Chapter 2

The bill

Schedule 1—Distributions to entities connected with a private company

Overview

2.1 Schedule 1 of the bill amends conditions relating to payments and loans to entities—shareholders or associates—connected with a private company under Division 7A of the *Income Tax Assessment Act 1936* (ITAA). As noted in the second reading speech, the schedule is intended to reduce the likelihood that taxpayers will inadvertently trigger a deemed dividend, reduce the punitive nature of the provisions and give the Commissioner of Taxation a discretion to disregard a deemed dividend triggered by honest mistakes:

> The amendments in this schedule reduce both the extent to which taxpayers can inadvertently trigger a deemed dividend under division 7A of the Income Tax Assessment Act 1936, and the punitive nature of the provisions. The amendments remove the automatic debiting of the company's franking account when a deemed dividend arises under division 7A.
>
> The amendments give the Commissioner of Taxation a discretion to disregard a deemed dividend that has arisen because of an honest mistake or omission by a taxpayer, providing greater flexibility to administration of the provisions. Further, certain shareholder loans will be able to be refinanced without triggering a deemed dividend, and division 7A compliant loans will be exempted from fringe benefits tax.[1]

2.2 The effect of the amendments is to reduce ongoing compliance costs and tax penalties for private companies.[2]

Removal of automatic debiting of a private company's franking account

2.3 Currently, where a deemed dividend arises under Division 7A of Part III of the ITAA 1936, the private company's franking account is debited and the shareholder

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1 The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, *House of Representatives Hansard*, 10 May 2007, p. 1.

2 The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, *House of Representatives Hansard*, 10 May 2007, p. 2.

pays tax on the deemed dividend at their marginal rate of tax.[3] The purpose of this Division is to prevent private companies from making tax-free distributions of profits to shareholders in the form of payment, loan or forgiven debt.[4]

2.4 The Explanatory Memorandum (EM) describes this current arrangement as a 'double penalty', debiting the private company and taxing the shareholder.[5] It notes that 'the tax impost resulting from a breach of Division 7A is considered to be out of proportion with the tax mischief involved'.[6] Accordingly, Schedule 1 of the bill will remove the automatic debiting of a private company's franking account. This means that shareholders and associates will be taxed only on the amounts received from the private company. These amounts will be included in their assessable income as unfranked dividends. This measure will be backdated to 1 July 2006.

2.5 Division 7A of the ITAA 1997 is a self-assessing provision. Prior to December 1997, the provision only applied when the Commissioner formed the opinion that the amount loaned, paid or credited represented a distribution of profits. After 4 December 1997, the provisions relating to the treatment of deemed dividends under Division 7A of the Act operated automatically through self-assessment. However, there have recently been concerns that this system is 'unduly punitive' and that its requirements for compliance are unclear. The EM explains that advice from the accounting profession and the ATO 'indicates that in practice the application of Division 7A is widely misunderstood by taxpayers resulting in inadvertent and frequent breaches of the provisions'.[7]

Section 109RD

2.6 To avoid inadvertent breaches of Division 7A, new Section 109RD provides discretion for the Commissioner of Taxation to disregard deemed dividends or allow them to be franked where they have been triggered by honest mistakes or omissions by taxpayers.[8] This discretion will apply to the 2001–02 income year and later income years. Further, the Commissioner will have discretion to disregard a deemed dividend where minimum yearly repayments have not been made on a private company loan because of circumstances beyond the control of the recipient of a loan.[9] The Commissioner can specify a later time by which these repayments must be made.[10]

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3 A franking account is an account into which taxation debits and credits are passed on to shareholders who have received franked (tax paid) dividends on their shareholdings.

4 EM, p. 38.

5 EM, p. 12.

6 EM, p. 38.

7 EM, p. 39.

8 EM, p. 12 and pp 21–29.

9 EM, p. 13.

10 EM, p. 30.

Amendments to conditions applying to shareholder loans

2.7 Schedule 1 of the bill makes five key changes to the treatment of loans made by a company to a shareholder under Section 7A of the ITAA (1936).

