The Senate

Economics Legislation Committee

Provisions of the Taxation Laws Amendment Bill (No. 7) 2003

September 2003

ISBN 0 642 71294 8

Printed by the Senate Printing Unit, Parliament House, Canberra.

Senate Economics Legislation Committee

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CHAPTER 1

INQUIRY INTO THE TAXATION LAWS AMENDMENT BILL (No.7) 2003

Background

1.1 The Taxation Laws Amendment Bill (No.7) 2003 (the Bill) was introduced into the House of Representatives on 26 June 2003 by the Hon. Peter Slipper MP, Parliamentary Secretary to the Minister for Finance and Public Administration.

Purpose of the Bill

1.2 The Bill is an omnibus Bill that makes various amendments relating to tax laws.

Reference of the Bill

1.3 On 13 August 2003, the Senate adopted the Selection of Bills Committee report No. 8 of 2003 and referred the Bill to the Senate Economics Legislation Committee for report by 8 September 2003.

Issues for consideration

1.4 The Selection of Bills Committee identified Schedules 5, 7, and 10 for particular consideration. Specific issues identified include:

- revenue risks associated with transitional rules to allow certain entities with foreign losses to be excluded from a consolidated group (Schedule 5);
- life offices may wish to comment on the adequacy of imputation rules (Schedule 7); and
- accounting and corporate tax advisers may wish to comment on the proposed tax treatment of investments in foreign hybrids (Schedule 10).

Submissions

1.5 The Committee advertised its inquiry on the Senate website, and contacted a number of individuals and organisations, including the Treasury and the Australian Taxation Office. They were alerted to the inquiry and invited to make a submission. A list of the parties from whom submissions were received appears at Appendix 1.

1.6 The Committee received five submissions. All submissions supported various aspects of the Bill.

Hearing and evidence

1.7 The Committee held one public hearing on this inquiry in Parliament House, Canberra on 22 August 2003. Witnesses who appeared before the Committee at that hearing are listed in Appendix 2.

1.8 Copies of the Hansard transcript are tabled for the information of the Senate. They are also available through the Internet at http://aph.gov.au/hansard.

Acknowledgment

1.9 The Committee is grateful to, and wishes to thank, all those who assisted with its inquiry.

CHAPTER 2

BACKGROUND TO THE BILL

2.1 This chapter outlines the main provisions of the Bill.

Contents of the Bill

2.2 The Bill is an omnibus Bill that makes various changes to the tax laws. The Bill amends:

- the income tax law to provide income tax and capital gains tax (CGT) exemptions for payments relating to persecution suffered and loss of, or damage to, property during the Second World War (Schedule 1);
- the *Income Tax Assessment Act 1997* (*ITAA 1997*) to update lists of specifically listed deductible gift recipients (schedule 2);
- the *ITAA 1997* from 1 July 2003 to:
    - Simplify the listing in the tax law of specifically deductible gift recipients by allowing listings to be made by regulation; and
    - To allow deductions for cash donations to deductible gift recipients to be spread over a period of up to 5 years (Schedule 3);
- the *Crimes (Taxation Offences) Act 1980* to correct a technical deficiency with the deeming mechanism in the Act, and to include Criminal Code harmonisation amendments to clarify the interpretation of offences under the Criminal Code (Schedule 4);
- the *Income Tax (Transitional Provisions) Act 1997* to allow certain entities with foreign losses to be excluded from a consolidated group for a transitional period (Schedule 5);
- the *A New Tax System (Goods and Services Tax) Act 1999* to ensure that certain supplies made as a result of the consolidation regime will not be taxable supplies (Schedule 6);
- the *ITAA 1997* to include imputation rules for life insurance companies. Broadly, the provisions set out the circumstances when franking credits and debits arise in franking accounts of life insurance companies, complementing the core Simplified Imputation System rules already introduced into the *ITAA 1997* (Schedule 7);
- the overseas forces tax offset provisions of the *Income Tax Assessment Act 1936* (*ITAA 1936*) to exclude periods of service for which an income tax exemption for foreign employment income is available (Schedule 8);

- the *ITAA 1997* to provide an automatic CGT roll-over for financial service providers on transition to the Financial Services Reform (FSR) regime during the FSR transitional period in certain circumstances (Schedule 9); and
- the *ITAA 1936* and the *ITAA 1997* to treat foreign hybrids as partnerships for all purposes of the income tax law. 'Foreign hybrid' includes limited partnerships, limited liability companies in the U.S. and other similar entities that are taxed on a partnership basis in their country of formation. However, limited partners will only be able to claim losses of the foreign hybrid to the extent of their exposure to economic loss through the foreign hybrid. Certain foreign hybrids will be excluded from this treatment where they are residents of Australia, or in general, where they would otherwise be dealt with under the foreign investment fund (FIF) regime and not the controlled foreign company (CFC) regime. Other amendments will be made to allow deductions or tax credits to be claimed for Australian or foreign taxes paid by the investors on income that is attributed to them under the CFC or FIF provisions, for a limited number of years. Amendments will also be made to provide greater certainty as to the foreign hybrid's country of residence for CFC purposes for those same years (Schedule 10).

