit from the expansion of the relief.[5] It will continue to be unavailable to same-sex couples.[6]

Schedule 2—Consolidation

Schedule 2 proposes changes to the consolidation rules relating to consolidated groups or Multiple Entry Consolidated (MEC) groups.[7] Specifically, the measure proposes to make changes to the *Income Tax (Transitional Provisions) Act 1997* (ITTPA) to remove a potential tax impediment to demergers.

Consolidation: roll-over provisions and mergers

For the purposes of consolidation, the application of certain pre-formation roll-over provisions is currently ignored to avoid a head company artificially increasing the tax cost settings of assets prior to, for example, a merger (section 701-35 ITTPA).[8]

Consolidation: roll-over provisions and demergers

However, where a demerger is planned, the demerging group may transfer assets between its members in order to facilitate the demerger. In this instance, ignoring the pre-formation roll-over provisions can deprive the demerging group of the benefits of the roll-over—an important consideration for the viability of a demerger. On the basis that tax considerations ought not to be an impediment to a demerger, the Explanatory

Memorandum clarifies that the application of these provisions in such circumstances is considered to be 'inappropriate'.[9] For further information, including in relation to the context of the proposed measure, the reader is referred to the discussion in the Explanatory Memorandum.[10]

Main provisions

The proposed changes relate to current section 701-35 ITTPA. **Item 6**, proposed **subsection 701-35(2A)** will provide that under certain circumstances pre-formation roll-overs will not be ignored, removing a significant impediment to demerging. Proposed **paragraphs 701-35(2A)(a)** to **(c)** will stipulate three cumulative prerequisites which must be fulfilled for this subsection to be triggered.[11]

Application and costs

Schedule 2 will apply retrospectively from 1 July 2002 (**item 8**). The anticipated costs to revenue are estimated to be a total of $35 million, that is, $20 million for the financial year 2006-07, and $5 million for each of the financial years 2006-07 to 2009-10.

Schedule 3—Simplified imputation system: imputation for NZ resident companies

Schedule 3 contains amendments to the trans-Tasman simplified imputation system measures. The measures have not been previously announced.

Background

In 2003, the Australian and New Zealand governments agreed to implement measures to overcome what is generally referred to as the 'triangular tax problem'.

'Triangular tax problem'

The 'triangular tax problem' occurs where:

> Australian shareholders in a New Zealand company operating in Australia were unable to access Australian sourced franking credits, with the same problem applying in reverse for New Zealand shareholders in Australian companies operating in New Zealand.[12]

Because companies were required to pay taxes without being able to pass on franking credits to its shareholders, the triangular tax problem resulted in the double taxation of distributions. To overcome this problem, both jurisdictions implemented legislation which enabled trans-Tasman companies to maintain franking or imputation credit accounts reflecting the tax paid in the respective comfort country.[13] For further background on the introduction of the measures introduced to overcome the triangular tax problem, the reader is referred to Bills Digest No. 175 of 2002-03.[14]

The triangular tax problem and non-assessable non-exempt income

Currently, the triangular tax problem still exists in relation to non-assessable non-exempt income. The Explanatory Memorandum notes that the current legislation does not operate as intended in relation to this income. Schedule 3 will make changes to the simplified imputation system to ensure that franked distributions by a New Zealand company, which are exempt or non-assessable non-exempt income, can be passed on by the Australian company on a pro-rata basis to its shareholders.

Main provision

Item 1 inserts proposed **section 220-350** into the ITAA 1997. This provision will provide that a franking credit will arise for the Australian company, where a New Zealand company makes a franked distribution either out of:

- attributed income (non-assessable non-exempt income pursuant to section 23AI ITAA 1936)
- non-portfolio dividend (non-assessable non–exempt income pursuant to section 23AJ ITAA 1936), or
- attributed foreign investment fund income (non-assessable non-exempt income pursuant to section 23AK ITAA 1936).