2.8 The first relates to the conversion of a private company's payment to a shareholder into a loan. Currently, paragraph 109D(3)(c) of the ITAA 1936 states that these payments cannot be treated as a loan unless there is an express or implied obligation to repay the amount to the private company. Where this obligation applies, the money must be repaid or put 'on a commercial footing' before the company's lodgement day for it not to be treated as a dividend.[11]

2.9 The bill allows a payment not already covered by paragraph 109D(3)(c) to be converted to a loan. The shareholder will have until the lodgement date for the company's tax return to either repay the loan in full or enter into a written loan agreement with the company. This can be done under the terms of Section 109N of the ITAA 1936, which requires minimum yearly repayments on the loan before the end of each financial year until the loan is repaid. This amendment will thereby prevent a deemed dividend arising.[12]

2.10 Second, the bill amends the treatment of loans paid from shareholders to private companies that fall short of minimum yearly repayments. Currently, where these repayments have not been met in an income year, the amount of the deemed dividend is the amount of the outstanding loan balance. The bill amends the amount of the deemed dividend to be the amount of the shortfall in the income year.[13]

2.11 Third, the bill enables private company loans to shareholders to be refinanced without resulting in a deemed dividend. Section 109N of the Act states the criteria for loans that do not attract a deemed dividend under Division 7A. Subsection 109R(2) provides that payments must not be taken into account—in the context of the repayments referred to in paragraph 2.8—if the shareholder intended to obtain the loan from the private company of an amount similar to or larger than the payment. The EM explains that this subsection prevents loans from being continually refinanced, thereby avoiding the operation of Division 7A.

2.12 The bill inserts subsection 109R(5) so that a loan can be refinanced without the attracting a deemed dividend under the provisions of subsection 109R(2). The context for this amendment is when a private company loan becomes subordinated to a loan from another entity, and the refinancing of the private company loan by the shareholder takes place because of that subordination.[14] The subordination must have arisen because of circumstances beyond the control of the shareholder.

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11 EM, p. 16.

12 EM, p. 17.

13 EM, pp. 17–18.

14 EM, p. 19.

2.13 The EM gives the example of a shareholder with a loan from the private company and a bank loan. The shareholder defaults on the bank loan and is required by the bank to make the private company loan subordinate to the bank loan. In other words, the shareholder must make the required payments on the bank loan before any repayments can be made on the loan from the private company. The shareholder can, under the provisions of the bill, refinance the loan with the private company to extend the term of the loan and reduce the yearly repayments.[15]

2.14 Fourth, the bill provides for the term of a loan to be extended in circumstances where an unsecured loan is converted to a loan secured by a mortgage over real property. Under Section 109N, the maximum term of this loan is 25 years less the period of the term already expired in the old loan. The EM provides the example of a private company that makes an unsecured seven year loan to one of its shareholders. The loan is refinanced after three years and a new loan is secured with the company by a mortgage over real property. The new loan is a maximum term of 22 years (25 less 3 years).[16]

2.15 Fifth, the bill amends Section 109UA of the Act to exempt guaranteed loans from attracting a deemed dividend where the shareholder enters into a loan agreement with the private company and that loan meets the requirements of section 109N. The EM provides the example of a bank that has made a loan to a shareholder of a private company. The company guarantees the loan but the shareholder defaults, meaning the company is liable to make a payment to the bank. This liability will cause a deemed dividend to arise unless the company and the shareholder enter into a loan agreement that meets the minimum interest rate and maximum term criteria in section 109N.[17]

Schedule 2—Transitional excess non-concessional contributions

The amendments

2.16 These amendments to the *Income Tax (Transitional Provisions) Act 1997* are designed to close a potential loophole that might result from the recently-legislated simplified superannuation arrangements.