CHAPTER 3

EVIDENCE PRESENTED TO THE INQUIRY

3.1 The Committee received five submissions to the inquiry. All submissions supported the Bill. Submissions made comment on Schedules 5, 6, 7, and 10. At the hearing, the Committee heard evidence from Treasury on Schedule 3.

Schedule 3 – Gifts and covenants

3.2 Schedule 3 allows eligible Deductible Gift Recipients (DGRs) to be listed by regulation, and allows deductions for cash donations to DGRs to be spread over a period of up to 5 years.

3.3 Treasury explained at the hearing that Schedule 3 will not affect the way in which Deductible Gift Recipients are approved, it will merely allow the specific listing of these organisations to be made by regulation.

> [T]he provisions in TLAB7 have no effect at all on the 18,000 organisations, to date, that seek to be DGRs under the general categories. We are only talking about those, to date, 100 organisations that the government has agreed to put in the law because they do not meet any of the general categories—or about ones that the government may agree to put in in the future. So these are all special cases. As part of the government agreeing to list them by name, the government could impose a restriction on it, if it chose, at present. Inserting that organisation by name via a regulation, as opposed to an amendment to the legislation, does not alter that process or outcome.[1]

Schedule 5 – Foreign losses and consolidation

Background to Schedule 5

3.4 Schedule 5 amends *The Income Tax (Transitional Provisions) Act 1997* to allow certain entities with foreign losses to be excluded from a consolidated group for a period of up to three years. The policy intent of these amendments is to account for anomalies that could have occurred in relation to the consolidation treatment of carry forward tax losses relating to foreign source income.

3.5 The consolidation regime allows groups of wholly-owned resident entities to elect to be treated as a single entity for income tax purposes. If a group chooses to do

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1 *Transcript of Evidence*, Barron, C. p.11.

this, all of a head company's eligible subsidiaries must generally be included in the consolidated group.[2]

3.6 Under existing law, a head company is restricted in using a joining entity's transferred losses (of any type) by the joining entity's 'available fraction'. This 'available fraction' is the proportion that the joining entity's market value represents in relation to the whole group at that time. The policy behind this rule is to ensure that the rate of loss recoupment inside consolidation approximates that which would have occurred in the absence of consolidation.[3]

3.7 This means that where a joining entity has carry forward tax losses relating to foreign source income, but, for example, the entity only represents 10% of the group's market value, the group will only be able to use 10% of those carry forward foreign losses. This may be despite the fact that these losses were incurred with the expectation that they could be used to offset considerable future income. The Bill would make amendments to allow the group to exclude that entity for a period of three years, within which time the entity could use the losses to offset foreign source income.

3.8 The amendments effectively act as a transitional measure, as to be eligible, the entity must have incurred the foreign loss prior to the 2002-2003 income year. Furthermore, the consolidated group must come into existence before 1 July 2004 and the entity must have been continuously wholly-owned by the head company from the start of 1 July 2002.[4]

Retrospective impact on projects

3.9 In supporting the Bill, the Corporate Tax Association of Australia (CTAA) argued that without the amendments, companies which had invested offshore in subsidiaries through a branch structure before the consolidation regime was developed, would be unable to access foreign losses as they might have planned to.[5] It argued that without these changes many projects could be rendered uneconomic.[6]

Three year limitation

3.10 Whilst supporting the amendments, the accounting firm Shaddick & Spence argued that the three year limitation on the ability of the foreign loss entity to remain outside a consolidated group is restrictive, and that many large foreign projects take some years to become 'income positive'. At the hearing Shaddick & Spence suggested that an indefinite period or at least a period of five years would have been better. They

2 *Explanatory Memorandum*, p.45.

3 *Explanatory Memorandum*, p.45.

4 *Explanatory Memorandum*, p.47.

5 *Submission 2*, p.3.

