The Senate

Standing Committee on Economics

Provisions of Schedules 1 and 2 of the Tax Laws Amendment (2008 Measures No. 3) Bill 2008

August 2008

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ISBN **978-0-642-71952-2**

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

Senate Standing Committee on Economics

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Chapter 1

Introduction

Background

1.1 The Tax Laws Amendment (2008 Measures No. 3) Bill 2008 was introduced into the House of Representatives on 29 May 2008 by the Treasurer, the Hon. Wayne Swan MP.

1.2 On 18 June 2008, on the recommendation of the Selection of Bills Committee, the Senate referred the provisions of the bill to the Economics Committee for report not before 18 August 2008.

1.3 The bill contains two unrelated schedules, one referring to share sell-back rights and the other to GST refunds. The two schedules are discussed in the following two chapters.

Conduct of the inquiry

1.4 The committee advertised the inquiry in the *Australian* newspaper on 25 June 2008 and invited written submissions by 7 July 2008. The committee received four submissions to its inquiry which are listed at Appendix 1. The committee did not hold a public hearing on the bill.

1.5 The committee thanks those who participated in the inquiry.

Conclusion

1.6 Based on the analysis in the following two chapters, the committee supports the bill.

Recommendation 1

The committee recommends that the bill be passed.

Chapter 2

Schedule 1 – Shareholder and unitholder rights

Background

2.1 Schedule 1 of the bill amends the Income Tax Assessment Act 1997 to address concerns over the tax treatment of call options and put options arising from the High Court's decision on share sell back rights in *Commissioner of Taxation v McNeil* 2007 (McNeil case).

2.2 An option is a derivative security that confers a right to buy or sell securities at an agreed price. Call options are a right to acquire shares at a pre-determined price. Put options are a right to sell shares at a pre-determined price. Where these rights are renounceable, shareholders are entitled to take up the offer, sell the right on the market or allow the offer to lapse. Non-renounceable rights cannot be traded.

2.3 The McNeil case involved St George Bank's issue of renounceable sell back rights to its shareholders, including Mrs McNeil. In this instance shareholders could exercise their right and sell back the shares for an amount in excess of their market value, sell the right itself on the market, or do nothing and have the right sold on their behalf for a designated price. Mrs McNeil did not exercise her right and was subsequently paid for their realised value. The central question in McNeil was whether this constituted assessable income subject to income tax or a receipt of capital subject to capital gains tax (CGT). The High Court decided that the market value of tradeable put options issued to shareholders was assessable as ordinary income at the time of issue and subject to income tax. [1]

2.4 Although the decision related directly to the acquisition of put options through the issue of sell back rights, there has been concern that it could also be applied to call options issued by companies attempting to raise capital.[2] The EM indicates that:

> This would require a shareholder or unitholder issued with call options in some circumstances to include the value of the option in their assessable income at the time of receiving the option. Such an outcome would seriously affect the capital markets and have significant implications for companies and trustees of unit trusts wanting to use call options to raise capital.[3]

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1 Treasury, *Answer to question on notice BET 97*, Budget Estimates, 29 May 2007, p. 1; Parliamentary Library, *Bills Digest*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, pp 3-4

2 *Explanatory Memorandum*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, p. 6

3 *Explanatory Memorandum*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, p. 6

2.5 Prior to the court's decision in McNeil, rights issues were treated as issues on capital account and subject to CGT provisions when the gain was realised.[4] On 26 June 2007 the then Minister for Revenue and Assistant Treasurer Peter Dutton MP issued a press release foreshadowing a legislative amendment to restore the tax treatment of rights that existed before McNeil. It said:

> Shareholders issued with rights by companies seeking to raise capital will not have an income liability at the time of issue. Instead, the long-standing position to treat rights issues on capital account will be maintained.[5]

2.6 The bill seeks to implement this intent. The EM states that:

> These amendments restore the original tax treatment of rights issued by issuing entities to existing shareholders or unitholders to acquire additional relevant interests in those entities. As a result, a taxing point will not arise for the shareholders or unitholders in relation to the rights until a subsequent capital gains tax (CGT) event happens to the rights or to relevant interests as a result of exercising the rights.[6]

Proposed amendments

2.7 Item 2 inserts new section 59-40 into the *Income Tax Assessment Act 1997*. This stipulates that the issue of a right to acquire an interest in the relevant entity is non-assessable and non-exempt income at the issue time for tax purposes. Section 59-40(2) lists a number of conditions upon which this will apply. These are:

- at the time of issue, the taxpayer must already own an interest in the issuing entity (known as original interests);
- the rights must be issued to the taxpayer because of their ownership of the original interests;
- the original interests and the rights must not be revenue assets or trading stock at the time the rights are issued;
- the rights must not have been acquired under an employee share scheme;
- the original interests and rights must not be traditional securities; and
- the original interests must not be convertible interests.[7]

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4 Parliamentary Library, *Bills Digest*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, p. 4

5 Mr Peter Dutton MP, *Press release*, 'Taxation of Rights Issues', 26 June 2007

6 *Explanatory Memorandum*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, p. 6

7 *Explanatory Memorandum*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, p. 9

2.8 These conditions ensure that the amendments only apply to those with acquired rights because of their original interest and who would ordinarily be taxed on capital account.

2.9 Income derived from the acquisition of call options is subject to capital gains tax (CGT) when a CGT event occurs, such as the shareholder disposing of their rights on the market.

2.10 Item 7 inserts new section 112-37 into the *Income Tax Assessment Act 1997*. This provision applies to ensure that double taxation does not occur where put options have been issued. The market value of the put option is included as assessable income at the time it is issued. To prevent this amount from being taxed again when a CGT event occurs, it is included in the cost base of the put option for CGT purposes. The difference between this and the eventual selling price is subject to CGT.

2.11 Item 9 stipulates that the amendments apply to rights issued on or after 1 July 2001.[8]

Issues

2.12 The Institute of Chartered Accountants in Australia ('the Institute') supported the passage of the bill to provide certainty in the circumstances described above. However, both they and the Law Council of Australia raised a number of concerns about the bill, particularly the exclusions at proposed section 59-40(2).

The pre-McNeil position is not restored

2.13 The Institute of Chartered Accountants notes that although double taxing issues relating to the issuing of put options have been addressed, the amendments do not in fact restore the treatment of put options that was thought to apply prior to McNeil. The Institute indicated that 'no policy reason has been provided for retaining the treatment of put options which arises as a consequence of McNeil's case'.[9]

Non-renounceable rights

2.14 The Law Council of Australia raised uncertainty about whether the McNeil case, which applied directly to renounceable (tradable) rights, also applied to non-renounceable rights. They said that the bill should clarify their status:

> Prior to McNeil the issue of these rights were considered not to create either an income gain or a capital gain to the shareholder.

8 *Explanatory Memorandum*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, pp 8-12; Parliamentary Library, *Bills Digest*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, pp 6-7

9 Institute of Chartered Accountants in Australia, *Submission 1*, p. 4

> The provisions should make it clear that this continues to be the case for both put and call options that are non-tradeable, in order to eliminate the uncertainties caused by the decision; those uncertainties impact on the efficient operation of the capital/markets. [10]

Subsidiaries

2.15 The Law Council commented that acquiring rights as a consequence of owning shares in a wholly owned subsidiary would not satisfy the requirement for the person issued the rights to have an original interest.[11]

Non-traditional rights issues

2.16 They also raised concerns over whether non-traditional rights issues would fall within the scope of new section 59-40. Using the example of a renounceable accelerated pro-rata issue with dual bookend-structure, they suggested that this type of rights issue would not satisfy section 59-40 because the structure is not an issue of rights by the issuing company and there is no market value at the time of issue.[12]

Convertible interests

2.17 Convertible interests are financial instruments that may be converted into shares. The EM explains that they are excluded from the amendments applying to the tax treatment of call options because 'the principles enunciated in McNeil's case are not easily applied to convertible interests'.[13] The Institute of Chartered Accounts warned that this exclusion could result in double taxation by the Australian Tax Office. They stated that 'it is unfortunate that the opportunity was not taken to ensure that the amendments contained in the Bill put the issue beyond doubt'.[14]

2.18 The Law Council of Australia also disagreed with the exclusion, describing it as 'misconceived'. They wrote:

> There appears to be no policy or other basis why rights issued to preference share holders who hold their shares on capital account should be taxed any different [sic] to those issued to other ordinary shareholders.[15]

Revenue assets and trading stock exclusions

2.19 Both the Institute of Chartered Accountants and the Law Council of Australia raised concerns over this exclusion covering shares held as revenue assets or trading