2.17 Under that legislation, non-concessional superannuation contributions up to a limit of $1 million may be made to a superannuation fund by a member of the fund from 10 May 2006 to 1 July 2007, and receive concessional taxation treatment from 1 July 2007.

2.18 Superannuation contributions made by persons on behalf of other persons, but which are not government co-contributions or contributions made on behalf of a

15 EM, p. 20.

16 EM, p. 20.

17 EM, p. 32.

spouse, employee or child, are not currently subject to the cap. These amendments would ensure that such contributions also would be subject to the cap.

2.19 The measure was announced by the Minister for Revenue and Assistant Treasurer on 24 April 2007. The Minister announced that the Government would act to address any avoidance activities undertaken with the date of effect of 7 December 2006.

Schedule 3—Capital gains of testamentary trusts

2.20 The provisions of Schedule 3 are summarised in the Explanatory Memorandum (EM) as follows:

> These amendments amend Subdivision 115-C of the ITAA 1997 to allow a trustee of a resident testamentary trust[18] to make a choice that has the effect that the trustee, rather that an income beneficiary, will be assessed on capital gains of the trust.

2.21 Under the current law, the taxation liability of an income beneficiary is assessed on the beneficiary's share of the testamentary trust's income which may include capital gains from which the beneficiary is not entitled to benefit.

2.22 The Schedule is intended to enable trustees of the trust to choose to be assessed on the capital gains of the trust, so that, if the choice is made, tax will in effect borne by the capital beneficiaries of the trust who will be assessed on capital gains of the trust.

2.23 In a detailed explanation the Government has provided several examples to illustrate how the proposed law would operate, under the following headings:

- Trusts for which a choice can be made;
- Circumstances in which a choice can be made;
- How choice is to be made; and
- Consequences if the trustee makes a choice.[19]

The EM provides information with regard to the period for making a choice and for amending an assessment to give effect to a choice.

Schedule 4—Taxation of superannuation death benefits to non-dependants

2.24 Schedule 4, ‘Taxation of superannuation death benefits to non-dependants (eg: parents and siblings) of defence personnel and police killed in the line of duty’, will amend the *Income Tax Assessment Act 1997* (ITAA 1997). The amendments will

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18 A testamentary trust is a trust which is created through the grantor's will and does not become operational until the grantor's death.

19 EM, pp 58 – 65.

make superannuation death benefits paid to non-dependants of defence personnel and police tax free, in line with the concessional treatment that will be applied for dependants of these people from 1 July 1997 following the introduction of the Simplified Superannuation reforms.

2.25 The circumstances of 'killed in the line of duty' will be set out in regulations. There will be some excluded circumstances, such as suicide, which will over-ride included circumstances such as participation in an overseas deployment.

2.26 While the legislation will apply from 1 July 2007, the concessional treatment of benefits for non-dependents will be back-dated to 1 January 1999 through the use of ex-gratia payments, which are to be made on behalf of the Commonwealth by the Commissioner of Taxation. The cost of the amendments is $0.2 million per year.[20] It is not clear whether this costing also includes the cost of ex-gratia payments.

Schedule 5—Thin capitalisation

2.27 This is a very short schedule making one simple amendment to the ITAA 1997. The effect of the amendment will be to extend by one year a transitional period relating to the application of accounting standards under the thin capitalisation rules.

2.28 The thin capitalisation rules are designed to prevent foreign-owned entities from allocating excessive debt to their Australian operations. They do this by disallowing business expenses that would otherwise be legitimate business expenses if debt levels exceed certain thresholds.

2.29 On 1 January 2005, Australia introduced new accounting standards that are equivalent to International Financial Reporting Standards. These replaced the previous Australian Generally Accepted Accounting Standards. There are some differences between the two sets of standards, which have an effect on the thin capitalisation calculations of a number of entities.

