2004-2005

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAX LAWS AMENDMENT (LOSS RECOUPMENT RULES AND OTHER MEASURES) BILL 2005

EXPLANATORY MEMORANDUM

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

Table of contents

Glossary 1

General outline and financial impact 3

Chapter 1 Loss recoupment rules for companies: modified continuity of ownership test 11

Chapter 2 Loss recoupment rules for companies: same business test income ceiling 63

Chapter 3 Loss recoupment rules for companies: other amendments 79

Chapter 4 Loss recoupment rules for companies: regulation impact statement 95

Chapter 5 Conduit foreign income 107

Chapter 6 Denial of deductions for illegal activities 151

Chapter 7 Copyright in film to be included in effective life depreciation 155

Chapter 8 Relief for employee share scheme participants in the event of a corporate restructure 163

Chapter 9 Allow the offsetting of a late payment of contributions against an employer's superannuation guarantee charge 183

Chapter 10 Applying superannuation guarantee to back payments of wages 189

Index 193

Glossary

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

Abbreviation	***Definition***
APRA	Australian Prudential Regulation Authority
ATO	Australian Taxation Office
CGT	capital gains tax
Commissioner	Commissioner of Taxation
COT	continuity of ownership test
declared CFI amount	declared conduit foreign income amount
ESS	employee share scheme
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
MEC group	multiple entry consolidated group
received CFI amount	received conduit foreign income amount
SBT	same business test
TAA 1953	*Taxation Administration Act 1953*

General outline and financial impact

Loss recoupment rules for companies

Schedule 1 to this Bill reforms the loss recoupment rules for companies by:

- introducing a new modified continuity of ownership test (COT) to replace the existing modified COT in Division 166 of the *Income Tax Assessment Act 1997*;
- removing the same business test (SBT) for companies whose total income is more than $100 million in the year of recoupment; and
- removing certain anomalies and clarifying some aspects of the existing law.

Companies that are widely held are eligible for the new modified COT, which:

- requires testing for continuity of ownership at the end of each income year, following a takeover bid or similar transaction and after a substantial capital raising; and
- contains tracing rules that simplify the tracing of ownership interests.

Date of effect: The new modified COT applies to losses incurred in income years commencing on or after 1 July 2002. It also applies to certain eligible pre-1 July 2002 losses.

The SBT amendments apply to losses incurred in income years commencing on or after 1 July 2005.

The other amendments to the loss recoupment rules have a variety of application dates.

Proposal announced: This measure was announced in the former Minister for Revenue and Assistant Treasurer's Press Release No. C021/04 of 7 April 2004 and the Minister for Revenue and Assistant Treasurer's Press Release No. 011 of 11 February 2005.

Financial impact: The financial impact of this measure is unquantifiable. There is expected to be an unquantifiable cost to revenue over the forward estimates period because the new modified COT takes effect from an earlier date than the removal of the SBT for large companies.

Compliance cost impact: This measure is expected to reduce compliance costs. It will be easier for companies that are eligible to apply the new modified COT to test for continuity of ownership. Large companies will no longer be able to apply the SBT if they fail the COT.

Summary of regulation impact statement

Regulation impact on business

Impact: The main impact will be on widely held companies whose total income is more than $100 million.

The changes to the COT will impact on widely held companies and companies owned by widely held companies.

The changes to the SBT will impact on large companies.

The companies that are affected by the removal of the SBT are those most likely to benefit from the simplified COT.

Main points:

- Uncertainty and compliance costs associated with applying the company loss recoupment rules to widely held companies and companies owned by widely held companies will be reduced.

- Administrative costs for the Australian Taxation Office will be reduced as it is expected that there will be fewer requests by taxpayers for rulings and company audits will be simplified.

Conduit foreign income

Schedule 2 to this Bill provides tax relief for conduit foreign income. Conduit foreign income is generally foreign income received by a foreign resident via an Australian corporate tax entity. This measure ensures those amounts are not taxed in Australia when distributed by the Australian corporate tax entity to its foreign owners. Generally, the measure only applies to foreign income that is ordinarily sheltered from Australian tax when it is received by the Australian corporate tax entity.

Chapter 5:

- describes how a corporate tax entity will calculate an amount of conduit foreign income; and
- explains how conduit foreign income can pass through a series of Australian corporate tax entities to ultimate foreign owners free of Australian tax.

Date of effect: The amendments made by this measure will allow an entity to calculate the amount of its conduit foreign income from the beginning of its first income year that starts on or after 1 July 2005.

Transitional rules will affect the first year of this calculation for all existing entities. They also ensure that an entity can only declare an amount to be conduit foreign income where that declaration is made on or after the date of Royal Assent.

Proposal announced: This measure was announced in the Treasurer's Press Release No. 32 of 13 May 2003.

Financial impact: The cost to revenue of this measure is expected to be $5 million in 2005-06, $20 million for each of the following 2 years and $25 million per annum thereafter.

Compliance cost impact: There may be an increase in compliance costs for Australian corporate tax entities that choose to access the benefits of this measure.

Where corporate tax entities choose to pass on conduit foreign income amounts to their members, the benefits conferred by the conduit foreign income rules would outweigh the additional compliance costs incurred.

Summary of regulation impact statement

Regulation impact on business

Impact: This measure impacts on Australian corporate tax entities making distributions to non-resident owners out of foreign profits declared to be conduit foreign income.

Corporate tax entities that distribute amounts declared to be conduit foreign income to other Australian entities are also affected. These entities are affected as they will be required to determine the amount of their conduit foreign income.

Main points:

- Providing tax relief for a broader range of foreign income than the current foreign dividend account rules further enhances the ability of Australian entities with foreign investments to compete for foreign capital. This should encourage those entities to remain Australian residents if their foreign shareholding becomes significant. This measure also improves the attractiveness of Australia as a location for regional holding companies.

- There may be additional compliance costs for entities in determining and distributing their conduit foreign income. These costs have been minimised to the extent possible while still having regard to integrity and effectiveness concerns.

Denial of deductions for illegal activities

Schedule 3 to this Bill amends the *Income Tax Assessment Act 1997* to deny deductions for losses and outgoings to the extent that they are incurred in the furtherance of, or directly in relation to, activities in respect of which the taxpayer has been convicted of an indictable offence. Similarly, the capital gains tax provisions will be amended so that losses and outgoings incurred in relation to illegal activities in respect of which the taxpayer was convicted of an indictable offence do not form part of the cost base or reduced cost base for capital gains purposes. This will ensure that no capital loss or reduced capital gain can arise from such expenditure.

Date of effect: This measure applies to losses and outgoings incurred after 29 April 2005.

Proposal announced: This measure was announced in the Treasurer's Press Release No. 038 of 29 April 2005.

Financial impact: Unquantifiable, but expected to be minor.

Compliance cost impact: Insignificant.

Copyright in film to be included in effective life depreciation

Schedule 4 to this Bill amends the *Income Tax Assessment Act 1997* to include copyright in a film in the general effective life depreciation of the uniform capital allowances provisions in the income tax law.

This measure will allow taxpayers to choose either the Commissioner of Taxation's (Commissioner) 'safe harbour' effective life determination or, self assess the effective life of their copyright in a film.

When depreciating their copyright in a film using effective life, taxpayers will have the choice of using the prime cost method or the diminishing value method.

Date of effect: This amendment applies to copyright in a film acquired on or after 1 July 2004.

Proposal announced: This measure was announced by the Government as part of the 2005-06 Budget on 10 May 2005.

Financial impact: This measure is estimated to cost the revenue as follows:

2005-06	***2006-07***	***2007-08***	***2008-09***
–$15 million	–$35 million	–$55 million	–$70 million

Compliance cost impact: This measure is expected to decrease compliance costs by providing a shorter write-off period under the general effective life depreciation than the current 25-year period.

Summary of regulation impact statement

Regulation impact on business

Impact: This measure will have favourable implications for film producers and investors of films that do not qualify as Australian films.

Main points:

- Taxpayers may write-off their copyright expenses in a film over a period based on its effective life rather than the current statutory 25-year period for copyrights.
- Taxpayers may choose the Commissioner's safe harbour effective life or, self assess the effective life of their copyright in a film.
- This measure will increase slightly the administrative costs for the Australian Taxation Office as the Commissioner has to determine a safe harbour effective life as soon as possible after the passage of this legislation.

Relief for employee share scheme participants in the event of a corporate restructure

Schedule 5 to this Bill amends the *Income Tax Assessment Act 1936* (ITAA 1936) to allow employee share scheme (ESS) participants — who acquire shares in a scheme for the acquisition of shares by employees who are assessed under section 26AAC of the ITAA 1936 — to treat the new shares or rights they are issued because of a corporate restructure as a continuation of their old shares or rights.

These amendments also allow ESS participants — who have made an election under Division 13A of the ITAA 1936 to be taxed upfront — to treat the new shares or rights they are issued because of a corporate restructure as a continuation of their old shares or rights.

Amendments are also made to the *Taxation Laws Amendment Act (No. 3) 2003*, the *Income Tax Assessment Act 1997* and the *Income Tax (Transitional Provisions) Act 1997* to ensure the capital gains tax provisions in those Acts reflect the amendments to the ESS provisions.

Date of effect: This amendment will apply to corporate restructures which occur on or after Royal Assent.

Proposal announced: This measure has not previously been announced.

Financial impact: The cost to the revenue is unquantifiable but expected to be small.

Compliance cost impact: This amendment is expected to have a minimal impact on compliance costs.

Allow the offsetting of a late payment of contributions against an employer's superannuation guarantee charge

Schedule 6 to this Bill amends the *Superannuation Guarantee (Administration) Act 1992* to allow the offsetting of a late payment of contributions against an employer's superannuation guarantee charge.

Date of effect: This measure applies to late payments of contributions made on or after 1 January 2006.

Proposal announced: This proposal was announced in the 2005 Budget on 10 May 2005.

Financial impact: This measure will have a cost to revenue as follows:

2005-06	***2006-07***	***2007-08***	***2008-09***
–$0.4 million	–$0.9 million	–$0.9 million	–$0.8 million

Compliance cost impact: An employer may experience some cost in providing evidence required by the Commissioner of Taxation to prove the relevant superannuation contributions had been paid to the superannuation fund or retirement savings account within the specified offset period.

Applying superannuation guarantee to back payments of wages

Schedule 7 to this Bill amends the *Superannuation Guarantee (Administration) Act 1992* to clarify that mandatory employer contributions under the superannuation guarantee arrangements are payable on wages or salary paid in a quarter following the termination of an employment relationship.

Date of effect: This measure applies to payments made on the first day of the first full quarter after Royal Assent.

Proposal announced: This proposal was announced in the 2005-06 Budget on 10 May 2005.

Financial impact: This measure will have a cost to revenue as follows:

2005-06	***2006-07***	***2007-08***	***2008-09***
Nil	–$3 million	–$3 million	–$3 million

Compliance cost impact: Nil.

Chapter 1
Loss recoupment rules for companies: modified continuity of ownership test

Outline of chapter

1.1 Schedule 1 to this Bill reforms the loss recoupment rules for companies by:

- introducing a new modified continuity of ownership test (COT) to replace the existing modified COT in Division 166 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- removing the same business test (SBT) for companies whose total income is more than $100 million in the year of recoupment; and
- removing certain anomalies and clarifying some aspects of the existing law.

1.2 This chapter explains the new modified COT for widely held companies that applies from 1 July 2002.

Context of amendments

1.3 If a company's deductions exceed its assessable income and net exempt income in an income year, the company has a tax loss, which it can carry forward to use as a deduction in a future income year. However, the company can only deduct the tax loss if it satisfies either the COT or the SBT.

1.4 The COT is satisfied if the same people hold more than 50 per cent of voting power and rights to dividends and capital at all times during the relevant test period. To apply the COT, a company must trace its ownership through companies, trusts and other entities to identify the people who ultimately hold (directly or indirectly) voting power and rights to dividends and capital distributions.

1.5 It is often difficult for companies to trace through entities such as listed companies, superannuation funds and managed funds to identify the ultimate individual owners. Accordingly, companies owned by these entities may incur substantial compliance costs in determining whether the COT has been satisfied. If such companies cannot determine ultimate ownership, the deductibility of their losses may be uncertain.

1.6 In addition to being a test for the recoupment of tax losses, the COT is also relevant in other contexts:

- A company must satisfy either the COT or the SBT to apply a prior year net capital loss or deduct a foreign loss or bad debt.
- A company must satisfy either the COT or the SBT when joining a consolidated group to transfer a loss of any sort to the head company.
- If a company fails both the COT and the SBT in an income year, it must work out its taxable income or tax loss and net capital gain or net capital loss for that income year in a special way.
- If a company fails the COT and has an unrealised net loss, it cannot take into account future capital losses or deductions in respect of capital gains tax assets that it owned at the time it failed the COT (to the extent of the unrealised net loss), unless it satisfies the SBT.
- If a company fails the COT, the tax attributes of significant equity and debt interests in the company may be adjusted to prevent multiple recognition of the company's losses.

Summary of new law

1.7 These amendments replace the modified COT in Division 166 of the ITAA 1997 with a new modified COT. They simplify the application of the COT for companies that are widely held by providing tracing rules that make it unnecessary for an eligible company to trace the ultimate owners of shares held by certain intermediaries and small shareholdings. ***[Schedule 1, item 79, section 166-3]***

1.8 The new modified COT applies to widely held companies and companies that are more than 50 per cent owned (directly or indirectly) by widely held companies, certain entities that are treated as ultimate owners, non-profit companies or charitable bodies.

1.9 Companies applying the modified COT must test for continuity of ownership at the end of each income year and at certain other specified times, rather than continuously as required by the ordinary COT.

1.10 The new modified COT contains tracing rules that assist the company in testing continuity of ownership:

- A direct stake of less than 10 per cent is attributed to a single notional entity.
- An indirect stake of less than 10 per cent is attributed to the top interposed entity.
- A stake of between 10 per cent and 50 per cent (inclusive) held by a widely held company is attributed to the widely held company as an ultimate owner.
- A stake held by an entity deemed to be a beneficial owner (a superannuation fund, approved deposit fund, special company or managed investment scheme) is generally attributed to that entity as an ultimate owner.
- An indirect stake held by way of bearer shares in a foreign listed company is attributed to a single notional entity in certain circumstances.
- An indirect stake held by a depository entity through shares in a foreign listed company is attributed to the depository entity as an ultimate owner in certain circumstances.

Comparison of key features of new law and current law

New law	*Current law*
The modified COT is applicable to widely held companies and eligible Division 166 companies.	The modified COT is applicable to listed public companies and their wholly-owned subsidiaries.

New law	***Current law***
Ownership is tested at the start of the test period, the end of each income year and at the end of certain corporate changes.	Ownership is tested at the start of the test period, the time of each abnormal trading in shares in the company and the end of each income year.
Direct stakes of less than 10 per cent are attributed to a single notional entity and indirect stakes of less than 10 per cent to the top interposed entity.	Direct shareholdings of less than one per cent are treated as if they were held by a single notional entity and all shareholdings of less than one per cent in an interposed listed public company are treated as if they were held by a different single notional entity.
Widely held companies with voting dividend and capital stakes of between 10 per cent and 50 per cent are treated as the ultimate owners of their stakes.	No equivalent.
Superannuation funds, approved deposit funds, special companies and managed investment schemes are treated as the ultimate owners of their stakes.	Superannuation funds, approved deposit funds and special companies are treated as the ultimate owners of their stakes.
Voting, dividend and capital stakes in foreign listed companies held by way of bearer shares are attributed to a single notional entity, if certain conditions are met.	No equivalent.
Depository entities which hold voting dividend and capital stakes in the tested company are treated as the ultimate owners if certain conditions are met.	No equivalent.
The tracing rules do not apply to stakes held by controlling entities, individuals with more than 25 per cent of (associate-inclusive) voting power or companies and trusts with more than 50 per cent of (associate-inclusive) voting power in the tested company.	If shares are controlled by a person with a substantial shareholding in the company those shares are not taken to be owned by the notional shareholder.

Detailed explanation of new law

1.11 The new modified COT applies to widely held companies and eligible Division 166 companies. It modifies how the ownership tests in Division 165 apply. Its key features are:

- companies are required to test for continuity of ownership at the end of each income year and at the end of certain corporate changes; and
- tracing rules assist companies in testing for continuity of ownership.

Eligibility for the modified continuity of ownership test

1.12 Companies that are either widely held or are eligible Division 166 companies throughout the relevant income year can apply the modified COT. A company that is widely held for part of the income year and is an eligible Division 166 company for the rest of the income year can also apply the modified COT. ***[Schedule 1, item 79, subsections 166-5(1), 166-20(1), 166-40(1) and 166-80(1) and section 166-220]***

1.13 A company is eligible for the new modified COT if it is widely held or an eligible Division 166 company for the income year in which it seeks to deduct a tax loss. Companies that are neither widely held nor eligible Division 166 companies continue to use Division 165 to determine whether they satisfy the COT.

Widely held companies

1.14 A ***company*** is widely held if it is listed on an approved stock exchange. ***[Schedule 1, item 168, section 995-1]***

1.15 A list of approved stock exchanges is contained in Schedule 12 to the *Income Tax Regulations 1936*.

1.16 A ***company*** is also widely held if it has more than 50 members, unless:

- at any time in the income year, 20 or fewer people hold or have the right to acquire or become the holder of shares representing 75 per cent or more of the value of shares in the company, other than shares entitled to a fixed rate of dividend only;

- at any time during the income year, 20 or fewer people are capable of exercising 75 per cent or more of the voting power in the company;
- in that year, 20 or fewer people receive 75 per cent or more of any dividend paid by the company; or
- the company did not pay a dividend in that year, but the Commissioner of Taxation (Commissioner) is of the opinion that, if a dividend had been paid by the company at any time during the income year, 20 or fewer people would have received 75 per cent or more of that dividend.

[Schedule 1, item 168, section 995-1]

Example 1.1: Eligibility of widely held companies

In the income year ending 30 June 2005, Jazz Limited (Jazz) has 1,000 ordinary shareholders. The top 20 shareholders hold 60 per cent by value of the shares and may exercise 60 per cent of the voting power in the company. Jazz is not listed.

No dividend is paid during the income year. According to the company's constitution, if any dividend was declared it would have to be apportioned equally among all the shares in the company. Therefore, the top 20 shareholders would have rights to 60 per cent of dividends and the Commissioner would be satisfied that there are not 20 or fewer people who would have had the right to 75 per cent or more of any dividend that was paid.

Therefore, Jazz is a widely held company during the income year ended 30 June 2005 and can apply the modified COT in testing whether it can deduct any tax losses in that year.

In the income year ending 30 June 2006, Jazz changes its constitution and issues preference shares to 10 people. The preference shares represent only 5 per cent by value of the shares in the company and none of the voting power. However, the only dividend the company distributes during the income year is to the preference shareholders.

Accordingly, Jazz is not a widely held company for the whole of the year ended 30 June 2006, because only 10 shareholders received 100 per cent of dividends that the company paid. Jazz is ineligible to apply the modified COT in testing whether it can deduct tax losses in that income year.

Eligible Division 166 companies

1.17 A ***company*** is also eligible for the new modified COT if it is an eligible Division 166 company — that is, more than 50 per cent of the voting power, rights to dividends or rights to capital distributions are held by one or more:

- widely held companies;
- superannuation funds;
- approved deposit funds;
- special companies;
- managed investment schemes ;
- entities that are prescribed under the tracing rule that deems entities to be beneficial owners;
- non-profit companies; or
- charitable institutions, charitable funds or any other kind of charitable bodies.

[Schedule 1, item 148, section 995-1]

1.18 Superannuation funds, approved deposit funds, special companies, managed investment schemes and prescribed entities are only taken into account if they meet the certain criteria. For example, a superannuation fund must be a complying superannuation fund or a superannuation fund established in a foreign country and regulated under a foreign law. ***[Schedule 1, item 79, subsection 166-245(3)]***

1.19 In order to qualify as an eligible Division 166 company for an entire income year, it is not necessary for the same entities to hold more than 50 per cent of voting power, dividend and capital distribution rights throughout the income year. For example, one widely held company may hold a 60 per cent interest in the tested company from 1 July until 31 January and then sell its interest to a different widely held company, which then holds the interest from 1 February to 30 June. In this case, the tested company qualifies as an eligible Division 166 company for the entire income year.

Example 1.2: Eligible Division 166 company

This example is continued from Example 1.1.

Throughout the period 1 July 2004 to 30 June 2006, Blues Limited (Blues) is 35 per cent owned by Jazz, 45 per cent owned by companies listed on the Australian Stock Exchange, and 20 per cent owned by individuals.

Jazz is a widely held company throughout the income year ended 30 June 2005. However, it is only a widely held company for part of the income year ended 30 June 2006.

Blues would be an eligible Division 166 company throughout the income year ended 30 June 2005, because it is 80 per cent (ie, 45% + 35%) owned by widely held companies. Accordingly, it would be eligible to apply the modified COT in that year.

Blues would not be an eligible Division 166 company for the whole of the income year ended 30 June 2006, because it would cease to be an eligible Division 166 company when Jazz ceased to be a widely held company. Accordingly, Blues would not be eligible to apply the modified COT in that year.

Interaction between the modified continuity of ownership test and the ordinary continuity of ownership test

1.20 The modified COT provides widely held and eligible Division 166 companies with an alternative method for testing continuity of ownership:

- Subdivision 166-A modifies the application of Subdivision 165-A to deductions for tax losses ***[Schedule 1, item 79, section 166-5].***
- Subdivision 166-B modifies the application of Subdivision 165-B, which concerns the calculation of income in a year of ownership change, and Subdivision 165-CB, which concerns the calculation of net capital gains in a year of ownership change ***[Schedule 1, item 79, section 166-20].***
- Subdivision 166-C modifies the application of Subdivision 165-C to deductions for bad debts ***[Schedule 1, item 79, section 166-40].***

- Subdivision 166-CA modifies the application of Subdivisions 165-CC and 165-CD in determining changeover times and alteration times for the purposes of the unrealised loss rules and inter-entity loss multiplication rules ***[Schedule 1, item 79, section 166-80]***.

- Subdivision 166-D explains how the ownership conditions interact with the rules in Subdivision 165-D ***[Schedule 1, item 79, section 166-135]***.

1.21 A company applying the modified COT satisfies the COT if it has substantial continuity of ownership at each test time in the ownership test period. ***[Schedule 1, item 79, subsections 166-5(3), 166-20(2), 166-40(3) and 166-80(2)]***

1.22 For each of Subdivisions 166-A, 166-B, 166-C and 166-CA, a widely held company or eligible Division 166 company has the right to elect that the modifications in Division 166 do not apply in relation to an income year. The choice must be made on or before the day the company lodges its income tax return for the year, or before a later day if the Commissioner allows. ***[Schedule 1, item 79, sections 166-15, 166-35, 166-50 and 166-90]***

Tax losses

1.23 Subdivision 166-A modifies the application of the COT in relation to deductions for tax losses of earlier income years. The COT is satisfied if there is substantial continuity of ownership between the beginning of the loss year and each test time in the test period. ***[Schedule 1, item 79, section 166-5]***

1.24 The test period runs from the start of the loss year to the end of the income year. The test times are the end of each income year in the test period and the end of certain corporate changes. ***[Schedule 1, item 79, subsections 166-5(2) to (4)]***

1.25 The test for substantial continuity of ownership is the alternative test in Division 165, but with several modifications. The alternative test requires a company to trace its ownership through to persons who are not companies. ***[Schedule 1, item 79, subsection 166-145(5)]***

1.26 If the company fails the modified COT, the company can nevertheless deduct the tax loss if it satisfies the SBT for the income year. ***[Schedule 1, item 79, subsection 166-5(5)]***

1.27 The SBT compares the business carried on by the company in the income year with the business carried on immediately before the company failed the COT. If the company does have substantial continuity of ownership at a particular test time, the SBT is applied to the business carried on immediately before that test time. ***[Schedule 1, item 79, subsection 166-5(6)]***

1.28 The SBT can only be satisfied if the company's total income is no more than $100 million in the income year for a loss that was incurred in an income year commencing on or after 1 July 2005. ***[Schedule 1, item 76, section 165-212A]***

Net capital losses, foreign losses and film losses

1.29 Subdivision 166-A is also relevant for net capital losses, foreign losses and film losses.

1.30 A net capital loss from an earlier income year can only be applied to reduce a net capital gain if it could have been deducted were it a tax loss (section 165-96 of the ITAA 1997). Accordingly, a company applies the tests in Subdivision 165-A to determine whether it can apply a net capital loss.

1.31 Similarly, a foreign loss does not reduce foreign income if Subdivision 165-A would have prevented a deduction had the foreign loss been a tax loss (subsection 160AFD(6) of the *Income Tax Assessment Act 1936* (ITAA 1936)).

1.32 Film losses are a subset of tax losses and are subject to the same rules regarding deductibility (with the addition of quarantining provisions in Subdivision 375-G).

1.33 It follows that the modifications that Subdivision 166-A makes to Subdivision 165-A are also relevant to determining whether:

- a net capital loss can be applied;
- a foreign loss can be taken into account; or
- a film loss can be deducted.

1.34 The SBT applies for these types of losses if the COT is failed. However, the SBT can only be satisfied if the company's total income is not more than $100 million in the income year. ***[Schedule 1, item 76, section 165-212A]***

Transfer of losses

1.35 Subdivision 166-A is also relevant to the transfer of losses to a head company under the consolidation regime and to the transfer of losses under Division 170 of the ITAA 1997.

1.36 The transfer of losses of any sort from a joining entity to the head company of a consolidated group depends on the joining entity being hypothetically entitled to utilise the loss in a trial year. Accordingly, in relation to a tax loss (including a film loss), a net capital loss or a foreign loss, the joining entity must meet the tests in Subdivision 165-A.

1.37 As a result, the modifications that Subdivision 166-A makes to Subdivision 165-A are relevant in determining whether losses can be transferred from a joining entity to a head company. Because the trial year is treated as if it were an income year, the end of the trial year is a test time for the purposes of the loss transfer tests.

1.38 A condition for the transfer of a loss under Division 170 is that neither company is prevented from deducting the loss by Division 165. Therefore, the modifications that Subdivision 166-A makes to Subdivision 165-A are also relevant for the purpose of Division 170 tax loss transfers.

Working out taxable income for a year of change

1.39 Subdivision 166-B modifies the operation of Subdivisions 165-B and 165-CB. Broadly, these Subdivisions require a company to divide its income year into separate periods for the purpose of calculating its taxable income, net capital gains, tax losses and net capital losses, if the company has had a change in ownership during the income year and has not satisfied the SBT.

1.40 For the purpose of Subdivision 166-B, substantial continuity of ownership is tested by comparing ownership at the beginning of the income year with ownership at the end of each corporate event during the year. ***[Schedule 1, item 79, subsections 166-20(2) and (3)]***

1.41 A key difference between Subdivision 166-B and the application of the modified COT in other contexts, is that in Subdivision 166-B there is no test time at the end of the income year. This is because an ownership change at the end of the year is not relevant for the purposes of dividing the income year into periods.

1.42 A company does not need to calculate its taxable income, net capital gains, tax losses and net capital losses under Subdivision 165-B or 165-CB unless either:

- there is a failure of substantial continuity of ownership at a test time during the income year; or
- a person begins to control, or becomes able to control, the voting power in the company for a purpose of getting a benefit or advantage (whether for themselves or someone else) in relation to how the ITAA 1997 applies (see section 165-40 of the ITAA 1997).

1.43 In either case, the company only needs to calculate its taxable income, net capital gains, tax losses and net capital losses under Subdivision 165-B or 165-CB if the company does not satisfy the SBT from the time immediately before the relevant test time (or the time the person become able to control the voting power) until the end of the income year. ***[Schedule 1, item 79, subsections 166-20(4) and (5)]***

1.44 If the company does not satisfy the SBT, the company must divide its income year into periods. Each period ends at the earliest time that either:

- there is a failure of substantial continuity of ownership; or
- a person begins or becomes able to control the voting power in the company for a purpose of getting a benefit or advantage (whether for themselves or someone else) in relation to how the ITAA 1997 applies.

[Schedule 1, item 79, section 166-25]

Deducting bad debts

1.45 Subdivision 166-C modifies the application of Subdivision 165-C for companies that are either widely held or eligible Division 166 companies for the entire income year in which the bad debt is written-off. ***[Schedule 1, item 79, subsection 166-40(1)]***

1.46 A company is taken to meet the conditions in section 165-123 about maintaining the same owners if there is substantial continuity of ownership at the relevant times. ***[Schedule 1, item 79, subsection 166-40(3)]***

1.47 If a debt is written-off as bad in the income year in which it is incurred, there must be substantial continuity of ownership between the start of the income year and each test time in the period ending at the end of the income year in which the debt is written-off. ***[Schedule 1, item 79, subsections 166-40(2) and (3)]***

1.48 If a debt incurred in a previous income year is written-off as bad, the company has a choice as to when the test period starts. The test period may start either on the day the debt was incurred or the start of the income year in which the debt was incurred. The company must establish substantial continuity of ownership between this start time and each test time in the period ending at the end of the income year in which the debt is written-off. ***[Schedule 1, item 79, subsections 166-40(2) and (3)]***

1.49 If the company cannot establish substantial continuity of ownership in the test period the company is not able to deduct the bad debt unless either:

- the Commissioner exercises the discretion provided in paragraph 165-120(1)(b) because it is considered to be unreasonable to require the company to meet the COT, having regard to the entities that beneficially owned shares in the company when the debt became bad; or

- the company satisfies the SBT for the second continuity period.

[Schedule 1, item 79, subsections 166-40(4) and (5)]

1.50 The SBT is applied to the business the company carried on immediately before the first test time on which there was no substantial continuity of ownership. ***[Schedule 1, item 79, subsection 166-40(6)]***

Changeover times and alteration times

1.51 Subdivision 166-CA modifies the application of Subdivisions 165-CC and 165-CD in determining whether there is a changeover time or alteration time during an income year in which a company is either a widely held company or an eligible Division 166 company at all times. ***[Schedule 1, item 79, subsection 166-80(1)]***

1.52 There is no changeover time or alteration time in a particular income year if there is substantial continuity of ownership between the reference time, the end of that income year and any other test times in that year. ***[Schedule 1, item 79, subsections 166-80(2) and (3)]***

1.53 The reference time is the date of the last changeover time for the company for the purposes of Subdivision 165-CC and the date of the last alteration time for the company for the purposes of Subdivision 165-CD. If no changeover time or alteration time has previously occurred, the reference time is the later of 11 November 1999 and the date the company came into existence.

1.54 If there is not substantial continuity of ownership at a test time, the changeover time or alteration time (as the case may be) occurs at the test time. ***[Schedule 1, item 79, subsections 166-80(4) to (6)]***

Substantial continuity of ownership

1.55 There is substantial continuity of ownership if (and only if) the company satisfies the alternative tests for voting power and rights to dividend and capital distributions. ***[Schedule 1, item 79, section 166-145]***

1.56 Broadly, the alternative tests are satisfied if during the test period:

- the same persons other than companies and trustees, directly or indirectly, hold more than 50 per cent of the voting power in the tested company ***[Schedule 1, item 79, subsection 166-145(2)]***;
- the same persons other than companies, directly or indirectly, hold for their own benefit more than 50 per cent of the rights to any dividends the tested company may pay ***[Schedule 1, item 79, subsection 166-145(3)]***; and
- the same persons other than companies, directly or indirectly, hold for their own benefit more than 50 per cent of the rights to any distributions of capital the tested company may make ***[Schedule 1, item 79, subsection 166-145(4)]***.

1.57 When testing for substantial continuity of ownership, there are two key modifications to the alternative tests in Subdivision 165-D:

- tracing rules can limit the tracing required by a company in determining who holds voting power or dividend and capital rights; and

- ownership is tested at the end of each income year and at the end of certain corporate changes, not continuously.

1.58 Apart from section 165-165, the other provisions in Subdivision 165-D apply for the purposes of substantial continuity of ownership. However, provisions relating to arrangements affecting the beneficial ownership of shares (section 165-180) and variations or potential variations in rights attaching to shares (sections 165-185 and 165-190) are read as if a reference to a particular time were a reference to the ownership test time. ***[Schedule 1, item 79, section 166-165]***

Test times

1.59 To satisfy the COT in Division 165 of the ITAA 1997, a company must maintain the same owners continuously from the start of the loss year to the end of the income year.

1.60 This rule is modified for widely held and eligible Division 166 companies by requiring substantial continuity of ownership between the start of the test period and certain specified times. There is no need to satisfy the modified COT continuously.

1.61 The end of each income year in the test period is a test time, other than for the purposes of Subdivision 166-B. The end of a corporate change in the test period is also a test time. ***[Schedule 1, item 79, subsections 166-5(3), 166-20(2), 166-40(3) and 166-80(2)]***

1.62 The following are the end of a corporate change:

- the end of the bid period of a takeover bid for the company (whether or not the takeover bid is successful) ***[Schedule 1, item 79, paragraphs 166-175(1)(a) and (2)(a)]***;

- the end of a court approved scheme of arrangement involving more than 50 per cent of the company's shares ***[Schedule 1, item 79, paragraphs 166-175(1)(b) and (2)(b)]***;

- the end of any other arrangement involving the acquisition of more than 50 per cent of the company's shares, regulated under either the *Corporations Act 2001* or a foreign law ***[Schedule 1, item 79, paragraphs 166-175(1)(c) and (2)(b)]***; and

- the end of an offer period for an issue of shares in the company that increases the issued capital or the number of

shares by 20 per cent or more ***[Schedule 1, item 79, paragraphs 166-175(1)(d) and (2)(c)].***

1.63 There is also a corporate change if one of those events happens to another company that holds more than 50 per cent of voting power, or dividend or capital rights in the tested company. ***[Schedule 1, item 79, paragraph 166-175(1)(e) and subsection 166-175(2)]***

1.64 In relation to the transfer of losses to a consolidated group, continuity of ownership is tested for a trial year ending just after the joining time (section 707-120). Because continuity of ownership is tested as if the trial year were an income year, the end of the trial year is a test time even if it does not correspond to the end of an actual income year. The same principle is relevant to other consolidation provisions that refer to trial years (see Division 715) or debt test income years (see Subdivision 709-D).

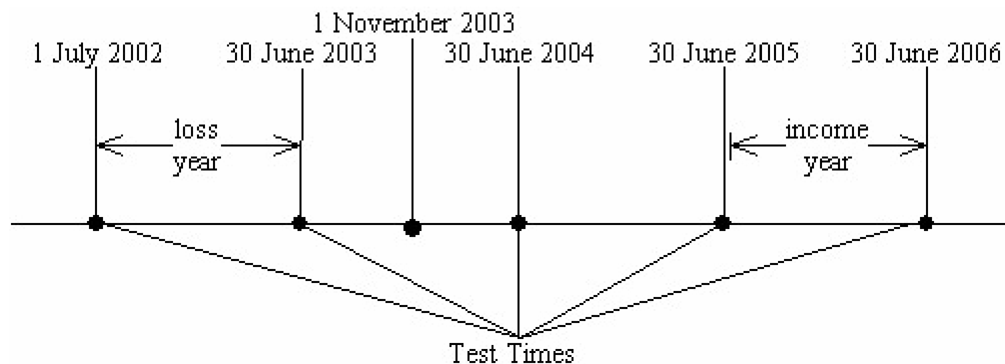
Example 1.3: Testing continuity of ownership

In the income year ended 30 June 2006, Loss Company is eligible for the modified COT because it is a widely held company.