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10 Law Council of Australia, *Submission 2*, pp 1-2

11 Law Council of Australia, *Submission 2*, p. 2

12 Law Council of Australia, *Submission 2*, pp 2-3

13 *Explanatory Memorandum*, Tax laws Amendment (2008 Measures No. 3) Bill 2008, p. 9

14 Institute of Chartered Accountants in Australia, *Submission 1*, pp 5-6

15 Law Council of Australia, *Submission 2*, p. 5

stock. The Institute stated that it was unclear how shareholders subject to the provision will be able to calculate their tax liability. They also questioned the rationale for the exclusion:

> …until the McNeil decision, there was no authority of which we are aware to the effect that the value of rights granted to a shareholder or unitholder in respect of pre-existing shares or units held on revenue account or as trading stock was assessable as income.[16]

2.20 They suggested that in these circumstances shareholders should only be taxed on profits made on the disposal of the rights. They added:

> To assess a shareholder … simply because the shareholder … has a right to invest more capital is in our view an undesirable outcome since such policy will create uncertainty and may adversely impact the capital raising alternatives available to Australian companies and unit trusts.[17]

2.21 The Law Council of Australia also objected to the exclusion. On shares held on revenue account, they indicated that shareholders could be exposed to an immediate tax liability even where no actual profit is subsequently realised.[18] With respect to trading stock, the Law Council commented that there was potential inconsistency between the proposed amendment and the existing provisions relating to trading stock.[19]

Consultation

2.22 The Institute indicated that government consultation was not 'entirely satisfactory'. They asserted that the government's response and feedback to the business sector following the McNeil decision was too slow, while the actual legislative development was too hasty once commenced. They submitted the following comment:

> Unfortunately, the consultation process was very abbreviated and focussed only on the most common scenario impacted by the McNeil decision and has resulted in a number of areas of uncertainty for stakeholders as noted above.[20]

Proposed amendments to the bill

2.23 The Law Council of Australia proposed the following changes to the bill to avoid unintended consequences for those with rights that are non-renounceable or not exercised:

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16 Institute of Chartered Accountants in Australia, *Submission 1*, p. 6

17 Institute of Chartered Accountants in Australia, *Submission 1*, p. 6

18 Law Council of Australia, *Submission 2*, p. 4

19 Law Council of Australia, *Submission 2*, pp 4-5

20 Institute of Chartered Accountants in Australia, *Submission 1*, p. 7

> If the Government considers [the exclusions] should be retained then, at the very least, the section should be amended to provide
>
> (3) Paragraphs 59-40(2)(c) to (f) do not apply if:
>
> (k) the rights are not tradeable; or
>
> (l) (i) the rights lapse without being exercised; and
>
> (ii) the shareholder receives no other consideration in respect of the transaction.[21]

Committee comment

2.24 The committee acknowledges the concerns raised about the bill during the inquiry. However, these should not delay the passage of the bill, which will largely circumvent the uncertainty created by the High Court's decision in McNeil. The Senate should therefore pass the bill. The committee is also of the view that the government should address the concerns of the Institute of Chartered Accountants, the Law Council of Australia and other concerned organisations through continuing consultation.

21 Law Council of Australia, *Submission 2*, p. 6

Chapter 3

Schedule 2 – Restriction on GST refunds and time limits for recovery and refund of indirect tax

Introduction

3.1 Schedule 2 of the bill amends the *Taxation Administration Act 1953* (TAA 1953) to correct a deficiency in the goods and services tax (GST) refund restriction provisions. The measure also addresses deficiencies in the four-year time limit on indirect tax and fuel tax credit related liabilities and entitlements to refunds related to indirect tax and fuel credits and ensures that they apply as intended.

Overview

3.2 Under section 105-65 of Schedule 1 to the TAA 1953 (restriction on refund provisions), if a business overpays GST on a sale to a customer then the GST may be refunded to the business only if the business has first refunded the overpaid amount to the affected customer. This is because it is the customer who is intended to bear the cost of the GST. Without the restriction on refund requirement, there is a potential for a windfall gain to arise to businesses that receive the refund of GST but have not borne the incidence of the tax.