Where the distribution is only partially made as non-assessable non-exempt income, proposed **subsection 220-350(3)** will ensure that the amount of franking credit on the distribution is available only for this part of the distribution.

Item 3 of Schedule 3 makes a consequential amendment to the ITAA 1936 to ensure that companies' conduit foreign income is reduced to reflect the franking credit arising under proposed section 220-35 ITAA 1997.

Application and costs

The amendments apply retrospectively from 1 April 2003. This is the date from which New Zealand companies could maintain franking accounts in Australia.

The Explanatory Memorandum estimates that the financial impact of this measure will be nil, with only negligible compliance costs for taxpayers.[15]

Schedule 4—CGT and foreign residents

Background

Schedule 4 proposes substantial and consequential amendments to the ITAA 1997, ITAA 1936 and the *Financial Corporations (Transfer of Assets and Liabilities) Act 1993* to implement rules relating to capital gains or losses of foreign residents.

Under the current law, a foreign resident makes an income tax relevant capital gain or loss from a particular capital gains tax (CGT) event if the asset at the heart of the CGT event has the necessary connection with Australia. Under the proposed measures, foreign residents will only be taxed if the CGT event relates to an asset which qualifies as 'taxable Australian property' as defined under the new law.

The measures were promised in the 2005/06 Budget. The Hon. Peter Dutton, Minister for Revenue and Assistant Treasurer, announced the measure on 22 June 2006. The Minister highlighted four for introducing the measure, including:

- enhancing Australia's status as an attractive place for business and investment
- addressing the disincentives to foreign investment (and regional holding companies) in Australia arising from the current broad, but ineffective, application of CGT to foreign residents
- narrowing the range of assets on which a foreign resident is subject to Australian CGT to Australian real property, and the business assets of Australian branches of a foreign resident, and
- protecting the integrity of this narrower CGT tax base.[16]

Further, the measure is said to better align the Australian tax framework with the recommendations by the Organisation for Economic Co-operation and Development (OECD), especially as framed in the *OECD Model Tax Convention on Income and on Capital* (OECD Convention).

Main provisions

The core rules of this proposed measure will be contained in proposed **Division 855** of the ITAA 1997—Capital Gains and foreign residents (**item 2, Schedule 4**). Division 855 will be comprised of two subdivisions, with proposed **Subdivision 855A** stipulating the circumstances in which a foreign resident can disregard a capital gain or loss and proposed **Subdivision 855B** providing special rules for situations in which certain taxpayers become Australian residents for tax purposes.

Subdivision 855A—Disregarding a capital gain or loss by a foreign resident

Proposed **section 855-5** will set out the objects of the subdivision which are to improve:

- first—Australia's status as an attractive place for business and investment (**paragraph 855-5(1)(a)**), and
- second**—**the integrity of the CGT base (**paragraph 855-5(1)(a)**).

The provision also explains that the proposed measure will further align Australia's tax laws with international tax practice.

Proposed **section 855-10** stipulates:

- that a capital gain or loss can be disregarded if the person is a foreign resident just before the CGT event occurs and this event occurred in relation to an asset that is *not* 'taxable Australian property' (**paragraphs 855-10(1)(a) and (b)**), and
- the CGT assets in relation to which CGT events can occur (**subsection 855-10(2)**).[17]

Proposed **section 855-15** defines the five categories of CGT assets which are considered to be 'taxable Australian property'. Assets which are taxable Australian property include:

- taxable Australian real property (that is, pursuant to proposed **section 855-20**, any real property situated in Australia, but also mining, prospecting or quarrying rights)
- certain indirect Australian real property interests (these are certain interests held through interposed entities, proposed **subsection 855-25(1)**) to strengthen the CGT tax base[18]
- those used in carrying on a business through a permanent establishment in Australia (within the meaning of section 23AH ITAA 1936). Proposed **section 855-35** provides that capital gains or losses from business assets must be reduced if the assets were used for business purposes only for part of the period between their acquisition and the CGT event
- option or rights to acquire the above interests, and
- CGT assets covered by subsection 104-165(4) ITAA 1997.