Loss Company incurred a tax loss in the year commencing 1 July 2002 and tests to determine whether it can deduct the tax loss in the year ended 30 June 2006.

On 1 November 2003, Loss Company issued further shares that increased its share capital by 30 per cent. It has had no takeover bids, schemes of arrangement or any other events in the nature of a takeover during the ownership period.

Loss Company will satisfy the modified COT if it can establish substantial continuity of ownership between 1 July 2002 and each of 30 June 2003, 1 November 2003, 30 June 2004, 30 June 2005 and 30 June 2006.



Tracing rules

1.65 The following tracing rules make it easier for companies to test for substantial continuity of ownership:

- A direct stake of less than 10 per cent is attributed to a single notional entity ***[Schedule 1, item 79, section 166-225]***.
- An indirect stake of less than 10 per cent is attributed to the top interposed entity ***[Schedule 1, item 79, section 166-230]***.
- A stake of between 10 per cent and 50 per cent (inclusive) held by a widely held company is attributed to the widely held company as an ultimate owner ***[Schedule 1, item 79, section 166-240]***.
- A stake held by an entity deemed to be a beneficial owner (a superannuation fund, approved deposit fund, special company or managed investment scheme) will generally be attributed to that entity as an ultimate owner ***[Schedule 1, item 79, section 166-245]***.
- An indirect stake held by way of bearer shares in a foreign listed company is attributed to a single notional entity in certain circumstances ***[Schedule 1, item 79, section 166-255]***.
- An indirect stake held by a depository entity through shares in a foreign listed company is attributed to the depository entity as an ultimate owner in certain circumstances ***[Schedule 1, item 79, section 166-260]***.

Direct stakes of less than 10 per cent

1.66 The tracing of small ownership interests gives rise to high compliance costs for widely held companies. The modified COT is designed to reduce compliance costs by removing the need to trace ownership interests of less than 10 per cent.

1.67 For all registered shareholdings carrying less than 10 per cent of voting power, the voting power is taken to be controlled by a single notional entity. The same rule applies in relation to rights to dividends and distributions of capital. ***[Schedule 1, item 79, section 166-225]***

1.68 The single notional entity is taken to be a person (other than a company), and is therefore regarded as an ultimate owner for the purpose

of the alternative test. The persons who actually hold the power or rights attributed to the single notional entity are taken not to hold those rights for the purposes of the alternative test. This prevents double counting of the voting power and rights to dividends and capital. ***[Schedule 1, item 79, paragraph 166-225(2)(c) and section 166-265]***

1.69 Voting power and rights to dividends and capital are dealt with separately. For example, if a particular shareholding represents 5 per cent of voting power, but 15 per cent of dividend rights, the voting power attached to the shareholding is allocated to the single notional entity, but not the dividend rights.

Nominee shareholders

1.70 If a nominee company is the registered shareholder, but holds the shares for more than one other entity, the tested company may treat the parcels of shares held by the nominee company as separate stakes for the purpose of this tracing rule. This means that if the nominee company's registered shareholding carries 10 per cent or more of voting power or rights, but the entities for which it holds the shares each have less than 10 per cent of voting power or rights, each of the stakes of less than 10 per cent can be attributed to the single notional entity. ***[Schedule 1, item 79, subsection 166-235(7)]***

Example 1.4: Nominee shareholders

> Beta Nominees Limited is the registered holder of 30 per cent of shares in the tested company. It holds these shares on behalf of 5 different entities, each of which beneficially own 6 per cent of the tested company's shares.
>
> Each stake of 6 per cent may be attributed to the single notional entity.

1.71 The separation of stakes held by nominee companies is optional. If the nominee company's registered shareholding is less than 10 per cent, its stake could be attributed directly to the single notional entity. In such a case, there would be no need for the tested company to inquire as to the identity of underlying stakeholders, provided the company is satisfied that the controlled test companies rule would not apply.

Indirect stakes of less than 10 per cent

1.72 A tested company does not need to trace the beneficial owners of indirect interests in the company that carry less than 10 per cent of the voting power and rights to dividends and capital. This rule will reduce the

compliance costs incurred by companies identifying their indirect ownership. ***[Schedule 1, item 79, subsection 166-230(1)]***

1.73 In relation to an indirect stake of less than 10 per cent, the top interposed entity is taken to hold the relevant voting stake, dividend stake or capital stake. The top interposed entity is the entity in which the stakeholder with a less than 10 per cent interest has a direct interest. This entity need not be a company. ***[Schedule 1, item 79, subsection 166-230(2)]***

1.74 For example, a stakeholder may have an 8 per cent voting stake in the tested company, which is held through a chain of interposed companies. The top interposed entity is the company in which the stakeholder is a shareholder. If a stakeholder holds an indirect interest in a company as a beneficiary in a trust, the trust would be the top interposed entity.

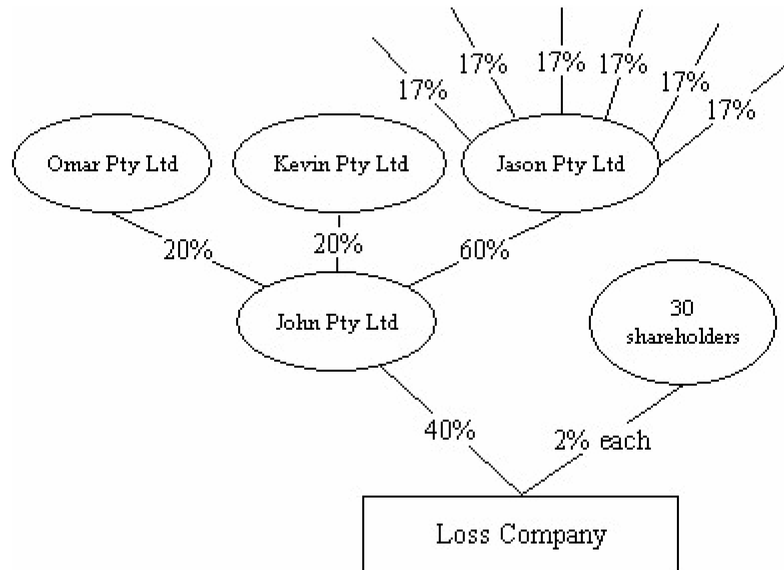
1.75 The tested company may treat a nominee company as holding a separate indirect stake in respect of each entity for which the nominee company holds shares. The effect is that each of these stakes of less than 10 per cent may be attributed to the company in which the nominee company holds shares as the top interposed entity. Separation of stakes for the purpose of the top interposed entity rule is optional. ***[Schedule 1, item 79, subsection 166-235(7)]***

1.76 The top interposed entity is taken to be a 'person (other than a company)' and is therefore regarded as the ultimate owner of the stake. ***[Schedule 1, item 79, paragraph 166-230(2)(d)]***

1.77 The persons who actually hold the power or rights attributed to the top interposed entity are taken not to hold that power or those rights for the purposes of the alternative test. This prevents double counting of the voting power and rights to dividends and capital. ***[Schedule 1, item 79, section 166-265]***

1.78 Voting, dividend and capital stakes are dealt with separately. For example, if an entity holds a voting stake of less than 10 per cent and dividend and capital stakes of 10 per cent or more, the voting stake would be attributed to the top interposed entity, but not the dividend or capital stakes.

Example 1.5: Direct and indirect stakes of less than 10 per cent



Loss Company is a listed company which is 40 per cent owned by John Pty Ltd. Thirty other shareholders hold 2 per cent each of its remaining shares. All shares in Loss Company carry equal rights in relation to voting, dividends and capital distribution.

The voting power, rights to dividends and rights to capital attaching to each of the 2 per cent shareholdings will be attributed to the single notional entity. This is because they are each direct stakes of less than 10 per cent in Loss Company. In total, the single notional entity will be taken to hold 60 per cent of voting power and rights to dividends and capital.

John Pty Ltd owns more than 10 per cent of Loss Company and is not a widely held company. Accordingly, it will be necessary to trace through John Pty Ltd.

John Pty Ltd is owned 20 per cent each by Omar Pty Ltd and Kevin Pty Ltd and 60 per cent by Jason Pty Ltd. The stakes of Omar Pty Ltd and Kevin Pty Ltd represent 8 per cent each of Loss Company (20% $\times$ 40%). Because the stakes of Omar Pty Ltd and Kevin Pty Ltd are each less than 10 per cent of Loss Company they will be attributed to the top interposed entity, which is John Pty Ltd.

The indirect stake of Jason Pty Ltd in Loss Company is 24 per cent (60% $\times$ 40%). Jason Pty Ltd is not a widely held company. Accordingly, it will be necessary to trace through Jason Pty Ltd.

Shares in Jason Pty Ltd are owned equally by 6 individual shareholders, each of those shareholders will have a 4 per cent indirect stake in Loss Company (16.7% × 60% × 40%). Because their stakes in Loss Company are less than 10 per cent, they will be attributed to Jason Pty Ltd as the top interposed entity.

The outcome of tracing is that the single notional entity is taken to hold 60 per cent of voting power and dividend and capital rights, John Pty Ltd is taken to hold 16 per cent of voting power and dividend and capital rights and Jason Pty Ltd is taken to hold 24 per cent of voting power and dividend and capital rights.

Interposition of a holding company between stakeholders and a top interposed entity

1.79 Ownership of a top interposed entity could be restructured after the start of the test period so that a holding entity is inserted between the top interposed entity and the less than 10 per cent stakeholders. Without any modification, this would be recognised as an ownership change and may lead to a failure of the modified COT because the new interposed entity would become the top interposed entity.

1.80 In such circumstances, provided certain conditions are met, the *new* top interposed entity can be regarded as having held the stake at all times the *old* top interposed entity did. The relevant conditions are:

- the new entity must acquire all the shares in the old entity;
- the new entity must have the same classes of shares or other interests as the old entity (eg, if the old entity is a unit trust, the interests in the new entity must be units in a unit trust);
- if the new entity is a company, its shares must not be redeemable; and
- each stakeholder must hold the same proportion of voting stakes, dividend stakes or capital stakes in the new entity just after the restructure as it did in the old entity just before the restructure.

[Schedule 1, item 79, subsection 166-230(3)]

1.81 The impact of introducing a new holding entity on the same share same interest rule is disregarded, except for the purpose of determining whether there is an alteration time. The introduction of a new holding

entity may lead to an alteration time. ***[Schedule 1, item 79, subsection 166-230(4)]***

Stakes held by widely held companies

1.82 A widely held company is treated as the ultimate owner of a direct or indirect stake in a tested company, if the stake is between 10 per cent and 50 per cent (inclusive). The rule only applies if the company is a widely held company for the whole of the income year in which the ownership test time occurs. ***[Schedule 1, item 79, section 166-240]***

1.83 Voting, dividend and capital stakes are treated separately. For example, if a widely held company's voting stake in the tested company is 40 per cent and its dividend stake is 55 per cent, it is treated as an ultimate owner in relation to its voting stake, but not its dividend stake.

Example 1.6: Widely held company

> Listed Co holds interests in the tested company through 2 or more different shareholdings. Listed Co owns a 20 per cent interest in Loss Company through A Co and a 35 per cent interest in Loss Company through B Co.
>
> The shareholdings of Listed Co are aggregated to determine its stake. Listed Co's stake in Loss Company is 55 per cent and therefore the widely held company tracing rule will not apply.

1.84 Stakes of less than 10 per cent are not subject to the widely held company tracing rule. Instead they are attributed to the single notional entity or the top interposed entity under those tracing rules.

1.85 The persons who hold power or rights in the tested company indirectly through the widely held company are taken not to hold that power or those rights for the purposes of the alternative test. This prevents double counting of the voting power and rights to dividends and capital. ***[Schedule 1, item 79, section 166-265]***

Interposition of a widely held holding company above an existing widely held company

1.86 If ownership of a company that is widely held is restructured after the start of the test period by inserting a holding company between the widely held company and its shareholders, the existing company would cease to be widely held, but the holding company may become widely held (eg, if it is listed).

1.87 The new widely held company is taken to hold the same stake at all times as the existing widely held company if the following conditions are met:

- the new company acquires all the shares in the widely held company;
- immediately before the acquisition, the shares of the widely held company were listed on an approved stock exchange;
- immediately after the acquisition, shares of the new company are listed on an approved stock exchange;
- the new company has the same classes of shares as the widely held company (which are not redeemable); and
- each entity that held stakes in the widely held company immediately before the acquisition holds stakes in the new company in the same proportions just after the acquisition.

[Schedule 1, item 79, subsection 166-240(4)]

1.88 The impact of introducing a holding entity on the same share same interest rule is disregarded, except for the purposes of determining whether there is an alteration time. The introduction of a new holding entity may lead to an alteration time. ***[Schedule 1, item 79, subsection 166-240(5)]***

Entities deemed to be beneficial owners

1.89 Generally, the COT requires a company to trace through all corporate shareholders and trusts until it identifies the ultimate individual holders of voting power and rights to dividends and capital.

1.90 However, in the modified COT, a tracing rule treats some types of entities as ultimate owners if they meet particular conditions. ***[Schedule 1, item 79, subsection 166-245(1)]***

1.91 The relevant entities are:

- superannuation funds;
- approved deposit funds;
- managed investment schemes; and
- special companies.

[Schedule 1, item 79, subsection 166-245(2)]

1.92 In addition, other entities may be prescribed by the *Income Tax Regulations 1997*. ***[Schedule 1, item 79, paragraph 166-245(2)(e)]***

1.93 If an entity deemed to be a beneficial owner has more than 10 members, the modified COT in Division 166 applies as if the entity were a person (other than a company) who held the relevant rights. ***[Schedule 1, item 79, subsection 166-245(6)]***

1.94 If such an entity has 10 or fewer members at a test time, each of the members is taken to hold the voting, dividend and capital stakes in the entity equally. Each member is also treated as a person (other than a company), regardless of whether the member is actually an individual or other kind of entity. ***[Schedule 1, item 79, subsection 166-245(4)]***

1.95 However, if each member's stake in the tested company is less than 10 per cent, it is attributed back to the entity that is deemed to be a beneficial owner. ***[Schedule 1, item 79, paragraph 166-245(5)(b)]***

1.96 The stakes of individuals who hold interests in the tested company through an entity treated as an ultimate owner are disregarded. ***[Schedule 1, item 79, section 166-265]***

1.97 This tracing rule does not apply to stakes of less than 10 per cent in the company. Instead, the tracing rule about direct stakes of less than 10 per cent or indirect stakes of less than 10 per cent will apply. ***[Schedule 1, item 79, paragraph 166-245(1)(b)]***

Superannuation funds

1.98 A superannuation fund is treated as an ultimate owner if it is a complying superannuation fund. ***[Schedule 1, item 79, subparagraph 166-245(3)(a)(i)]***

1.99 A superannuation fund is also treated as an ultimate owner if it is established in a foreign country and regulated under a foreign law relating to the supervision of superannuation funds. ***[Schedule 1, item 79, subparagraph 166-245(3)(a)(ii)]***

Approved deposit funds

1.100 Approved deposit funds are deemed to be beneficial owners if they are complying approved deposit funds. ***[Schedule 1, item 79, paragraph 166-245(3)(b)]***

Special companies

1.101 Special companies are deemed to be beneficial owners. ***[Schedule 1, item 79, paragraph 166-245(3)(c)]***

1.102 Mutual insurance companies, mutual affiliate companies, trade unions registered under an Australian law and sporting clubs are 'special companies'. In addition, the regulations may prescribe certain companies to be special companies (see subsection 995-1(1) of the ITAA 1997).

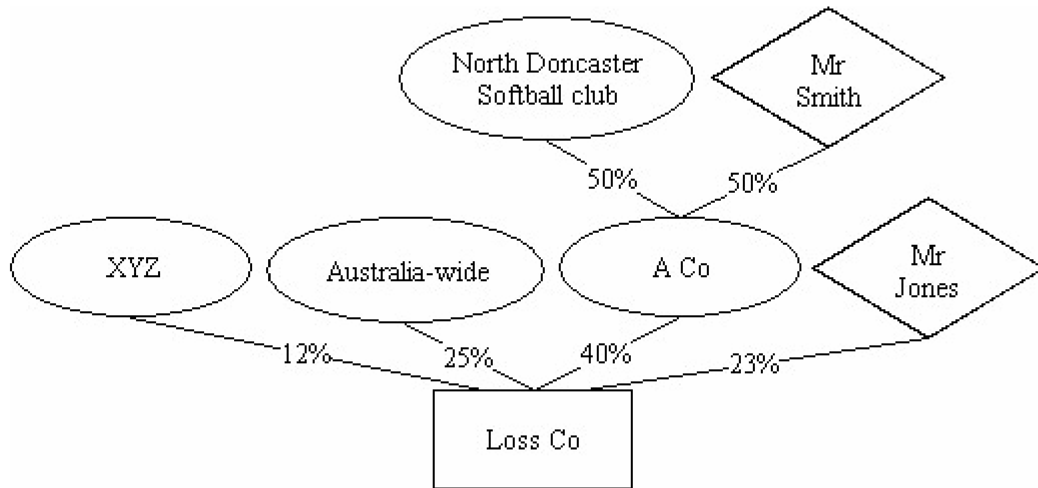
Managed investment schemes

1.103 A 'managed investment scheme' is deemed to be a beneficial owner if it has more than 20 members and it is either registered under Part 5C of the *Corporations Act 2001* or is regulated as a managed investment scheme under a foreign law. ***[Schedule 1, items 79 and 151, paragraph 166-245(3)(d) and subsection 995-1(1)]***

Regulations

1.104 There is a regulation-making power to add other entities to the list of those deemed to be beneficial owners. This will allow other entities to be treated as ultimate owners if it is demonstrated that there is difficulty in tracing ownership through particular types of entities and there is little risk of loss trafficking in deeming such entities to be beneficial owners. ***[Schedule 1, item 79, paragraphs 166-245(2)(e) and (3)(e)]***

Example 1.7: Entities deemed to be beneficial owners



The shareholding of Loss Co Pty Ltd is:

XYZ Managed Investment Fund	12%
Australia-wide Insurance Ltd (a mutual insurance company)	25%
A Co Pty Ltd	40%
Mr Jones	23%

All shares in Loss Co Pty Ltd carry equal voting, dividend and capital rights. Loss Co Pty Ltd is an eligible Division 166 company.

XYZ Managed Investment Fund is registered under Part 5C of the *Corporations Act 2001* and has more than 20 members. Accordingly, it will be treated as the ultimate owner of its 12 per cent stake.

Australia-wide Insurance Ltd has more than 10 members and is a mutual insurance company. Therefore, it will be treated as the ultimate owner of its 25 per cent stake.

A Co Pty Ltd is 50 per cent owned by the North Doncaster Softball club, which is a sporting club with more than 10 members. The other 50 per cent of A Co Pty Ltd is owned by Mr Smith. North Doncaster Softball club is a sporting club, a type of special company. Hence it will be treated as the ultimate owner of its 20 per cent indirect stake in Loss Co Pty Ltd.

Accordingly, the result of applying the Division 166 tracing rules to Loss Co Pty Ltd is that the following owners are identified:

XYZ Managed Investment Fund	12%
Australia-wide Insurance (a mutual insurance company)	25%
North Doncaster Softball Club	20%
Mr Smith	20%
Mr Jones	23%

Bearer shares

1.105 Bearer shares are negotiable instruments which accord ownership of shares in a company to the person who possesses the bearer share certificate. The owners of bearer shares are not recorded in a register. Rather, the transfer of bearer shares occurs through the physical handover of the share certificate. Accordingly, it is not ordinarily practicable for a company to trace ownership through bearer shares.

1.106 Bearer shares are common in many countries, although Australian companies are prohibited from issuing bearer shares (section 254F of the *Corporations Act 2001*).

1.107 A tracing rule applies to bearer shares carrying voting, dividend or capital stakes in a foreign listed company which has a direct or indirect stake in the tested company if the following conditions are satisfied:

- There are persons (or it is reasonable to assume there are persons), other than companies or trustees, who have a voting stake, dividend stake or capital stake in the tested company. (This condition would always be met because there would be persons who hold voting stakes, dividend stakes or capital stakes in the tested company, even if such persons cannot be identified.)

- No other tracing rule has applied in relation to the stake.

- A foreign listed company is interposed between those persons and the tested company.

- The principal class of shares of the foreign listed company is listed for quotation in the official list of an approved stock exchange. The principal class of shares is the ordinary or

common shares of the company provided they represent the majority of voting power and value of the company. If there is no single class that represents the majority of voting power or value it is the aggregate of those classes that together do represent such a majority.

- Fifty per cent or more of the voting, dividend or capital stakes in the foreign listed company are held by way of bearer shares.

- The beneficial owners of some or all of the bearer shares have not been disclosed to the foreign listed company.

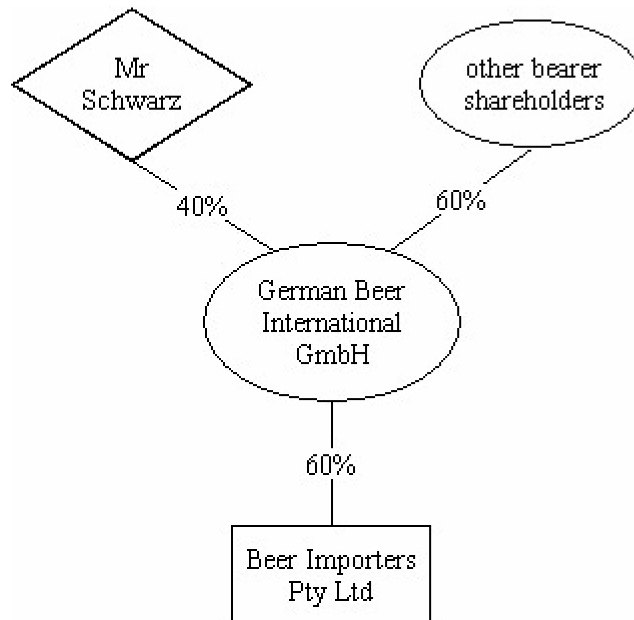
[Schedule 1, items 79 and 159, subsections 166-255(1) and 995-1(1)]

1.108 If the tracing rule applies, a single notional entity is taken to control the voting power in the tested company that is carried by the bearer shares and to have the right to receive any dividends and distributions of capital in the tested company that those shares carry. ***[Schedule 1, item 79, subsection 166-255(2)]***

1.109 However, this concession only applies to shares whose beneficial owners have not been disclosed to the foreign listed company. For example, if a foreign listed company received a notice that disclosed substantial shareholdings, the tracing rule would not apply in relation to those shares, even if the disclosure was required under the corporate law of the relevant jurisdiction. ***[Schedule 1, item 79, subsection 166-255(2)]***

1.110 The single notional entity that is taken to hold the voting power and dividend and capital rights is a different single notional entity to that which is taken to hold direct ownership interests of less than 10 per cent in the tested company. ***[Schedule 1, item 79, subsection 166-255(3)]***

Example 1.8: Bearer shares



Beer Importers Pty Ltd is 60 per cent owned by German Beer International GmbH, a company listed on the Frankfurt Stock Exchange. All of the shares in German Beer International GmbH are held by way of bearer shares that carry equal rights to voting, dividends and capital.

German Beer International GmbH has not been informed directly of the identities of its bearer shareholders, but it is aware that one of its directors, Mr Schwarz, owns 40 per cent of the German Beer International GmbH shares. Mr Schwarz became a director after he acquired his 40 per cent stake.

The other 40 per cent of shares in Beer Importers Pty Ltd are held by a variety of individuals and companies and no shareholding is 10 per cent or more.

German Beer International GmbH is listed on an approved stock exchange and more than 50 per cent of its shares are held as bearer shares. Accordingly, the bearer shares are taken to be owned by a single notional entity. However, the shareholding of Mr Schwarz is known to German Beer International GmbH and therefore this interest is not included in the shareholding attributed to the single notional entity.

Voting power and dividend and capital stakes of Beer Importers Pty Ltd are attributed as follows:

- twenty-four per cent to Mr Schwarz;
- forty-per cent to a single notional entity (the interests of less than 10 per cent); and
- thirty-six per cent to a different single notional entity (the bearer shares, minus Mr Schwarz's interest).

Depository entities

1.111 A depository entity is a central securities repository, which provides custody of share certificates and services relating to the exchange of shares. The Depository Trust Company in the United States is an example of a depository entity. ***[Schedule 1, item 79, subsection 166-260(5)]***

1.112 If a law of the country in which a depository entity is based prohibits the disclosure of shareholder information by the depository entity, it may be impossible for an Australian company to trace its ownership through the depository entity. If these shareholders hold 50 per cent or more of shares in the company, then the company would not be able to establish whether it satisfies the COT.

1.113 A tracing rule applies to shares in a foreign listed company held by a depository entity if the following conditions are satisfied:

- There are persons (or it is reasonable to assume there are persons), other than companies or trustees, who have a voting stake, dividend stake or capital stake in the tested company. (This condition would always be met because there would be persons who hold voting stakes, dividend stakes or capital stakes in the tested company, even if such persons cannot be identified.)
- No other tracing rule has applied in relation to the stake.
- A foreign listed company is interposed between those persons and the tested company.
- The 'principal class of shares' of the foreign listed company is listed for quotation in the official list of an approved stock exchange. The principal class of shares is the ordinary or common shares of the company provided they represent the majority of voting power and value of the company. If there

is no single class that represents the majority of voting power or value it is the aggregate of those classes that together represent such a majority.

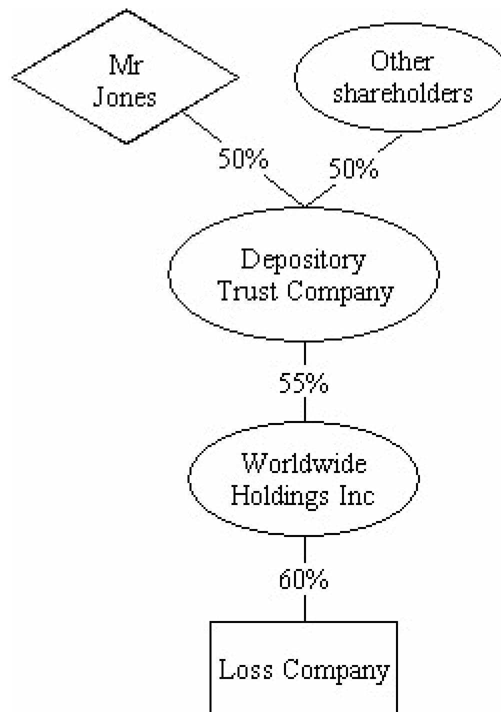
- Fifty per cent or more of the voting power or dividend or capital rights in the foreign listed company are held through one or more depository entities.
- A law of the foreign country, or part of the foreign country in which the approved stock exchange is located, prevents the disclosure of the beneficial owners of some or all of the shares that are held by the depository entity.
- The beneficial owners of some or all of the shares held by the depository entities have not been disclosed to the foreign listed company.

[Schedule 1, items 79 and 159, subsections 166-260(1) and 995-1(1)]

1.114 The tracing rule provides that the depository entity is taken to be a person (other than a company) who holds all of the voting power and dividend and capital rights carried by the relevant shares. The rule does not apply to the extent that the beneficial owners of the relevant shares have been disclosed to the foreign listed company. For example, in a particular jurisdiction a depository entity may be allowed to provide to the foreign listed company the names of the beneficial owners who have advised the depository entity that they do not object to their details being revealed to the company. The stakes held by such shareholders would not be attributed to the depository entity. ***[Schedule 1, item 79, subsection 166-260(2)]***

1.115 If one depository entity replaces another, the new depository entity is taken to have held at all relevant times the stakes that were held by the old depository entity. This rule ensures that a change in the entity who has custody of the share certificates which is not accompanied by a change in underlying beneficial ownership does not cause failure of the modified COT. ***[Schedule 1, item 79, subsection 166-260(4)]***

Example 1.9: Depository entities



Loss Company Pty Ltd is 60 per cent owned by Worldwide Holdings Inc, a company listed on the New York Stock Exchange. Fifty-five per cent of shares in Worldwide Holdings Inc are held by the Depository Trust Company. A law of the relevant jurisdiction prohibits the Depository Trust Company from disclosing the names of the beneficial owners of the shares which it holds.

All shares in Loss Company Pty Ltd and Worldwide Holdings Inc carry equal rights to voting, dividends and capital.

The Depository Trust Company will be treated as holding 33 per cent (60% × 55%) of Loss Company Pty Ltd.

However, if Worldwide Holdings Inc was aware that 50 per cent of the interests held through the Depository Trust Company were held by Mr Jones, the Depository Trust Company would not be attributed the interests of Mr Jones. In such a case, Mr Jones would be attributed the 16.5 per cent interest that he holds (50% of 33%), and the Depository Trust Company would be attributed the remaining 16.5 per cent interest.

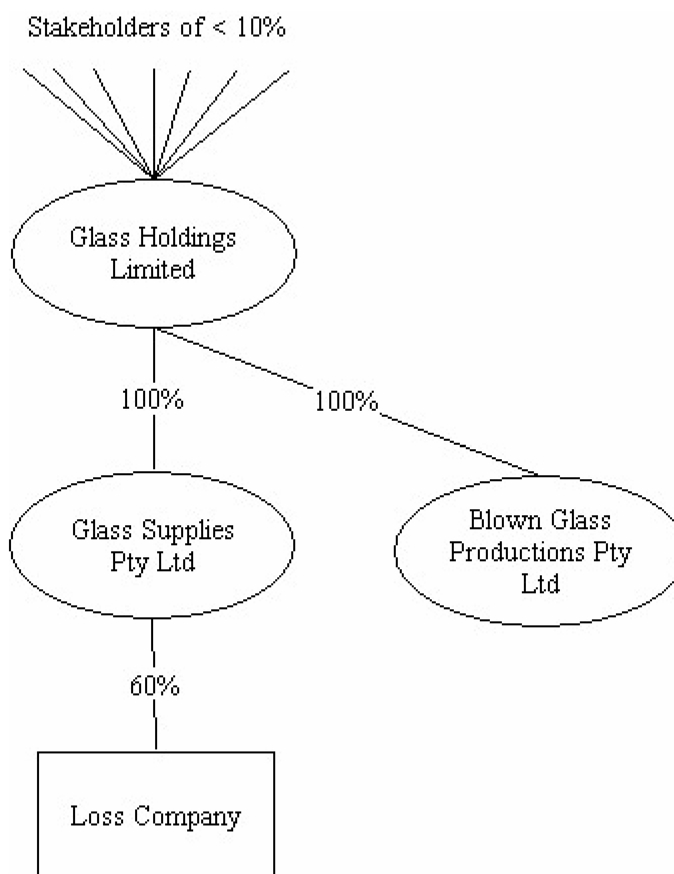
Same share same interest rule

1.116 In applying the normal COT, a company can only take account of interests held by persons if they are the same interests and are held by the same persons throughout the test period. The rule ensures that a loss is not available for deduction if it has been substantially duplicated through CGT events happening to direct or indirect interests in the company.

1.117 The new modified COT contains a comparable rule, but it is only applicable in respect of shares or other interests held by a top interposed entity, a widely held company, an entity deemed to be a beneficial owner or a depository entity ***[Schedule 1, item 79, section 166-272].*** The purpose is to ensure that a loss or deduction is not available if it has been substantially duplicated through capital gains tax (CGT) events happening to interests held directly or indirectly by top interposed entities, widely held companies, entities deemed to be beneficial owners or depository entities.

1.118 For example, if a top interposed entity holds shares directly in the tested company, those shares must be the same shares at each test time to be taken into account for the modified COT. Similarly, if a top interposed entity holds shares in another company that holds shares in the tested company, both the shares held by the top interposed entity and the interposed company must be the same shares and held by the same persons at each test time. ***[Schedule 1, item 79, subsection 166-272(2)]***

Example 1.10: Same share same interest rule



Loss Company incurs a tax loss in the income year ending 30 June 2006. At the start of the loss year, Loss Company is 60 per cent owned by Glass Supplies Pty Ltd. Glass Supplies is a wholly-owned subsidiary of Glass Holdings Limited. No entity holds a 10 per cent or greater stake in Loss Company through Glass Holdings. Accordingly, Glass Holdings is attributed stakes totalling 60 per cent by the top interposed entity tracing rule.

Before the next test time, Glass Holdings undertakes a group restructure. Shares in Loss Company are transferred from Glass Supplies to Blown Glass Productions Pty Ltd, another 100 per cent subsidiary of Glass Holdings Limited.

At the second test time, the same share same interest rule prevents the attribution of the stake to Glass Holdings Limited. This is because Glass Holdings Limited no longer holds its interest in Loss Company through the same shares.

However, if there is no substantial duplication of losses, the savings provision may apply.

1.119 The same share same interest rule does not require that shares or interests held by persons in a top interposed entity, widely held company, entity deemed to be a beneficial owner or depository entity be the same shares or interests. Nor does the rule require that stakes attributed from less than 10 per cent stakeholders to a top interposed entity, for example be the same at each test time. Provided that the top interposed entity itself holds the same shares or other interests, all stakes attributed to it through the top interposed entity tracing rule can be taken into account.

Example 1.11: Same share same interest rule and attribution of stakes

Alpha Pty Ltd holds 30 per cent of shares in the tested company throughout the test period. At the start of the period, the top interposed entity tracing rule attributes stakes totalling 15 per cent to Alpha. At the second time in the test period, the top interposed entity tracing rule attributes stakes totalling 30 per cent to Alpha.

Provided Alpha continues to hold the same shares, the fact that the stakes attributed to it have increased from 15 per cent to 30 per cent is irrelevant to the same share same interest rule. It is also irrelevant that the people whose stakes have been attributed to Alpha may have changed.

1.120 The same share same interest rule contains provisions that ensure that share splits, unit splits, share consolidations and unit consolidations do not affect continuity of ownership. ***[Schedule 1, item 79, subsections 166-272(3) to (6)]***

Savings provision

1.121 The same share same interest rule is subject to a savings provision. The savings provision in effect negates the same share same interest rule if there is not substantial duplication of the tax loss, notional loss, bad debt or unrealised net loss (as the case may be) through CGT events occurring in respect of direct or indirect interests in the tested company during the test period. ***[Schedule 1, item 79, subsections 166-272(8) and (11)]***

1.122 Although the savings rule does not directly refer to net capital losses or foreign losses of the tested company, the effect of section 165-96 of the ITAA 1997 and subsection 160AFD(6) of the ITAA 1936 is that it will also apply if there is not substantial duplication of these types of losses.

1.123 In determining whether loss duplication has occurred the only interests taken into account are those held by top interposed entities, widely held companies, entities deemed to be beneficial owners and depository entities, as well as entities interposed between them and the tested company. The duplication of a loss at the level of persons who hold stakes of less than 10 per cent, for example will not prevent the savings provision applying.

1.124 A loss can only be reflected in ownership interests to the extent that it represents an economic loss. Therefore, the savings provision would apply if the relevant loss is predominantly a non-economic loss.

1.125 Similarly, the savings provision would apply if losses (or reduced gains) on the sale of shares were disregarded because the shares were pre-CGT assets.

1.126 The savings provision will not apply if the loss will be duplicated in the future because of a CGT event during the period. This might occur if a capital loss has been recognised, but deferred by Subdivision 170-D.

1.127 The savings provision does not apply for the purpose of determining whether an alteration time occurs ***[Schedule 1, item 79, subsection 166-272(9)]***. Accordingly, in some cases the modified COT may be failed because of the application of the same share same interest rule for the purposes of Subdivision 165-CD, but not failed for other purposes. Subdivision 165-CD can result in a reduction of the reduced cost base of certain direct or indirect interests in the tested company. This may be sufficient to prevent the substantial duplication of a loss and therefore result in the savings provision applying for other purposes.