3.3 In the case of business-to-business transactions, the Commissioner is not required to refund overpaid GST because the purchasing business is potentially entitled to input tax credits to offset the GST included in the price of its acquisition. A discretion exists so that, for example, in business-to-business transactions, the Commissioner may refund overpaid amounts if the supplier can demonstrate that they have first reimbursed the registered recipient of a supply for the amount of GST included in the price and the Commissioner considers it reasonable in the circumstances.

3.4 The Federal Court of Australia in *KAP Motors Pty Ltd v Commissioner of Taxation* [2008] FCA 159 (KAP Motors) held that a taxpayer that had overpaid GST on a motor vehicle holdback payment need not first reimburse their customer for this amount before seeking a refund from the Commissioner because the transaction resulting in the overpayment was not a 'supply' for GST purposes.

3.5 The decision in KAP Motors also highlighted a deficiency in the operation of the rule imposing a four-year time limit on indirect tax liabilities and entitlements to refunds. While generally refunds can only be claimed and tax recovered within four years, the relevant provisions may not apply in all circumstances as intended.

3.6 Under the current provisions, the four-year time limit on recovery of liabilities by the Commissioner may not apply in situations in which a taxpayer received a refund in relation to GST and it is later determined that the taxpayer was entitled to a

lesser refund in relation to GST for the relevant tax period. Similarly, the four-year time limit on refunds may not apply in situations where a taxpayer has overstated their tax liability for the relevant tax period to which the refund relates.[1]

Proposed amendments

3.7 Item 17 repeals section 105-65 of Schedule 1 of the TAA and replaces it with a new section. The impact of the new section is that the Commissioner need not refund an overpaid GST amount where no supply of goods occurred and either the Commissioner is not satisfied that the taxpayer has first reimbursed the person to whom the supply was made, or the recipient of the goods or services was registered for GST purposes or required to be registered for GST purposes. Item 18 requires the amendment made by Item 17 above applies on or after 1 July 2008.

3.8 The amendments seek to ensure that the restriction on providing refunds of GST applies to situations in which transactions have been treated incorrectly as taxable supplies to any extent. This includes where a taxpayer has remitted GST on transactions for which there was no supply. This reinstates the approach taken by the Commissioner prior to the decision in KAP Motors and overcomes the identified deficiency in the law on or after 1 July 2008.

3.9 The amendments also ensure that the four-year time limit on recovery of liabilities applies in situations in which taxpayers were entitled to a refund in relation to GST, wine equalisation tax, luxury car tax or net fuel amounts for the relevant tax period to which the liability relates. In relation to the four-year time limit on refunds, these amendments ensure that the time limit applies in situations where taxpayers have overpaid an amount of GST, wine equalisation tax, luxury car tax or net fuel amounts for the relevant tax period to which the refund relates.

3.10 The amendments aim to restore the intended operation of the four-year time limit and ensure that the law provides certainty for taxpayers, allowing them a reasonable period to finalise their affairs knowing that, other than in cases of fraud or evasion, their tax position will not change after that time.[2]

Issues

3.11 The committee received one submission on schedule 2 of the bill. The Institute of Chartered Accountants in Australia argued that schedule 2 should be amended to correct drafting errors and address defects in the framework of the refund and the time limitation provisions.

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1 Revised Explanatory Memorandum, pp 13-14.

2 EM, pp 14-15.

Refund provisions

3.12 The Institute argued that section 105-65 does not contain any statutory direction as to the matters to be taken into account by the Commissioner to deny a refund that is otherwise properly payable. The Institute suggested that it would assist administration and promote certainty if the provision contained matters that would be taken into account in determining whether the discretion to allow a refund ought to be exercised.[3]

3.13 The Institute also argued that the administration of the refund would be better served if the legislation provided for an exclusive code for refunds of overpaid GST and indirect tax.

> The clear inference of the decision in KAP Motors is that Subdivision 105-C does not represent an exclusive code and that common law rights of refunds persist to the extent that the legislation does not preclude that right.[4]

3.14 The Institute submitted that the Explanatory Memorandum, in particular paragraphs 2.3 and 2.4 (discretionary power of the Commissioner), contains a number of statements that may give rise to some doubt as to the intended operation of section 105-65 and that it should be more accurately expressed.[5]

Time limitation provisions

3.15 The proposed subsection 105-50(2) proposes to treat as no longer recoverable, an amount paid to a taxpayer that exceeds the amount the taxpayer was entitled to be paid, if it has not been subject to a relevant notice from the Commissioner four years after the excess became payable. The Institute argued that the four-year time limit ought to expire four years after the overpayment – in this way the four year limit for an overpayment of a refund will coincide with the underpayment of a positive net amount.[6]

3.16 The Institute further argued that the law should require that the Commissioner specify the amount of the underpayment or overpayment, the tax periods and the particular of the items in question (subsection 105-50(3)). The Institute suggested that the existing terminology without any clarification creates uncertainty as to when a taxpayer's affairs reach finality.