2.30 Accordingly, the Government introduced a three-year transitional arrangement allowing entities to elect, on an annual basis, to use one or the other standard for the purposes of making calculations under the thin capitalisation rules. This arrangement is extended by one year as a result of the amendment in the schedule.

2.31 The second reading speech for the bill states that the extension will enable a 'thorough assessment' of the impact on the thin capitalisation rules of the change in accounting standards. It will also provide time to develop and consult on any changes to the rules that are considered appropriate.[21]

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20 EM, p. 6.

21 The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, *House of Representatives Hansard*, 10 May 2007, p. 1.

Schedule 6—Repeal of dividend tainting rules

2.32 According to the EM, this schedule will repeal the seven sections (46G to 46M) of the ITAA 1936 that deal with dividend tainting rules because the schemes that the rules were primarily directed at preventing can no longer be entered into.

2.33 There are also three consequential amendments proposed to the ITAA 1997. The proposed amendments will ensure that distributions from a share capital account continue to be unfrankable, and will also enable the Commissioner of Taxation, when considering whether to apply a general anti-avoidance rule relating to the imputation system, to take into account whether a distribution is sourced from unrealised or untaxed profits.

Schedule 7—Clarification of exemption from interest withholding tax

2.34 Schedule 7, 'The Clarification of exemption from interest withholding tax (IWT)', more closely specifies those debt interests that are eligible for exemption from Interest Withholding Tax (IWT).

2.35 The amendments proposed in Schedule 7 ensure this exemption remains consistent with the Government's original policy, which was to ensure that Australian business does not face a restrictively higher cost of capital, or constrained access to capital, as a result of the IWT burden being shifted from the non-resident lender to the Australian borrower.

Background

2.36 Legislative amendments in 2005 extended various exemptions in order to reflect the 2001 changes to Australia's debt/equity rules. This was to enable hybrid instruments now characterised as debt interests (under the debt/equity rules) as eligible for the exemption where they performed a capital raising function. However, the 2005 amendments unintentionally resulted in the exemption being potentially available to all debt interests. This represented a threat to the integrity of the tax system and was not consistent with the Government's original policy intent.

2.37 Schedule 2 of the Tax Laws Amendment (2006 Measures No. 7) Bill 2006 sought to introduce changes to the IWT. The bill was considered by this committee in February 2007. During that inquiry, four of the five submissions received by the committee expressed concerns about the amendments in Schedule 2, particularly with regard to the effect of the changes on the syndicated loan market.

2.38 Submitters were concerned that Schedule 2 reversed the pre-existing situation and would prejudice the ability of Australian firms to participate in the syndicated loan market. They contended that without the IWT exemption, Australian borrowers would be forced to pay more for the cost of capital as non-resident lenders would charge higher rates on loans to compensate for IWT. In its report of February 2007, the committee described the concerns expressed in submissions and evidence about syndicated loans and expressed the view that it would be desirable for the Government

to respond to concerns raised about this issue. Ultimately, Schedule 2 was removed from the bill when it came before the Senate in March 2007.

2.39 Schedule 7 of this bill will reintroduce the amendments which the Government believes now fully expresses the Government's initial intentions.

Definitions

What is Interest Withholding Tax?

2.40 IWT is a 10 per cent withholding tax on the gross amount of interest paid or credited from Australia to non-residents.[22]

> IWT was first imposed in 1968 to replace an assessment system of taxing interest payments to non-residents that was open to abuse. The view underlying the IWT system was that since IWT levied by Australia would generate a tax credit in the lender's home country, the burden of the tax would fall on foreign revenue collections. Unfortunately, the response of many foreign lenders was to increase interest margins on loans to Australia, shifting the burden of the tax to Australian borrowers. To avoid imposing higher capital costs on Australian business, limited exemptions from IWT were introduced in 1971 for certain types of offshore borrowing. The prime objective of the exemptions was, and has remained, to ensure Australian business does not face a higher cost of capital as a consequence of the imposition of IWT. The limitations also recognised that some forms of money raising have the potential to reduce the integrity of Australia's tax system and, consequently, the exemptions were targeted at arm's length arrangements.[23]