Example 1.12: Savings provision

In Example 1.10, the savings provision may, however, apply so that Loss Company can continue to satisfy the modified COT in respect of its carry-forward tax loss.

The savings rule would apply if the tax loss is not reflected in deductions, capital losses or reduced assessable income for Glass Holdings, Glass Supplies or Blown Glass Productions. This could be the case if:

- Glass Holdings, Glass Supplies and Blown Glass Productions are part of a consolidated group, so no CGT event occurs on the transfer of the shares; or

- the application of Subdivision 165-CD prevents a capital loss arising for Glass Supplies on the transfer of its shares to Blown Glass Productions.

Minimum interests rule

1.128 The same share same interest rule does not apply in respect of stakes held by a single notional entity. The application of the same share same interest rule to direct interests in the tested company of less than 10 per cent would be inappropriate because it would be contrary to the policy of allowing the tested company to disregard interests of less than 10 per cent.

1.129 Instead, a minimum interests rule applies to stakes taken to be held by a single notional entity under the tracing rule relating to direct stakes of less than 10 per cent or the tracing rule relating to bearer shares.

1.130 The minimum interests rule restricts the total proportion of voting power, dividend rights and capital rights attributed to the single notional entity to the proportion attributed to it at the beginning of the test period. ***[Schedule 1, item 79, section 166-270]***

1.131 Changes among the less than 10 per cent stakeholders are not relevant to the operation of the minimum interests rule. It is only an increase in the aggregate proportion that is taken to be held by the single notional entity that is prevented.

1.132 Further, an increase in the number of shares that carry voting power or rights is not relevant if it does not correspond to an increase in the proportion of voting power or rights. For example, the tested company may raise capital during the test period by issuing shares to existing shareholders. This may substantially increase the number of shares holding voting power or dividend or capital rights that are attributed to the single notional entity. However, unless it causes an increase in the proportion of voting power or rights, the minimum interests rule has no operation.

Example 1.13: Minimum interests rule

At the start of the test period, there are 3 shareholders with a less than 10 per cent stake in the tested company. Simon holds 8 per cent, Natalie holds 6 per cent and Tim holds 5 per cent. The tracing rule concerning direct stakes of less than 10 per cent operates to attribute their stakes, totalling 19 per cent, to the single notional entity.

At the next test time, Simon continues to hold 8 per cent, Natalie holds 9 per cent and Fiona holds 7 per cent. Tim no longer holds an interest in the tested company. Their total interest of 24 per cent would be attributed to the single notional entity. However, because this exceeds the proportion at the start of the test period, the minimum interests rule operates to reduce the amount taken into account to 19 per cent.

No detrimental operation of tracing rules

1.133 The purpose of the tracing rules is to assist a company trace its ownership interests to determine whether it satisfies the COT. However, there may be cases where these rules make it more difficult for a company to satisfy the COT. While the company could choose not to apply the modified COT, that would not allow the company to use any of the tracing rules.

1.134 The modified COT allows a tracing rule to be disregarded in respect of a particular stake if it would cause the company to fail the ownership tests. A company is taken to satisfy the relevant conditions if the company believes on reasonable grounds that it would not fail the conditions if the tracing rule did not apply in respect of that stake. ***[Schedule 1, item 79, section 166-275]***

1.135 The rule does not prevent other tracing rules potentially applying to the relevant stake or the same tracing rule applying in respect of other stakes. It merely allows tracing rules to be disregarded in these circumstances to the extent that they would cause a failure of the modified COT.

1.136 The company must hold a reasonable belief that it would not fail the tests if the tracing rule did not apply. In most cases a company would be expected to form this view by applying the test for substantial continuity of ownership in the normal way, this is without the use of that tracing rule in respect of the particular stake. However, it is recognised that in some cases, despite its best endeavours, a company may be unable to obtain sufficient information to determine with certainty that it would pass the ownership tests without the tracing rule. In such a case, the modified COT allows a company to draw a conclusion about whether it would satisfy the ownership tests based on any information that it has reasonably been able to obtain. ***[Schedule 1, item 79, section 166-275]***

1.137 Circumstances where the operation of a tracing rule could cause the ownership tests to be failed and, therefore, might trigger the operation of this rule include:

- a direct shareholder's interest in the tested company rises to 10 per cent or more or drops below 10 per cent during the test period;
- an indirect stakeholder's interest in the tested company rises to 10 per cent or more or drops below 10 per cent during the test period;
- a widely held company's interest in the tested company rises above 50 per cent or drops to 50 per cent or less during the test period;
- a company that has not more than a 50 per cent interest in the tested company either becomes a widely held company or ceases to be a widely held company during the test period; or
- the holders of bearer shares or of interests through depository entities become known to the tested company during the test period.

1.138 In each of these cases, the application of the tracing rule may imply a larger change in ownership than actually occurs.

Example 1.14: Increase of shareholding to more than 10 per cent

At the start of the ownership test period Lisa owns 9 per cent of the shares in the tested company. In the following year, Lisa increases her shareholding in the tested company to 11 per cent.

At the start of the test period, the rule in section 166-225 about direct stakes of less than 10 per cent in the tested company, would operate to attribute Lisa's interest to the single notional entity. However, in the following year, section 166-225 would not apply to the stake held by Lisa because it exceeds 10 per cent. Accordingly Lisa, rather than the single notional entity, would hold that stake for the purpose of Division 166.

If the operation of section 166-225 in relation to the stake held by Lisa at the start of the test period would cause the tested company to fail the COT in the following year, then the concessional tracing rule, section 166-275, would apply. The effect of section 166-275 is to ignore the operation of section 166-225 to Lisa's stake at the start of the test period. Accordingly, the tested company could treat Lisa herself as owning the 9 per cent interest at the start of the test period and the 11 per cent interest at the later point in the test period.

Controlled test companies

1.139 A tracing rule does not apply to modify how the ownership tests apply in respect of voting power or dividend or capital rights held directly or indirectly by an entity that sufficiently influences the tested company. ***[Schedule 1, item 79, subsection 166-280(1)]***

1.140 Broadly, a company is sufficiently influenced by an entity if the company, or its directors, are accustomed or under an obligation to act in accordance with the directions, instructions or wishes of the entity or would reasonably be expected to do so.

1.141 A minority shareholder would not generally be regarded as having sufficient influence over a company merely because it is assertive about how the company or its directors should act, or because it has a representative on the company's board of directors. In contrast, a shareholder may have sufficient influence where under a formal or informal arrangement with other shareholders it is able to control the majority of appointments to the company's board of directors.

1.142 In addition, if the tested company is a widely held company, the tracing rule does not modify how the ownership tests apply in relation to the voting power of the tested company if:

- a natural person, together with any associates, directly or indirectly, controls more than 25 per cent of the total voting power in the tested company; or
- a company or trust, together with its associates, directly or indirectly, controls more than 50 per cent of the total voting power in the tested company.

[Schedule 1, item 79, subsection 166-280(2)]

1.143 The controlled test companies rule requires a company to trace its ownership through to the entity who has sufficient influence, the natural person who (with associates) controls more than 25 per cent of the voting power, or the company or trustee which (with associates) controls more than 50 per cent of the voting power.

1.144 The controlled test companies rule prevents the strict operation of the tracing rules hiding significant interests in the tested company. For example, if a company indirectly holds more than 50 per cent of the tested company, but does so through a number of stakes in entities which directly hold less than 10 per cent of the tested company, in the absence of the

controlled test company rule, the rule about direct stakes of less than 10 per cent would attribute these interests to a single notional entity.

1.145 The controlled test companies rule only prevents tracing rules applying to:

- stakes held by controlling entities (ie, entities with sufficient influence or with associate inclusive voting power of more than 25 per cent or 50 per cent, as the case may be); and
- stakes held by entities interposed between the tested company and controlling entities.

Tracing that is unaffected by controlled test companies rule

1.146 The controlled test companies rule does not prevent the tracing rules applying in relation to stakes held indirectly through a controlling entity. This is the case even if the operation of the tracing rule causes the stake to be attributed to the controlling entity.

Example 1.15: Controlled test companies rule

A widely held company holds 40 per cent of the tested company and its associates hold 20 per cent. Because the widely held company together with its associates holds more than 50 per cent of the tested company, the tracing rule regarding stakes of 50 per cent or less held by widely held companies cannot apply.

In tracing through the widely held company the tested company finds that all shareholders in the widely held company have a less than 10 per cent stake in the tested company. Those stakes can be attributed to the widely held company through the application of the rule for indirect stakes of less than 10 per cent.

1.147 Similarly, the controlled test companies rule does not affect the operation of the bearer shares rule merely because the foreign listed company referred to in that section holds more than 50 per cent of the shares in the tested company. Generally, the controlled test companies rule could not apply in the context of bearer shares, because the identity of bearer shareholders would not be known.

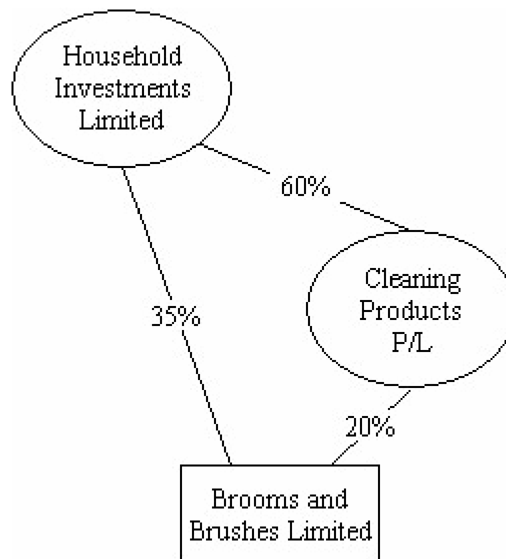
1.148 The controlled test companies rule does not affect the operation of the tracing rule for depository entities merely because a depository entity holds more than 50 per cent of the shares in a tested company. This is because the depository entity does not control voting power in the tested company — it only has custody of shares on behalf of other entities.

Generally, the controlled test companies rule could not apply in relation to stakes held through a depository entity because the identity of stakeholders would not be known.

Example 1.16: Controlled test company

Brooms and Brushes Limited is a listed company that has incurred tax losses. Twenty per cent of the shares in Brooms and Brushes Limited are held directly by Cleaning Products Pty Ltd. Household Investments Limited holds 35 per cent of shares in Brooms and Brushes Limited and also 60 per cent of shares in Cleaning Products Pty Ltd. Household Investments Limited is also a listed company.

All shares referred to in this example carry equal rights to voting, dividends and capital.



Household Investments Limited holds 2 stakes in Brooms and Brushes Limited — a 35 per cent direct stake and a 12 per cent indirect stake through Cleaning Products Pty Ltd. If the controlled test companies rule in section 166-280 did not apply, Household Investments Limited could be treated as the ultimate owner of its 2 stakes in Brooms and Brushes Limited because it is a widely held company with stakes of not more than 50 per cent.

Cleaning Products Pty Ltd is an associate of Household Investments Limited. This is because Housing Investments Limited holds a majority voting interest in Cleaning Products Pty Ltd (see subsection 318(2) of the ITAA 1936).

Household Investments Limited together with its associate controls 55 per cent of Brooms and Brushes Limited (ie, 35% + 20%). Accordingly, the controlled test companies rule prevents application of the tracing rule for stakes of 10 per cent to 50 per cent held by widely held companies that would otherwise operate to treat Household Investments Limited as the ultimate owner of its stakes in Brooms and Brushes Limited.

Instead, Brooms and Brushes Limited must trace through Household Investments Limited in respect of the 35 per cent direct stake and 12 per cent indirect stake.

The controlled test companies rule does not prevent the tracing rules applying to stakes held indirectly through Household Investments Limited. Stakes of less than 10 per cent in Brooms and Brushes Limited which are held by shareholders of Household Investments Limited will be attributed to Household Investments Limited through the operation of the tracing rule for indirect stakes of less than 10 per cent.

Example of the new modified continuity of ownership

1.149 Example 1.17 illustrates the operation of the new modified COT.

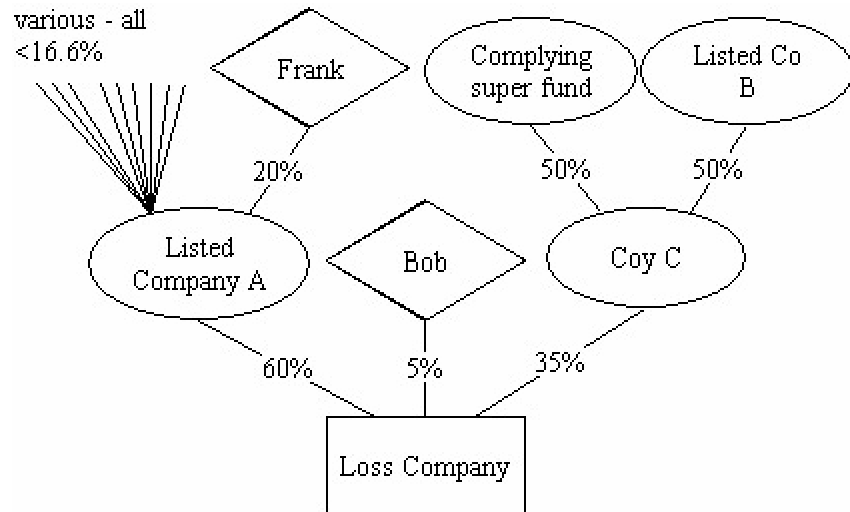
Example 1.17

In the year ending 30 June 2005, Loss Company incurs a tax loss of $10 million.

In the year ending 30 June 2006, Loss Company has sufficient assessable income (net of deductions), against which to deduct its $10 million loss. In determining whether it can deduct the loss it needs to satisfy the COT.

Firstly, it must determine whether it is eligible to apply the modified COT in Division 166.

At 30 June 2006 its ownership structure is:



Eligibility of Loss Company for the modified COT

Loss Company is not a widely held company because it is not listed and has less than 50 members.

Loss Company will nevertheless be eligible for the modified COT if more than 50 per cent of the relevant rights in Loss Company are owned (either directly or indirectly) by widely held companies or entities deemed to be beneficial owners at all times in the year ended 30 June 2006.

At 30 June 2006:

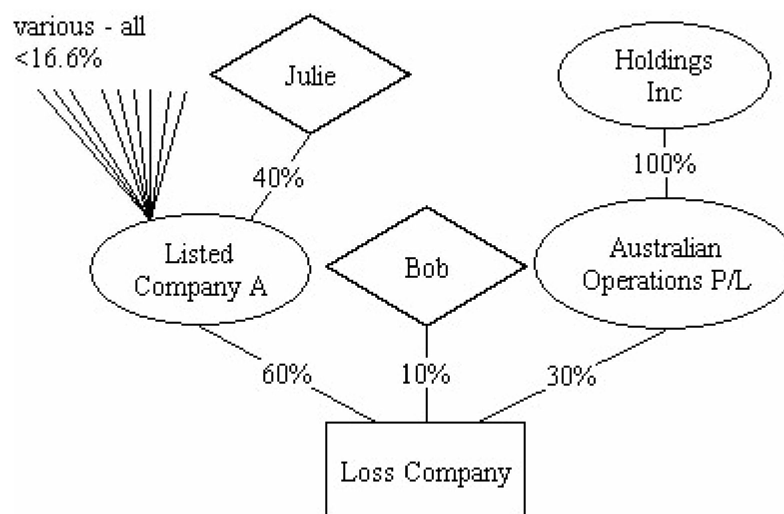
- Listed Company A directly owns shares carrying 60 per cent of the voting power and dividend and capital distribution rights and, because it is a listed company, meets the definition of 'widely held company';
- Listed Company B indirectly owns shares carrying 17.5 per cent (50% of 35%) of voting power and dividend and capital rights and, because it is a listed company, meets the definition of 'widely held company'; and
- Complying super fund indirectly owns shares carrying 17.5 per cent (50% of 35%) of voting power and dividend and capital rights and is an entity deemed to be a beneficial owner.

Although 5 per cent of the relevant interests are held by a natural person (Bob) this does not disqualify the company from eligibility for the modified COT.

Because more than 50 per cent of the rights are held by widely held companies, entities deemed to be beneficial owners, non-profit companies or charitable bodies at all times in the income year ending 30 June 2006, Loss Company is eligible for the modified COT.

Application of tracing rules at 1 July 2004

At 1 July 2004 (the start of the loss year), shareholdings in Loss Company were as follows:



All shares carry equal voting power, rights to dividends and rights to capital. Accordingly, this example refers to shares and stakes in the Loss Company and does not separately refer to voting power or rights to dividends or capital distributions.

Listed Company A is listed on the Australian Stock Exchange and accordingly is a widely held company. However, it will not be regarded as the ultimate beneficial owner under section 166-240 because its stake in Loss Company is more than 50 per cent. Accordingly, Loss Company will need to trace through the interest held by Listed Company A:

- Julie's stake in Loss Company is 24 per cent (60% × 40%) and is attributed to her.
- The other shareholders in Listed Company A have indirect stakes in Loss Company. Each of these indirect stakes is less than 10 per cent (60% × 16.6%). Accordingly these

stakes will be attributed to the top interposed entity pursuant to section 166-230. The top interposed entity is Listed Company A. Therefore, Listed Company A is taken to hold a 36 per cent stake in Loss Company.

Bob holds exactly 10 per cent of shares in Loss Company. As stakes of *less than* 10 per cent are attributed to the single notional entity under the tracing rule in section 166-225, this rule will not apply to Bob's stake. Consequently, Bob is taken to hold his 10 per cent stake in Loss Company.

Australian Operations Pty Ltd holds 30 per cent of shares in Loss Company. It is not a widely held company and therefore Loss Company will need to trace its beneficial ownership through Australian Operations Pty Ltd.

- Australian Operations Pty Ltd is wholly-owned by Holdings Inc, a company which is listed on the New York Stock Exchange. Holdings Inc is a widely held company because it is listed on an approved stock exchange. Since it has a not more than 50 per cent indirect stake in Loss Company, Holdings Inc will be treated under the tracing rule in section 166-240 as a person other than a company that holds the stake. It will not be necessary to trace beneficial ownership through Holdings Inc.

In conclusion, at 1 July 2004, the ownership of the tested company is attributed as follows:

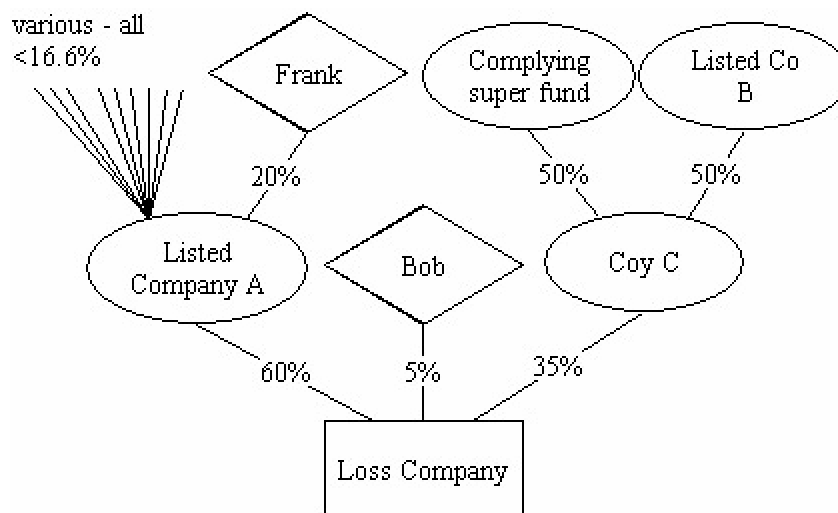
- Julie 24%
- Listed Company A 36%
- Bob 10%
- Holdings Inc 30%

Application of tracing rules at 30 June 2005

The ownership of Loss Company at 30 June 2005 is the same as at 1 July 2004. Accordingly, the tracing of ownership at 30 June 2005 would give the same outcome as above.

Application of tracing rules at 30 June 2006

As at 30 June 2006, shareholders in Loss Company are as follows:



For the reasons discussed above, Loss Company needs to trace through the shareholding of Listed Company A:

- Frank's indirect interest in the Loss Company is 12 per cent (60% × 20%) and is attributed to him.

- All other shareholders have an interest in the interposed Listed Company A less than 16.6 per cent, representing less than 10 per cent stakes in Loss Company. Hence these stakes, totalling 48 per cent (60% × 80%), are attributed to Listed Company A.

Bob's 5 per cent interest is deemed to be held by a single notional entity, as it is a direct interest amounting to less than 10 per cent of total rights.

As Company C is not a widely held company or an entity deemed to be a beneficial owner, beneficial ownership must be traced through it:

- As Listed Company B is a widely held company which indirectly owns between 10 per cent and 50 per cent of relevant rights in Loss Company, it is deemed to be the beneficial owner of the 17.5 per cent interest.

- As Complying super fund is an entity deemed to be a beneficial owner with more than 10 members, it is deemed to be the beneficial owner of the 17.5 per cent interest.

At 30 June 2006, the following stakes are identified:

- Frank 12%
- Listed Company A 48%
- Listed Company B 17.5%
- Complying super fund 17.5%
- Single notional entity 5%

Conclusion

Listed Company A is the only entity that was a stakeholder at both points in time. The interest of Listed Company A at the start of the test period was 36 per cent. However, its full 48 per cent interest at the second test time can be taken into account because it continues to hold the same shares in Loss Company in the same way.

Bob's interest was attributed directly to him at the start of the test period, but attributed to the single notional entity pursuant to section 166-225 at 30 June 2006. If this operation of section 166-225 causes Loss Company to fail the COT, it can be ignored by Loss Company (under section 166-275 because it would cause Loss Company to fail the COT) and Bob's 5 per cent stake at 30 June 2006 can be attributed directly to him.

Putting aside Bob's stake, the same people (ie, Listed Company A) owns 36 per cent at 1 July 2004 and 48 per cent at 30 June 2006. Accordingly, there is not substantial continuity of ownership.

If Bob's stake is attributed to him rather than the single notional entity, continuity of ownership in Loss Company would be 46 per cent at the start of the period and 53 per cent at the later time. Even with Bob's stake there is not substantial continuity of ownership because the same persons do not hold more than 50 per cent of voting power or relevant rights at each test time.

Accordingly, Loss Company fails the modified COT.

Application and transitional provisions

1.150 The new modified COT applies to:

- tax losses incurred in income years commencing on or after 1 July 2002;

- net capital losses made in income years commencing on or after 1 July 2002;
- deductions for bad debts that are claimed in income years commencing on or after 1 July 2002; and
- determine whether a changeover time or alteration time occurs at any time on or after 1 July 2002.

[Schedule 1, subitem 170(1)]

1.151 The new modified COT also applies in relation to an earlier tax loss or net capital loss if:

- the tax loss could have been deducted (in accordance with the loss recoupment rules in force at that time) in the first income year commencing after 30 June 2002; or
- the net capital loss could have been applied (in accordance with the loss recoupment rules in force at that time) in the first income year commencing on or after 1 July 2002.

[Schedule 1, subitem 170(4)]

1.152 In determining whether a tax loss could have been deducted in the first income year commencing after 30 June 2002, the fact that it can only be deducted to the extent the company has sufficient income (section 36-17) is ignored. ***[Schedule 1, subparagraph 170(4)(a)(ii)]***

1.153 In determining whether a net capital loss could be applied in the first income year commencing after 30 June 2002, the fact that a net capital loss may only be used to reduce capital gains is ignored. ***[Schedule 1, subparagraph 170(4)(b)(ii)]***

1.154 The effect of the amendments for a company with a substituted accounting period is that the modified COT applies for the first accounting period that commences after 1 July 2002.

1.155 For example, a company with a substituted accounting period of 1 April to 31 March, will not be eligible for the modified COT in respect of losses incurred in its income year commencing 1 April 2002, unless it could have deducted those losses under the existing rules in its income year commencing 1 April 2003.

1.156 The new modified COT will apply to a foreign loss in the same way as it would apply to a tax loss incurred in the same year (subsection 160AFD(6)).

1.157 If a pre-1 July 2002 loss is eligible for the modified COT (ie, it could have been deducted in an income year commencing on or after 1 July 2002), the new modified COT rules apply at all test times. For example, if the loss was incurred in 1998-99 income year and the company is seeking to deduct it in 2006-07 income year, the modified COT tracing rules are used to test ownership in 1998-99 and 2006-07 (as well as intervening years).

1.158 The new modified COT cannot apply to deductions for bad debts written-off before 1 July 2002. Unlike losses, deductions for bad debts can be claimed in the income year the debt is written-off. If the company's deductions for that income year exceed its income, the bad debt deduction merely contributes to the loss (subject to the application of section 165-132).

1.159 In some cases, a tax loss or a net capital loss is taken to have been made in the income year immediately before a changeover time (section 165-115B). The modified COT will not apply to a loss that is treated as having been made in an income year before 1 July 2002 unless the loss could have been used in the first income year commencing on or after that date.

Consolidation interactions

1.160 Section 707-140 treats the head company of a consolidated group as having made a loss of any sort that is transferred to it in the income year in which it is transferred. Therefore, if a loss is transferred to the head company of a consolidated group on or after 1 July 2002, the loss will be eligible for the modified COT if the income year in which the transfer occurred commenced on or after 1 July 2002.

1.161 The assumptions contained in subsection 707-210(4) and section 709-215 do not affect the application of the modified COT. This is because these provisions do not deem the relevant loss or bad debt to be incurred at a different time.

1.162 If a subsidiary company with losses joins a consolidated group on 1 July 2002, it cannot use the new modified COT to determine whether it can transfer its losses to the head company of the group because it does not have an income year commencing after 30 June 2002. It is not recognised as a stand-alone company for tax purposes after this date. However, if a

company joins a consolidated group later in that year, the modified COT can apply as a transfer test to pre-1 July 2002 losses if the relevant company has at least part of an income year (ie, a non-membership period under section 701-30) in which it could have utilised those losses commencing after 30 June 2002.

Choice to disregard amendments for prior years

1.163 If a tax loss was incurred, a net capital loss made or a deduction claimed in respect of a bad debt, or if a changeover or alteration time occurred in an income year that ends before the date the Bill receives Royal Assent, the company may choose not to apply the amendments made to the COT for those income years. ***[Schedule 1, subitem 170(2)]***

1.164 The company must make this choice before its first income tax return is lodged after the Bill receives Royal Assent, or within such further time as the Commissioner allows. Accordingly, companies that have traced their ownership under the existing modified COT for prior years are not required to apply the new tracing rules unless they choose to do so. ***[Schedule 1, subitem 170(3)]***

Consequential Amendments

1.165 Notes are inserted to alert readers of Division 165 or Division 707 to the modifications made by the new modified COT. ***[Schedule 1, items 14, 28, 42, 54 and 113]***

1.166 Definitions that were relevant to the operation of the old modified COT, but are not used in the new modified COT are repealed. ***[Schedule 1, items 142, 146, 150, 153, 154, 155, 157, 158 and 166]***

1.167 Definitions of ‘test period’ and ‘test time’ in the Dictionary are updated to take into account changes resulting from the new modified COT provisions. ***[Schedule 1, items 162 and 163]***

Chapter 2
Loss recoupment rules for companies: same business test income ceiling

Outline of chapter

2.1 Schedule 1 to this Bill reforms the loss recoupment rules for companies by:

- introducing a new modified continuity of ownership test (COT) to replace the existing modified COT in Division 166 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- removing the same business test (SBT) for companies whose total income is more than $100 million in the year of recoupment; and
- removing certain anomalies and clarifying some aspects of the existing law.

2.2 This chapter explains amendments that remove the SBT for companies whose total income is more than $100 million in relation to losses incurred in income years commencing on or after 1 July 2005.

Context of amendments

2.3 A company that fails the COT can nevertheless deduct a tax loss if it satisfies the SBT.

2.4 A company satisfies the SBT if it carries on the same business in the year it wishes to deduct the loss as it did immediately before it failed the COT and it does not derive income from a business or transaction of a new kind. Because of the practical difficulties in applying the COT, some companies have placed considerable reliance on the SBT to recoup prior year losses.

2.5 The introduction of tax consolidation has highlighted shortcomings with the SBT. It is difficult to compare the nature of a large and diverse business across two points in time, which may be several years apart.

2.6 This Bill introduces a ceiling for the SBT that prevents large companies (including consolidated groups) from satisfying the SBT if the total income is more than $100 million. The SBT ceiling is introduced in conjunction with measures to make the COT easier to apply. As a result, for large companies the focus of the loss recoupment rules will shift toward testing for continuity of ownership.

Summary of new law

2.7 An income ceiling of $100 million is introduced for the SBT. A company or consolidated group cannot satisfy the SBT in an income year in which its total income (including exempt income and non-assessable non-exempt income) is more than $100 million.

2.8 The ceiling only applies in relation to losses incurred in income years commencing on or after 1 July 2005.

Comparison of key features of new law and current law

New law	*Current law*
The SBT is satisfied for a period if the company carried on the same business, engaged in no new kinds of transactions or businesses and (in relation to losses incurred in years starting on or after 1 July 2005) did not have total income of more than $100 million in the income year.	The SBT is satisfied for a period if the company carried on the same business and engaged in no new kinds of transactions or businesses during that period.

Detailed explanation of new law

2.9 A total income ceiling applies to large companies (including consolidated groups) for the purposes of the SBT.

2.10 A company is not able to satisfy the SBT for the whole or a part of an income year if its total income for the income year is more than $100 million. The ceiling applies to losses incurred in income years commencing on or after 1 July 2005. ***[Schedule 1, items 76 and 172, section 165-212A]***

2.11 Total income is tested for the income year in which the SBT period occurs.

2.12 The SBT period for tax losses and net capital losses is the income year in which the losses are recouped. Accordingly, a company cannot satisfy the SBT if its total income is more than $100 million in that year.

2.13 For example, a company incurs a tax loss in the income year ending 30 June 2006 and the company wishes to deduct the loss in the income year ended 30 June 2008. In determining whether it satisfies the SBT, the company needs to calculate its total income for the period 1 July 2007 to 30 June 2008. The total income of the company for the income years ending 30 June 2006 and 30 June 2007 will not be taken into account.

2.14 The SBT period for the application of the current year loss rules (Subdivisions 165-B and 165-CB) is that part of the year after the company fails the COT. Total income is calculated for the whole income year, even though the SBT period may only be part of the year.

2.15 The SBT period for bad debts is the second continuity period. The second continuity period is either the current income year or part of the current income year. As with the current year loss rules, the total income is calculated for the whole of the current income year, even if the second continuity period is only a part of the current income year.

2.16 If a company is a subsidiary member of a consolidated group for part of an income year, it determines its taxable income for each non-membership period as if that period were an income year (section 701-30 of the ITAA 1997)). Accordingly, in determining whether the SBT is satisfied in a non-membership period, total income is calculated for the non-membership period. However, total income is adjusted to a 12-month equivalent. ***[Schedule 1, item 76, section 165-212C]***

2.17 The failure of the SBT because the total income ceiling is exceeded does not necessarily preclude a future deduction of a tax loss or the future application of a net capital loss. The failure of the SBT in a given income year does not extinguish a tax loss or a net capital loss (other than in the context of a transfer to the head company of a consolidated

group). Accordingly, it would be possible for the SBT to be satisfied and the loss claimed in a subsequent year if total income falls below $100 million. The same outcome does not arise in respect of a bad debt since a bad debt can only be deducted in the income year in which it is written-off.

What is total income?

2.18 Total income consists of:

- assessable income;
- exempt income; and
- non-assessable non-exempt income.

[Schedule 1, item 76, subsection 165-212B(1)]

2.19 Total income is a calculation of gross income and accordingly it is not reduced by current year deductions or tax losses.

2.20 The total income of a head company of a consolidated group or multiple entry consolidated group (MEC group) includes amounts derived by subsidiary members of the group. This is an outcome of the single entity rule in section 701-1 of the ITAA 1997.

2.21 Net capital gains are excluded from total income as they are not reflective of the on-going income earning potential of the company. Capital gains that are disregarded are also excluded from total income, because these amounts are neither exempt income nor non-assessable non-exempt income. ***[Schedule 1, item 76, subsection 165-212B(1)]***

2.22 Amounts that are non-assessable non-exempt income under section 17-5 because they represent goods and services tax (GST) collected by a company are excluded from total income. ***[Schedule 1, item 76, paragraph 165-212B(2)(a)]***

2.23 Non-assessable non-exempt income is also excluded from total income if it represents an amount that has been included in assessable income. Such amounts are excluded from total income to prevent double counting. ***[Schedule 1, item 76, paragraph 165-212B(2)(b)]***

2.24 Examples of non-assessable non-exempt income that are excluded from total income are:

- Amounts received on the disposal of trading stock outside the ordinary course of a business, where the market value of the trading stock is included in assessable income (section 70-90 of the ITAA 1997).

- Attribution account payments in cases where attribution account debits arise. Broadly, attribution account payments (eg, dividends from controlled foreign companies) are exempt from tax because the profits of the foreign subsidiary have already been included in the assessable income of the Australian company under the controlled foreign companies provisions (section 23AI of the ITAA 1936).

- Foreign investment fund attribution account payments where attribution account debits arise. Broadly, foreign investment fund attribution account payments (eg, dividends from foreign investment funds) are exempt from tax because the profits have already been included in the assessable income of the Australian company under the foreign investment fund provisions (section 23AK of the ITAA 1936).

- Amounts distributed from a trust where the income has already been attributed to the company pursuant to Division 6AAA of Part III of the ITAA 1936 (paragraph 99B(2)(e) of the ITAA 1936).

- Dividends that offset a shareholder loan that has been treated as a deemed dividend under Division 7A of Part III of the ITAA 1936 (subsection 109ZC(3) of the ITAA 1936).

Example 2.1: Same business test total income ceiling

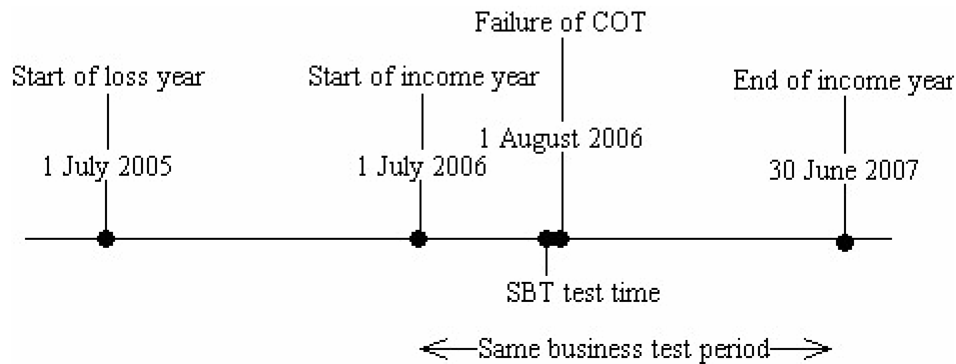
In the year ended 30 June 2006, Steel Limited incurs a tax loss of $50 million.

On 1 August 2006, Minerals Limited acquires 60 per cent of Steel Limited pursuant to a takeover bid. As a consequence, Steel Limited fails the COT on that day.

In the year ended 30 June 2007, Steel Limited has assessable income of $90 million and deductions (not including tax losses) of $60 million. $10 million of its assessable income comes from a net capital gain.

In the same year, a foreign company pays Steel Limited a dividend of $25 million. The dividend is a non-portfolio dividend that is non-assessable non-exempt income under section 23AJ of the ITAA 1936.