These changes will mean that foreign residents who invests in shares in Australian companies or holding interests in certain trusts will benefit significantly.[19]

Proposed **section 855-25** stipulates that interests held by a holding entity in another entity (called the *test entity*) are indirect Australian real property interests if:

- the *non-portfolio interest test* (**paragraph 855-25(1)(a) –** this test is defined in proposed **section 960-195**, see below), and
- the *principal asset test* (**paragraph 855-25(1)(b) –** this test is defined in proposed **section 855-30**, see below)

are fulfilled.

Proposed **section 855-30** defines the *principal asset test*. Proposed **subsection 855-30(2)** stipulates that an interest held by a holding entity in a test entity fulfils the principal asset test if the market value of the test entity's assets, which constitute taxable Australian real property, exceeds the market value of those assets which are not taxable Australian real property. Proposed **subsection 855-30(4)** contains specific rules in relation to the treatment of the market value referred to in proposed **subsection 855-30(2)**. This subsection is linked to several forms of participation interests which are further defined in proposed **Subdivision 960-G—Participation interests in entities**.[20]

Proposed **section 855-40** makes provision for the tax treatment of foreign residents in relation to fixed trusts. A foreign resident may disregard gains derived from an interest in a fixed trust if the gain is attributable certain CGT asset held by the trust directly or indirectly and the asset is not taxable Australian property within the meaning of proposed section 855-15 or fulfils the conditions set out in proposed **subsections 855-40(5)** to **(8)**.

Subdivision 855B—Becoming an Australian resident

Proposed **subdivision 855B** sets out the rules which govern the situation where certain foreign residents become Australian residents for taxation purposes.[21] This subdivision applies to individual taxpayers and entities (proposed **section 855-45**), trusts (proposed **section 845-50**) and controlled foreign companies (proposed **section 855-55**).[22]

Consequential and other amendments

The measure requires a number of consequential and other amendments. These include amendments in relation to the managed fund provisions (for example, **items 29, 40** or **87**), interests in active foreign companies (**items 83** to **86**), provisions concerning currency calculation (**items 97** to **99**) and several additions to, and deletions from, the definition set out in section 995-1 (**items 100** to **108**). These amendments also include changes to:

- **sections 104-160**, **165** and **170** ITAA 1997—CGT event I1 and I2: Individual, company or trust stops being a resident. The amendments will ensure consistency between the proposed new regime applying to foreign residents and the provisions dealing with a taxpayer ceasing to be a Australian tax resident, and
- **Division 128** ITAA 1997—reflecting the changes of this Schedule in relation to the current provisions regulating the consequences of death for CGT purposes, especially the transfer of assets held by a foreign resident just before dying to a legal personal representative or beneficiary.[23]

Costs and application

The cost to revenue is expected to be $50 million for 2006-07, and $65 million for each of the following years. The Explanatory Memorandum notes that it is unlikely that the measure will cause large compliance costs for taxpayers. However, it is noted that the some foreign investors have increased compliance costs if they have 'indirect holdings in Australian real estate property'.[24]

Comment

Foreign investors holding shares in Australian companies and interests in certain trusts will gain significant benefits from this measure because these interests are excluded from CGT for foreign residents under the proposed regime. It has been noted that the measure is likely to be successful, providing a good stimulus for merger and acquisitions.[25] In their legal update of 20 July 2006, tax experts from the national law firm Minters Ellison identified several likely results from this measure, including:

- Increased activity by non-residents in Australian unlisted companies and unit trusts, and in interests of 10% or more in Australian listed companies, where the underlying assets do not comprise predominantly Australian real property
- [that] Australia will become a more desirable holding company location
- [that] non-residents will be more likely to structure the carrying on of a business in Australia via an Australian subsidiary entity rather than an Australian branch, and
- An increase in Australian investment by non-residents.[26]

Concluding comments

Where necessary, comments to each Schedule can be found immediately after their respective discussion.