Further definitions

Debenture: is a long term debt instrument used by governments and large companies to obtain funds. A debenture is unsecured in the sense that there are no liens or pledges on specific assets. It is however, secured by all properties of the issuing company not otherwise pledged. In the case of bankruptcy, debenture holders are considered general creditors.[24]

Debt Interest: is defined by reference to Division 974 of the *Income Tax Assessment Act (ITAA) 1997*. It is a broad term that includes both financial

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22 Explanatory Memorandum (EM), p. 85. The taxation of interest paid or credited from Australia to non-residents, and residents operating through offshore permanent establishments, is dealt with in the IWT provisions contained in Division 11A of the *Income Tax Assessment Act 1936*. It provisions work in conjunction with the *Income Tax (Dividends, Interest and Royalties) Withholding Tax Act 1974*. The obligation for collecting the IWT is placed on the person making the payment (ie, the borrower). The provisions define 'interest' and stipulate when an amount of interest is subject to withholding tax.

23 EM, pp 81–82.

24 Bills Digest, p. 15.

instruments and financing arrangements, and embeds the concept of a non-contingent obligation to pay an amount to the holder of the debt interest, at least equal to its issue price, in the future. For the holder, this reflects receipt of a financial benefit, which need not amount to interest.[25]

Non-debenture debt: is a debt that is not secured by way of a debenture and would most likely be a debt secured by a charge over a specific asset of the issuing company.[26]

Non-equity shares: are shares in a company that are viewed as equity on a legal form assessment, but characterised as debt interests based on economic substance. As non-equity shares perform a similar capital raising function to debentures it is appropriate that they be eligible for IWT exemption, subject to satisfying the public offer test. An example of such an instrument may be a preference share issued by a company. Generally, preference share dividends, and capital returns (if any) are paid first before dividends paid in respect of ordinary shares.[27]

Syndicated loans: are loans or other form of financial accommodation where there are at least two lenders. They are close substitutes for debentures and are often used for large debt capital raisings as they are a means by which Australian borrowers can access offshore lending in order to benefit from greater liquidity in some of these markets.[28]

Syndicated loan facility: is a written agreement between one or more borrowers and at least two lenders and describes itself as a 'syndicated loan facility' or a 'syndicated facility agreement'. The agreement can accommodate one lender with the provision for the addition of other lenders.

Summary of the new law

2.41 Schedule 7 specifies that only non-debenture debt interests that are non-equity shares (including those subject to the related scheme rules in section 974-15 of the ITAA 1997), and syndicated loans will be eligible for IWT exemption, unless the non-debenture debt interest is prescribed as eligible for exemption by regulation.[29] The amendments clarifying the scope of the IWT exemption will apply only to interest paid in respect of debt interests issued on or after 7 December 2006.

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25 Senate Standing Committee on Economics, *Tax Laws Amendment (2006 Measures No. 7) Bill 2006*, February 2007.

26 Bills Digest, p. 15.

27 Bills Digest, p. 15.

28 EM, p. 83 & p. 89.

29 EM, p. 83.

2.42 Schedule 7 does differ in one significant effect to the IWT amendments that were introduced on 7 December 2006 in that the current amendments explicitly provide that debt interests that are syndicated loans are eligible for IWT exemption.[30]

Schedule 8—Forestry managed investment schemes

Background

2.43 Schedule 8 is the culmination of a review of the taxation of plantation forestry conducted by the Commonwealth Government since July 2005. In December 2006, the Assistant Treasurer and Minister for Revenue, the Hon. Peter Dutton MP, announced new arrangements for the taxation of investments in forestry managed investment schemes. The centrepiece of these plans was a separate statutory provision in the ITAA 1997 entitling investors in forestry managed investment schemes to immediate upfront tax deductibility for all expenditure. Mr Dutton explained that the proposed arrangements will provide greater certainty for investors, the continued expansion of Australia's plantation estate and reduced reliance on both native forests and overseas imports.[31] These are the key goals of the 1997 strategy, *Plantations for Australia: the 2020 Vision*.[32]