Steel Limited's taxable income is $30 million (excluding any tax loss deduction). Therefore, Steel Limited could deduct up to $30 million of its tax loss if it satisfies the relevant loss recoupment tests. Since Steel Limited has failed the COT, it must rely on the SBT.



Steel Limited has been a manufacturer of steel products since 1990. It continues to conduct the same business of steel manufacturing throughout the period 1 July 2006 to 30 June 2007 (the SBT period) as it did immediately prior to 1 August 2006.

Notwithstanding that it carries on the same business activities, Steel Limited cannot satisfy the SBT for the year ending 30 June 2007 because its total income for the period 1 July 2006 to 30 June 2007 is $105 million, comprising $80 million of assessable income (not including the net capital gain) and $25 million of non-assessable non-exempt income. Accordingly, Steel Limited exceeds the $100 million SBT ceiling in the income year ending 30 June 2007.

Because Steel Limited does not satisfy the SBT it cannot deduct its tax loss in the income year ending 30 June 2007.

Grossing-up of total income for periods of less than 12 months

2.25 If the period in which total income is tested is not 12 months, the total income is adjusted so that it corresponds to a 12-month period. This can occur if a company:

- comes into existence or ceases to be in existence during the relevant income year; or

- is a subsidiary member of a consolidated group for part of the relevant income year.

[Schedule 1, item 76, subsection 165-212C(1)]

2.26 The total income of a company whose income period is not 12 months is the amount that the company reasonably estimates would be its total income for a complete 12-month period. ***[Schedule 1, item 76, subsection 165-212C(2)]***

2.27 For example, a company is only in existence for 3 months of the year and has a total income of $30 million. Generally, the amount adjusted for 12 months would be $120 million (4 × $30 million). However, a company's calculation of total income in these circumstances may vary if seasonal factors affect the company's business, or if total income is growing or falling through the income year.

2.28 This adjustment mechanism applies instead of section 716-850, which would otherwise operate to adjust thresholds for the purpose of subsection 701-30(3) in respect of periods of less than 365 days. ***[Schedule 1, item 76, subsection 165-212C(3)]***

Total income ceiling and consolidation

2.29 When a company joins a consolidated group, the company must satisfy the loss recoupment tests to transfer its losses of any sort (including tax losses, net capital losses and foreign losses) to the head company of the consolidated group (section 707-120 of the ITAA 1997). Losses not transferred to the head company cannot be utilised after the joining time (section 707-150).

2.30 For the purpose of the transfer of losses to the head company of a consolidated group, a company can only satisfy the SBT if total income is $100 million or less in both:

- the income year in which the COT was failed; and
- the income year that ends during the trial year (or, if there is no such year, the income year in which the joining time occurs).

2.31 The SBT ceiling is not applied to a trial year because the trial year generally overlaps 2 income years and is not a period for which the joining company separately calculates its income. Instead, the ceiling applies to the total income of the company for the income year that ends

during the trial year. A company does not satisfy the SBT for a trial year if its total income is more than $100 million for the income year that ends during the trial year. ***[Schedule 1, item 133, paragraph 716-805(1)(a)]***

2.32 In some cases, an income year does not end during a trial year. This may occur when the company has recently exited a consolidated group, or has recently come into existence. If an income year does not end during the trial year, then the company calculates its total income for the income year in which the joining time occurs ***[Schedule 1, item 133, paragraph 716-805(1)(b)]***. In such a case, the company adjusts its total income if the period is less than 12 months.

2.33 A company joining a consolidated group also has to satisfy the SBT for the income year in which the SBT test time occurs, that is, the year the company fails the COT (section 707-125). Accordingly, the company's total income must also be $100 million or less in the income year that the SBT test time occurs to satisfy the SBT for the purposes of transferring a loss to the head company of a consolidated group. ***[Schedule 1, item 133, subsection 716-805(2)]***

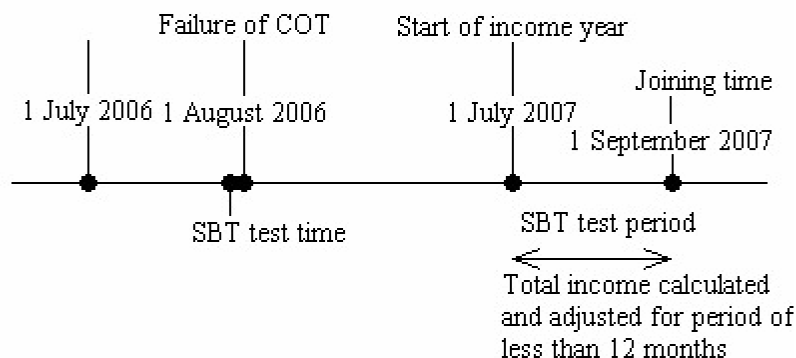
2.34 For losses incurred in income years commencing on or before 30 June 1999, the SBT only needs to be satisfied for the trial year (section 707-125), but such losses are not subject to the total income ceiling.

Example 2.2: Same business test total income ceiling and consolidation

Continuing from Example 2.1, on 1 September 2007, Minerals Limited acquires the remaining 40 per cent of shares in Steel Limited. Minerals Limited is the head company of a consolidated group and therefore Steel Limited joins the consolidated group.

Deduction of tax loss before joining time

Steel Limited will treat the period 1 July 2007 to 31 August 2007 as if it were an income year (see section 701-30).



Steel Limited's assessable income for the pre-joining time period (1 July to 31 August) is $10 million and its deductions (not including tax losses) are $8 million. It has no exempt or non-assessable non-exempt income in this period.

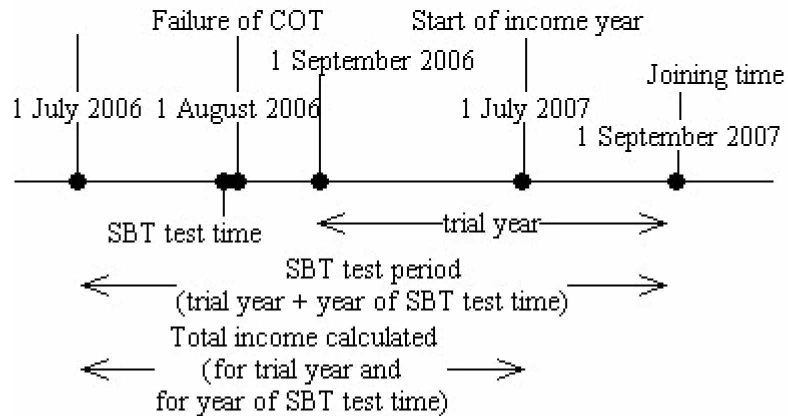
Steel Limited can only deduct $2 million of its tax loss in the non-membership period if it satisfies the SBT.

Steel Limited's total income for the non-membership period is the sum of its assessable income ($10 million), its exempt income (nil) and its non-assessable non-exempt income (nil). Its total income is adjusted by the length of the period (see section 165-212C). There are no seasonal factors affecting Steel Limited's income, so Steel Limited grosses up its total income by reference to the proportion of the income year that falls in the non-membership period. In this case, the adjustment results in total income for Steel Limited of $58.9 million ($10 million $\times$ 365/62).

Steel Limited continues to carry on the same business during the non-membership period as it did immediately prior to 1 August 2006 (when it failed the COT). Accordingly, Steel Limited satisfies the other conditions for the SBT and can deduct $2 million of its tax losses, to reduce its taxable income to nil.

Transfer of tax loss to Minerals Limited

Steel Limited will apply sections 707-120 and 707-125 to determine whether it can transfer its remaining tax losses of $48 million to Minerals Limited on joining the consolidated group.



Steel Limited must satisfy the SBT for the trial year, which is 1 September 2006 to 1 September 2007 and the income year in which it failed the COT, 1 July 2006 to 30 June 2007. Steel Limited will only be able to satisfy the SBT for these periods if its total income is $100 million or less for:

- the income year in which the test time occurred (1 July 2006 to 30 June 2007); and

- the income year which ended during the trial year (also 1 July 2006 to 30 June 2007).

Steel Limited's total income is $105 million for the income year 1 July 2006 to 30 June 2007 (see Example 2.1), and will not be able to satisfy the SBT. Accordingly, Steel Limited will not be able to transfer its tax losses to Minerals Limited.

Interaction with consolidation bad debt rules

2.35 Subdivision 709-D concerns the interaction between consolidation and the deduction of bad debts. Subdivision 709-D applies if a debt is written-off as bad and is held by a company that is a member of a consolidated group for some, but not all, of the time between when the debt was incurred and when it was written-off. In such a case, Subdivision 709-D divides the test period into segments (debt test periods) for the purposes of applying the COT and the SBT.

2.36 A company can only claim the bad debt deduction if each entity that was owed the debt would have been entitled to deduct it in its debt test

income year. This requires each entity to satisfy the COT or the SBT for its debt test income year.

2.37 A debt test income year (and hence the SBT period) ends either at the end of the income year in which the debt is written-off or the end of the debt test period. A debt test income year that ends at the end of an income year may be a normal 12-month income year or a shorter period if the debt test period starts after the start of the income year (item 1 in the table in subsection 709-215(3)).

2.38 In a case to which item 2 in the table in subsection 709-215(3) applies, the debt test income year will only end at the end of an income year if the debt test period ends at the end of an income year. Regardless of the length of the debt test period, the debt test income year will be no more than 12 months. However, it could be shorter than 12 months or it could overlap 2 income years.

2.39 The SBT ceiling applies to the income year in which the debt is written-off (when item 1 in the table in subsection 709-215(3) applies). It also applies to an income year in which a debt test period ends (when item 2 in the table in subsection 709-215(3) applies) — broadly, this is the income year in which an entity ceased to be owed the debt. If total income of the entity is more than $100 million in such a year, the entity cannot satisfy the SBT for its debt test income year. ***[Schedule 1, item 133, subsection 716-805(3)]***

Interaction between consolidation and loss integrity measures

2.40 Subdivisions 715-A and 715-D (in part) deal with the interaction between Subdivision 165-CC (change of ownership or control of a company that has an unrealised net loss) and Part 3-90 (consolidation).

2.41 The SBT is applied in the following contexts on formation of a consolidated group or when an entity joins the group:

- On an entity joining a consolidated group, the step 1 amount of the allocable cost amount may be reduced in relation to a membership interest in the joining entity that is a Subdivision 165-CC tagged asset, unless the member holding the interest satisfies the SBT (section 715-50).
- On an entity joining a consolidated group, the step 2 amount of the allocable cost amount may be reduced in relation to an accounting liability that the joining entity owes to another member of the group if the accounting liability is a

Subdivision 165-CC tagged asset, unless that other member satisfies the SBT (section 715-55).

- On formation of a consolidated group, a loss denial pool may be created if the head company owns a capital gains tax (CGT) asset that is a Subdivision 165-CC tagged asset unless the head company satisfies the SBT (section 715-60).
- On formation of a consolidated group, a loss denial pool may be created if a chosen transitional entity holds a Subdivision 165-CC tagged asset unless the entity satisfies the SBT (section 715-70).
- On formation of a consolidated group, a loss denial pool may be created if the head company has a Subdivision 170-D deferred loss that it made on a Subdivision 165-CC tagged asset and it does not satisfy the SBT (section 715-355).
- On an entity joining a consolidated group, a loss denial pool may be created if the entity has a Subdivision 170-D deferred loss that it made on a Subdivision 165-CC tagged asset and it does not satisfy the SBT (section 715-360).

2.42 In all of these cases, the SBT period is the trial year of either the head company or the relevant member. The total income ceiling is tested for the income year that ends during the relevant trial year. ***[Schedule 1, item 133, paragraph 716-805(4)(b)]***

2.43 For example, section 715-50 requires a member of a consolidated group to apply the SBT for the period consisting of the head company's trial year. For the purposes of section 715-50, the total income ceiling is applied in relation to the income year that ended during the head company's trial year.

2.44 If there is no income year which ends during the trial year, then the SBT ceiling is instead applied to the income year in which the joining time occurs for the entity whose trial year is used as the SBT period. ***[Schedule 1, item 133, paragraph 716-805(4)(c)]***

2.45 If a company leaves the consolidated group with a Subdivision 165-CC tagged asset and the head company has a final residual unrealised net loss greater than nil, then there may be certain consequences for the head company or the leaving entity unless the head company satisfies the SBT (section 715-95). The SBT period is the period starting 12 months before the leaving time (or more recently if the head company has come into existence in the last 12 months) and ending just before the leaving time. In such a case, the total income ceiling is applied

to the income year of the head company that ends within the 12 months before the leaving time. ***[Schedule 1, item 133, paragraph 716-805(4)(a)]***

2.46 However, if no income year of the head company ends in this period (eg, if the head company recently came into existence or ceased to be a member of a consolidated group), the total income ceiling is applied to the income year in which the leaving time occurs. ***[Schedule 1, item 133, paragraph 716-805(4)(c)]***

Application and transitional provisions

2.47 The amendments relating to the SBT total income ceiling apply to:

- tax losses incurred in income years commencing on or after 1 July 2005;
- net capital losses made in income years commencing on or after 1 July 2005; and
- deductions claimed in respect of bad debts incurred in income years commencing on or after 1 July 2005.

[Schedule 1, subitem 172(1)]

2.48 If a company has a substituted accounting period, the SBT ceiling will apply to its first income year commencing after 1 July 2005. For example, an early balancing company whose substituted accounting period is 1 April to 31 March will first be subject to the SBT for losses incurred in its income year commencing 1 April 2006.

Effect of deemed dates

2.49 Section 165-115B treats a tax loss or a net capital loss as having been made in the income year immediately before the changeover time. Accordingly, the SBT ceiling will not apply to a loss that is treated by section 165-115B as having been deemed to be made in an income year commencing before 1 July 2005.

2.50 Section 707-140 treats the head company of a consolidated group as having made a loss of any sort that is transferred to it in the income year in which it is transferred. However, the deemed date for the loss is disregarded in determining whether the SBT ceiling applies. If the loss was actually incurred by the joining entity in an income year commencing before 1 July 2005, the SBT ceiling will not apply. Further, if a loss has

previously been transferred, the SBT ceiling will not apply if the loss was originally incurred by the entity that first made it in an income year commencing before 1 July 2005. ***[Schedule 1, paragraph 172(2)(a)]***

2.51 Subdivision 709-D provides for the deduction of a bad debt if the debt is owed to a consolidated group for some of the period it was in existence. Section 709-215 modifies the period in which continuity of ownership is tested. However, it does not deem the debt to be incurred on a date different from that it was actually incurred. Accordingly, section 709-215 does not affect the application of the SBT ceiling to a bad debt. The SBT ceiling does not apply to debts incurred before 1 July 2005 that are later written-off as bad even though the first and second continuity periods may commence after that date.

Unrealised losses

2.52 There is an exception to the application of the SBT ceiling in respect of a tax loss or a net capital loss if the company had a unrealised net loss immediately before the commencement of its first income year starting on or after 1 July 2005. The exception operates by comparing the tax loss or net capital loss made in an income year, with the tax loss or net capital loss that would have been made in that year, if a changeover time occurred just before the start of the company's first income year commencing on or after 1 July 2005.

2.53 If there is an unrealised net loss at a changeover time, future deductions or capital losses may be recharacterised as tax losses or net capital losses (as appropriate) for the income year before the changeover time. An outcome of this recharacterisation is that a tax loss or net capital loss in the current year may be reduced. The SBT ceiling does not apply to a tax loss or net capital loss to the extent that the deduction or capital loss comprising the tax loss or net capital loss relates to an unrealised net loss immediately before 1 July 2005. ***[Schedule 1, paragraph 172(2)(b)]***

Foreign losses

2.54 As foreign losses are subject to the SBT in the same way as tax losses (subsection 160AFD(6)), the SBT ceiling applies to a foreign loss incurred in an income year commencing on or after 1 July 2005.

Consequential amendments

2.55 The SBT ceiling is an element of whether a company satisfies the SBT. The concept of a company 'satisfying the same business test'

replaces the existing concept in Divisions 165 and 166 of a company 'carrying on the same business' in the amendments to incorporate the SBT ceiling into the SBT.

2.56 This Bill amends references to a company 'carrying on the same business' (or similar) to 'satisfying the same business test' (or similar) in provisions, guides and notes to provisions as required. ***[Schedule 1, items 4 to 9, 13, 18, 22, 27, 31, 41, 53, 59, 63, 66, 80, 89 and 98]***

2.57 Notes and changes to guide material and tables alert readers of this Bill to the SBT ceiling. ***[Schedule 1, items 12, 14, 19 to 21, 24 to 26, 28, 33, 35, 36, 40, 43 to 45, 52, 55, 62, 65, 67, 74, 75, 81, 90, 107, 108, 110, 113, 115, 119 to 132, 137, 138 and 140]***

Chapter 3
Loss recoupment rules for companies: other amendments

Outline of chapter

3.1 Schedule 1 to this Bill reforms the loss recoupment rules for companies by:

- introducing a new modified continuity of ownership test (COT) to replace the existing modified COT in Division 166 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- removing the same business test (SBT) for companies whose total income is more than $100 million in the year of recoupment; and
- removing certain anomalies and clarifying some aspects of the existing law.

3.2 This chapter explains amendments to the company loss recoupment rules that remove certain anomalies and clarify aspects of the existing rules.

Summary of new law

3.3 Amendments to the company loss recoupment rules:

- provide that the COT is not failed merely because an external administrator or provisional liquidator is appointed to the tested company or to a corporate shareholder;
- amend the application of the income injection rules to an insolvent company;
- provide that the consolidation entry history rule is disregarded for the purposes of the SBT;

- provide that a medical defence organisation does not fail the SBT merely because of a restructure to satisfy the requirements of the *Medical Indemnity (Prudential Supervision and Product Standards) Act 2003*;
- treat shares held by a trustee of a family trust as if they were owned by a notional entity to ensure that a change in the trustee or the appointment of more than one trustee does not affect the COT being satisfied;
- provide that non-profit companies, mutual affiliate companies and mutual insurance companies only need to establish continuity of voting power to satisfy the COT;
- treat certain government bodies, statutory bodies, non-profit companies and charitable bodies as if they were persons (and not companies) for the purposes of the COT;
- allow companies without shares to apply the COT as if their membership interests were shares;
- provide that the alternative test applies when one or more companies become shareholders of the tested company after the start of the loss year;
- clarify that the COT can be satisfied when the tested company is in existence for only part of the loss year or part of the income year;
- repeal a provision that prevents companies taking into account redeemable shares when applying the COT;
- disregard special voting shares issued by dual listed companies for the purposes of the voting power condition of the COT; and
- correct some incorrect references to the COT ownership test period and the calculation of net capital losses.

Comparison of key features of new law and current law

New law	*Current law*
The COT is not failed merely because the tested company or a shareholder is, or becomes, externally administered (eg, goes into liquidation) or a provisional liquidator is appointed.	The COT may be failed if the tested company and a majority shareholder become externally administered.
The consolidation entry history rule is disregarded for the purposes of the SBT.	The interaction between the consolidation entry history rule and the SBT is uncertain.
A company that is in existence for only part of the loss year or part of the income year can satisfy the COT.	It is uncertain whether a company can satisfy the COT if it is in existence for only part of the loss year or part of the income year.
The alternative test applies if a company has shares or interests in shares in the tested company at any time in the test period.	The alternative test only applies if a company has shares or interests in shares in the tested company at the start of the test period.
Shares owned by the trustee of a family trust are taken to be beneficially owned by a single notional entity. Relevant rights held by the trustee are also attributed to the single notional entity. A change in trustee is not regarded as a change in ownership.	Shares owned by the trustee of a family trust are taken to be owned beneficially. Relevant rights held by the trustee are taken to be held for the trustee's own benefit.
Non-profit companies only need to satisfy the voting power condition to satisfy the COT.	Non-profit companies need to satisfy the voting power and dividend and capital rights conditions to satisfy the COT.
Certain government bodies, statutory bodies, non-profit companies and charitable bodies are treated as persons and not companies for the purposes of the COT.	No equivalent.
Companies without shares apply the COT as if their membership interests were shares.	The application of the COT to companies without shares is uncertain.
Dual listed companies ignore special voting shares for the purposes of the voting power test.	No equivalent.

Detailed explanation of new law

Externally administered companies

3.4 This Bill contains amendments to expressly provide that the appointment of a liquidator, other external administrator or a provisional liquidator to a company has no impact on:

- whether the company satisfies the COT; or
- whether shares or interests in shares that it holds can be taken into account in determining whether another company satisfies the COT.

3.5 Broadly, the amendments provide that:

- the fact that a company becomes an externally administered body or a provisional liquidator is appointed does not prevent a shareholder from beneficially owning shares in the company or having control of voting power, or rights to dividends or capital in the company ***[Schedule 1, items 1 and 2, subsections 80B(8A) and 160ZNRA(1) of the Income Tax Assessment Act 1936 (ITAA 1936); item 73, subsection 165-208(1) of the ITAA 1997]***; and
- the fact that a shareholder company becomes an externally administered body or a provisional liquidator is appointed does not prevent it beneficially owning shares, controlling voting power or having rights to dividends and capital distributions attaching to those shares ***[Schedule 1, items 1 and 2, subsections 80B(8B) and 160ZNRA(2) of the ITAA 1936; item 73, subsection 165-208(2) of the ITAA 1997].***

3.6 Accordingly, satisfaction of the COT is unaffected if the tested company, or a company interposed between the tested company and an ultimate owner, goes into external administration or a provisional liquidator is appointed to the company or interposed company.

3.7 In addition, the appointment of an external administrator to a company does not affect control of voting power in the company for the purposes of the test in section 165-15 (or equivalent tests in sections 165-40, 165-115D, 165-115M, and 165-129). ***[Schedule 1, item 78, section 165-250]***

3.8 A company is an 'externally-administered body corporate' under section 9 of the *Corporations Act 2001* if:

- it is being wound up;
- a receiver, or a receiver and manager, has been appointed and is acting in respect of its property;
- it is under administration;
- it has executed a deed of company arrangement that has not yet been terminated; or
- it has entered into a compromise or arrangement with another person, the administration of which has not yet been concluded.

3.9 The same rules apply in relation to an entity which has a similar status under a foreign law or the Companies Code. ***[Schedule 1, items 1 and 2, sections 80B and 160ZNRA of the ITAA 1936; items 73 and 78, sections 165-208 and 165-250 of the ITAA 1997]***

Income injection and insolvent companies

3.10 Loss trafficking can occur when entities inject income from other sources into a loss company. The income injection provisions of the income tax law (Division 175) disallow deductions for tax losses in specified circumstances. However, the Commissioner of Taxation (Commissioner) cannot disallow a loss if the continuing shareholders will benefit from the derivation or accrual of the injected amount to an extent that the Commissioner thinks is fair and reasonable, having regard to either their respective rights and interests or their respective shareholding interests in the company.

3.11 The intention is that if continuing shareholders do not receive benefits from the income injected the loss should be denied. However, it is arguable that where a company is insolvent and in some form of external administration, the Commissioner cannot deny the loss on the grounds that it is reasonable that the benefit of income injected into the company flows to the creditors of the company rather than to the continuing shareholders.

3.12 The amendment provides that the provisions limiting the Commissioner's power to disallow a loss or deduction do not apply during a relevant income year if the company was insolvent at the time it becomes an externally-administered body corporate under the *Corporations Act 2001* or an entity with similar status under a similar foreign law. ***[Schedule 1, item 103, section 175-100]***

3.13 The amendments apply to insolvent companies whose external administration begins on or after the day this Act receives Royal Assent. ***[Schedule 1, item 176]***

The same business test and the entry history rule

3.14 When a consolidated group or multiple entry consolidated group (MEC group) applies the SBT, its business is that of the group as a whole and not just that of the head company. This is because the single entity rule provides that subsidiary members of the group are taken to be parts of the head company for the purpose of working out the head company's liability for income tax (section 701-1).

3.15 The entry history rule provides that for certain purposes everything that happened to a subsidiary before it became a member of a consolidated or MEC group is taken to have happened to the head company (section 701-5).

3.16 If the entry history rule applies for the purposes of the SBT, the head company may be regarded as carrying on the business that subsidiary members carried on before they joined the consolidated group. This could lead to anomalous outcomes. For example, changes in the business of a subsidiary before it became a group member could cause the head company to fail the SBT.

3.17 This Bill clarifies that the entry history rule does not operate to deem the head company of a consolidated or MEC group to carry on the activities of a subsidiary member of the group during a period before the subsidiary member joined the group. ***[Schedule 1, item 76, section 165-212E]***

3.18 When an entity joins a consolidated or MEC group, its activities are treated as activities of the head company from its joining time for the purposes of the SBT. Activities that the entity carried on before the joining time are not attributed to the head company for the purposes of determining whether the head company has carried on the same business.

3.19 The rule has practical implications only when an entity joins an existing consolidated group. The entry history rule does not affect the application of the SBT in relation to entities that join a consolidated group on its formation, because the SBT does not compare the business of the head company before and after consolidation (see section 707-400 of the ITAA 1997).

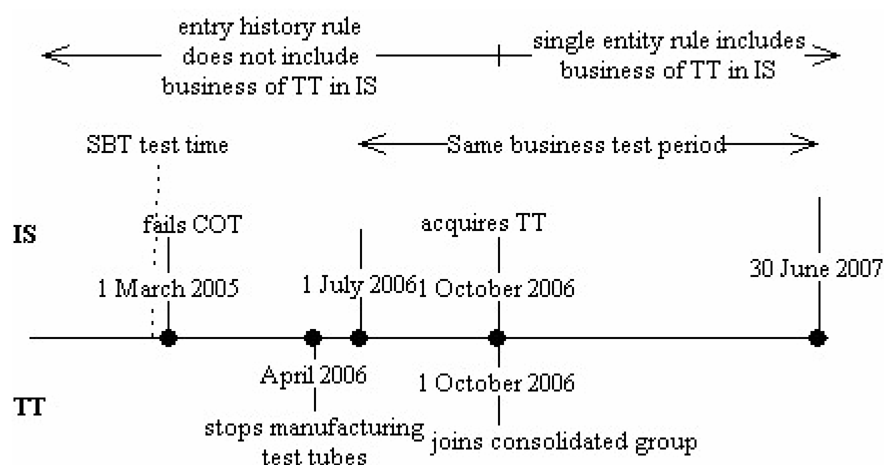
Example 3.1: Same business test and entry history rule.

Innovative Solutions Ltd is the head company of a consolidated group that carries on research and development in the biotechnology industry.

Innovative Solutions Ltd has tax losses from the year ended 30 June 2004 and failed the COT on 1 March 2005. It wishes to use its tax losses in the income year ended 30 June 2007 and must demonstrate that it carries on the same business in the income year ended 30 June 2007 that it carried on immediately before 1 March 2005.

Innovative Solutions Ltd acquired Tests and Things Pty Ltd on 1 October 2006.

Tests and Things Pty Ltd is a small company that carries on biotechnology research. The research is similar to that conducted by Innovative Solutions Ltd and its subsidiaries. Tests and Things Pty Ltd previously manufactured test tubes, but it ceased that part of its business in April 2006.



If the entry history rule applied in relation to the SBT, Innovative Solutions Ltd would be deemed to carry on the test tube manufacturing business up until April 2006. Accordingly, it would not carry on the same business immediately before 1 March 2005 as it carries on in the income year ended 30 June 2007 and would therefore fail the SBT.

The amendment confirms that, for the purposes of the SBT, Innovative Solutions Ltd is not taken to have conducted the activities of Tests and Things Pty Ltd prior to 1 October 2006. Accordingly, Innovative Solutions Ltd is not to be regarded as carrying on the test

tube manufacturing business at the SBT test time and will therefore satisfy the SBT.

Medical defence organisations

3.20 The *Medical Indemnity (Prudential Supervision and Product Standards) Act 2003* required medical indemnity providers to make changes to the way in which they provided medical indemnity services. In particular, it required that a medical indemnity provider be a general insurer and that medical indemnity be provided by means of a contract of insurance.

3.21 The amendments confirm that changes made by a medical defence organisation in order to conform to the requirements of the *Medical Indemnity (Prudential Supervision and Product Standards) Act 2003* do not cause a failure of the SBT. Similarly, changes made by a related general insurance company because of the restructure by a medical defence organisation do not prevent the general insurance company from satisfying the SBT. ***[Schedule 1, item 76, section 165-212D]***

Family trusts

3.22 Existing section 165-207 applies if the trustee of a family trust either directly or indirectly holds an interest in shares in the tested company. The application of the existing law is uncertain when there is a change of trustee or when there is more than one trustee of the family trust.

3.23 These amendments ensure that a single notional entity that is a person but not a company or a trustee:

- is taken to own the shares beneficially for the purposes of the primary test ***[Schedule 1, item 72, subsection 165-207(2)]***; and
- is taken to control the voting power held by the family trust and have the right to receive for its own benefit the percentage of the dividends and capital to which the trust is entitled ***[Schedule 1, item 72, subsection 165-207(3)].***

3.24 A change in trustee does not affect the attribution of beneficial ownership, voting power or rights to dividends or capital held by the single notional entity. ***[Schedule 1, item 72, subsection 165-207(4)]***

3.25 The single notional entity referred to in this section is a different notional entity to the ones referred to in sections 166-225 and 166-255. ***[Schedule 1, item 79, subsections 166-225(3) and 166-255(3)]***

Non-profit companies

3.26 A company satisfies the COT if it satisfies conditions relating to voting power, rights to dividends and rights to capital distributions.

3.27 A company that is prohibited from making any distributions to its shareholders cannot test the dividend and capital conditions because it never pays a dividend or makes a distribution of capital to its shareholders. Accordingly, under the existing rules it is uncertain how a non-profit company is to apply the COT. A similar situation exists for mutual insurance companies and mutual affiliate companies.

3.28 The amendments provide that a company that is a non-profit company, a mutual affiliate company or a mutual insurance company throughout the test period is taken to satisfy the dividend and capital conditions. As a result, these companies satisfy the COT if they satisfy the voting power condition.

3.29 This amendment applies for:

- tax losses ***[Schedule 1, item 17, subsection 165-12(7A)]***;
- current year losses ***[Schedule 1, item 30, subsection 165-37(4A)]***;
- changeover times ***[Schedule 1, item 47, subsection 165-115C(4A)]***;
- alteration times ***[Schedule 1, item 50, subsection 165-115L(5)]***; and
- bad debts ***[Schedule 1, item 58, subsection 165-123(7A)].***

3.30 A company is a ***non-profit company*** (as defined in the *Income Tax Act 1986*) if it is not carried on for the profit or gain of its individual members and is prohibited from making distributions to its members. A friendly society dispensary is also a non-profit company. ***[Schedule 1, item 156, subsection 995-1(1)]***

Certain entities treated as persons other than companies

3.31 The primary tests for the COT require the identification of persons who hold voting power, rights to dividends and rights to capital.

3.32 The alternative tests for the COT apply when the tested company has a corporate shareholder. It requires the identification of persons other than companies (and, in the case of voting power, other than trustees) who hold voting power and dividend and capital rights.

3.33 Subsection 995-1(1) of the ITAA 1997 defines 'person' to include a company. However, it does not specify whether bodies politic (eg, governments) are also regarded as persons. A similar issue arises in relation to statutory corporations which are often essentially government bodies.

3.34 These amendments ensure that government bodies and statutory corporations are to be regarded as persons (and not companies) for the purposes of a loss recoupment test. It applies to shares held by:

- the Commonwealth, a state or a territory;
- a municipal corporation;
- a local governing body;
- the government of a foreign country or of part of a foreign country; and
- a company, established under a law, in which no person has a membership interest (eg, a statutory corporation).

[Schedule 1, item 71, subsection 165-202(1)]

3.35 A company may not be able to trace its ownership through a non-profit company or a charitable body. The amendment also provides that non-profit companies and charitable bodies (including charitable institutions and charitable funds) are regarded as persons other than companies. This amendment ensures that companies do not need to trace their ownership through non-profit companies and charitable bodies. ***[Schedule 1, item 71, subsection 165-202(2)]***

3.36 These amendments apply for the purposes of both the primary and alternative tests.

Companies without shares

3.37 The primary tests for the COT focus on rights attaching to shares and the alternative tests are only applicable if another company holds shares in the tested company. Accordingly, its unclear under the existing rules how companies without shares, such as companies limited by guarantee, can apply the COT.

3.38 These amendments ensure that companies without shares can apply the COT. Membership interests in a company without shares are

treated as if they were shares for the purpose of applying a test. This means that if no companies are members of the tested company, the company applies the primary tests and treats its membership interests as if they were shares for the purposes of those tests. If a company holds membership interests in the tested company, the tested company applies the alternative tests. ***[Schedule 1, item 71, section 165-203]***

3.39 If a company without shares is a non-profit company, the amendments relating to non-profit companies mean that the company applies the voting power test.

Application of alternative ownership tests

3.40 To work out whether it satisfies the COT, a company applies either the primary test or the alternative test for each of the conditions. The primary test looks at the immediate beneficial ownership of shares carrying voting power and dividend and capital rights. The alternative test applies where a company holds shares in the tested company and traces the ownership of the voting power and dividend and capital rights to the non-corporate shareholders.

3.41 Under the existing law, the alternative test only applies if one or more companies beneficially held shares or interests in shares in the tested company at the beginning of the ownership test period. If no companies hold shares in the tested company at the start of the test period, the primary test applies.

3.42 The effect of this rule is that the interposition of a company between existing shareholders (none of which are companies) and the tested company after the start of the test period automatically causes a company to fail the COT even though ultimate ownership remains unchanged.

3.43 The COT is amended so that the alternative test applies if a company beneficially owns shares in the tested company at any time in the ownership test period. This applies for:

- tax losses (Subdivision 165-A);
- current year loss rules (Subdivision 165-B);
- changeover times (Subdivision 165-CC);
- alteration times (Subdivision 165-CD); and
- bad debts (Subdivision 165-C).

[Schedule 1, items 16, 29, 46, 49 and 57, subsections 165-12(6), 165-37(3), 165-115C(3), 165-115L(4) and 165-123(6)]

3.44 Thus, a company does not fail the COT merely because a holding company is interposed between individual shareholders and a tested company during the ownership test period. However, the question of whether the COT is satisfied in any particular case would depend on the effect of the same share test (see section 165-165 and subsections 165-12(7), 165-37(4), 165-115C(4) and 165-123(7)).

Companies that come into existence or cease to exist during a period

3.45 The COT requires a company to establish continuity of ownership between the start of the loss year and the end of the income year. The SBT requires that a company carry on the same business during the income year as it did immediately before it failed the COT.

3.46 The application of the loss recoupment rules to companies that come into existence during the loss year is uncertain. This uncertainty is removed by an amendment to clarify the operation of the company loss recoupment rules when a company comes into existence. If a period would start before the company comes into existence, it starts on the day the company comes into existence. That is, if a company incurs a tax loss in the year it is incorporated, it applies the COT on the basis that the loss year commenced at the time it was incorporated, rather than from the start of the income year. ***[Schedule 1, item 78, subsection 165-255(1)]***

3.47 These amendments also clarify the application of the company loss rules to a company which ceases to exist. The amendment provides that if a period would end after the company ceases to exist, it instead ends on the day the company ceases to exist. The effect is that a company can satisfy the COT in a year it is deregistered provided it satisfies the COT up until the day of deregistration. Similarly, it can satisfy the SBT provided that it carries on the same business until the day of deregistration. ***[Schedule 1, item 78, subsection 165-255(2)]***

3.48 These amendments apply for the purposes of Divisions 165 and 166. This includes where those Divisions are applied because of the operation of a tax provision outside those Divisions. For example, it would apply for the purposes of testing whether a loss can be transferred from a joining entity to the head company of a consolidated group.