Endnotes

1. CCH, CCH Master Tax Guide 2006, Melbourne, 2006, p. 763.
2. M Brough, then Minister for Revenue and Assistant Treasurer, Extending The Marriage Breakdown Capital Gains Tax Roll-Over Relief And Related Amendments, Media Release, Canberra, 4 May 2005.

3. The *basic case* stipulates that capital gains or losses made from a CGT event that occur in relation to a taxpayer's dwelling or the taxpayer's ownership interest in a dwelling can be disregarded in certain circumstances.

4. Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No. 4) Bill 2006, p. 4.

5. According to Mal Brough MP, then Minister for Revenue and Assistant Treasurer, the tax relief was specifically not extended to same-sex couples because: 'The capital gains tax rollover on marriage breakdown should not be the 'lead vehicle' for the implementation of social change'. M Brough, then Minister for Revenue and Assistant Treasurer, 'Answer to Question on Notice No. 243 'Taxation: Capital Gains Tax' (Questioner: M Danby MP), House of Representatives, 9 December 2004, p. 193.

6. This is a result of the definition chosen for de-facto in section 995-1 of the ITAA 1997. See also the explanation in Paragraph 1.20 of the Explanatory Memorandum, op. cit., p. 12.

7. The CCH Master Tax Guide 2006 explains that multiple entry consolidated groups are groups of 'Australian resident wholly owned subsidiaries of a common foreign holding company.' CCH Master Tax Guide 2006, p. 848.

8. ibid., pp. 834–5.

9. Explanatory Memorandum, op. cit., p. 22.

10. ibid., pp. 21–3.

11. For more information on the main provisions of Schedule 2, the reader is referred to the Explanatory Memorandum, ibid., p. 23.

12. CCH, op. cit., p. 143.

13. In Australia, the measure was incorporated as Division 220 into the ITAA 1997 by the Taxation Laws Amendment Bill (No. 6) 2003. See G Selleck and P Prince, 'Taxation Laws Amendment Bill (No. 6) 2003, Bills Digest, No. 175, Department of Parliamentary Services, Canberra, 2002-03, pp. 9-11. In New Zealand, the measure was enacted as the *Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003*.

14. Selleck and Prince, ibid., pp. 9–11.

15. Explanatory Memorandum, op. cit., p. 5.

16. P Dutton, Minister for Revenue and Assistant Treasurer, Government Introduces Further Improvements to the Tax System, Media Release, No. 39, Canberra, 22 June 2006 (http://treasurer.gov.au/pcd/content/pressreleases/2006/039.asp).

17. For details and further explanations in relation to the CGT events covered by this measure, see the Explanatory Memorandum, op. cit., pp. 35–6.

18. ibid., p. 38.

19. Deacons, Major Australian capital gains tax reforms for non-residents introduced, Legal Update, June 2006.

20. For a detailed explanation of the participation interests, including several examples and diagrams which illustrate the operation of the provision, the reader may refer to the Explanatory Memorandum, op. cit., pp. 41–52.
21. The original provisions dealing with this issue are located in Division 136 which is to be repealed (**item 1**, **Schedule 4**) and relocated to proposed Division 855.
22. A *controlled foreign company* is defined in section 340 of the ITAA 1936 to mean a company resident in a so-called listed country or an unlisted country if certain requirements are fulfilled.
23. For a detailed explanation of the consequential amendments the reader may refer to the Explanatory Memorandum, op. cit., pp. 56–60.
24. ibid, p. 5.
25. Corrs Chambers Westgarth Lawyers, Capital gains tax and foreign residents, Legal Update, 30 June 2006.
26. P Horden, Legal Update – Capital Gains Tax and foreign residents, Legal Update, Minter Ellison Lawyers, 20 July 2006.

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