Schedule 8 Part 1—Investments in forestry managed investment schemes

2.44 The main provision of Schedule 8, Part 1 is to insert into Division 394 of the ITAA 1997 a tax deduction for initial and secondary investors in forestry schemes equal to 100 per cent of their contributions.[33] To be eligible for the deduction, however, there must be a 'reasonable expectation' at 30 June in the year in which an amount is first paid under the scheme, that at least 70 per cent of that expenditure is direct forestry expenditure (DFE).

2.45 The '70 per cent' rule is set out in section 394-35 of the ITAA 1997. The EM notes that a 'reasonable estimate' of 70 per cent DFE is:

> the amount of DFE under the scheme (the *sum* of the net present values of all DFE under the scheme) *divided* by the amount of payments under the scheme (the *sum* of the net present values of all amounts that participants in the scheme have paid or will pay) must be greater than or equal to 70 per cent.

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30 EM, p. 96.

31 The Hon Peter Dutton MP and Senator the Hon. Eric Abetz, 'Review of the Taxation of Plantation Forestry', *Joint Media Release*, 21 December 2006. The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, *House of Representatives Hansard*, 10 May 2007, p. 3.

32 *Plantations 2020*, http://www.plantations2020.com.au/vision/ (accessed 24 May 2007).

33 A secondary investor is an investor who acquires an interest in a forestry scheme through secondary market trading (ie: trading in intangible assets—such as securities—after their initial issue and purchase).

2.46 Sections 394-10 and 394-15 of the ITAA 1997 establish the requirements for these deductions. The investor must be in a scheme whose purpose is establishing and felling trees in Australia, and must not have day-today control over the operation of a scheme. In addition, the trees must have all been established within 18 months of the end of the income year in which the first payment is made by the investor.[34] This provision extends the current 12 month prepayment rule.

2.47 The bill is a deliberate measure to encourage investment in forestry schemes in Australia through the tax system. The ITAA 1997 currently denies initial investors in forestry schemes from claiming tax deductions, as it excludes expenses that are capital in nature. Further, secondary investors do not receive deductions for their ongoing costs.[35] The new rules proposed in the bill waive the current requirement for taxpayers to demonstrate that they are 'carrying on a business' in order to access the deduction. Nor is there any requirement that the amount paid is revenue in nature.[36]

Schedule 8 Part 2—Disposals of interests in forestry managed investment schemes

2.48 There is currently uncertainty as to the deductibility of investors' contributions to forestry schemes. This uncertainty extends to whether an investor that disposes of their interest in the scheme prior to harvest had the intention of carrying on a business until harvest. This intention is required to qualify for some deductions. In practice, this is most likely to apply to cases of hardship. Where interests are disposed of due to hardship, there is also uncertainty as to how an acquiring investor's acquisition costs and proceeds are treated.

2.49 The Government has decided through these amendments to provide certainty to investors and industry by providing a specific deduction for investments in forestry managed investment schemes. As investors are no longer required to have an intention to hold the interests until harvest under the specific deduction, this change facilitates secondary market trading of those interests.

2.50 The existence of secondary markets, which the Government supports, should increase the financial transparency of forestry scheme investments by introducing pricing information into the market and increasing liquidity. This should increase the relative attractiveness of forestry investments.[37]

2.51 Schedule 8, Part 2 of the bill clarifies the tax treatment for sale and harvest proceeds that are received by secondary investors in forestry managed investment schemes and payments made by secondary investors in relation to forestry schemes. They provide for the deductibility of ongoing contributions made by a secondary investor to a forestry scheme and clarify the income tax treatment of sale or harvest

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34 EM, p. 100.