Redeemable shares

3.49 Section 165-195 was introduced as a specific anti-avoidance measure. However, it is no longer necessary given the Commissioner's discretion in relation to arrangements affecting the beneficial ownership of shares (section 165-180) and the same share test (section 165-165). Accordingly, this Bill repeals section 165-195 and deletes the reference to existing section 165-195 in subsection 165-200(1). ***[Schedule 1, items 69 and 70]***

3.50 If redeemable shares are issued by a company to enable it to satisfy the COT, the Commissioner would be entitled (under section 165-180) to treat the holders of the redeemable shares as if they did not beneficially own those shares. A note is added to section 165-180 to alert readers to that section's potential operation in these circumstances. ***[Schedule 1, item 68]***

Dual listed companies

3.51 A dual listed voting share is disregarded in applying the voting power test. Accordingly, dual listed companies do not need to trace ownership of special voting shares to determine continuity of ownership. ***[Schedule 1, item 73, section 165-209]***

3.52 A dual listed company voting share is a share in a company, issued as part of a dual listed company arrangement that does not have any rights to financial entitlements (except the amount paid up on the share and a dividend paid that is equivalent of a dividend paid on an ordinary share).

Applying capital losses of earlier years

3.53 Subsections 165-96(1), 175-40(1) and 175-45(1), paragraphs 165-235(2)(c), 175-50(1)(b) and 180-5(2)(c) and several notes, incorrectly imply that a company may apply a prior year net capital loss in calculating its net capital loss for the current year.

3.54 These provisions are amended to clarify that a prior year net capital loss cannot be taken into account in calculating the net capital loss for the current year. ***[Schedule 1, items 37, 38, 77, 87, 88 and 104, subsections 165-96(1), 165-235(2), 175-40(1) and 180-5(2)]***

Ownership test period

3.55 Item 2 in the table headed *Tax losses of corporate tax entities* in section 36-25, describes the COT as requiring a comparison of owners in the loss year and the income year. The COT also requires the same owners during any intervening period. Item 2 is therefore amended to confirm that the COT requires the same owners in the loss year, the income year and any intervening period. ***[Schedule 1, item 7, section 36-25]***

3.56 The same description of the test periods occurs in note 2 to subsection 165-96(1) and the note to subsection 175-40(2). This Bill corrects these notes by specifying that the COT applies from the beginning of the loss year to the end of the income year. ***[Schedule 1, items 39 and 90, subsections 165-96(1) and 175-40(2)]***

Application provisions

3.57 The amendments to the ITAA 1997 relating to companies in external administration apply from the commencement of the relevant provisions in the ITAA 1997. The comparable amendments to the ITAA 1936 apply in respect of any income year for assessments made on or after 1 July 1997. ***[Schedule 1, item 169]***

3.58 The amendments relating to the income injection rules and insolvent companies apply from the date of Royal Assent. ***[Schedule 1, item 176]***

3.59 The amendment to disregard the entry history rule in the consolidation regime when applying the SBT applies on and after 1 July 2002, the date the consolidation regime came into effect. ***[Schedule 1, item 175]***

3.60 The amendments relating to the application of the SBT to a medical defence organisation or general insurance company that restructures to comply with the *Medical Indemnity (Prudential Supervision and Product Standards) Act 2003* apply to:

- all tax losses incurred by the company;

- all net capital losses made by the company; and
- all deductions claimed in respect of bad debts written-off by the company.

[Schedule 1, item 174]

3.61 The amendment relating to family trusts applies from the time section 165-207 was first inserted into the ITAA 1997. ***[Schedule 1, item 173]***

3.62 The amendments relating to:

- non-profit companies;
- shareholders that are government bodies, statutory bodies, non-profit companies and charitable bodies;
- companies without shares;
- dual listed companies; and
- repeal of the provision regarding redeemable shares,

have the same application date as the modified COT amendments. ***[Schedule 1, item 170]***

3.63 The amendments relating to the application of the alternative ownership test apply to deductions claimed for tax loses and bad debts and net capital losses applied in income years ending after 21 September 1999. This restores the position to that time. The amendments apply in relation to changeover times and alteration times from 11 November 1999, the date those provisions commenced. ***[Schedule 1, item 171]***

Consequential amendments

3.64 The definition of 'dual listed company voting share' in subsection 125-60(3) is modified to remove the requirement that the share is issued in the head entity of a demerger group. This allows the definition to apply appropriately in respect of the COT amendments. There is no substantive effect of this change on the demerger rules. Subsection 125-60(2) is amended so that the treatment of a dual listed company voting share as not being an ownership interest only applies if the share is in a

company that is the head entity of a demerger group. ***[Schedule 1, items 10 and 11, subsection 125-60(2) and subparagraph 125-60(3)(a)(i)]***

3.65 Notes are inserted to alert readers to the amendments concerning companies in external administration, income injection and insolvent companies, companies that come into existence or cease to exist in an income year and the entry history rule. ***[Schedule 1, items 23, 32, 34, 51, 64, 82 to 86, 92, 94 to 97, 99 to 101 and 105]***

Chapter 4
Loss recoupment rules for companies: regulation impact statement

Background

4.1 Under Australia's income tax regime, if a company's deductions exceed its assessable income and net exempt income in an income year, the company has a tax loss. This tax loss can be carried forward and may be deducted against assessable income for a later income year provided that the company satisfies either the continuity of ownership test (COT) or the same business test (SBT).

4.2 Currently, the COT is satisfied if the same people hold more than 50 per cent of voting power and rights to dividends and capital at all times during the test period. To apply the COT, a company must trace its ownership through companies, trusts and other entities to identify the people who ultimately hold (directly or indirectly) voting power and rights to dividends and capital distributions.

4.3 A company that fails the COT can still deduct tax losses if it satisfies the SBT. A company will satisfy the SBT if, broadly, it carries on the same business in the year it wishes to deduct the loss as it did immediately before it failed the COT.

4.4 During 2002 Treasury undertook consultation with representatives of the Australian Taxation Office (ATO) and a selected group of industry representatives and tax practitioners with a view to identifying options to improve the company loss recoupment rules. The focus was on ensuring those rules would apply appropriately when losses are transferred to a head company of a consolidated group from a subsidiary member that joins the group.

4.5 The consultation process identified that companies were placing considerable reliance on the SBT to deduct tax losses because of the uncertainty and high compliance costs associated with tracing ownership to satisfy the COT. It also identified that the SBT was a difficult and uncertain test for large and diverse businesses to apply. Tax consolidation would exacerbate these problems with the SBT because it would require the test to be applied on a group-wide basis.

4.6 A conclusion reached from the consultation process was that the tax loss recoupment rules could be improved by remedying the difficulties identified with tracing ownership to satisfy the COT. A consequence of such an approach would be decreased reliance on the SBT.

Policy objective

4.7 The objective is to:

- reduce the uncertainty and compliance costs associated with applying the company loss recoupment rules to widely held companies and companies owned by widely held companies; and
- broadly maintain the current rate of loss recoupment.

Implementation options

Modifications to the continuity of ownership test

4.8 It is appropriate to modify the COT to make it easier for widely held companies and companies owned by widely held companies to apply. Two key implementation issues arose:

- the time that the COT test must be applied; and
- the approach for relaxing the COT tracing rules.

4.9 In addition, a range of technical modifications would clarify the operation of the COT and to make it easier to apply.

Time that the continuity of ownership test must be applied

4.10 The existing law allows listed public companies and their 100 per cent subsidiaries to test for substantial continuity of ownership at the time of 'abnormal trading' and at the end of each income year if they apply the modified COT. Companies were uncertain as to the circumstances that would be regarded as being a time of 'abnormal trading' and, in some cases, this deterred them from using the modified COT.

Option 1: apply a known change of ownership test

4.11 Under this option companies would have to test for continuity of ownership when they had a known change of ownership. A company would have a known change of ownership if:

- it was reasonable for the company to conclude that it would have failed the ordinary COT rules at a particular time; and
- this failure would not have occurred by reason only of the sale of shares in a company in the ordinary course of trading for that company, or the sale of interests in an interposed entity in the ordinary course of trading for that entity.

Option 2: identify specific testing times

4.12 Under this option companies would have to apply the tracing rules to test for continuity of ownership at the end of each income year and when an event that is likely to cause a change in majority ownership of a company occurs. Events that are likely to cause a change in majority ownership of a company are a takeover bid (or similar arrangement), a scheme of arrangement or a significant capital raising (more than 20 per cent of shares or capital) in either the tested company or another company that controls the tested company.

Relaxation of the continuity of ownership test tracing rules

4.13 The existing tracing rules allow direct interests of less than one per cent in the tested company to be attributed to a notional entity. The only option considered was to reduce the circumstances in which the tracing rules must be applied by increasing the proportion of ownership that must be held in the tested company before a requirement to trace ownership is triggered.

4.14 Under this option this threshold would be increased. After some consideration, a 10 per cent threshold was chosen as this would align ownership tracing with other provisions in the tax law that distinguish between portfolio and non-portfolio shareholdings.

4.15 In determining an appropriate threshold of ownership for the notional entity, analysis was undertaken of the likely effect on companies listed on the Australian Stock Exchange. Analysis showed that a 10 per cent threshold would reduce the requirement to trace to 2 or fewer owners for about 90 per cent of the sample examined. On the other hand, a 5 per cent threshold, for example, would often require more significant ownership tracing.

Modifications to the same business test

4.16 Consultation revealed that the application of the SBT was highly uncertain for large and diverse businesses. However, the test was generally capable of reasonable application for companies that operated on a small scale and engaged in a very limited field of business.

4.17 The only practical means identified for excluding the SBT in cases where its application would be difficult and uncertain was on the basis of the size of the company or group.

Option 1: introduce an income ceiling for the same business test

4.18 Under this option companies whose total income was more than $100 million in the income year it was seeking to deduct the loss would be denied access to the SBT.

Option 2: exclude all companies that benefit from the continuity of ownership test changes from the same business test

4.19 Under this option widely held companies and companies owned by widely held companies that would benefit from relaxation of the COT would be denied access to the SBT.

Option 3: exclude all consolidated groups from the same business test

4.20 Under this option companies that are members of consolidated groups would be denied access to the SBT.

Impact group identification

4.21 The changes to the COT will impact on widely held companies and companies owned by widely held companies.

4.22 The changes to the SBT will impact on large companies.

4.23 These changes will potentially affect about 1,000 to 1,400 companies and corporate groups (although the numbers vary from year to year).

4.24 The companies that are affected by the removal of the SBT are those most likely to benefit from the simplified COT. In this sense, it is not expected that loss recoupment rates will alter over the longer term.

Analysis of costs / benefits

Modifications to the continuity of ownership test

Time that the continuity of ownership test must be applied

Option 1: apply a known change of ownership test

Benefits

4.25 Changes of ownership during an income year that are not due to takeovers, schemes of arrangement or substantial capital raisings would be identified. Thus companies would not be able to offset a loss incurred in one part of an income year when it was owned by one set of shareholders against income derived in another part of the year when it was owned by different shareholders. Therefore, there could be a small gain to revenue.

Costs

4.26 Companies would have to apply the ordinary COT rules if there was a known change of ownership. This would place a heavy compliance burden on companies with large share registers and would be inconsistent with the rationale for providing special rules. Compliance costs would be increased.

4.27 Widely held companies would continue to be uncertain as to when they would have to apply the tracing rules to test for continuity of ownership.

4.28 Practical problems that arise under option 1 are the level of information that would be required to decide whether a known change of ownership had occurred and whether off-market transactions, such as dividend investment schemes, had to be taken into account.

4.29 The practical problems arise from the wide range of potential sources that information would need to be drawn from to determine whether a known change of ownership had occurred. The possible sources of information that could indicate a change of majority ownership include notices of substantial shareholdings, media reporting of dealings in a company’s shares and market or industry knowledge of substantial transactions.

Option 2: identify specific testing times

Benefits

4.30 Under option 2 the circumstances in which widely held companies and companies owned by widely held companies would have to apply the tracing rules to test for continuity of ownership would be certain.

4.31 It would clearly achieve the policy objective of making the company loss recoupment rules more certain and reducing compliance costs for widely held companies and companies owned by widely held companies. Specifying the times for testing continuity of ownership would reduce compliance costs. Estimates of compliance cost savings cannot be quantified due to the lack of data.

Costs

4.32 Under option 2 widely held companies and companies owned by widely held companies could have a change of ownership during an income year but will not have to apply the tracing rules to test for continuity of ownership until the end of the income year. In limited circumstances this could allow companies to offset a loss incurred in one part of an income year when it was owned by one set of shareholders against income derived in another part of the year when it was owned by different shareholders. These circumstances would occur if the change in majority ownership arose from transactions that are not a takeover, scheme of arrangement or significant capital raising. Therefore, there is a slight risk to revenue under option 2.

Relaxation of the continuity of ownership test tracing rules

Benefits

4.33 A 10 per cent threshold would align ownership tracing with other provisions in the tax law that distinguish between portfolio and non-portfolio shareholdings. A higher threshold would lower the compliance costs for companies because less tracing of ownership would be required. Compliance costs cannot be quantified due to the lack of empirical data in this area.

4.34 A 10 per cent threshold is beneficial because it would substantially reduce compliance costs for widely held companies and companies owned by widely held companies.

Costs

4.35 The higher the threshold the more significant the risk that significant ownership changes in the tested company would be effectively ignored in applying the COT. Therefore, moving to a higher threshold of 10 per cent could allow companies to access prior year losses inappropriately. This could occur if a company was wholly-owned by shareholders holding less than 10 per cent and all the shareholders sold their shares to other shareholders each of whom then held less than 10 per cent. Therefore, there is a slight risk to revenue under this approach.

Modifications to the same business test

Option 1: introduce an income ceiling for the same business test

Benefits

4.36 Size of the company or group is the most practical means for excluding cases from the SBT where its application would be difficult and uncertain.

4.37 Particular difficulties arise for a consolidated group because determining the business of the head entity would require a detailed analysis of all the activities being undertaken by the group at the test time (ie, when it fails the COT) and through the SBT period. The uncertainty arises in determining whether the introduction of new activities or cessation of previous activities is a change in the business a company or group is conducting.

4.38 The benefit of an income ceiling is that it draws on income as already reported in company tax returns. An income ceiling of $100 million was chosen having regard to the following factors.

- The high correlation between companies with total income exceeding $100 million and companies that benefit from the proposed reforms to the COT.
- An income ceiling of $100 million does not exclude the SBT for small and medium sized companies — the SBT generally operates in a manner consistent with the policy intent for these companies.
- An income ceiling of $100 million is consistent with the ATO's definition of the large business segment.

Consequently, there is detailed information and monitoring concerning this segment.

Costs

4.39 A test based on an income ceiling causes difficulty for companies whose total income fluctuates over and under the ceiling from year to year. In addition, although the level at which the ceiling is set is soundly based, it is somewhat arbitrary.

Option 2: exclude all companies that benefit from the continuity of ownership test changes from the same business test

Benefits

4.40 This option is consistent with the New Zealand approach (on which the COT modifications are largely based). This approach has the advantage that the two offsetting measures would affect exactly the same group.

Costs

4.41 The option would exclude a number of small to medium size companies from the SBT and leave existing issues with large closely held companies and groups unresolved. If closely held groups could continue to rely on the SBT they would not be concerned about failing the COT on technical grounds.

4.42 The option would also discourage large companies from using the modified COT if they could access the SBT by using the ordinary COT.

Option 3: exclude all consolidated groups from the same business test

Benefits

4.43 The problems with the SBT were exacerbated by tax consolidation. Therefore, this option would target the source of concerns that had been raised about the SBT.

Costs

4.44 This option would introduce non-neutrality in the taxation of consolidated groups and single companies. It would discriminate against consolidated groups and discourage consolidation. The consolidation regime was introduced to promote business efficiency as well as tax system integrity. Denying consolidated groups access to the SBT would continue the inconsistent treatment of wholly-owned groups with losses. As large

single companies would continue to have access to the SBT, there would be no incentive to resolve technical problems with the COT.

Revenue impact

4.45 The changes to the COT will reduce revenue, but the changes to the SBT will increase revenue. The net revenue effect of the changes is unquantifiable.

Administration costs

4.46 It is expected that the new COT tracing rules and the SBT total income ceiling will reduce administration costs for the ATO by reducing requests by taxpayers for rulings and by simplifying company audits.

Economic benefits

4.47 The changes are expected to provide greater certainty in the tax treatment of company losses. This is expected to address inefficiencies arising from compliance difficulties, uncertainties and anomalies relating the current company loss recoupment rules. These inefficiencies arise from the need to divert company resources to non-productive areas. Therefore, the changes would improve resource allocation and benefit the economy.

Consultation

4.48 Commencing in 2002, extensive consultation was carried out to identify means of improving the company loss recoupment rules.

4.49 Meetings were held in April, August and November 2002. Attendees included representatives of the Treasury and the ATO, partners of several accounting firms and representatives of the Law Council of Australia, the Taxation Institute of Australia, the Institute of Chartered Accountants in Australia and the Corporate Tax Association.

4.50 Participants in the consultation process were forwarded a draft discussion paper in November 2002 and a further draft reform proposal in March 2003.

4.51 Their comments were taken into account in developing a discussion paper outlining proposed reforms to the company loss recoupment rules. This paper was released publicly on 7 April 2004 at the same time the Government announced the measure.

4.52 Confidential targeted consultation with stakeholders occurred in July 2004 and meetings were held with stakeholders to discuss the issues raised in submissions.

4.53 On 11 February 2005, an exposure draft of the legislation was publicly released. Those who made submissions in response to the exposure draft were invited to further consultation meetings that were held in May and August 2005.

4.54 Participants in the consultation process strongly supported the objective of making the company loss recoupment rules more certain and reducing compliance costs for widely held companies and companies owned by widely held companies. The key change suggested by participants was to adopt specific testing times (rather than a known change of ownership approach) for determining the time when widely held companies and companies owned by widely held companies have to apply the tracing rules to test for continuity of ownership.

4.55 Other suggested changes to the legislation were relatively minor and related mainly to clarifying the application of the legislation in particular circumstances and making various technical refinements. Most of these changes have been incorporated into the current legislation.

Conclusion and recommended option

Modifications to the continuity of ownership test

Time that the continuity of ownership test must be applied

4.56 The option to identify specific testing times (option 2) is the preferred approach. This option better achieves the policy objective of making the company loss recoupment rules more certain and reducing compliance costs for widely held companies and companies owned by widely held companies and is strongly supported by participants in the consultation process. It is not expected to alter significantly the rate at which losses are recouped.

Relaxation of the continuity of ownership test tracing rules

4.57 The only option considered was to reduce the circumstances in which the tracing rules must be applied by increasing the proportion of

ownership that must be held in the tested company before a requirement to trace ownership is triggered and by removing the tracing requirement in certain circumstances. A 10 per cent threshold for the notional entity rule was preferable because it better achieves the policy objective of reducing compliance costs.

4.58 The modifications to the COT apply from the income year commencing on or after 1 July 2002. These changes will benefit affected taxpayers and remove the difficulties that arise under the current law in applying the COT to widely held companies and companies owned by widely held companies.

Modifications to the same business test

4.59 The option to deny access to the SBT to companies with total income exceeding $100 million (option 1) is the preferred approach. This approach is the only practical option for excluding the SBT in cases where its application is difficult and uncertain. This approach also ensures that small to medium size companies retain access to the SBT.

4.60 Although companies will need to calculate their total income to determine whether they are eligible for the SBT, the total income ceiling is not expected to impose a significant compliance burden because it is based on information that companies already collect for taxation purposes.

4.61 The option to exclude all companies that benefit from the COT changes from the SBT (option 2) is not preferred because it would inappropriately increase compliance costs for small to medium size companies that would be denied access to the SBT.

4.62 The option to exclude all consolidated groups from the SBT (option 3) is not preferred because it would introduce an unjustifiable non-neutrality in the taxation of consolidated groups and single companies.

4.63 The removal of the SBT for companies whose total income exceeds $100 million applies from the income year commencing on or after 1 July 2005.

4.64 The Treasury and the ATO will monitor this taxation measure as part of the whole taxation system on an ongoing basis.

Chapter 5
Conduit foreign income

Outline of chapter

5.1 Schedule 2 to this Bill inserts Division 802 into the *Income Tax Assessment Act 1997* (ITAA 1997). This Schedule also makes changes to various provisions in the *Income Tax Assessment Act 1936* (ITAA 1936). The changes provide tax relief for conduit foreign income, which generally is foreign income received by a foreign resident through an Australian corporate tax entity. Generally, the measure only applies to foreign income that is ordinarily sheltered from Australian tax when it is received by the Australian corporate tax entity.

5.2 This chapter:

- explains the conduit foreign income measure which will provide tax relief for conduit foreign income;
- describes how a corporate tax entity will calculate an amount of conduit foreign income; and
- explains how conduit foreign income can pass through a series of Australian corporate tax entities to ultimate foreign owners free of Australian tax.

5.3 All legislative references are to the ITAA 1997 unless otherwise stated.

Context of amendments

5.4 This measure implements the Government's decision to establish foreign income account rules. This decision was in response to Recommendation 3.11(1) of the Board of Taxation's report to the Treasurer on international taxation. The decision was announced in the Treasurer's Press Release No. 32 of 13 May 2003.

5.5 Foreign residents who structure their foreign investments through Australian entities will often be subject to Australian tax on the income

from those investments either when the income is derived or when it is distributed to the foreign residents. However, if the foreign residents derived that income directly, or through an interposed *foreign* entity, the income would not be subject to Australian tax because foreign residents are taxed only on their Australian source income. Similar differences may arise in connection with offshore banking activities in Australia and operations conducted in the Joint Petroleum Development Area under the treaty with East Timor. By reducing those tax differences, the measure will improve Australia as an investment choice for foreign investors.

5.6 However, this measure does not, nor is it intended to, remove any Australian tax paid by the interposed Australian entity on the income from the foreign investments. Nor does it refund any of that entity-level tax when the income is distributed to foreign investors. To do either of these things would mean giving foreign-owned Australian companies an unfair competitive advantage over Australian-owned companies when it comes to investing offshore (and could involve quite complex law). Nevertheless, it is important to note that there is no Australian entity-level tax on the profits from carrying on or disposing of offshore active businesses. Notwithstanding these limitations, what is done by these amendments will improve the attractiveness of Australia as a location for regional holding companies and particular businesses of foreign groups. The measure will also enhance the ability of Australian entities with foreign investments to compete for foreign capital and therefore encourage them to remain Australian residents if their foreign shareholding becomes significant.

5.7 The conduit foreign income measure replaces the foreign dividend account provisions contained in Division 11A of Part III of the ITAA 1936. Those provisions provide rules for foreign non-portfolio dividends to flow through an Australian company to foreign shareholders free from dividend withholding tax. The conduit foreign income measure provides relief from Australian tax on distributions to foreign shareholders of a broader range of foreign income and gains than the foreign dividend account rules.

5.8 This measure also ensures conduit foreign income can flow through more than one Australian corporate tax entity by removing Australian company tax on this income when it is distributed. This removes a limitation in the foreign dividend account rules. That limitation meant that foreign residents did not get tax relief for conduit foreign income where they invested indirectly, through Australian entities, in other Australian entities that earned foreign income. Removal of that limitation should provide greater flexibility in structuring holding company arrangements in Australia, including via joint ventures between Australian and foreign investors.

Summary of new law

5.9 The conduit foreign income measure makes two significant changes to the income tax law. First, it broadens the categories of foreign income earned by an Australian corporate tax entity which can be distributed to foreign owners free of Australian tax. Secondly, the measure provides a mechanism to ensure that Australian tax is not payable where conduit foreign income is distributed through one or more further Australian corporate tax entities.

5.10 A dividend withholding tax exemption will be provided for conduit foreign income that is paid to foreign residents. Where the conduit foreign income is distributed to the foreign shareholder via an Australian permanent establishment the income will not be assessable. Australian corporate tax entities that receive an unfranked distribution declared to be conduit foreign income will not pay Australian tax on that income if the conduit foreign income is on-paid to shareholders. The Australian corporate tax entity must pay an equivalent amount of conduit foreign income (net of related expenses) within a certain time period. Where these conditions are met, the Australian corporate tax entity will treat the amount of the conduit foreign income in the unfranked distribution it received as non-assessable non-exempt income.

5.11 Broadly, amounts considered to be conduit foreign income are amounts of foreign income and gains that are earned by or through an Australian corporate tax entity and not taxed in Australia at the entity level. Some examples of conduit foreign income are:

- foreign non-portfolio dividends received by an Australian company;
- foreign income and certain capital gains derived directly or indirectly by an Australian company from carrying on business in a foreign country through a permanent establishment;
- capital gains on the disposal of shares in a foreign company with an underlying active business; and
- foreign income (eg, royalties) and net capital gains included in the assessable income of a corporate tax entity where the Australian tax liability on that income is reduced by foreign tax credits.

5.12 An Australian corporate tax entity can only declare an amount of an unfranked distribution to be conduit foreign income if it has records that demonstrate that it has at least that much conduit foreign income to distribute.

5.13 Conduit foreign income can be calculated from the start of an income year starting on or after 1 July 2005. However, a distribution can only be declared to be conduit foreign income on or after Royal Assent. Entities with income years starting before 1 July 2006 but after Royal Assent will only be able to make such declarations from the start of that year.

5.14 Transitional rules ensure that the existing foreign dividend account provisions generally operate until the time an entity can make a distribution that is declared to be conduit foreign income.

Comparison of key features of new law and current law

New law	*Current law*
Conduit foreign income received by or from an Australian corporate tax entity will be able to be distributed to foreign shareholders without incurring dividend withholding tax.	Foreign non-portfolio dividends received by an Australian company can be distributed to foreign shareholders without incurring dividend withholding tax.
Subject to specified time limits, an Australian corporate tax entity will not pay Australian tax on an unfranked distribution it receives that is declared to be conduit foreign income, to the extent that it on-pays the distribution to its shareholders.	No equivalent.
Conduit foreign income will be reduced by most expenses that reasonably relate to that income.	The foreign dividend account is debited by the amount of expenses that relate to the dividend and that would have been deductible if the section 23AJ dividends were treated as assessable income.
A capital gain that is reduced because of the operation of section 768-505 or disregarded because of the operation of section 23AH of the ITAA 1936 will increase the amount of conduit foreign income. A capital loss that is reduced or disregarded under those provisions will decrease conduit foreign income.	No equivalent.

New law	***Current law***
Foreign tax credits are grossed up and included in conduit foreign income. The amount reflects an amount of assessable foreign income that cannot be distributed as a fully franked distribution.	No equivalent.
Distributions that are non-assessable non-exempt income under section 23AI or section 23AK of the ITAA 1936 or amounts not assessed because of paragraph 99B(2)(e) of the ITAA 1936, will not be included in conduit foreign income.	Section 23AI or section 23AK of the ITAA 1936 amounts, or amounts not assessed because of paragraph 99B(2)(e) of the ITAA 1936, do not give rise to a foreign dividend account credit which means those amounts cannot be distributed free of withholding tax under the foreign dividend account rules.
Conduit foreign income is adjusted if an Australian corporate tax entity streams a frankable distribution with an amount declared to be conduit foreign income to some shareholders and not others or different amounts of conduit foreign income are declared for different shareholders.	Similar anti-streaming rules are currently contained in the foreign dividend account provisions and in the imputation rules.
Penalties will apply where an Australian corporate tax entity declares an amount to be conduit foreign income where that amount is greater than the amount of conduit foreign income the entity has available to distribute.	A penalty applies where the foreign dividend account percentage resulted in an amount of a foreign dividend account declaration exceeding the foreign dividend account surplus.

Detailed explanation of new law

Broad outline

5.15 As a result of these amendments, an Australian corporate tax entity is able to make an unfranked distribution to its foreign owners free of dividend withholding tax to the extent that the distribution is declared to be conduit foreign income ***[Schedule 2, item 1, paragraph 802-15(1)(b)]***. This declaration must be made on or before the day on which the distribution is made ***[Schedule 2, item 1, subsection 802-15(2)]***. Similarly, where the distribution is attributable to an Australian permanent establishment of the foreign shareholder, it will not be assessable income of the foreign shareholder to the extent it is declared to be conduit foreign income ***[Schedule 2, item 1, paragraph 802-15(1)(a)]***. That amount will be non-assessable non-exempt income of a foreign resident recipient. This means that the amount of conduit foreign income will not reduce any Australian tax loss of the foreign resident, particularly where the

distribution is received through a permanent establishment in Australia. Where the distribution is made to a partnership with foreign partners or a trust with foreign beneficiaries, the conduit foreign income amount will be exempt from withholding tax, or will be non-assessable non-exempt income, to the extent that tax would otherwise have been payable. In certain circumstances an unfranked distribution declared to be conduit foreign income that is paid to an Australian corporate tax entity will not be included in the entity's assessable income ***[Schedule 2, item 1, section 802-20]***.

5.16 Under section 202-75 a corporate tax entity is required to provide a distribution statement to its owners when it makes a frankable distribution. The distribution statement must be in a form approved by the Commissioner of Taxation and include certain information. It is anticipated that the approved form of a distribution statement will require the portion of the distribution declared to be conduit foreign income to be shown. The entity receiving the distribution can rely on the amount of the conduit foreign income declared in the distribution statement. A resident shareholder that is not a corporate tax entity can ignore this information because amounts declared to be conduit foreign income do not change the resident's taxable income or tax payable. It is expected that partnerships or trustees in receipt of this information will deal with it in the same way in which they handle franking credits on distribution statements.

5.17 This measure revolves around amounts treated as conduit foreign income. Unlike the foreign dividend account provisions, the measure does not prescribe a detailed mechanism of credits and debits for an entity to use to determine the amount of its conduit foreign income. An entity is also not required to know the amount of its conduit foreign income at all times by keeping a rolling balance of its conduit foreign income. However, the law does say what is included in or excluded from conduit foreign income at a particular time by reference to transactions or events happening up to that time. ***[Schedule 2, item 1, section 802-25]***

5.18 An entity that carries on business must keep records to record and explain all transactions that are relevant for income tax purposes under section 262A of the ITAA 1936. This means that an entity would need to keep records to explain the amount of conduit foreign income it has at the time it makes a distribution declared to be conduit foreign income. If an entity makes a declaration before making the distribution it would need to have a record to explain the amount of its conduit foreign income at the time of the declaration.

5.19 This measure will apply to Australian corporate tax entities. An entity that is an Australian resident company or corporate limited partnership at a particular time is an Australian corporate tax entity at that time. If the entity is a corporate unit trust or public trading trust, it is an Australian corporate tax entity if it is a resident unit trust for the income year in which the time occurs. ***[Schedule 2, item 17, subsection 995-1(1)]***

5.20 The following paragraphs describe how the legislation operates for Australian companies. However, as the legislation generally applies to other types of corporate tax entities, the explanations also apply, with the appropriate modifications, to those other entities and to head companies of consolidated groups. The legislation does not apply in calculating the attributable income of controlled foreign companies as those entities cannot have conduit foreign income. Therefore, they would not be able to declare a distribution to be conduit foreign income and so cannot treat any dividend income they receive as non-assessable non-exempt income under the new legislation.

Calculation of conduit foreign income

5.21 This measure is designed to allow conduit foreign income to flow through Australian companies to foreign shareholders without being taxed further in Australia.

The basic conduit foreign income amount

5.22 Broadly, conduit foreign income is a foreign amount derived by an Australian company which the company has available to distribute as a profit to its shareholders. Much of that income or gain is exempt from Australian tax when derived by the company and so would be subject to withholding tax when distributed to the company's foreign owners. This is the income that these provisions are primarily targeting. Foreign amounts that are normally included in an Australian company's assessable income are excluded from conduit foreign income in the first instance because they generate franking credits that allow the net profit amount to be distributed to foreign shareholders free of further Australian tax ***[Schedule 2, item 1, subsection 802-30(2)]***. If foreign tax credits reduce the Australian tax liability in relation to the assessable foreign income then an amount is included in conduit foreign income. This is explained in paragraphs 5.63 to 5.67.

5.23 Initially, an amount is included in conduit foreign income if it satisfies the following three conditions:

- The amount must be ordinary or statutory income derived by the company.
- The income would not be assessable income if the company were treated as a foreign resident.
- The income is included in an income statement or similar statement.

[Schedule 2, item 1, subsection 802-30(1)]

5.24 In respect of the third condition above, it does not matter whether the amount has been included in an income statement before it is derived for tax purposes or will be included in one after derivation. However, conduit foreign income can still only include amounts derived in income years that start after 30 June 2005. This condition is based on accounting concepts and is used as a mechanism to restrict conduit foreign income to amounts of distributable profits. It is appropriate to use accounting concepts because these determine the actual amounts a company may distribute.

5.25 In order to give more certainty to which of these amounts is to be included in conduit foreign income, the basic tax concepts of ordinary and statutory income derived by the company are used. One intended effect of this is to exclude unrealised profits or gains and foreign exchange gains (except to the extent that the tax law explicitly deals with them). Using these tax concepts minimises compliance costs as an Australian company would be required to use this information to prepare its income tax returns. The meanings of ordinary and statutory income underpin Division 6.

5.26 The final requirement for determining conduit foreign income is to know whether the income amount is foreign. Instead of using the definition of 'foreign income' in section 6AB of the ITAA 1936 a more general approach has been adopted, again using Division 6. That Division does not deal explicitly with the foreign source income of an Australian resident, as residents are initially required to include income from all sources in assessable income. Foreign residents, on the other hand, only include in assessable income Australian source income or other specified amounts. The remainder of their income is effectively foreign source income.

5.27 Hence, the Australian company is treated as though it were a *foreign* company for the purpose of this initial determination, to capture all types of foreign income. The company is not treated as a resident of any particular foreign country which means that none of Australia's tax treaties impacts on the calculation, with the exception of the Taxation Code for the Timor Sea Treaty because it governs activity in the Joint Petroleum Development Area and it applies to persons regardless of their residence. Targeting the amounts derived by the company that would not be assessable under Division 6 if the company were a foreign resident more generally identifies the income that is considered to be foreign income of an Australian company. The effect of this approach is that generally no Australian source income is included in the calculation of conduit foreign income. However, some exceptions to that outcome are discussed in paragraphs 5.34 to 5.38.

5.28 Generally, the reference to an income statement will be to the income statement of the company which derived the amount but it may be recorded in another entity's income statement. A similar statement is any sort of financial statement that is prepared to determine the amount an Australian company can distribute to its members. Financial statements (as defined by the Australian Accounting Standards) are to be prepared by certain entities governed by the *Corporations Act 2001*. The types of entities include public companies, registered schemes and large proprietary companies.

5.29 The reference to the income statement is to the income statements of the individual entities that form part of a consolidated or multiple entry consolidated (MEC) group. The reference is not only to the income statement of the head company. Groups that prepare consolidated accounts where individual members of the group do not prepare an income statement can rely on similar statements that may be prepared by those subsidiaries or on the consolidated income statement of the group.