6 *Submission 2*, p.3.

did however, acknowledge that three years was in line with other consolidation measures.[7]

Entity leaving a consolidated group

3.11 The Institute of Chartered Accountants in Australia (ICAA) noted that without the amendments in Schedule 5, when an entity leaves a consolidated group, any carried forward foreign losses will remain with the head company, even though the leaving entity may continue to accrue foreign source income.[8]

Revenue considerations

3.12 Shaddick & Spence and the Corporate Tax Association of Australia (CTAA) both supported Treasury's assessment that the revenue impact of the measure would be neutral, and both suggested it may in fact be revenue positive.[9] At the hearing the CTAA stated:

> We would not have anticipated any costings being included in forecasts for disallowance of these losses in the overall consolidation package and this therefore is just fixing up an anomaly or what would have otherwise been, I suppose, considered a windfall gain to the revenue. The provisions would only apply for a limited time of three years and overall, as Mr Spence has said, would generally be revenue positive.[10]

Schedule 6 – GST – interaction with consolidation regime

3.13 Schedule 6 of the Bill would amend the *A New Tax System (Goods and Services Tax) Act 1999* to ensure that certain supplies made in relation to the consolidation regime would not be taxable supplies.

3.14 The Corporate Tax Association of Australia supported this measure in their submission, but argued that further amendments are required to ensure certain income tax and GST interactions maintain the existing outcomes when moving into the consolidation regime. They expressed concern that under the 'single-entity' rule in the consolidation regime a consolidated group could be denied an income tax deduction for non-creditable GST arising on an intra-group acquisition.[11] At the hearing it explained:

> [I]n consolidation the group is treated as a single entity and, for all intents and purposes, cannot make a supply or make an acquisition within itself. So we ignore that transaction. But in the GST we still get denied the input tax

7 *Transcript of Evidence*, Spence, K. p.3.

8 *Submission 4*, p.3.

9 *Submission 2*, p.3; *Submission 3,* p.6.

10 *Transcript of Evidence*, p.3.

11 *Submission 2*, p.4.

> credit and it is that economic loss that the group potentially would not be able to claim a tax deduction to which we are referring. So we would very much like to see in some subsequent bill an amendment made there to ensure the preconsolidation situation is maintained in a post-consolidation environment.[12]

3.15 The CTAA acknowledged that the matter had been raised with Treasury.[13]

Schedule 7 – Imputation for life insurance companies

3.16 Schedule 7 amends the *ITAA 1997* to include imputation rules for life insurance companies. The provisions set out the circumstances when franking credits and debits arise in franking accounts of life insurance companies, complementing the core Simplified Imputation System rules already introduced into the *ITAA 1997.*

3.17 The Taxation Institute of Australia expressed support for Schedule 7, but noted that there were minor technical issues that may arise:

> [T]here is the issue of the franking deficit tax offset problem, in as much as s 205-70(2) step 2 could provide a problem for any taxpayer with a franking deficit at year end where their income year straddles 30 June 2002 (i.e. introduction of the new simplified imputation system rules). It is possible, even where a taxpayer may have underfranked a dividend (and therefore suffered s 160APX debit), to be in deficit at year end and subject to franking deficit tax, whereas the offset for the franking deficit tax would only be as to 70% even though there has been, in fact, no overfranking. This represents effectively a double penalty. However this is only a transitional issue and could be adjusted by some transitional provision inserted into the amending bill. The Institute would be loath to see the whole thing delayed unless such an amended provision could be easily inserted. [14]

Schedule 10 – Foreign hybrids

3.18 Schedule 10 would amend the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997* to ensure that foreign hybrid entities (broadly U.K. and U.S. limited partnerships and limited liability partnerships and U.S. limited liability companies) are treated as partnerships for the purposes of income tax, as opposed to companies.

3.19 Limited partnerships, limited liability partnerships and limited liability companies (ie. 'foreign hybrids') are particularly common in the U.S. and U.K., as in those jurisdictions they are used to facilitate joint investment between tax-exempt or concessionally taxed entities, and taxable entities. They are commonly used in the case of pension funds.

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12 *Transcript of Evidence*, p.5.

13 *Transcript of Evidence*, p.5.

14 *Submission 5*, p.2.

3.20 Uncertainty and the possibility of double taxation exists for Australian tax payers who invest in such entities. Currently taxpayers with interests in foreign hybrids may be subject to the Foreign Investment Fund (FIF) or controlled foreign company (CFC) rules. However, in the case of deemed CFCs, the entity would be treated as a company resident in no particular jurisdiction.

3.21 In supporting the Bill the Corporate Tax Association of Australia (CTAA) argued that a potential and unintended consequence of that treatment could be that the income of such an entity that is beneficially attributable to an Australian resident company tax payer could be taxed in Australia, and also taxed in the foreign jurisdiction.