35 EM, p. 102.

36 EM, p. 103.

37 EM, pp 127–128.

proceeds. These amendments are introduced together with a specific deduction provision for investors in forestry schemes.

2.52 Schedule 8, Part 2 introduces amendments that ensure that secondary investors can obtain deductions for ongoing contributions to forestry scheme arrangements under the new deduction provision. However, secondary investors cannot obtain a deduction for their acquisition costs under this provision. This ensures that sale or harvest proceeds received by a secondary investor are assessable income to the extent the proceeds match deductions obtained by the investor under the new deduction provision. Where secondary investors hold the interests on revenue account as trading stock, the balance of the proceeds will be assessable income. Where secondary investors hold the interests on capital account, the proceeds will be subject to a modified capital gains tax (CGT) assessment.

2.53 Proceeds received by initial investors will be treated on revenue account. In order to limit tax arbitrage that may arise from the different treatments and differences in tax rates between investors, Schedule 8 introduces a pricing rule and a four-year holding period rule which restricts initial investors from selling before four years.

2.54 Furthermore, arrangements intended to exploit any opportunities for arbitrage, for instance, through transfers to tax-preferred entities, such as self-managed superannuation funds, just before receipt of harvest proceeds, may be subject to anti-avoidance legislation as part of the ITAA 1936.[38]

2.55 The EM states that the proposed measures in Schedule 8 will add $61 million to government revenue in 2008–09, $103 million in 2009–10. In 2010–11, however, the EM lists an estimated revenue loss of $222 million.[39]

Schedule 9—Non-resident trustee beneficiaries

Introduction

2.56 Schedule 9 outlines amendments to ensure that a trustee can be taxed on net income of the trust in relation to a non-resident trustee beneficiary similar to the treatment of non-resident company and individual beneficiaries. This treatment is, in effect, similar to a withholding system because the beneficiary is still assessed on these amounts but can reduce their tax liability by the tax paid by the trustee.

2.57 These amendments ensure a trustee is liable to pay tax in relation to a non-resident trustee beneficiary in a similar way to that a trustee is currently liable to pay tax in relation to a non-resident company or individual beneficiary.[40]

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38 EM, p. 128.

39 Les Nielson and Peter Hicks, Tax Laws Amendment (2007 Measures No. 3) Bill 2007, *Bills Digest No. 159*, 2006–07, p. 27.

40 Explanatory Memorandum (EM), p. 147.

Background

2.58 Under the current law, a trustee is liable to pay tax on a beneficiary's share of the net income of the trust if the beneficiary is a non-resident company or individual at the end of the income year. However, a trustee is not currently liable to pay tax if the beneficiary is a non-resident trustee of another trust. This means the taxation of trustees in relation to non-resident beneficiaries is inconsistent. Further, although a non-resident trustee is liable to pay Australian tax under the current rules in relation to non-resident company or individual beneficiaries, collecting the tax is difficult.[41]

Summary of the new law

2.59 Schedule 9 introduces amendments that extend a trustee's liability to be taxed on the net income of a trust to include the case where a trustee beneficiary who is a non-resident at the end of an income year is presently entitled to trust income. The trustee is to pay tax on that beneficiary's share of the net income of the trust attributable to an Australian source. It is not clear whether the non-resident trustee beneficiary must themselves reside away from Australia.[42]

2.60 The broadening of the taxation of trustees does not apply to Australian managed investment trusts covered by the separate measure in Schedule 10. Similarly, it does not apply to Australian intermediaries covered by Schedule 10 to the extent their income is managed investment trust income.[43]

2.61 Transitional provisions implement the exclusion for Australian managed investment trusts and intermediaries from this schedule until the amendments in Schedule 10 apply. Specific provisions in that schedule will ensure the exclusion applies for later periods.[44]

Schedule 10—Distributions to foreign residents from managed investment trusts

Introduction

2.62 Schedule 10 to this bill is intended to implement a new withholding regime for distributions to foreign residents of net income of managed investment trusts attributable to Australian sources.