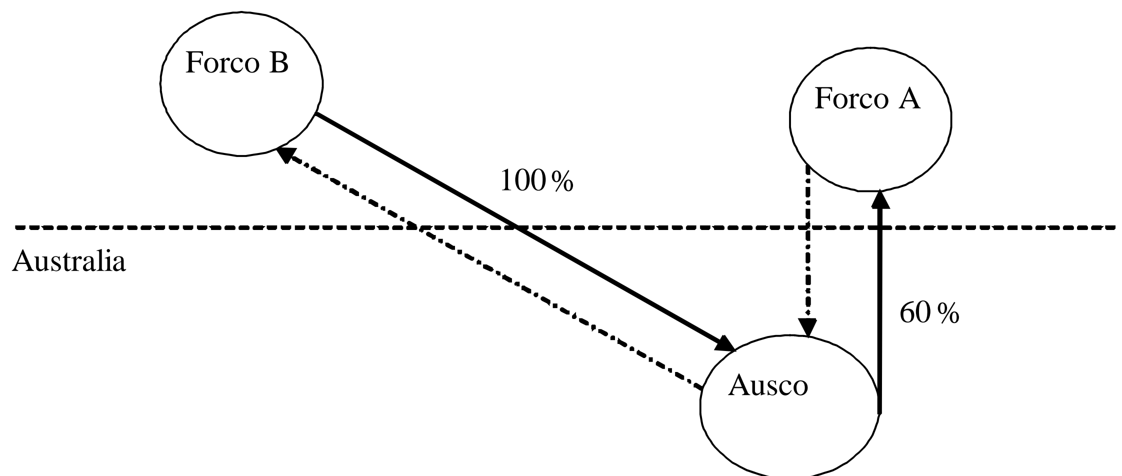
5.30 Amounts that are applied for the benefit of a company are also considered to be derived by the company ***[Schedule 2, item 1, subsection 802-30(7)]***. For example, withholding tax deducted by a foreign entity from a payment to the Australian company will be treated as an amount derived by the Australian company. Those amounts are likely to be included in an income statement because the gross amount of the distribution would contribute to profit and the foreign tax would be an expense.

5.31 Foreign income amounts that are assessable (eg, interest and royalties) can generally be distributed as a franked distribution to the extent Australian tax is paid on those amounts. Since no withholding tax is payable on those distributions, foreign income amounts that are included in the company's assessable income under existing provisions are excluded from conduit foreign income, to avoid a double benefit arising. The possibility that unfranked distributions which include conduit foreign income might be non-assessable non-exempt income is ignored at this stage of the calculation ***[Schedule 2, item 1, subsection 802-30(2)]***. The assumption that the company is a foreign resident does not apply when determining those amounts. Foreign tax credits that reduce an Australian tax liability on the foreign income give rise to conduit foreign income in the next income year (see paragraphs 5.63 to 5.67 for more details).

5.32 The amount that is left is essentially the foreign income on which no Australian company tax is payable (eg, foreign branch income or non-portfolio dividends exempt under section 23AH or section 23AJ of the ITAA 1936, respectively). This amount may be called the basic conduit foreign income amount.

Example 5.1: Primary elements of basic conduit foreign income

Overseas



Dividend - · - · - · - · - · -

Ownership ————————

Ausco is wholly-owned by Forco B and has a controlled foreign company, Forco A. It owns 60 per cent of Forco A. No income is attributed to Ausco in the 2005-06 or 2006-07 income years.

On 2 January 2007 Forco A distributes a $600 dividend to Ausco from which 5 per cent withholding tax is deducted ($30). Interest expenses that relate to deriving the dividend income from Forco A amount to $50.

Ausco received various amounts of assessable foreign income from small investments totalling $150 (on which $21 foreign tax is paid) during the income year ended 30 June 2007. Ausco incurred $50 of expenses that related to that foreign income.

Ausco purchases all the shares in a foreign company HK Co on 1 June 2006 for $10,000. The foreign company assets are all active assets. Ausco sold HK Co for a capital gain of $500 on 15 June 2007.

Ausco does not derive any other income in the year ended 30 June 2007.

Ausco wants to declare and make an unfranked distribution to its parent company on 31 August 2007. How much of that distribution can it declare to be conduit foreign income?

The $600 dividend from Forco A qualifies to be included in Ausco's basic conduit foreign income — it is ordinary income included in its income statement that would not be assessable income if Ausco were a foreign resident. Moreover, it remains included because it is not actually assessable income for Ausco. The $150 of assessable foreign income qualifies in the first instance but is then excluded because it is actually assessable income. None of the capital gain on the disposal of the shares in HK Co is included because it would not be statutory income for a foreign resident. (The calculation for determining the amount of capital gain (or loss) included in conduit foreign income is described in Example 5.3.)

Under the general record keeping rules, Ausco would need to record all amounts (income, gains and expenses) relevant to the calculation of its conduit foreign income.

5.33 A public trading trust or a corporate unit trust may not have any amounts that form basic conduit foreign income (except where either is the head company of a consolidated group). The calculation of the net income of these trusts generally means that all their ordinary and statutory income will be assessable. These entities are not entitled to most foreign income exemptions that an Australian company is entitled to. But section 23AH of the ITAA 1936 does allow the exemption from tax for foreign branch profits of trusts to flow through to Australian company beneficiaries. Further, to the extent that those trusts may be entitled to foreign tax credits on foreign income or if they receive a dividend declared to be conduit foreign income those amounts may be conduit foreign income. This will enable these entities to pay unfranked distributions declared to be conduit foreign income.

The treatment of some particular amounts

5.34 At first, an unfranked distribution from an Australian company would be included in the conduit foreign income of the Australian company that received the distribution. This amount is ordinary income that would be included in an income statement and is not assessable income if the recipient Australian company is treated as a foreign resident. Section 128D of the ITAA 1936 specifically excludes amounts from assessable income where those amounts are subject to withholding tax. A distribution paid to a foreign shareholder is subject to withholding tax. Similarly, if a distribution includes an amount of conduit foreign income, that amount is excluded from assessable income ***[Schedule 2, item 1, subsection 802-15(1)]***. This means that some Australian source income is included in conduit foreign income in the first instance. However, as the distribution is in fact included in the company's assessable income, the amount is appropriately excluded from conduit foreign income by the second step. The same process rightly excludes interest or royalty income paid by an Australian resident to the company.

5.35 Net capital gains in relation to assets with the necessary connection with Australia are included in assessable income of a foreign resident and therefore are statutory income. However, the search here is for amounts that are not included in assessable income. No capital gains will meet the conditions of being statutory income and not being included in assessable income of a foreign resident. Further, disregarded capital gains or losses are not ordinary or statutory income and so are not included in basic conduit foreign income. This means no capital gain amounts will be included in basic conduit foreign income. However, some capital gains (and losses) are specifically included in conduit foreign income under other provisions (see paragraphs 5.54 to 5.62).

5.36 Capital gains and losses on CGT assets acquired before 20 September 1985 are usually disregarded which means they are not included in calculating net capital gains. Because a disregarded gain or net gain is not statutory or ordinary income, those amounts will not be included in basic conduit foreign income. Nor will a disregarded loss or net loss reduce basic conduit foreign income. These amounts are not included under the specific provisions dealing with capital gains and losses even where they relate to foreign assets because the proposed measure is primarily about future investments. It is not the intention of the new measure to impact on past investment decisions and it would add considerable complexity to identify which pre-CGT gains and losses should be given conduit foreign income treatment. On the other hand, gains or losses on assets acquired on or after 20 September 1985 but before this Bill receives Royal Assent are dealt with because it was relatively easier to decide which of them is foreign.

5.37 The amount of income from offshore banking activities of an offshore banking unit in Australia that is not included in assessable income because of section 121EG of the ITAA 1936 will normally be included through the above steps in the company's basic conduit foreign income. While this income may not always be foreign income, even leaving aside section 121EJ of the ITAA 1936, it is intended that it be conduit foreign income. In this way, the income will receive the same tax treatment in Australia as if it had been derived directly by a foreign resident operating as an offshore banking unit in Australia.

5.38 Similarly, some of the business profits derived by an Australian company from activities conducted in the Joint Petroleum Development Area that are governed by the Timor Sea Treaty and the associated Taxation Code will be conduit foreign income. The relevant portion is the 90 per cent of business profits that are not taxed in Australia (but are taxed in East Timor). The reason for this is similar to that for the untaxed portion of offshore banking income. That portion of business profits still has to satisfy the other requirements for conduit foreign income. That is, it must consist of ordinary or statutory income that is included in an income statement.

Adjustments to the basic conduit foreign income amount

Unfranked distributions of conduit foreign income

5.39 The basic conduit foreign income amount is increased by the amount of an unfranked distribution paid to the company that is declared to be conduit foreign income ***[Schedule 2, item 1, paragraph 802-30(3)(a)]***. The amount of conduit foreign income is shown on a distribution statement. An Australian company will receive a distribution statement that shows the amount that the company can include in its conduit foreign income. This simple mechanism allows for the transfer of an amount of conduit foreign income from one Australian company to another. The impact on the paying company's conduit foreign income is discussed in paragraphs 5.68 to 5.70. The amount that is included in the recipient company's conduit foreign income may be reduced when some of the unfranked distribution remains assessable (see paragraphs 5.71 to 5.75).

5.40 A company that receives a trust or partnership distribution that includes a share of a frankable distribution that was declared to include conduit foreign income includes that share of the declared conduit foreign income amount in its own conduit foreign income. The company would include its share of the declared conduit foreign income amount where it is presently entitled to the income of the trust. ***[Schedule 2, item 1, paragraph 802-30(3)(b)]***

Foreign non-portfolio dividends

5.41 Section 23AJ of the ITAA 1936 treats foreign non-portfolio dividends as being non-assessable non-exempt income. The section only applies to Australian companies and not to other types of corporate tax entities. The amount of those dividends is included in basic conduit foreign income to the extent that the amount is included in an income statement. Non-portfolio dividends considered to be a return of capital under accounting principles are not included in an income statement or in basic conduit foreign income. An adjustment is required to increase the basic conduit foreign income amount by the amount of a non-portfolio dividend that is not already included in that amount, to preserve the current treatment of non-portfolio dividends. ***[Schedule 2, item 1, paragraph 802-30(3)(c)]***

5.42 Foreign portfolio dividends are included in assessable income which means they will not be included in basic conduit foreign income ***[Schedule 2, item 1, subsection 802-30(2)]***. An adjustment is not required to include any of those amounts in conduit foreign income in the same way as for non-portfolio dividends because they are not given conduit treatment under existing law. However, to the extent that a foreign tax credit is allowed for these dividends, the conduit foreign income amount will be increased (see paragraphs 5.63 to 5.67).

Income representing amounts previously taxed under the accruals tax regimes

5.43 The basic conduit foreign income amount is reduced by any amount:

- that is excluded from the company's assessable income under section 23AI or 23AK both of which are in the ITAA 1936 ***[Schedule 2, item 1, paragraph 802-30(4)(a)]***; or
- that is not included in assessable income because of paragraph 99B(2)(e) of the ITAA 1936 ***[Schedule 2, item 1, paragraph 802-30(4)(b)]***.

5.44 Amounts are excluded from assessable income by sections 23AI and 23AK and paragraph 99B(2)(e) because those amounts represent amounts that were previously taxed in Australia through the accruals tax rules. The provisions prevent amounts being taxed twice in Australia: once under the accruals rules and again when amounts are paid to Australian recipients.

5.45 A franking credit arises for a company where Australian tax is paid on amounts included in assessable income under the accruals rules. An amount that is excluded from assessable income under section 23AI, 23AK or paragraph 99B(2)(e) can still be distributed by an Australian company as a franked distribution. The franking credits that could be used relate to the Australian tax that would have been paid under the accruals tax rules. Fully franked distributions generally do not incur any further Australian tax in the hands of foreign or company recipients. This means there is no need to treat this income as conduit foreign income because it will pass through Australia without further taxation. Where a foreign tax credit arises in respect of section 23AI or 23AK amounts, an amount would be added to conduit foreign income in the following year (see paragraphs 5.63 to 5.67).

Non-assessable foreign income with franking credits attached

5.46 Foreign dividend income does not usually have franking credits attached to that income. However, where a foreign company can choose to apply the Australian imputation system the foreign company keeps a franking account and is able to pay frankable distributions to its shareholders. The frankable distributions may have franking credits attached to them. Only Australian shareholders of the foreign company benefit from receiving the attached franking credits. An Australian company that receives those dividends can credit its own franking account with those credits if the dividends are assessable. The Australian company is then able to use those franking credits to frank its own distributions.

5.47 If an Australian company received foreign income with franking credits attached, it could distribute that income as a fully franked distribution to the extent of the franking credits it received. Conduit foreign income is already reduced by assessable foreign income which would give rise to franking credits which means it is only franking credits for non-assessable foreign income which must be considered.

5.48 As discussed previously, distributions that are fully franked can pass through Australia without further taxation. This means the income should not be treated as conduit foreign income to the extent it can be distributed fully franked. The basic conduit foreign income amount is reduced by an amount using the following formula:

$$\text{available franking credit} \times \frac{(1 - \text{general company tax rate})}{\text{general company tax rate}}$$

The available franking credit is the amount credited to the Australian company's franking account at the time the company received the dividend. The available franking credit is restricted to the amount that relates to the amount of the foreign dividend that still remains in the basic conduit foreign income amount. ***[Schedule 2, item 1, paragraph 802-30(4)(c)]***

Expenses related to amounts included in conduit foreign income

5.49 Expenses that relate to the total amount included in conduit foreign income, as discussed so far, reduce conduit foreign income. There does not have to be actual matching of the individual expenses to individual amounts of the conduit foreign income. These would normally be expected to be expenses taken into account in preparing the company's income statement and would not necessarily be limited to expenses incurred solely in earning the conduit foreign income. Expenses should reduce the amount of conduit foreign income because the profit available for distribution that is sourced from foreign income is reduced. Correctly reducing the amount of conduit foreign income prevents other types of income being distributed as an unfranked distribution declared to be conduit foreign income. ***[Schedule 2, item 1, subsection 802-30(5)]***

5.50 The expenses that are reasonably related to the conduit foreign income are those expenses that would ordinarily be considered to relate to deriving the income. The term 'expense' has its ordinary meaning in the context of the application of the provisions. That is, as these provisions would generally apply to a company that carries on business, the term 'expense' would take its meaning from the application of that term to companies carrying on business. An example of such an expense would be any foreign tax paid on the foreign income. How related an expense is to the conduit foreign income is a question of fact based on the test of what a reasonable person would say.

5.51 There are some expenses that relate to foreign income that will not reduce the amount of conduit foreign income. These are expenses that are deductible from a company's assessable income whether or not the foreign income they relate to is included in assessable income. An example of an expense that is deductible even though the foreign income is not assessable is an interest expense that is an allowable deduction under section 25-90. Expenses that are deductible do not reduce conduit foreign income because they reduce the amount of franking credits that would be available to pay fully franked distributions. If the conduit foreign income was also reduced there would be foreign income that could not be distributed free of withholding tax. This would effectively mean double counting the expenses.

5.52 Frankable distributions declared to be conduit foreign income may be included in assessable income or may be non-assessable non-exempt income (see explanation in paragraphs 5.76 to 5.86). When calculating expenses that might otherwise be deductible for the purpose of reducing the conduit foreign income amount, the whole amount of such dividends is treated as non-assessable non-exempt income. ***[Schedule 2, item 1, subsection 802-30(5)].*** An adjustment is made at a later time when it is known to what extent such dividends remain assessable (see paragraphs 5.72 to 5.75).

Example 5.2: Subtracting related expenses

> Assume the same facts as in Example 5.1. How much of the Ausco's expenses are subtracted from the $600 of basic conduit foreign income?
>
> First, the $50 of interest expenses are not subtracted because they are deductible under section 25-90. The withholding tax of $30 taken from the dividend paid by Forco A is subtracted as it is a non-deductible expense. Neither the $21 foreign tax expense nor the $50 of other expenses incurred in earning the assessable foreign income is deducted because that income is not included in basic conduit foreign income. Therefore, the basic conduit foreign income amount is reduced by $30.

Other things that affect conduit foreign income

5.53 The basic conduit foreign income amount adjusted by any amounts described in paragraphs 5.39 to 5.52 results in an amount to be included in the company's conduit foreign income ***[Schedule 2, item 1, subsection 802-30(6)].*** Other events may also affect the amount of conduit foreign income an Australian company has available to distribute. Those effects and their timing are described in paragraphs 5.54 to 5.75.

How do capital gains affect conduit foreign income?

5.54 Conduit foreign income may be increased by certain capital gains of an Australian company that are not included in the calculation of its net capital gain. An Australian company only includes its *net* capital gains in statutory income. Individual capital gains and losses that make up the net amount are neither statutory nor ordinary income. This means that the individual capital gains (and the capital losses discussed in paragraphs 5.59 to 5.61) must be explicitly included in (or excluded from) conduit foreign income.

5.55 A capital gain (or part of it) may be excluded from the calculation of a net capital gain by section 768-505. This section operates when certain CGT events happen in relation to non-portfolio interests in foreign companies. The non-portfolio interest must be shares and the company must hold at least a 10 per cent voting interest in the foreign company. The capital gains would generally relate to amounts received as a result of the sale of shares in foreign companies with an underlying active business.

5.56 Where a capital gain for an Australian company is reduced under section 768-505 the amount of the reduction is added to conduit foreign income ***[Schedule 2, item 1, paragraph 802-35(1)(a)]***. Those amounts are included in conduit foreign income because they are gains that would not be taxable in Australia if the shares in the foreign company had been held directly by a non-resident. Distributions of those amounts would be unfranked as no Australian tax is payable which means there are no franking credits available. To ensure Australian tax is not paid on those amounts when distributed to foreign residents those distributions can be declared to be conduit foreign income.

5.57 Certain capital gains are ignored in the calculation of a net capital gain because of the operation of section 23AH of the ITAA 1936. Broadly, section 23AH applies to capital gains made directly or indirectly by an Australian company in disposing of non-tainted assets used in deriving foreign branch income. The amount of the capital gain disregarded under section 23AH is included in conduit foreign income. ***[Schedule 2, item 1, paragraph 802-35(1)(b)]***

5.58 The amount of any capital gain that is not taxable in Australia under the Alienation of Property Article of the Taxation Code for the Timor Sea Treaty is also included in conduit foreign income. That article primarily covers gains and losses of a capital nature from the alienation of property situated in the Joint Petroleum Development Area. Ninety per cent of any such gain is not taxable in Australia (but may be taxable in East Timor) and that amount is included in conduit foreign income. ***[Schedule 2, item 1, paragraph 802-35(1)(c)]***

How do capital losses affect conduit foreign income?

5.59 Conduit foreign income is reduced by certain capital losses of an Australian company that are not included in the calculation of a net capital gain. A capital loss (or part of it) may be ignored in the calculation of net capital gains by section 768-505. Where a capital loss for an Australian company is reduced by the operation of section 768-505 the amount of the

reduction reduces conduit foreign income. ***[Schedule 2, item 1, paragraph 802-35(2)(a)]***

5.60 Capital losses made directly or indirectly by an Australian company may be ignored because of the operation of section 23AH of the ITAA 1936. The amount of the capital loss disregarded under section 23AH reduces conduit foreign income. ***[Schedule 2, item 1, paragraph 802-35(2)(b)]***

5.61 The amount of any capital loss that is disregarded in Australia under the Alienation of Property Article of the Taxation Code for the Timor Sea Treaty reduces an entity's conduit foreign income. Ninety per cent of any loss covered by the Article is disregarded for Australian tax purposes and that amount is subtracted from conduit foreign income. ***[Schedule 2, item 1, paragraph 802-35(2)(c)]***

When do capital gains and losses affect conduit foreign income?

5.62 Capital gains and losses that result from a CGT event in an income year and which are relevant to the calculation of conduit foreign income are likely to be calculated at the end of that income year. To avoid errors that might arise from a requirement for an immediate adjustment of conduit foreign income because of these events, some delay in making the adjustments is prescribed in the legislation. The amount of a capital gain or loss not included in the calculation of a net capital gain under section 768-505 changes conduit foreign income at the end of the income year in which the relevant CGT event occurred. Similarly, capital gains and losses disregarded under section 23AH of the ITAA 1936 and the Alienation of Property Article of the Taxation Code for the Timor Sea Treaty affect the amount of conduit foreign income at the end of the income year in which the relevant CGT event occurred. The net disregarded gain or loss will be taken into account at the end of the income year. ***[Schedule 2, item 1, subsection 802-35(3)]***

Example 5.3: Capital gains

Again assume the same facts as in Example 5.1. How much, if any, of the capital gain from the sale of the shares in HK Co would be included in Ausco's conduit foreign income at the end of the income year?

Since all the assets of HK Co are assumed to be active assets, all of the capital gain from the disposal of Ausco's interest in it would be disregarded. Therefore all the gain would be included in Ausco's conduit foreign income.

Is assessable foreign income included in conduit foreign income?

5.63 The calculation of conduit foreign income, to this point, has captured foreign income and gains that are not included in assessable income. Allowing a credit for foreign tax paid on foreign income and gains included in assessable income (eg, rents and royalties) effectively means that no Australian tax is payable on some of that foreign income/gain. This means there are less franking credits available to enable the distribution of the foreign income or gain to be franked.

5.64 To address this deficiency, an amount is added to conduit foreign income where an Australian company has claimed foreign tax credits. This enables it to distribute all its assessable foreign income (net of expenses) without further Australian tax to its foreign shareholders. The amount is based on the amount of foreign tax credit calculated under section 160AF of the ITAA 1936 for the income year immediately before the one in which the adjustment to the conduit foreign income is made. The amount added to the conduit foreign income is calculated using the following formula:

$$\text{foreign tax credits} \times \frac{(1 - \text{general company tax rate})}{\text{general company tax rate}}$$

[Schedule 2, item 1, section 802-40]

5.65 The credit is grossed up to determine the amount of net foreign income that, as a result of the foreign tax paid, is effectively free of any further Australian tax and therefore qualifies as conduit foreign income.

5.66 This amount is included in a company's conduit foreign income in the income year immediately following the one for which the credit arose. This is because the foreign tax credits available under section 160AF generally cannot be properly ascertained until after the end of the relevant income year. The amount is included in conduit foreign income in the next year at an appropriate time. ***[Schedule 2, item 1, section 802-40]***

5.67 Because this inclusion is based on the amount of foreign tax credit allowed for a year, if there is excess foreign tax for a particular class of foreign income in a year, that additional foreign tax would lead to an increase in conduit foreign income only when it was used in a later year to shelter further foreign income from Australian tax. If there is an overall loss for a class of foreign income, no foreign tax credit is allowed for that income and no adjustment is made to conduit foreign income. Effectively an adjustment will be made in a later year when some or all of the loss is recouped and the foreign tax credit that is then allowed is reduced.

Therefore, no specific adjustment needs to be made to the amount of foreign tax credit when calculating conduit foreign income because excess foreign tax or a foreign loss is carried forward.

Example 5.4: The inclusion of assessable foreign income

> Assume the same facts as in Example 5.1. How much of the net assessable foreign income from minor investments would be included in Ausco's conduit foreign income?
>
> Ausco would be allowed a foreign tax credit for the $21 of foreign tax in its assessment for the 2007 income year and would have to pay $9 of Australian tax on this assessable foreign income. Applying the above formula, Ausco's conduit foreign income would be increased by $49 (=$21 × 7/3) in the 2008 year when that credit had been calculated. (Together with the ability to pay a franked dividend of $21 out of the franking credit of $9 arising from the payment of Australian tax on this income, Ausco would be able to distribute all the net amount of that income ($70) to its parent company free of withholding tax.)

How do previous declarations affect conduit foreign income?

5.68 A company's conduit foreign income will be reduced where it makes an unfranked distribution that includes an amount declared to be conduit foreign income. The amount of the reduction is equal to the amount of the distribution that the company has declared to be conduit foreign income. ***[Schedule 2, item 1, section 802-45]***

5.69 The amount of the reduction also includes amounts that are taken to have been declared to be conduit foreign income under the anti-streaming rule (see paragraphs 5.89 to 5.94). These are amounts that should have been declared to be conduit foreign income to ensure all membership interests received the same amount of conduit foreign income.

5.70 After the company has declared an amount to be conduit foreign income, the remaining balance can be included as part of any later declarations that the company may make. ***[Schedule 2, item 1, note to section 802-45]***

How do distributions received from other Australian corporate tax entities affect conduit foreign income?

5.71 If a company receives an unfranked distribution from another Australian company it is able to include those amounts declared to be conduit foreign income in its own conduit foreign income ***[Schedule 2, item 1, paragraph 802-30(3)(a)].*** The receiving company treats the distribution received in one of two ways for the purposes of determining its own taxable income. Either:

- the distribution (or part of it) is non-assessable non-exempt income if an amount of conduit foreign income is on-distributed (see paragraphs 5.76 to 5.86); or
- the distribution continues to be included in the assessable income of the company.

5.72 The conduit foreign income of a company is reduced where an amount of conduit foreign income it receives from another Australian company remains assessable income. This is done because including some or all of the distributed conduit foreign income in assessable income means that subsequent distributions paid out of that amount can be franked. ***[Schedule 2, item 1, subsection 802-50(1)]***

5.73 The amount of the reduction is the amount of the distribution that has been included in assessable income *less* any expenses that reasonably relate to that amount ***[Schedule 2, item 1, subsection 802-50(2)].*** This may include some expenses that are not deductible for income tax purposes. All relevant expenses are subtracted from the assessable amount of the distribution because they previously reduced the conduit foreign income amount (see paragraphs 5.49 to 5.52).

5.74 The due date for lodgement of the company's tax return would be an appropriate time at which to reduce the company's conduit foreign income. If a company is granted an extension of time to lodge its tax return the new due date becomes the appropriate time for reducing the conduit foreign income.

5.75 By the time the company lodges its tax return for an income year, there should be no amount left in its conduit foreign income that relates to a distribution of conduit foreign income the company received in that income year. The distribution declared to be conduit foreign income that a company receives will have either been distributed as conduit foreign income or included in assessable income.

Example 5.5: Impact of a received CFI amount on a company's conduit foreign income

Aust Co 2 received from Aust Co 1 a $100 distribution. All of the distribution was declared to be conduit foreign income. Aust Co 2 had $20 of expenses that relate to the distribution.

Assume that Aust Co 2 distributed an unfranked distribution, $60 of which is declared to be conduit foreign income. This means that $75 of the $100 was treated as non-assessable non-exempt income (see Example 5.6). The balance of $25 remains part of Aust Co 2's assessable income for that income year.

Aust Co 2's conduit foreign income would be reduced by $20 ($25 – $5) because Aust Co 2 had expenses of $5 ($\frac{1}{4}$ of $20) in relation to the assessable amount of $25.

In summary, the transactions affect Aust Co 2's conduit foreign income in the following way if Aust Co 2 were to keep a rolling balance:

- the $100 distribution is included in its conduit foreign income when Aust Co 2 receives the distribution;
- the $20 of expenses that relate to the distribution reduces the amount of conduit foreign income when those expenses are incurred;
- the $60 Aust Co 2 paid out as conduit foreign income reduces the conduit foreign income at the time of the declaration (or the making of the distribution); and
- the $20 that is the net amount of the dividend included in assessable income reduces the amount of conduit foreign income when Aust Co 2 lodges its tax return.

Distributions between Australian corporate tax entities

5.76 Generally, an Australian company would include the amount of an unfranked distribution in its assessable income and would pay Australian tax on that amount. However, under this measure an unfranked distribution declared to be conduit foreign income may end up being non-assessable non-exempt income. The reason for treating an unfranked distribution in this way is to allow conduit foreign income to flow through additional Australian companies to foreign shareholders without incurring

any Australian tax. A distribution is treated as not assessable and not exempt where three conditions are met.

5.77 The first condition is that an Australian company receives from another Australian company an unfranked distribution which has an amount declared to be conduit foreign income. The distribution statement will show the amount of the unfranked distribution that is conduit foreign income. The conduit foreign income amount shown on the distribution statement is called '*a received CFI amount*'. ***[Schedule 2, item 1, paragraphs 802-20(1)(a) and (b)]***

5.78 The second condition is that the company that receives the distribution must make an unfranked distribution it declares wholly, or in part, to be conduit foreign income. This is to ensure that the conduit foreign income is passed on to shareholders and not accumulated in interposed Australian companies. The amount the company declares to be conduit foreign income is called '*a declared CFI amount*'. ***[Schedule 2, item 1, paragraph 802-20(1)(c)]***

5.79 The third condition is that the unfranked distribution that the recipient company has declared to be conduit foreign income must be distributed within the required time. The time is before the due date for lodgement of the income tax return of the recipient company for the income year in which the distribution was received ***[Schedule 2, item 1, paragraph 802-20(1)(c)].*** The due date for lodgement includes any extension obtained by the company from the Australian Taxation Office (ATO).

5.80 The third condition ensures that Australian tax relief is given to an Australian company only where it distributes conduit foreign income in a timely manner. Without this time restriction compliance and administration costs in keeping track of conduit foreign income over long periods of time would increase. In addition, there could be undue deferral of Australian tax on unfranked foreign income accruing to the benefit of Australian shareholders.

How is the amount of non-assessable non-exempt income calculated?

5.81 The company calculates the amount of unfranked dividends that will not be assessable and will not be exempt by using the formula set out in paragraph 5.84 ***[Schedule 2, item 1, subsection 802-20(2)].*** First, the company adds all the *received CFI amounts* (amounts of unfranked distributions that are declared to be conduit foreign income) that it received in the income year for which the calculation is being made. The company then adds all the *declared CFI amounts* (amounts of unfranked distributions that it declared to be conduit foreign income) it has declared for the period from the beginning of the income year until the time it lodges its tax return for that income year.

5.82 The company cannot count *a declared CFI amount* more than once ***[Schedule 2, item 1, subsection 802-20(4)].*** This means that where an amount is declared to be conduit foreign income before the lodgement of the tax return for the previous year but after the beginning of the current year the amount can only be used once in the calculation of the total *declared CFI amount*. The amount can either be used in calculating the amount of non-assessable non-exempt income for the preceding year or in the calculation for the current year if there had been no *received CFI amount* in the preceding income year.

5.83 A distribution that is non-assessable non-exempt income will not reduce the loss of an Australian company. The loss company must meet all the conditions that allow an unfranked distribution that it receives and has been declared to be conduit foreign income to be non-assessable non-exempt income. This includes the condition that the company that received the distribution must also make an unfranked distribution of conduit foreign income before lodging its tax return. If the company is unable to make a distribution because of insufficient profits the unfranked distribution it received will remain assessable income and will reduce its tax loss.

5.84 The amount of a received unfranked distribution that is non-assessable non-exempt income cannot exceed the amount of the distribution that was declared to be conduit foreign income. The amount that is non-assessable non-exempt income is the lesser of the total received CFI amounts or the amount calculated using the following formula:

$$\text{total received CFI amounts} \times \frac{\text{total declared CFI amounts}}{\text{total received CFI amounts} - \text{related expenses}}$$

The idea of the denominator in this formula is to determine how much of the total received CFI amount remains as profit available for distribution. ***[Schedule 2, item 1, subsection 802-20(2)]***

5.85 Where there is nothing left of the total received CFI amount because of expenses that relate to that amount (as distinct from using that amount for other purposes), then the whole of the received CFI amount will be non-assessable non-exempt income. This will ensure that that conduit foreign income is not taxed in Australia. Where the received CFI amount is wholly non-assessable non-exempt income all expenses that relate to that amount will not be deductible. ***[Schedule 2, item 1, subsection 802-20(3)]***

5.86 Where an amount of conduit foreign income is distributed through one or more partnerships or trusts to another Australian company, the outcome in terms of how much if any of that amount is not assessable income of the company should be the same as if the amount had been distributed directly to the company. This is achieved by applying the rules in Subdivision 207-B to frankable distributions as they apply to franked distributions and to conduit foreign income amounts as they apply to franking credits. Where there is a chain of trusts and/or partnerships the rules are applied iteratively to each partnership or trust. In the case of a distribution of conduit foreign income received by a trust, this rule will apply when the company is presently entitled to a share of the income of the trust. If the trustee is taxable on some or all of the distribution under section 99 or section 99A of the ITAA 1936, none of that amount will be non-assessable. In that case, the trustee will be treated like an individual and not like a company for the purposes of this provision. ***[Schedule 2, item 1, subsection 802-20(5)]***

Example 5.6: Calculating non-assessable non-exempt income

> Aust Co 1 and Aust Co 2 are both Australian resident companies.
>
> Aust Co 1 pays an unfranked distribution of $100 to Aust Co 2. All of the $100 received by Aust Co 2 is declared to be conduit foreign income (the total received CFI amounts is $100).
>
> Aust Co 2 has $20 of deductible expenses relating to the $100 dividend.
>
> Aust Co 2 makes an unfranked distribution of $90. Aust Co 2 declares $60 of the $90 to be conduit foreign income (the total declared CFI amounts is $60).
>
> The amount that is not assessable income and is not exempt income for Aust Co 2 is:

$$\$100 \times \frac{\$60}{\$80} = \$75$$

Note 1: The remaining $25 is included in Aust Co 2's assessable income and it can deduct $5 of the expenses (the part that is related to the $25).

Note 2: If Aust Co 2 had instead made a distribution that declared $80 to be conduit foreign income the whole of the $100 distribution it received would be non-assessable non-exempt income.

Example 5.7: Calculating non-assessable non-exempt income when the recipient has other conduit foreign income

The same facts as in Example 5.6 apply in relation to the amount of conduit foreign income Aust Co 2 receives from Aust Co 1.

However, as a result of other foreign amounts it has received Aust Co 2 makes an unfranked distribution of $200. It can declare the entire amount to be conduit foreign income.

In this case, the amount that is not assessable income and is not exempt income for Aust Co 2 is $100.

This is the lesser of:

the total received CFI amounts being $100; and

the amount calculated using the formula

$$\$100 \times \frac{\$200}{\$100 - \$20} = \$250.$$

Example 5.8: Calculating non-assessable non-exempt income when the recipient has non-deductible expenses

The same facts as in Example 5.6 apply in relation to the amount of conduit foreign income Aust Co 2 receives from Aust Co 1. However, as well as the deductible expenses Aust Co 2 has non-deductible expenses of $5 that relate to the dividend it received.

Aust Co 2 makes an unfranked distribution of $90. Aust Co 2 declares $60 of the $90 to be conduit foreign income (the total declared CFI amounts is $60).

The amount that is not assessable income and is not exempt income for Aust Co 2 is:

$$\$100 \times \frac{\$60}{\$75} = \$80$$

Note: The remaining $20 is included in Aust Co 2's assessable income and it can deduct $4 (the part of the $20 deductible expenses that is related to the assessable $20 amount).

What is the interaction between a deduction under section 46FA of the ITAA 1936 and an amount that is conduit foreign income?

5.87 An Australian company wholly-owned by a foreign company may get a deduction under section 46FA of the ITAA 1936. A deduction is allowed for unfranked non-portfolio dividends received by an Australian company that are on-paid to the foreign parent. The deduction is available in the income year in which the flow-on dividend is paid. However, by these amendments, an unfranked non-portfolio dividend received by a resident company declared to be conduit foreign income may be treated as being non-assessable non-exempt income if the requisite amount of conduit foreign income is paid to the foreign parent within the prescribed time (see paragraphs 5.76 to 5.86).

5.88 Without an explicit rule a company would receive a double tax benefit from the same non-portfolio dividend it receives once it on-distributed it to the foreign parent company. The amount would be a deduction for the company under section 46FA and would be excluded from assessable income if the distribution is treated as non-assessable non-exempt income. The company may choose whether to treat the dividend as non-assessable non-exempt income or claim a deduction when on-distributed. However, the company will be prevented from choosing both options where the dividend has been on-distributed to the foreign parent company. ***[Schedule 2, item 1, section 802-55]***

What happens if a company streams distributions declared to be conduit foreign income to particular shareholders?