3.17 The Institute suggested that that the proposed amendment to subsection 105-55(2) should clarify whether the 'refund' that is claimed is the overpayment of a positive net amount or an overpayment of GST on a supply. The Institute further argued that the taxpayer ought to be required to specify the amount of the

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3 The Institute of Chartered Accountants, *Submission* 1, Appendix B, p. 2.

4 The Institute of Chartered Accountants, *Submission* 1, Appendix B, p. 2.

5 The Institute of Chartered Accountants, *Submission* 1, Appendix B, pp 3-5.

6 The Institute of Chartered Accountants, *Submission* 1, Appendix B, p. 5.

overpayment, the tax period and the particularity of the overpayment within the four year period (subsection 105-55(3)). [7]

3.18 The Institute submitted that the Explanatory Memorandum, for the reasons set out above, fails to fully explain the impact and the context of the time limitation in sections 105-50 and 105-55.[8]

Committee comment

3.19 The committee considers that Schedule 2 addresses deficiencies related to the restriction on GST refunds and time limits for recovery and refund of indirect tax. The committee believes that the proposed changes reinforce the original intent of the GST refunds policy – namely, that a refund of overpaid GST will only be made where the customer is first reimbursed.

Senator Annette Hurley

Chair

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7 The Institute of Chartered Accountants, *Submission* 1, Appendix B, p. 6.

8 The Institute of Chartered Accountants, *Submission* 1, Appendix B, p. 7.

Coalition Senators' Dissenting Report

Senator Alan Eggleston (Deputy Chair),
Senator Barnaby Joyce, Senator David Bushby

OVERVIEW

Schedule 1

The McNeil case, in its briefest summary, stated that unexercised rights were income for tax purposes. Generally, one would expect it to be capital and if you make a profit or loss after holding and selling the rights, held for a prescribed period, you would get the benefits under Capital Gains Tax legislation. The McNeil Case meant that a rights issue was assessable on issue date as income, and as such would be taxed at and above the highest bracket that your income was in.

The effect of premiums paid out of share dividend accounts was also clouded after the McNeil case, as was the position of derivatives such as options. In conclusion there was a widespread belief that the process of the act, as generally understood and planned for, had been changed by the High Court. It was believed by all sectors that this went against the intent of the legislation and needed to be remedied.

The Coalition Senators however, do query how the financial impact of "nil", as stated on page three of the revised explanatory memorandum, could be so when we are returning to the tax advantageous position of "capital", revenue which, because of the McNeil case, would have been assessed as "income". The EM's statement that the McNeil case "would seriously affect the capital markets" because of the changed assessment of options seems to be counter intuitive if the decision was one of nil financial impact, that is people were not reacting to the tax consequences.

RECOMMENDATION

It is the belief of the Coalition Senators that this situation is in need of remedy and the purpose of the act is to return the legislation to its original intent so should be supported.

Schedule 2

In brief the KAP Motors Case implied that overpayment of GST does not need to be reimbursed to the customer before you can claim it back from the Commissioner of Taxation. The KAP Motors case also brought an uncertainty as to the four year time limit a taxpayer has to finalise their tax position in regard to changes to their tax liability.

The purpose of the Schedule 2 is to circumvent the effect of the KAP Motors Case and take the legislation back to its initial intent.

Apart from some drafting errors there is no real reason for there not to be a return to the legislation's original intent. Other issues such as a code for refunds are away and apart from the purpose of this schedule.

RECOMMENDATION

It is the belief of the Coalition Senators that this situation is in need of remedy and the purpose of the act is to return the legislation to its original intent so should be supported.

APPENDIX 1

Submissions Received

Submission Number	Submitter
1	Institute of Chartered Accountants
2	Business Law Section, Law Council of Australia
3	Taxation Institute of Australia
4	The Treasury