2.63 These amendments require trustees of managed investment trusts that make certain payments directly to foreign residents, to withhold from these payments tax at the company tax rate (30 per cent). Payments made from managed investment trusts

41 EM, p. 147.

42 Bills Digest, p. 29.

43 As discussed in Briefing Paper 10.

44 EM, p. 148.

indirectly through one or more Australian intermediaries are also subject to the withholding regime. In this situation, the Australian intermediary making the payment to the foreign resident will withhold at the company tax rate. Income consisting of dividends, interest or royalty income is generally excluded from this measure, as are capital gains on assets other than taxable Australian property.[45]

Background

2.64 Under the proposed law outlined in Schedule 9, a trustee presently entitled to income of a managed investment trust would be liable to pay tax on a beneficiary's share of the net income if they are a foreign resident at the end of the income year. The rate at which tax is payable depends on whether the foreign resident is a company, individual or trustee. This means that trustees of Australian managed investment trusts need to be cognisant of whether the foreign resident beneficiary is a company, individual or a trustee of a trust to determine the correct amount of tax payable.

2.65 Most distributions made from Australian managed investment trusts to foreign residents are made through one or more Australian intermediaries. The varying terms and conditions of the arrangement under which the intermediary provides its services, and the nature of the legal relationship between Australian intermediaries, managed investment trusts and foreign resident investors, can result in uncertainty about taxation obligations. This uncertainty may relate to both the requirement to pay tax and the rate of tax payable.

2.66 Schedule 10's amendments will simplify the existing tax collection mechanisms and avoid the complexities and uncertainties that could otherwise occur. They will do this by requiring withholding at a single rate for affected payments by managed investment trusts and intermediaries to foreign resident investors, regardless of the identity of the foreign resident or the relationship between the foreign resident investor and the intermediary.[46]

Definitions

2.67 To assist in understanding this brief and the EM, the following definitions are provided.

> **Managed investment trust**: for an income year, three requirements must be satisfied at the time of the making of the first fund payment:
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> - the trust has a relevant connection with Australia;
> - the trust satisfies certain *Corporations Act 2001* requirements pertaining to the management of investments; and

45 EM, pp. 169–170.

46 EM, pp. 169–170.

- the trust is either listed or is widely held.[47]

Intermediary: To qualify as an 'intermediary' in respect of a payment, three requirements must be satisfied at the time of receipt of that payment:

- the entity has a relevant connection with Australia;
- the entity satisfies certain *Corporations Act 2001* requirements pertaining to the conduct of an intermediary business; and
- the entity must have received a notice relating to the payment.[48]

Summary of the new law

2.68 Schedule 10 introduces amendments that are intended to improve the efficiency of the managed funds industry in respect of the collection of tax from distributions to foreign residents.[49]

2.69 Payments covered by this measure are, broadly speaking, payments of income of a managed investment trust to the extent they form part of the net income of the trust, excluding dividends, interest, royalties, foreign source income and capital gains on assets that are not taxable Australian property. Dividends, interest and royalty payments are generally excluded because they are already ordinarily subject to their own withholding tax arrangements in the *Income Tax Assessment Act 1936*. Foreign source income and capital gains on assets that are not taxable Australian property are excluded because these are generally not taxable in the hands of foreign residents.[50]

2.70 The ultimate beneficiary is taxed on the relevant portion of their share of net income which is reasonably attributable to an amount that is subject to withholding. An appropriate portion of the amount withheld is available to the ultimate beneficiary as a credit.[51]

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47 EM, p. 172.

48 EM, p. 184.

49 EM, p. 193.

50 EM, p. 170.

51 EM, p. 170.