5.89 The policy behind this measure is that all members of a company receive conduit foreign income in proportion to their interest in the company. That is, unfranked distributions declared to be conduit foreign income are not to be streamed to foreign shareholders in preference to resident shareholders. In this way conduit foreign income amounts distributed to resident individuals are intentionally wasted. This is little different to the wastage that occurs where foreign shareholders receive franked distributions where resident shareholders would otherwise have a greater use for the attached imputation credits.

5.90 Given the policy not to stream income to particular shareholders that would most benefit from the receipt of that income, a company should

distribute its conduit foreign income to all its shareholders in the same proportion as their membership interests. Membership interests that do not include a right to receive distributions are ignored for this purpose ***[Schedule 2, item 1, subsection 802-60(3)].*** All distributions made during a franking period (generally, a period of 6 months in the case of public companies and an income year in the case of private companies) must have the same proportion declared to be conduit foreign income for all shareholders ***[Schedule 2, item 1, subsection 802-60(2)].*** At least one of the distributions must include some conduit foreign income for this rule to apply. ***[Schedule 2, item 1, subsection 802-60(1)]***

5.91 An adjustment will be made to the company's conduit foreign income where a company does not declare an equal proportion of conduit foreign income on the distributions it makes during a franking period. Even if there is a breach of the franking benchmark rule and a fully franked dividend is paid in a period when an unfranked distribution which includes conduit foreign income is paid, an adjustment will be required. The amount of the adjustment is the amount required to reduce the conduit foreign income to the amount it would have been if the same proportion of conduit foreign income had been declared equally on all the distributions made during the period. The adjustment is based on the distribution with the greatest proportion of declared conduit foreign income. The adjustment is in addition to the amount initially declared by the company to be conduit foreign income. ***[Schedule 2, item 1, subsections 802-60(1) and (2)]***

5.92 An administrative penalty is imposed on the company only if an adjustment to its conduit foreign income results in a negative amount of conduit foreign income at the relevant time. The relevant time is the time when a dividend is declared, or where there is no declaration when a distribution is made. See paragraphs 5.95 to 5.100 for a discussion of the new penalty arrangements.

5.93 There is no immediate penalty if the adjustment to the company's conduit foreign income results in the conduit foreign income remaining positive. Instead the reduction to conduit foreign income will affect the amount that the company can distribute as conduit foreign income in the future. ***[Schedule 2, item 1, note to subsection 802-60(2)]***

Example 5.9: Streaming of conduit foreign income

> The membership interests in an Australian company are split equally between Australian shareholders and foreign shareholders. Assume the company has $100 of conduit foreign income. It has $200 available for distribution.

The company makes a declaration to distribute unfranked dividends totalling $160 to all its shareholders ($80 to the resident shareholders and $80 to the foreign shareholders). It declares that the $80 to its foreign shareholders is conduit foreign income. It does not make the same declaration to its resident shareholders.

In this instance, the company would be deemed to have declared the $80 unfranked dividend paid to the residents to be conduit foreign income. The company's conduit foreign income is reduced by a further $80 at the time the dividend declaration is made.

The additional $80 adjustment will mean that the amount of the company's conduit foreign income is minus $60. The company is therefore liable to a penalty on the $60 (see Example 5.10). This is the amount of conduit foreign income taken to have been declared in excess of the amount available.

5.94 The consequences that result from streaming distributions only affect the company making the distributions. This means shareholders can continue to rely on the amount that was declared to be conduit foreign income in the statements they receive. ***[Schedule 2, item 1, subsection 802-60(4)]***

What happens if a company over declares an amount of conduit foreign income?

5.95 A company will be liable to a penalty if it declares a distribution to include more conduit foreign income than it has available. At a particular time, a company overstates its conduit foreign income if it declares or makes a frankable distribution and the amount of the unfranked part declared to be conduit foreign income exceeds the amount of the company's conduit foreign income. It should be remembered that the penalty imposed for over declaring conduit foreign income is a penalty on the company making the distribution and not on the shareholders. It is not intended that the amount distributed to shareholders nor the declared conduit foreign income amount would be changed. ***[Schedule 2, item 25, subsection 288-80(1) of the Taxation Administration Act 1953]***

5.96 The relevant time for a company to determine the amount of conduit foreign income it is able to distribute will depend on whether it declares a dividend or simply makes a distribution without a prior declaration. If a company makes a dividend declaration, the relevant time will be at the time of the declaration. Where no declaration is made, the relevant time will be the time the company actually makes the distribution. ***[Schedule 2, item 25, paragraph 288-80(1)(c) of the Taxation Administration Act 1953]***

5.97 The penalty is a composite amount that depends on the extent to which the distribution was paid to resident or foreign shareholders or a mixture of both. The over declared amount is apportioned between foreign and Australian membership interests and each allocation is then multiplied by an appropriate penalty rate. ***[Schedule 2, item 25, subsection 288-80(2) of the Taxation Administration Act 1953]***

5.98 How much is paid to foreign or resident shareholders is determined by whether amounts are required to be withheld from the distribution under section 12-210 of the *Taxation Administration Act 1953*. Membership interests in respect of which withholding is required, or would be required if section 12-300 of the same Act were disregarded, are counted as foreign membership interests ***[Schedule 2, item 25, definition of 'foreign membership interests' in subsection 288-80(4) of the Taxation Administration Act 1953]***. The remaining membership interests are called Australian membership interests ***[Schedule 2, item 25, definition of 'Australian membership interests' in subsection 288-80(3) of the Taxation Administration Act 1953]***.

5.99 Where distributions on Australian membership interests are over declared to be conduit foreign income, the penalty rate is the company tax rate. This is called the general company tax rate. The resident shareholders that would benefit the most from an over declaration of conduit foreign income would be Australian companies. The penalty rate equates to the level of company income tax that may not be paid by those companies because of the over declaration. The over declaration means there is an opportunity for too much of the distribution to be treated as non-assessable non-exempt income. ***[Schedule 2, item 25, subsection 288-80(3) of the Taxation Administration Act 1953]***

5.100 Where distributions on foreign membership interests are over declared to be conduit foreign income, the penalty rate is 50 per cent of the tax rate specified in subparagraph 7(a)(ii) of the *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974*. The current rate in that subparagraph is 30 per cent which means the penalty rate will be 15 per cent. The 15 per cent penalty is comparable to the withholding tax rate in many tax treaties. However, in recently negotiated tax treaties, this rate has been reduced to zero, 5 or 10 per cent for non-portfolio distributions. The 15 per cent rate represents a balanced outcome between those rates and the 30 per cent rate applicable to distributions to residents of non-tax-treaty countries. This rate is called the applicable withholding tax rate. ***[Schedule 2, item 25, subsection 288-80(4) of the Taxation Administration Act 1953]***

Example 5.10: Over-declaration penalty

Using the same assumptions as in Example 5.9 and assuming that total membership interests number 200, the total amount of the penalty is $13.50:

$$30\% \times \$60 \times \frac{100 \text{ (Australian membership interests)}}{200 \text{ (total membership interests)}} = \$9$$

$$15\% \times \$60 \times \frac{100 \text{ (foreign membership interests)}}{200 \text{ (total membership interests)}} = \$4.50$$

Consolidated and MEC groups

5.101 Consolidated and MEC groups are particular groups of entities for income tax purposes. A consolidated group is made up of a head company (an Australian resident) and subsidiary members (all Australian residents). A MEC group has a provisional head company during an income year and subsidiary members, similarly restricted to Australian residents. A MEC group has a head company only at the end of an income year. The rules for consolidated and MEC groups are contained in Part 3-90. Generally, rules that relate to consolidated groups apply equally to MEC groups.

5.102 Head companies and provisional head companies are Australian corporate tax entities. Corporate tax entities calculate their conduit foreign income at a particular time ***[Schedule 2, item 1, section 802-25]***. This means a head company is also able to calculate its conduit foreign income at a particular time. Subsidiary members are treated as part of the head company which means amounts of conduit foreign income they receive are treated as being received by the head company ***[Schedule 2, item 15, section 715-875]***. Subsidiary members of a consolidated group do not calculate their own amounts of conduit foreign income.

5.103 Ordinary and statutory income of a subsidiary member is deemed to be derived by the head company ***[Schedule 2, item 15, section 715-875]***. It is the head company that is treated as a foreign resident to work out if an amount is included in the first step when calculating its basic conduit foreign income amount. However, the condition that an amount is included in an income statement does not mean the amount must be included in an income statement of the head company. Instead, the amount may be

included in the income statement of the subsidiary member that received the amount.

5.104 It should be noted that any new provision which deals with distributions between Australian corporate tax entities will have no application where distributions are made between members of the same consolidated or MEC group. Those distributions are ignored for taxation purposes under the consolidation rules.

5.105 Where a company joins a consolidated group, the extended application of the entry history rule will ensure amounts of conduit foreign income received by the company before it joins the group will be amounts the head company can treat as conduit foreign income ***[Schedule 2, item 15, subsection 715-875(1)].*** Subsequent amounts that the company receives will become the amounts received by the head company as previously discussed. If the company later leaves the consolidated group it will be unable to take an amount of conduit foreign income with it ***[Schedule 2, item 15, section 715-880].*** Amounts that were received by the company either before it joined the group or while it was a member of a consolidated group will remain with the head company of the group.

Application and transitional provisions

5.106 These amendments allow a company to calculate the amount of its conduit foreign income from the beginning of its first income year that starts on or after 1 July 2005. All relevant transactions that occur after that time should be taken into account whenever in the future a company wants to declare a dividend to include conduit foreign income. In accordance with the general rules for the keeping of records, the company must have appropriate records to substantiate its calculation of conduit foreign income at any such time in the future. The amendments repealing or amending existing provisions dealing with the foreign dividend account regime apply from the date of Royal Assent, subject to the transitional rule discussed in paragraph 5.114. So too does the new penalty provision but it can only be relevant from the time that a company can declare a dividend to comprise conduit foreign income which may be after that date. ***[Schedule 2, item 26]***

5.107 Transitional rules affect the first year of this calculation for those companies with an income year that starts on or after 1 July 2005 and before 1 July 2006. The application of those rules will also depend on whether that income year starts before or after Royal Assent.

What modifications apply to companies with an income year that starts on or after 1 July 2005 but before Royal Assent?

5.108 There are four transitional rules that apply to a company whose income year starts on or after 1 July 2005 but before Royal Assent. ***[Schedule 2, subitem 27(1)]***

5.109 The first rule ensures that a company can only declare an amount to be conduit foreign income where that declaration is made on or after the date of Royal Assent ***[Schedule 2, subitem 27(2)]***. However, a company can continue to make declarations from a foreign dividend account until the time of Royal Assent. The current foreign dividend account rules will continue to operate until that time. This allows those amounts to be distributed free of any dividend withholding tax.

5.110 The second rule ensures a foreign dividend account surplus that exists at the end of the day before Royal Assent can be converted to conduit foreign income at that time. The amount included in a company's conduit foreign income will be equal to the amount of the surplus at that time ***[Schedule 2, subitem 27(3)]***. This allows the company to declare distributions of those amounts to be conduit foreign income on or after Royal Assent, which in turn means those amounts can be distributed free of any dividend withholding tax. Expenses incurred by the company after Royal Assent that relate to dividends that gave rise to credits in the foreign dividend account do not reduce conduit foreign income. Conduit foreign income will not be reduced even though those expenses may have given rise to a debit under paragraph 128TB(1)(b) of the ITAA 1936.

5.111 The third rule ensures that non-portfolio dividends that are a credit to a foreign dividend account for the period up until Royal Assent cannot also be included in a company's conduit foreign income. ***[Schedule 2, subitem 27(4)]***

5.112 The final rule prevents these companies from including in the calculation of conduit foreign income for the first year amounts that relate to foreign tax credits. This is because those amounts relate to credits received for foreign income derived in a period prior to the commencement of this measure. ***[Schedule 2, subitem 27(5)]***

Example 5.11: The first year starts before Royal Assent

Assume that Royal Assent for this Bill is 16 December 2005. Aust Co 1 has a 1 July to 30 June income year and maintains a foreign dividend account (FDA). It has an FDA surplus of $100 at 1 July 2005.

Aust Co 1 receives the following amounts in the 2006 income year

- section 23AJ exempt dividends from:
  - ForCo 1: $500 on 1 August 2005;
  - ForCo 2: $750 on 1 February 2006.

Withholding tax was/will be paid on the non-portfolio dividends as follows:

- ForCo 1: $50 (10%)
- ForCo 2: $75 (10%)

Aust Co 1 also derives $5,000 of active foreign branch income from the provision of services on 31 August 2005 and incurred expenses of $1,000 in earning that income. This income will be excluded from assessable income under section 23AH for the 2006 income year.

Aust Co 1 declares an unfranked dividend of $500 on 15 September 2005. Aust Co 1 wants to declare another unfranked dividend of $3,000 on 15 March 2006.

For the period up until the end of the day immediately before the date of Royal Assent, Aust Co 1 would continue to maintain its foreign dividend account. On 1 September 2005 Aust Co 1 has an FDA surplus of $550. The FDA has the following credits (there are no debits):

$100 — FDA surplus as at 1 July 2005;

$450 — net dividend received from ForCo 1 on 1 August 2005

Aust Co 1 can make a foreign dividend account declaration percentage of 100 per cent in relation to the unfranked dividend declared on 15 September 2005. The FDA surplus after the payment of the dividend is $50.

On the day of Royal Assent, Aust Co 1's FDA surplus of $50 can be treated as being conduit foreign income. When Aust Co 1 declares its dividend on 15 March 2006, the amount of conduit foreign income that it has available to distribute would be $4,725 calculated as:

$50 — the FDA surplus transferred to conduit foreign income;

$5,000 — foreign branch income derived on 31 August 2005;

($1,000) — expenses incurred in earning foreign branch income;

$750 — dividend received 1 February 2006;

($75) — foreign tax expense payable on the $750 dividend.

Aust Co 1 will therefore be able to declare the entire $3,000 unfranked dividend to be conduit foreign income as the amount of its conduit foreign income at that time is greater than the unfranked dividend which it intends to declare. This would reduce the conduit foreign income amount to $1,725. This amount can then be used to declare future unfranked distributions as conduit foreign income.

What modifications apply to companies with an income year that starts on or after Royal Assent but before 1 July 2006?

5.113 There are three transitional rules that apply to a company whose income year starts on or after Royal Assent but before 1 July 2006. ***[Schedule 2, subitem 28(1)]***

5.114 The first rule ensures the provisions relating to the repeal of the foreign dividend account rules will not take effect until the start of the first income year that commences on or after Royal Assent. This will allow those companies to make declarations from their foreign dividend account up until that time. Those dividends can then be distributed free of withholding tax because the repeal of the existing withholding tax exemption will also not apply until the start of that first income year. ***[Schedule 2, subitem 28(2)]***

5.115 The second rule ensures the foreign dividend account surplus that exists at the start of the first income year after Royal Assent is converted to conduit foreign income at that time ***[Schedule 2, subitem 28(3)]***. The amount included in a company's conduit foreign income will be equal to the amount of the surplus at that time. The conversion of the foreign dividend account surplus means that a company can continue to pay those unfranked dividends to foreign shareholders without incurring any dividend withholding tax.

5.116 The final rule prevents these companies from including in the calculation of conduit foreign income for the first year, amounts that relate to foreign tax credits. That is, these entities are unable to include in their first income year's amount of conduit foreign income, amounts that relate to foreign tax credits. ***[Schedule 2, subitem 28(4)]***

Consequential amendments

5.117 Several items repeal or amend provisions that relate to the foreign dividend account rules. These rules are repealed as a result of the introduction of the conduit foreign income measure. ***[Schedule 2, items 7, 8, 9, 16 and 19 to 24, paragraph 128B(3)(gaa), section 128D and Subdivision B of Division***

11A of Part III of the ITAA 1936, Subdivisions 717-J and 717-X and subsection 995-1(1)]

5.118 There are also several consequential amendments resulting from making a distribution of conduit foreign income non-assessable non-exempt income of a foreign resident. ***[Schedule 2, items 4, 5, 10 and 14, subsections 102AAW(1) and 121G(12) and subparagraph 159GZZZQ(4)(b)(i) of the ITAA 1936 and subparagraph 118-12(2)(a)(vi)]***

5.119 Other provisions have been replaced with provisions that reflect the change from the foreign dividend account rules to the new conduit foreign income measure. ***[Schedule 2, item 13, paragraphs 703-75(3)(c) and (d)]***

5.120 Notes have been added to subsections 44(1) (concerning assessable dividends) and 128B(1) (concerning withholding tax on dividends paid to non-residents) of the ITAA 1936 to alert taxpayers to the fact that they do not apply to dividends that are declared to be conduit foreign income. ***[Schedule 2, items 2, 3 and 6, subsections 44(1) and 128B(1) of the ITAA 1936]***

5.121 An item includes a reference to new provisions in the list of circumstances when a non-resident is taken to have quoted a tax file number. ***[Schedule 2, item 11, paragraph 202EE(1)(d) of the ITAA 1936]***

5.122 An item updates the checklist in section 11-55 to include a reference to distributions of conduit foreign income. ***[Schedule 2, item 12, section 11-55]***

5.123 A definition of ‘conduit foreign income’ has been inserted in the Dictionary. ***[Schedule 2, item 18, subsection 995-1(1)]***

REGULATION IMPACT STATEMENT

Policy objective

5.124 The conduit foreign income measure is a further instalment of reforms following the *Review of International Taxation Arrangements*. The overall purpose of the reforms is to build on Australia’s position as an attractive place for business and investment.

5.125 This measure is designed to provide tax relief for conduit foreign income, which generally is foreign income received by a foreign resident through an Australian co-rporate tax entity. Generally, this measure only

applies to foreign income that is ordinarily sheltered from Australian tax when it is received by the Australian corporate tax entity.

The objectives of this measure

5.126 The conduit foreign income measure aims to reduce tax impediments for foreign investors who structure their foreign investments through Australian entities. This is intended to provide those investors with a more neutral Australian tax outcome on those investments when compared to the foreign investors who have direct holdings in their foreign investments.

5.127 Reducing tax barriers will enhance Australia as an investment choice for foreign investors. This will improve the attractiveness of Australia as a location for regional holding companies of foreign groups. This measure will also enhance the ability of Australian entities with foreign investments to compete for foreign capital and therefore encourage them to remain Australian residents if their foreign shareholding becomes significant.

Implementation options

5.128 The conduit foreign income measure (originally known as the foreign income account measure) arises from the recommendations made by the Board of Taxation as part of the *Review of International Taxation Arrangements*. The Board's recommendation was to proceed with the foreign income account rules as recommended by the report on the *Review of Business Taxation: A Tax System Redesigned.*

5.129 The basis for the implementation of this measure can be found in the Board of Taxation's report, *International Taxation: A Report to the Treasurer* (the Board's Report), the Treasury's consultation paper, *Review of International Taxation Arrangements* (Consultation Paper) and John Ralph's report, *Review of Business Taxation: A Tax System Redesigned* (the Ralph Report).

5.130 This measure, and principles underlying it, were discussed in the Board's Report in Recommendation 3.11(1), pages 104 to 106, the Consultation Paper under Option 3.11, pages 50 to 52 and the Ralph Report in Recommendations 21.1 to 21.5, pages 647 to 650.

5.131 This measure will ensure no withholding tax is imposed on an unfranked distribution paid to non-resident owners to the extent that the distributing entity declared the distribution to be conduit foreign income.

5.132 This measure will also allow conduit foreign income to flow through a chain of Australian entities to the ultimate non-resident owners without there being any Australian tax imposed. This allows foreign owners of Australian entities involved in Australian joint ventures to access the benefits of this measure. Addressing this issue was seen as removing a limitation that exists in the current foreign dividend account rules that are being replaced by this measure.

5.133 The Treasury and ATO will monitor this taxation measure, as part of the whole taxation system, on an ongoing basis.

Assessment of impacts

Impact group identification

5.134 The conduit foreign income measure in this Bill specifically impacts on Australian corporate tax entities making distributions to non-resident owners out of foreign profits. Corporate tax entities that distribute amounts declared to be conduit foreign income to other Australian entities are also affected.

5.135 In general, an Australian corporate tax entity is an entity that is an Australian resident company or corporate limited partnership. A corporate unit trust or public trading trust is also an Australian corporate tax entity if it is a resident unit trust for the relevant income year.

Analysis of costs / benefits

5.136 It has not been possible to provide a fully detailed analysis of the impacts on compliance costs because of the lack of available information on affected taxpayers. However, some general observations are outlined below.

Compliance costs

5.137 There may be increased compliance costs for taxpayers who want to take advantage of this measure. Corporate tax entities will have a minor increase in their compliance costs as a result of the need to change their distribution statements to include information that appropriately identifies

the components of the distribution including amounts declared to be conduit foreign income.

5.138 Increased compliance costs may also arise for corporate tax entities in determining the amount of their conduit foreign income. However, this Bill seeks to minimise these costs by not prescribing detailed accounting requirements that have to be satisfied.

5.139 Unlike the foreign dividend account provisions, the measure does not prescribe a mechanism for entities to use to determine the amount of their conduit foreign income. An entity is not required to know the amount of its conduit foreign income at all times. However, it is required to keep sufficient records to explain the amount of conduit foreign income it has at the time it makes a distribution declared to be conduit foreign income. Where an entity makes a declaration before making the distribution it would need records to explain the amount of its conduit foreign income at the time of the declaration.

5.140 For corporate tax entities already in receipt of foreign income, the increased compliance costs should be minimal as they would generally have systems in place which identify this type of income. However, systems may need to be set up for those entities whose only conduit foreign income amounts are distributions declared, in whole or in part, to be conduit foreign income that are received from other Australian entities. These entities will need to identify that income so that it remains free of Australian tax if on-distributed within specified time constraints.

5.141 Taxpayers may also incur some additional compliance costs if they require advice from the ATO and tax professionals in respect of this measure.

Administration costs

5.142 As a result of this measure, the ATO may incur some initial costs in making changes to its material and educating its staff about the measure. It may also incur costs in providing advice to taxpayers, including by public and private rulings.

5.143 The ATO may also incur additional costs in its compliance activity to ensure that taxpayers are complying with the requirements of this measure.

Government revenue

5.144 The financial impact of the conduit foreign income measure is outlined in Table 5.1

Table 5.1: Financial impact of the conduit foreign income measure

	2005-06	*2006-07*	*2007-08*	*2008-09*
Introduce a conduit foreign income measure (as announced in November 1999) applying to all foreign income.	–$5 million	–$20 million	–$20 million	–$25 million

Economic benefits

5.145 This measure provides relief from Australian taxation for distributions made by Australian corporate tax entities to their foreign owners, to the extent that the distributions relate to amounts of conduit foreign income.

5.146 But for special rules, there is disparity in the Australian tax treatment of foreign residents deriving most sorts of foreign income through direct foreign investment and those foreign residents deriving the same foreign income through an Australian entity. This discourages foreign entities from using Australia for their regional holding companies. It could also mean that Australian entities are less likely to attract foreign capital if they want to expand offshore.

5.147 The conduit foreign income measure will provide a more comprehensive conduit treatment than the current foreign dividend account rules. The measure will apply to a wider range of foreign income ensuring such income can be distributed to foreign resident owners without incurring withholding tax. This measure will also extend the scope of conduit treatment for foreign income by allowing foreign income to effectively flow through a chain of Australian entities without any additional Australian tax being payable. This further enhances the benefits for foreign investors in Australian companies.

5.148 This measure will encourage the establishment in Australia of regional holding companies for foreign groups and will improve Australia's attractiveness as a continuing base for our multinational companies by improving their ability to compete for foreign capital.

Consultation

5.149 Business, legal and accounting representatives and the ATO have been consulted extensively and have actively assisted in developing this measure. This involved the establishment of an advisory group constituted by members of industry and professional peak bodies to help in the design of legislation. The more technical issues and the details of the measure were referred to a particular sub-group, known as the Conduit Working Group.

5.150 Groups consulted as part of the process outlined above include the:

- Business Council of Australia.
- Australian Bankers' Association.
- Taxation Institute of Australia.
- Corporate Tax Association.
- Law Council of Australia.
- Institute of Chartered Accountants in Australia.
- Certified Practising Accountants Australia.

5.151 Suggestions on the legislative details of the measure made by working group members were adopted where they were consistent with the intended policy objectives and the integrity of the measure. Account was also taken of submissions received from interested parties as a result of the legislation having initially been released for comment as an exposure draft.

5.152 The consultative groups have been supportive of the consultation process and of the final form of the measure.

Conclusion

5.153 This measure is a further instalment of reforms to implement the Government's response to the *Review of International Tax Arrangements*. The measure is consistent with the Government's policy objectives of increasing the attractiveness of Australia as a location for business and investment.

5.154 The conduit foreign income measure encourages the establishment of regional holding companies for foreign groups and improves the ability of Australian companies to compete for foreign capital. This is achieved through the provision of additional taxation relief for conduit foreign income. While access to the benefits of this measure will necessarily involve some increase in compliance costs for taxpayers, these costs have been minimised to the greatest extent possible having regard to integrity concerns.

5.155 The Treasury and ATO will monitor this taxation measure, as part of the whole taxation system, on an ongoing basis.

Chapter 6
Denial of deductions for illegal activities

Outline of chapter

6.1 Schedule 3 to this Bill inserts section 26-54 into the *Income Tax Assessment Act 1997*. The provision will deny deductions for losses and outgoings where they are incurred in the furtherance of, or directly in relation to, activities in respect of which the taxpayer has been convicted of an indictable offence.

6.2 Complementary amendments to the capital gains tax provisions will ensure such losses and outgoings are not included in cost base calculations.

Context of amendments

6.3 The income tax law allows deductions against a taxpayer's assessable income for any loss or outgoing incurred in gaining or producing assessable income, or necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. Generally, deductions will be allowed under these provisions if there is sufficient nexus or link between the loss or outgoing and the business or production of assessable income, and the amount is not of a private or capital nature.

6.4 On 5 June 2003, the Full Federal Court in *Commissioner of Taxation v La Rosa* confirmed earlier decisions to allow a tax deduction for $220,000 for money stolen from the taxpayer, as it was considered there was a sufficient link between the theft and the taxpayer earning his assessable income through illegal drug dealing.

6.5 The Full Federal Court found that the taxpayer being engaged in an illegal activity when the loss was sustained did not mean that the deduction should be denied.

6.6 On 27 October 2004 the High Court refused the Commissioner of Taxation's (Commissioner) special leave application to appeal the Full Federal Court's decision.

Summary of new law

6.7 These amendments will deny deductions for losses and outgoings whether they are of a revenue nature or capital nature to the extent that they are incurred in the furtherance of, or directly in relation to, activities in respect of which the taxpayer has been convicted of an indictable offence. Indictable offences are offences that are punishable by imprisonment for at least one year.

Comparison of key features of new law and current law

New law	*Current law*
Where a taxpayer has been convicted of an indictable offence, deductions under the general deduction and capital gains tax provisions will be denied.	Income from illegal means is income according to the ordinary concept of income. Deductions against ordinary income are allowable under the general deduction provisions (section 8-1) or taken into account for the purposes of capital gains tax provisions.

Detailed explanation of new law

Expenditure in relation to illegal activities

6.8 Subsection 26-54(1) will operate to deny deductions for losses and outgoings to the extent they are incurred in the furtherance of, or directly in relation to, activities in respect of which the taxpayer has been convicted of an offence which is punishable by imprisonment for at least 12 months. ***[Schedule 3, item 2, subsection 26-54(1)]***

6.9 Relevant activities in relation to the offence are those that comprise the physical element of the offence, that is the conduct, result of conduct or circumstances in which conduct results or occurs. 'Physical element' has the same meaning as it appears in the *Criminal Code Act 1995*.

6.10 Deductions will be denied for all expenditure where the activities are wholly illegal such as drug dealing or people smuggling. For example, dealing in illegal drugs (buying and selling and associated activities) is an

offence in its own right, not just acquiring illegal drugs, though that in itself is an offence.

6.11 On the other hand, there will be cases where a taxpayer is conducting a lawful business but is convicted of an illegal activity while carrying on that business. In these cases only the expenditure that is incurred directly or in the furtherance of the illegal activity will be denied. Expenditure that is incurred in undertaking the underlying lawful activity and that would have been incurred regardless of the illegal activity will continue to be deductible. This is because the expenditure cannot be said to further or be directly related to the illegal activity. The expenditure is too remote to the illegal activity.

Expenditure in relation to capital gains

6.12 Similarly, the capital gains tax provisions will be amended so that losses and outgoings incurred in relation to illegal activities in respect of which the taxpayer was convicted of an indictable offence do not form part of the cost base or reduced cost base for capital gains purposes. This will ensure that no capital loss or reduced capital gain can arise from such expenditure. ***[Schedule 3, items 3 and 4]***

Amendment period

6.13 The Commissioner will have up to 4 years after the taxpayer is convicted of an indictable offence to issue an amended assessment. This will provide an appropriate amendment period where a taxpayer makes a claim for a deduction in an income tax return and is subsequently convicted of an indictable offence. ***[Schedule 3, item 2, subsection 26-54(2)]***

Application and transitional provisions

6.14 These amendments will apply to losses and outgoings incurred after 29 April 2005. This is the date of announcement by the Treasurer. It is appropriate that amendments to deny inappropriate tax outcomes where criminal behaviour is involved apply from the date of announcement.

Chapter 7
Copyright in film to be included in effective life depreciation

Outline of chapter

7.1 Schedule 4 to this Bill amends Division 40 of the *Income Tax Assessment Act 1997* (ITAA 1997) to include copyright in a film in the general effective life depreciation of the uniform capital allowances provisions. Also included in this Schedule are amendments to Division 10B of the *Income Tax Assessment Act 1936* (ITAA 1936) which ensure appropriate interaction between Division 10B of the ITAA 1936 and Division 40 of the ITAA 1997.

Context of amendments

7.2 The capital allowances provisions contained in Division 40 allow taxpayers a deduction equal to the decline in value of a depreciating asset they hold during an income year. That decline in value is worked out by reference to the effective life of the asset. The effective life of an asset is the length of time over which any entity can use the particular asset for taxable purposes (broadly, producing assessable income) or for the purpose of producing exempt income.

7.3 Under Division 40 the Commissioner of Taxation (Commissioner) makes ‘safe harbour’ effective life determinations for a wide range of assets. Taxpayers may use determined safe harbour effective lives for their assets where there is one in force, or choose to self assess the effective life of their asset having regard to the wear and tear reasonably expected from their circumstances of use and assuming the asset will be maintained in reasonably good order or condition. If a determination is not in force for a particular asset, the taxpayer must self assess the effective life of that asset. Taxpayers have the choice of using either the diminishing value method or the prime cost method to work out the decline in value of the assets.

7.4 In the case of intangible assets, the capital allowances provisions prescribe statutory effective lives. These assets include rights that an entity

holds under the *Copyright Act 1968* as the owner or a licensee of a copyright. As the law applies a specific statutory rate, taxpayers cannot choose an effective life as determined by the Commissioner or choose to self assess an effective life for these assets.

7.5 The current law provides the following capital allowance treatment for expenditure on films:

- A deduction over 2 years for capital expenditure to acquire rights in or under copyright relating to an 'Australian film' under Division 10B of Part III of the ITAA 1936.

- An immediate deduction under Division 10BA of the ITAA 1936 for investors for capital expenditure to produce a 'qualifying Australian film' that gives those investors an interest in the initial copyright of the film.

7.6 Capital expenditure on a copyright in a film which does not qualify for deduction under these provisions may be deductible under Division 40 if the expenditure forms part of the cost of a depreciation asset you hold and use for a taxable purpose. The current law provides a statutory effective life for such assets of 25 years or the period remaining in the copyright, or the licence relating to a copyright, whichever is the lesser.

Summary of new law

7.7 The new law includes a copyright in a film in effective life depreciation provisions of the uniform capital allowances rather than using the existing 25-year statutory life.

Comparison of key features of new law and current law

New law	*Current law*
A copyright in a film is excluded from the general category of 'copyright' at item 5 in subsection 40-95(7).	The general category of 'copyright' at item 5 in subsection 40-95(7) includes copyright in a film.
A licence to a copyright in a film is excluded from 'a licence relating to a copyright' at item 7 in the above	The meaning of 'a licence relating to a copyright' at item 7 in the above subsection includes a licence to a

New law	*Current law*
subsection.	copyright in a film which is itself a depreciating asset.
These exclusions mean that copyright, or licenses relating to a copyright, in a film will automatically come under effective life depreciation.	No equivalent.
Copyright in a film is carved out of the exception category of intellectual property in subsection 40-70(2). The amendment ensures that both prime cost and diminishing value methods will be available to the write-off of depreciating assets which are either copyright, or licenses relating to a copyright, in a film.	Intellectual property, including copyright in a film can only be written-off using the prime cost method (ie, straight line write-off) by the operation of subsection 40-70(2).

Detailed explanation of new law

7.8 Copyright in a film is excluded from the general category of copyright at item 5 in subsection 40-95(7) and a licence relating to a copyright subsisting in a film is excluded from a licence relating to a copyright at item 7 in this subsection. ***[Schedule 4, items 5 and 6, subsection 40-95(7)]***

7.9 Copyright in a film is carved out of the exception category of intellectual property in subsection 40-70(2). This ensures that both prime cost and diminishing value methods may apply to copyright in a film write-off under Division 40. ***[Schedule 4, item 4, paragraph 40-70(2)(b)]***

7.10 Subsection 40-100(4) is amended to clarify that paragraphs 40-100(4)(a) to (c) apply only if relevant to a particular asset, as specific factors that the Commissioner must take into account in determining the asset's effective life. These specific factors are not the only factors the Commissioner can take into account. ***[Schedule 4, item 7, subsection 40-100(4)]***

7.11 Subsection 40-105(1) is amended to clarify that paragraphs 40-105(1)(a) and (b) apply only if relevant to a particular asset, as specific factors that a taxpayer must take into account in self assessing the asset's effective life. Other relevant factors that may be taken into account are those the Commissioner takes into account. ***[Schedule 4, item 8, subsection 40-105(1)]***

7.12 Subsection 40-105(4) has been amended to ensure that this subsection does not operate to exclude copyright in a film from the effective life self assessment provision. ***[Schedule 4, item 9, subsection 40-105(4)]***

7.13 Subsection 40-110(5) has been amended to ensure that this subsection does not operate to exclude copyright in a film from the effective life recalculation provision. ***[Schedule 4, item 11, subsection 40-110(5)]***

Application and transitional provisions

7.14 This measure will apply to film copyright acquired on or after 1 July 2004.

Consequential amendments

7.15 Currently a taxpayer can elect that the 2-year write-off provided in subsection 124UA(1) does not apply in which case a 25-year write-off applies under that Division. As amended, a taxpayer will make to an election such that the Division does not apply. ***[Schedule 4, item 3, subsection 124UA(2)]***

7.16 Section 124U of the ITAA 1936 is repealed as the section is no longer required to provide a 25-year write-off for copyright in a film as an alternative to the 2-year write-off. ***[Schedule 4, item 2]***

7.17 Paragraph 124PA(4)(b) is amended to reflect the repeal of section 124U. ***[Schedule 4, item 1, paragraph 124PA(4)(b)]***

7.18 These consequential amendments will effectively align the Division 10B election with the current Division 10BA election. The effect of either the amended election in Division 10B or the current Division 10BA election is that taxpayers would no longer be considered as being able to deduct an amount under the relevant Division. This ensures that taxpayers are able to write-off copyright in a film under Division 40 of the ITAA 1997 where no deduction has been claimed under Division 10B or Division 10BA.