3.22 The CTAA argued that this could occur, because the active income test could not be used, and that the income tax paid in the foreign jurisdiction would not be recognised for the purposes of Part X because that tax would be paid by the partner/investor and not the deemed CFC itself.[15] It contended that active income of an entity formed under U.K. or U.S. law could be subject to less favourable tax treatment than non-active income derived in a less comparable tax system, or even a tax haven.[16] It stated that it has been advised that income from such investments could, in certain circumstances, be subjected to total effective tax rates of up to 60 or 71%.[17]

3.23 The amendments were strongly supported in submissions.[18] The Institute of Chartered Accountants in Australia state that the amendments will be particularly helpful for small-value investors, who would be able to gain Foreign Investment Fund (FIF) treatment.[19]

Conclusion

3.24 The Committee notes that all submissions support the Bill. The only concerns raised in submissions were minor technical issues relating to Schedules 6 and 7, and when raising these concerns, submitters emphasised that these issues should not hinder the passage of this Bill.

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15 *Submission 2*, p.5.

16 *Submission 2*, p.6.

17 *Submission 2*, p.6.

18 *Submission 2*, p.4.; *Submission 4*, p.4. *Submission 5*, p.3.

19 *Submission 4*, p.5.

Recommendation

The Committee recommends that the Bill be passed.

SENATOR GEORGE BRANDIS
Chairman

Senate Economics Legislation Committee
Taxation Laws Amendment Bill (No.7) 2003
Labor Senators' Minority Report

This minority report relates to Schedule 3 of the bill – Gifts and Covenants.

There has been considerable public controversy arising from the draft legislation circulated by the government to deal with the tax treatment of charities. A number of charities have argued that the draft legislation would have the effect, if enacted, of gagging their participation in public debate.

The government says the bill is only intended to codify 400 years of common law on the definition of a charity. The question is why it is necessary to codify such well established common law? The charities believe that the government may use the new law to restrict them entering into public debate on issues such as the extent of need in an area, or government policy and resource allocation by arguing that their activities are more than incidental to the organisation's charitable purpose, thus denying them eligibility for tax exempt status.

Taxation Laws Amendment Bill (No.7) 2003 contains a schedule dealing with a related issue – the method of conferring DGR (deductible gift recipient) status on an organisation. Currently some organisations receive DGR status by being explicitly named in legislation. This bill proposes to change that to naming organisations in regulations. The government would also be able to use the regulations to impose conditions or time limits on eligibility for DGR status for a particular organisation.

While governments have in the past put conditions on the purposes for which deductible gift recipient status has been given that has been done through legislation. The regulatory power provided by this bill could make it easier for the government to act against organisations to restrict their participation in public debate.

The Committee inquired whether there were any safeguards in the legislation to protect DGRs against the government abusing this power to make regulations. The response from Treasury was:
"No, and that is replicating the current situation where the government can choose to specifically name an organisation in the legislation, in order that it receive deductible gifts, and to impose any conditions that it chooses."

The essential issue here is that under the present arrangements using legislation, the parliament not only has the opportunity to scrutinise any conditions it also has the ability to amend them. By allowing organisations to be named in regulations parliament would be giving up the capacity to amend obnoxious conditions. The only option it would be left with is to reject the entire regulation and in so doing would deny the organisation proposed to be named DGR status.

Recommendation

We recommend that the Senate delete that part of Schedule 3 that provides for the naming of DGR's by regulation.

Senator Ursula Stephens
Deputy Chair

Senator Ruth Webber

Appendix 1

Submissions Received

Submission Number	Submittor
1	Investment and Financial Services Association Ltd (IFSA)
2	Corporate Tax Association of Australia Inc
3	Shaddick & Spence
4	The Institute of Chartered Accountants in Australia
5	Taxation Institute of Australia

Appendix 2

Public Hearing and Witnesses

Friday, 22 August 2003 Canberra

BARRON, Ms Christine, Manager, Individuals Tax Unit, Department of the Treasury

JONES, Mr Robert John, Manager, International Tax and Treaties Division, Department of the Treasury

MOONEY, Mr Michael James, Project Manager, Foreign Hybrids Measure (EL2.1), Australian Taxation Office

O'CONNOR, Mr Mark John, Manager, Individuals and Entities, Tax Division, Department of the Treasury

REGAN, Mr Anthony Clive, Manager, Capital Gains Tax Unit, Business Income Division, Department of the Treasury

SPENCE, Mr Kenneth John, Partner, Shaddick and Spence

TIMMERS, Mr P. Miquel, Assistant Director, Corporate Tax Association of Australia Incorporated