7.19 The examples in subsection 40-110(1), describing the circumstances where a taxpayer may choose to recalculate their asset's effective life, have been repealed. The same examples and an example to include a changed circumstance when a taxpayer would choose to recalculate the effective life of their copyright in a film have been inserted. ***[Schedule 4, item 10, subsection 40-110(1)]***

REGULATION IMPACT STATEMENT

Policy objective

7.20 Write-offs for copyright in films which do not qualify as Australian films should be based on the copyright's economic life rather than the current 25-year statutory life or the period until the copyright ends, whichever is the less. The Treasurer announced the new tax treatment for copyright in films as part of the 2005-06 Budget on 10 May 2005.

Implementation options

7.21 There are two options to implement the policy objective under the capital allowances provision of the income tax law:

- introduce a shorter statutory write-off period for copyright in a film; or
- include copyright in a film in effective life depreciation.

Assessment of impacts

7.22 Both options above would replace the current 25-year write-off period with a period that more closely reflects the economic life of the film copyright. Both options would advantageously affect the same relatively small number of taxpayers and effectively reduce compliance costs due to the shorter write-off period.

Impact group identification

7.23 This measure impacts on film producers and investors, of films that do not qualify as Australian films. These taxpayers will be allowed to write-off the capital cost of their copyright in their film based on either the Commissioner's safe harbour effective life determination or their self assessment of their film's effective life. Should taxpayers choose to self assess, they will need to have regard to, and keep a record of, their particular circumstances in determining their film's effective life.

7.24 The measure has a small impact on the Australian Taxation Office (ATO) as the Commissioner is required to issue a safe harbour effective life determination for film copyright as soon as possible after the enactment of this measure.

Analysis of costs / benefits

7.25 Under both options, the impact on film producers and investors would be similar as both options replace a statutory write-off period with another period. Under Option 1, there would have been no impact on the ATO as one statutory period would have merely been replaced with another. However, the Option 1 would not have offered taxpayers the choice of self assessment and may not reflect the economic life for some films. This would have resulted in an implementation shortfall of the policy objective.

7.26 Option 2 will require the Commissioner to issue a safe harbour effective life determination. The Commissioner has a dedicated team that considers effective lives of numerous assets across numerous specific industries. Including film copyright in effective life depreciation will have a negligible effect on resources. For the cost of this minimal impact on the ATO, Option 2 will effectively satisfy the policy objective by offering taxpayers the choice of effective lives, that is, the Commissioner's determined safe harbour effective life or a self assessed effective life reflecting the taxpayer's particular circumstances.

Consultation

7.27 Consultation was undertaken with both the Department of Communication, Information Technology and the Arts and the ATO to achieve a broad consensus for this proposal.

Conclusion and recommended option

7.28 Both options address the Government's policy objective, both options have similar impact on film producers and investors. Although Option 2 will have a small impact on the Commissioner, this concern would be largely cancelled by the increased benefit this option provides. Option 2 is the more effective option in implementing the Government's policy objective. Accordingly the second option is the preferred option.

The Treasury and ATO will monitor this taxation measure, as part of the whole taxation system, on an ongoing basis.

Chapter 8
Relief for employee share scheme participants in the event of a corporate restructure

Outline of chapter

8.1 Schedule 5 to this Bill amends the *Income Tax Assessment Act 1936* (ITAA 1936) to allow employee share scheme (ESS) participants — who acquire shares in a scheme for the acquisition of shares by employees who are assessed under section 26AAC of the ITAA 1936 — to treat the new shares or rights they are issued because of a corporate restructure as a continuation of their old shares or rights.

8.2 These amendments also allow ESS participants — who have made an election under Division 13A of the ITAA 1936 to be taxed upfront — to treat the new shares or rights they are issued because of a corporate restructure as a continuation of their old shares or rights.

8.3 Amendments are also made to the *Taxation Laws Amendment Act (No. 3) 2003*, the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Income Tax (Transitional Provisions) Act 1997* to ensure the capital gains tax (CGT) provisions in those Acts reflect the amendments to section 26AAC and Division 13A.

Context of amendments

8.4 An ESS participant acquires shares or rights under an ESS if the shares or rights were acquired in connection with employment, and if the consideration paid for them was less than their market value at that time. Any discount that an ESS participant receives from acquiring shares or rights for less than their market value is assessable as income.

8.5 If an ESS participant acquires shares or rights in respect of employment on or before 6.00 pm by legal time in the Australian Capital Territory on 28 March 1995 the section 26AAC provisions will apply. If an ESS participant acquires shares or rights after that time the Division 13A provisions will apply. Under both sets of provisions an ESS

participant can, subject to certain conditions, access concessions in relation to the discount.

8.6 In the event of a corporate restructure, an ESS participant may be issued with new shares or rights to replace the old shares or rights they previously held. However, the new shares or rights may not qualify for the same concessions on the discount that applied to the old shares or rights.

8.7 These amendments ensure that the new shares or rights issued to ESS participants in the event of a corporate restructure are treated as a continuation of the old shares or rights they previously held, subject to certain conditions. The amendments also ensure that concessions in relation to the discount are not lost where shares or rights are disposed of in the event of a corporate restructure.

Summary of new law

8.8 Under section 26AAC an ESS participant can, subject to certain conditions, access one of two alternative tax concessions on the discount they receive: the *tax-excluded* concession and the *tax-deferred* concession.

8.9 These amendments ensure that ESS participants with *tax-excluded* shares or rights under section 26AAC can treat the new shares or rights they are issued in a corporate restructure as a continuation of their old shares or rights. This will ensure that the capital gain or loss a trustee makes when new shares or rights exit an employee share trust is disregarded.

8.10 The amendments also ensure that ESS participants with *tax-deferred* shares or rights under section 26AAC can treat the new shares or rights they are issued in a corporate restructure as a continuation of their old shares or rights. This will ensure the continuation of the deferral period that applies to tax-deferred shares or rights.

8.11 Under Division 13A an ESS participant can, subject to certain conditions, access one of two tax concessions in relation to the discount they receive: the *tax-upfront* concession and the *tax-deferred* concession.

8.12 These amendments ensure that ESS participants with *tax upfront* shares or rights under Division 13A can treat the new shares or rights they are issued in a corporate restructure as a continuation of their old shares or rights. In addition, certain conditions of the ESS do not need to be satisfied in relation to the new shares or rights. This ensures that:

- the capital gain or loss a trustee makes when new shares or rights exit a trust is disregarded;
- ESS participants with new shares or rights retain the same CGT cost base treatment as their old shares or rights;
- ESS participants who acquire new shares or rights no longer have to satisfy the condition relating to not disposing of the shares or rights within 3 years of acquiring them; and
- the new rights an ESS participant is issued are treated as a continuation of their old rights.

8.13 The amendments also clarify the point in time at which an ESS participant must be employed to have new rights to acquire shares under Division 13A treated as a continuation of old rights to acquire shares.

Comparison of key features of new law and current law

New law	***Current law***
ESS participants with new *tax-excluded* shares or rights which fall under the scope of section 26AAC will have their new shares or rights treated as a continuation of their old shares or rights.	ESS participants with new *tax-excluded* shares or rights which fall under the scope of section 26AAC may not receive relief when their shares or rights exit an employee share trust.
ESS participants with new *tax-deferred* shares or rights which fall under the scope of section 26AAC will have their new shares or rights treated as a continuation of their old shares or rights.	ESS participants with new *tax-deferred* shares or rights which fall under the scope of section 26AAC may have to pay tax on the discount when their old shares or rights are disposed of.

New law	***Current law***
ESS participants with new *tax-upfront* shares or rights under Division 13A will have their new shares or rights treated as a continuation of their old shares or rights and will not be subject to the same restrictions.	ESS participants with new *tax-upfront* shares or rights under Division 13A may not receive the same concessional treatment that applied to the old shares or rights they previously held.

Detailed explanation of new law

Relief for section 26AAC shares or rights

Background

8.14 If an ESS participant acquires shares or rights under a scheme for the acquisition of shares by employees prior to 6.00 pm by legal time in the Australian Capital Territory on 28 March 1995, then the provisions in section 26AAC will apply. Under these provisions an ESS participant can, subject to certain conditions, access one of two tax concessions on the discount they receive: the *tax-excluded* concession, or the *tax-deferred* concession.

8.15 Under the *tax-excluded* concession, an ESS participant may be entitled to reduce the amount of the discount they are taxed on by up to $200 per year, with the remainder of the discount treated as assessable income in that same year. Any capital gain or loss an ESS participant makes from the shares or rights after they have paid tax on the discount is subject to CGT on disposal. The first element of the CGT cost base for the shares or rights is their market value at the time of absolute entitlement.

8.16 A corporate restructure may trigger a CGT taxing point for tax-excluded shares or rights as the shares or rights may no longer be owned by the ESS participant. The ESS participant may be issued with new shares or rights to replace the old shares or rights, however, these new shares or rights will not be recognised as a continuation of the old shares or rights. As a result, the taxation treatment attached to the old shares or rights will not apply.

8.17 The new tax-excluded shares or rights may be subject to double taxation if they have been held in a trust. Under existing law, any capital gain or loss a trustee makes is disregarded when shares or rights exit the trust. This ensures that the shares or rights are not taxed twice: once in

the hands of the trustee and once in the hands of the ESS participant. However, this treatment only applies to old shares or rights, and any capital gain or loss made by a trustee on new shares or rights issued to replace old shares or rights will not be disregarded.

Example 8.1

> In 1993 Luke acquired 500 tax-excluded ordinary shares in his employer Grape Company under a scheme for the acquisition of shares by employees. The shares are held in an employee share trust. In 2001 Grape Company is bought out by Orange Company and Luke is issued with 1,000 new ordinary shares in Orange Company with a total value equal to his 500 Grape Company shares at that time. These shares are also held in an employee share trust. In 2003 the shares are released from the employee share trust and Luke becomes absolutely entitled to his Orange Company shares. The trustee pays CGT on the shares when they exit the trust.

8.18 Under the *tax-deferred* concession, an ESS participant can elect to defer paying tax on the discount received until restrictions on disposal of the shares or rights cease, or the shares or rights are disposed of.

- The discount on shares is the difference between their market value at the time restrictions cease, and any amount paid or payable for the shares.
- The discount on rights (or shares which are disposed of prior to restrictions lifting) is the difference between the amount received for the rights and any amount paid or payable for the rights.

8.19 Any capital gain or loss an ESS participant makes from the shares or rights after they have paid tax on the discount is subject to CGT at a later time, for example, on disposal. The first element of the CGT cost base for the shares or rights is their market value at the time the tax on the discount is paid.

8.20 A corporate restructure may trigger a taxing point for tax-deferred shares or rights if the shares or rights are considered to be disposed of by the ESS participant. The ESS participant may be issued with new shares or rights to replace the old shares or rights, however, these new shares or rights will not be regarded as a continuation of the old shares or rights, and the treatment attached to the old shares or rights will not apply.

8.21 As a result, the deferral time which applied to the old tax-deferred shares or rights will end, and the ESS participant will be liable to pay tax on the discount received at the time of the corporate restructure. The deferral period cannot be carried over and applied to the new shares or rights.

Example 8.2

> In 1989 Jodie acquired 2,000 tax-deferred ordinary shares in her employer Sunlight Company under a scheme for the acquisition of shares by employees. The shares are held in an employee share trust. In 2002 Sunlight Company restructures and splits into Moonlight Company and Starlight Company. Jodie is issued with 1,000 new shares in her new employer, Moonlight Company, however these shares are not considered to be a continuation of her old shares in Sunlight Company. Consequently, Jodie is required to pay tax on the discount received on her Sunlight Company shares.

8.22 These amendments resolve these issues by ensuring that in the event of a corporate restructure new shares or rights are treated as a continuation of old shares or rights, provided that:

- the new shares or rights in the new company can be reasonably regarded as matching the old shares or rights acquired under a scheme for the acquisition of shares by employees in the old company ***[Schedule 5, item 3, paragraph 26AAD(1)(a)]***;
- the new shares or rights in the new company are issued in connection with a corporate restructure or 100 per cent takeover of the old company ***[Schedule 5, item 3, paragraph 26AAD(1)(b)]***; and
- the shares or rights in the old company ceased to be held by the ESS participant as a result of the corporate restructure or 100 per cent takeover of the old company ***[Schedule 5, item 3, paragraph 26AAD(1)(c)]***.

Conditions for matching shares or rights

8.23 Relief is limited to matching shares or rights that can be reasonably regarded as matching or mirroring the conditions of the old shares or rights that the ESS participant held in the old company. Matching shares or rights are the replacement shares or rights provided to ensure that the financial position of an ESS participant immediately before

a corporate restructure is maintained afterwards. ***[Schedule 5, item 3, paragraph 26AAD(1)(a)]***

8.24 Matching shares or rights should reasonably match the value of the old shares or rights that the ESS participant held immediately before the restructure so there is no additional benefit from the restructure. There is no need for a one-to-one ratio between the old shares and rights and the new shares or rights for them to be matching, provided the value of the new shares or rights relative to the old shares or rights remains unchanged. ***[Schedule 5, item 3, paragraph 26AAD(1)(a)]***

Example 8.3

In 1992 Tim acquired 900 tax-deferred ordinary shares in his employer Progress Company under a scheme for the acquisition of shares by employees. In 2006 Advantage Company buys out all shares in Progress Company. At the time of the buy out each share in Progress Company was valued at $2. Tim is issued with 300 shares in Advantage Company valued at $6 each. The 300 new shares that Tim receives in Advantage Company are considered matching as they have the same value as his original shares in Progress Company. Tim can continue to defer payment of tax, provided certain other conditions are met.

8.25 The replacement of old shares or rights with a combination of equivalent shares or rights and cash is also considered to be matching. However, to the extent that the old shares or rights are replaced with cash or some other thing of value, shares or rights to the value of that cash or some other thing will not be considered a continuation of the old shares or rights and will cease to exist, as relief only applies to matching shares or rights. ***[Schedule 5, item 3, subsection 26AAD(2)]***

Example 8.4

In 1991 Naomi is issued 5,000 tax-deferred shares in Nappy Company under a scheme for the acquisition of shares by employees. In 2007 Rattle Company acquires Nappy Company in a 100 per cent takeover. Immediately prior to the takeover, Naomi's shares in Nappy Company were valued at $1 each. Rattle Company issues Naomi with 2,000 shares valued at $2 each and pays her $1,000 cash. The value of her new shares in Rattle Company is less than the value of her old shares in Nappy Company. Relief only applies to the proportion of Nappy Company shares that match the value of the Rattle Company shares. The old shares in Nappy Company that Naomi holds that are not matched by new shares in Rattle Company will have a cessation time, and Naomi will have to pay tax on the discount on those shares.

8.26 To be regarded as reasonably matching, the attributes of the new shares or rights need to be the same, or substantially the same, as those old shares or rights that existed immediately before the restructure. Attributes include whether it was a share or right. For example, the replacement of shares with rights after a corporate restructure would not be considered matching, as the interests of the ESS participant after the restructure would have substantially changed. ***[Schedule 5, item 3, subsection 26AAD(2)]***

8.27 Relief will only apply to matching new shares or rights acquired in connection with a 100 per cent takeover or restructure. Relief will not apply to shares or rights that an ESS participant ceases to hold for reasons other than a corporate restructure, such as a voluntary disposal of shares or rights. ***[Schedule 5, item 3, paragraph 26AAD(1)(b)]***

8.28 Relief is achieved by ensuring that the replacement of old shares or rights in the old company, does not give rise to a disposal for taxation purposes of the old shares or rights in that company. That is, the new shares or rights are taken to be a continuation of the old shares or rights, subject to certain conditions. ***[Schedule 5, item 3, paragraph 26AAD(1)(c)]***

8.29 Where an ESS participant has acquired shares or rights in the old company at different times, the matching shares or rights are also held to be acquired at those different times. Any restrictions on disposal will continue to apply from the date it first applied to the old shares or rights. This also means that the new shares or rights are treated as having the same acquisition date as the old shares or rights. ***[Schedule 5, item 3, paragraph 26AAD(1)(c)]***

8.30 The treatment of non-matching shares or rights immediately after a corporate restructure will be determined on the basis of the application of the existing law. Relief will not apply.

Other conditions for relief

8.31 In order for a share or right to be treated as a continuation of an old share or right, the first condition is that the ESS participant must have held shares or rights in the old company in a scheme for the acquisition of shares by employees, immediately before the corporate restructure. It does not matter whether the ESS participant was employed by the old company at that time or not. ***[Schedule 5, item 3, subsection 26AAD(3)]***

8.32 The second condition is that the new shares or rights must be ordinary shares, or rights to acquire ordinary shares. This ensures that relief is only provided to ESS participants that have the voting and other rights associated with ordinary shares. Relief is not available to those ESS

participants who do not have ordinary shares, or rights to acquire ordinary shares. ***[Schedule 5, item 3, subsection 26AAD(4)]***

Example 8.5

> In 1992 Zoe acquired tax-excluded rights to buy 100 shares under a scheme for the acquisition of shares by employees in her employer, Bass Company. In 2007 the company restructured and a new holding entity called Treble Company was formed. Zoe was employed by Treble Company, and received new rights to buy ordinary shares in Treble Company equal in value to the rights she held in Bass Company immediately before the restructure. Relief will apply to Zoe's replacement rights as they were rights to acquire ordinary shares.

8.33 Another condition is that the matching shares or rights are subject to the same conditions and restrictions, or conditions and restrictions that have the same effect as, those that the old shares or rights were subject to (if any) prior to the corporate restructure. ***[Schedule 5, item 3, subsection 26AAD(5)]***

8.34 For example, an employer may loan an ESS participant funds to buy shares under a scheme for the acquisition of shares by employees on the condition that the loan be fully repaid when the ESS participant ceases employment. In the event of a corporate restructure it would be appropriate for a condition with the same effect to apply to the new shares or rights. ***[Schedule 5, item 3, subsection 26AAD(5)]***

Example 8.6

> In 1988 Jeff acquired 10,000 tax-excluded shares under a scheme for the acquisition of shares by employees in his employer, Abacus Company. Abacus Company lent Jeff money to purchase the shares and imposed the condition that the loan must be fully repaid when Jeff leaves the employment of Abacus Company. In 2006 Abacus Company was bought out by Calculator Company. Jeff received new shares in Calculator Company equal in value to the shares he held in Abacus Company immediately before the restructure. Calculator Company continued the loan to Jeff and imposed the condition that the loan must be fully repaid when Jeff leaves the employment of Calculator Company. Relief will apply as the conditions that apply to Jeff's new shares have the same effect as the conditions that applied to his old shares.

Types of corporate restructures that can give rise to relief

8.35 Relief is provided where a corporate restructure has occurred. A corporate restructure may include a change in ownership, or a change in the structure of the ownership of the company, which results in some or all of the shares or rights in the company under a scheme for the acquisition of shares by employees being replaced, or reasonably regarded as being replaced. ***[Schedule 5, item 3, subsection 26AAD(8)]***

8.36 Relief is also provided where a 100 per cent takeover occurs. A 100 per cent takeover of a company by another company is an arrangement that is intended to result in the company becoming a 100 per cent subsidiary of the other company, or of a holding company. ***[Schedule 5, item 3, subsection 26AAD(8)]***

8.37 In a takeover scenario an ESS participant of the old company becomes an ESS participant of the new or restructured company when their shares or rights are replaced by matching shares or rights in the new or restructured company. Relief will only apply where 100 per cent of the old company's shares and rights are acquired by the new company. In the case of a partial takeover, an ESS participant may choose whether or not to dispose of their old shares or rights, but relief will not apply. ***[Schedule 5, item 3, subsection 26AAD(8)]***

Example 8.7

In 1994 Hannah acquired 1,500 tax-deferred shares under a scheme for the acquisition of shares by employees in her employer Buggy Company. In 2008 Car Company makes a takeover offer for Buggy Company. Hannah decides to sell 500 of her shares but remains employed by Buggy Company. Car Company ultimately acquires a 65 per cent interest in Buggy Company. A cessation time arises for the 500 shares and relief does not apply because there is not a 100 per cent takeover. No relief is necessary for the remaining shares as Hannah still owns them and is still employed by Buggy Company.

8.38 Relief can also apply to demergers in limited circumstances. It will only apply, however, to the extent that an ESS participant's interest in the old company ceases. ESS participants must no longer hold shares or rights in the old company for the new shares or rights to be treated as a continuation of the old shares or rights. ***[Schedule 5, item 3, subsection 26AAD(8)]***

Apportionment of consideration paid for the old shares and rights

8.39 Any consideration an ESS participant paid for the old shares or rights should be spread evenly among the matching new shares or rights in proportion to their market values immediately after the restructure. This ensures that an ESS participant is not advantaged or disadvantaged because of a corporate restructure. ***[Schedule 5, item 3, subsection 26AAD(6)]***

8.40 When calculating the value of the apportionable assets for the original shares or rights consideration should be given to:

- the value of the new matching shares or rights held by an ESS participant because of the relief provisions ***[Schedule 5, item 3, paragraph 26AAD(7)(a)]***;
- the value of anything else that an ESS participant may have acquired in connection with the corporate restructure that can reasonably be regarded as matching shares or rights ***[Schedule 5, item 3, paragraph 26AAD(7)(b)]***; and
- the value of the old shares or rights an ESS participant may have held in the old company immediately before and after the corporate restructure, that can reasonably be regarded as matching shares or rights ***[Schedule 5, item 3, paragraph 26AAD(7)(c)]***.

Example 8.8

In 1990, Julie acquires 1,000 shares worth $3 each in her employer, Chocolate Company, for $2 each. In 2005, Chocolate Company is bought out by Nut Company. Chocolate Company shares are worth $10 each at this time. Julie's 1,000 shares in Chocolate Company are replaced with 2,000 $5 shares in Nut Company. The $2,000 that Julie paid to acquire the 1,000 Chocolate Company shares is apportioned between the 2,000 Nut Company shares. That is, Julie is treated as having paid $1 for each Nut Company share.

Interaction between section 26AAD and the CGT provisions

8.41 Subdivision 130-DA of the *Income Tax (Transitional Provisions) Act 1997* treats an ESS participant as having acquired a share or right at the time it was acquired by an employee share trust, if, at the time it was acquired by the trust, it was possible to determine that the share or right would later be provided to the ESS participant.

8.42 These amendments ensure that this treatment also applies to matching new shares or rights which are treated as a continuation of old shares or rights acquired by an employee share trust. ***[Schedule 5, item 15, subsection 130-80(3)]***

8.43 Subdivision 130-D of the *Income Tax (Transitional Provisions) Act 1997* establishes the interaction between section 26AAC and CGT. However, the Subdivision only applies to old shares or rights acquired under a scheme for the acquisition of shares by employees.

8.44 These amendments ensure that this Subdivision also applies to matching new shares or rights acquired as a result of a corporate restructure, and that new matching shares or rights are treated as a continuation of old shares or rights held under section 26AAC for CGT purposes. ***[Schedule 5, items 17 and 18, subsections 130-95(3) and 130-110(5)]***

Example 8.9

> In 1993, Michael acquired 5,000 tax-excluded ordinary shares in his employer Donut Company. The shares are held in an employee share trust. In 2007 Donut Company is bought out by Biscuit Company, and Michael receives matching shares in Biscuit Company equal in value to the shares he held in Donut Company immediately before the restructure. Relief will apply so that the new shares in Biscuit Company are not taxed when they exit the employee share trust, and so that Michael retains the same cost base treatment that applied to his shares in Donut Company, for his new Biscuit Company shares.

Relief for Division 13A shares or rights

Background

8.45 If an ESS participant acquires shares or rights in respect of employment after 6.00 pm by legal time in the Australian Capital Territory on 28 March 1995 then the provisions in Division 13A will apply. Under these provisions an ESS participant can, subject to certain conditions, access one of two alternative tax concessions in relation to the discount: the *tax-deferred* concession and the *tax-upfront* concession.

8.46 Under the *tax-deferred* concession, an ESS participant can defer paying tax in relation to the discount until a cessation time occurs, up to a maximum of 10 years. The discount in relation to the share is either the consideration received on disposal of the share *less* what was paid to acquire the share, or the market value of the share at the cessation time *less* what was paid to acquire the share. In relation to rights which are

exercised, the amount paid for the share will include the value of any consideration given to exercise that right.

8.47 A corporate restructure will, in most instances, have no impact on an ESS participant with tax-deferred shares or rights as relief is provided for such shares or rights under section 139DQ of the ITAA 1936. ESS participants with tax-deferred shares or rights can treat the new shares or rights they are issued as a continuation of their old shares or rights.

8.48 Under the *tax-upfront* concession, ESS participants can elect that the first $1,000 of the discount on the shares or rights is not taxable, but they are taxed on the remaining discount in the year the shares or rights are received. Any capital gain or loss an ESS participant makes from the shares or rights after they have paid tax on the discount is subject to CGT.

Issues for tax-upfront shares and rights in a corporate restructure

Continuation

8.49 Without relief a corporate restructure may trigger a CGT taxing point for tax-upfront shares or rights as the shares or rights may no longer be owned by the ESS participant. The ESS participant may be issued with new shares or rights to replace the old shares or rights, however, these new shares or rights will not be considered a continuation of the old shares or rights. As a result, the taxation treatment attached to the old shares or rights will not apply.

Employee share trusts

8.50 Without relief the replacement tax-upfront shares or rights may also be subject to taxation if they cease to be held by an employee share trust. Under existing law, any capital gain or loss a trustee makes is disregarded when shares or rights exit the trust. This is to ensure the shares or rights are not taxed twice: once in the hands of the trustee and once in the hands of the ESS participant. This treatment only applies to old shares or rights; any capital gain or loss made by a trustee on new shares or rights issued to replace old shares or rights will not be disregarded.

Example 8.10

In 2002, Simon acquired a beneficial interest in a share worth $20 in his employer Reef Company. The share was held under an employee share trust and Simon elected to pay tax upfront. Reef Company is taken over by Sand Company, and the share within the trust (now

worth $25) is replaced with a new share. When the new share is released from the trust (now worth $30), the trustee and the employee pay capital gains tax on any increase in value in the new share. If there had been no takeover, Simon would not have paid capital gains tax when the old share was released from the trust.

Cost base

8.51 Without relief the replacement shares or rights may also have a different CGT cost base to the old shares or rights.

- For a tax-upfront share or right acquired on or after 5.00 pm by legal time in the Australian Capital Territory on 27 February 2001, the first element of the cost base is the market value of the share or right at the time it was beneficially acquired.
- For a tax-upfront share or right acquired before this time, ESS participants have a choice whether the first element of the cost base is the market value of the share or right at the time it was absolutely acquired, or the market value of the share or right at the time it was beneficially acquired.

Example 8.11

In 2000, Nicola acquired a beneficial interest in 200 shares worth $10 each in her employer North Company, held under an employee share trust and elected to pay tax upfront. In 2001, North Company is taken over by South Company, and Nicola is issued with matching new shares which are held in the trust. In 2002 the shares (now worth $11 each) are released from the trust. In 2004 Nicola sells the shares for $9 each. Nicola has no choice as to the cost base, and must use $10 (the market value at the date of beneficial entitlement) as the cost base.

3-year holding requirement

8.52 Without relief the new tax-upfront shares or rights may also fail to satisfy the 3-year holding condition. To receive the $1,000 discount, an ESS must be operated so that no ESS participant is permitted to dispose of the shares or rights acquired under the ESS before the earlier of 3 years or cessation of employment from the time the shares or rights were acquired. A corporate restructure may result in the new company deciding not to operate the replacement ESS plan to satisfy this 3-year holding condition. Where this happens an ESS participant would be liable to repay the tax payable on the $1,000 discount.

Example 8.12

> In 2004, Melanie acquired shares under an ESS in her employer Bottle Company. She paid tax upfront and accessed the $1,000 concession. In 2006, Bottle Company is acquired by Can Company, and Melanie's Bottle Company shares are replaced with matching Can Company shares. Melanie has disposed of her ESS shares in Bottle Company within 3 years of acquiring them, and without relief would be required to repay the tax on the $1,000 concession.

Refund of taxation on rights

8.53 An ESS participant with a tax-upfront right is treated as never having acquired the right to acquire shares if the right is lost without the ESS participant having exercised it. If a right is lost and an ESS participant has elected to pay tax upfront on that right, any tax paid on the right is refundable to the ESS participant. However, without relief, if an ESS participant receives new matching rights as a result of a corporate restructure and those rights are subsequently lost, the ESS participant will not be entitled to a refund of tax paid.

Example 8.13

> Maddi received rights to acquire shares in her employer Solar Company under an ESS, and paid tax upfront, but could only exercise the rights if the company met a certain performance target. Solar Company was taken over by Energy Company, and Maddi's rights to acquire shares in Solar Company were replaced with rights to acquire shares in Energy Company with the same restrictions attached. As this is not considered to be a loss of the right to acquire shares in Solar Company, Maddi could not access a refund of tax paid at this time.
>
> Maddi continues to be employed by Solar Company. A few months later Solar Company failed to meet a certain performance target, and Maddi lost her rights to acquire shares in Energy Company without exercising her rights. Without relief Maddi would not be entitled to a refund of tax paid because the new rights are not treated as a continuation of the old rights.

8.54 These amendments resolve these issues by ensuring that, in the event of corporate restructure, new shares or rights are treated as a continuation of old shares or rights.

Relief for tax-upfront shares and rights

Continuation

8.55 Relief is available to ESS participants with tax-upfront shares or rights acquired under an ESS who acquire new shares or rights as a result of a corporate restructure. Relief is provided in the same way that continuation is provided to tax-deferred ESS participants who access continuation treatment under section 139DQ of the ITAA 1936. ***[Schedule 5, item 10]***

8.56 The mechanism for providing relief for tax-upfront shares or rights is the removal of subsection 139DR(4) of the ITAA 1936, which limits relief to ESS shares and rights that have a cessation time. While a cessation time may arise for tax-deferred shares or rights in the event of a corporate restructure, there is no cessation time for tax-upfront shares or rights. Hence they cannot access the relief provisions in section 139DQ which are conditional on subsection 139DR(4) being met. Removing this subsection enables ESS participants with tax-upfront shares or rights to access relief. ***[Schedule 5, item 10]***

8.57 There is no requirement for employment to continue after a 100 per cent takeover or corporate restructure in order for tax-upfront ESS participants to receive relief. In effect, relief is not conditional on a continuing employment relationship for tax-upfront shares or rights. ***[Schedule 5, item 9, subsection 139DR(2)]***

Example 8.14

> In 1998 Ben acquired shares under an ESS in his employer Bell Company and elected to pay tax upfront. Ben changed employers in 2004, but continued to hold shares in Bell Company in an employee share trust. In 2006 Bell Company is acquired by Whistle Company, and Ben is issued new shares in Whistle Company. Relief will be provided when Ben's new shares exit the employee share trust.

Refund of taxation on rights

8.58 When a new right to acquire a share, which is a continuation of an old right, is lost without having been exercised, and the company was, at the time the right was acquired, the employer of the ESS participant, the ESS participant is treated as never having acquired the right.

8.59 Subsection 139DD(2A) clarifies that a right is not lost if a new right is treated as a continuation of an old right. However, a right is lost

when a new right is lost without having been exercised. ***[Schedule 5, item 6, subsection 139DD(2A)]***

8.60 To access the refund of tax paid, the ESS participant must be employed by the company at the time that the right is issued. This has the same effect as the current law but the wording is changed to make the timing clearer. ***[Schedule 5, item 7, subsection 139DD(3)]***

Example 8.15

From Example 8.13, Maddi acquired rights to acquire shares in her employer Solar Company under an ESS, and paid tax upfront, but could only exercise the rights if Solar Company met a certain performance target.

Solar Company was subsequently taken over by Energy Company, and Maddi's rights to acquire shares in Solar Company were replaced with rights to acquire shares in Energy Company, with the same restrictions attached. Solar Company did not meet the performance target, and Maddi lost the rights to acquire shares in Energy Company without exercising them. Maddi is entitled to a refund of tax paid.

8.61 There is no requirement for employment to continue after a 100 per cent takeover or corporate restructure in order for an ESS participant with tax-deferred rights to receive relief. An ESS participant with tax-deferred rights who has ceased employment and subsequently loses the rights may be unfairly disadvantaged if relief is limited to only ESS participants with continuing employment. ***[Schedule 5, item 8, subsection 139DD(3B)]***

Example 8.16

From Example 8.13, Maddi's co-worker Catherine acquired rights to acquire shares under the same ESS, but deferred the payment of tax. The same restrictions applied, namely that she could only exercise the rights if Solar Company met a certain performance target. Catherine later ceased employment with Solar Company and paid tax on her rights but was not required to exercise them at that time.

Solar Company was subsequently taken over by Energy Company, and Catherine's rights to acquire shares in Solar Company were replaced with rights to acquire shares in Energy Company, with the same restrictions attached. Solar Company did not meet its performance target, and Catherine lost her rights in Energy Company without exercising them. Catherine, like Maddi, is also entitled to a refund of tax paid, even though she is not employed by Energy Company.

3-year holding requirement

8.62 The 3-year holding condition does not need to be satisfied in the event of a 100 per cent takeover or corporate restructure provided that the new shares or rights are treated as a continuation of the old shares or rights. ***[Schedule 5, items 4 and 5, subsections 139CE(1) and (3A)]***

Example 8.17

> From Example 8.14, if the new shares are treated as a continuation of the old shares, Melanie does not have to comply with the 3-year requirement to receive relief.

Interaction between Division 13A and the CGT provisions

Employee share trusts

8.63 When a new share or right, which is a continuation of an old share or right, is released from an employee share trust, any capital gain or loss made by a trustee or beneficiary is disregarded, provided certain conditions are met.

Example 8.18

> From Example 8.10, because the new share is treated as a continuation of the old share, Simon and the trustee do not have to pay CGT when the new share exits the trust.

Cost base

8.64 When an ESS participant is provided with new shares or rights that are treated as a continuation of old shares or rights, they are treated as a continuation for the purposes of the cost base choice described in paragraph 8.51. ***[Schedule 5, item 19]***

8.65 For a tax-upfront share or right acquired before 5.00 pm by legal time in the Australian Capital Territory on 27 February 2001, ESS participants have a choice whether the first element of the cost base of the new share or right is the market value of the old share or right at the time it was absolutely acquired, or the market value of the old share or right at the time it was beneficially acquired. ***[Schedule 5, item 19]***

Example 8.19

From Example 8.11, because her new shares are treated as a continuation, Nicola can elect whether to use the market value at the date of beneficial entitlement or the market value at the date of absolute entitlement as the first element of cost base for her shares.

Other CGT outcomes

8.66 For the purposes of the CGT 50 per cent discount (which requires that an asset be held for 12 months for the concession to be accessed), an ESS participant is treated as having acquired an ESS share at the time that they first acquired a beneficial interest in the share. A new share or right which is treated as a continuation of an old share or right is treated as having been acquired at the time the ESS participant first acquired a beneficial interest in the old share or right. ***[Schedule 5, item 13, subsection 115-30(1A)]***

8.67 Section 130-80 of the ITAA 1997 establishes the cost base treatment for tax-upfront shares and rights. The insertion of a new note into section 130-80 will clarify that new tax-upfront shares or rights issued to replace old tax-upfront shares or rights can be treated as a continuation. ***[Schedule 5, item 14, subsection 130-80(1)]***

8.68 As previously noted in paragraph 8.41, Subdivision 130-DA of the *Income Tax (Transitional Provisions) Act 1997* treats an ESS participant as having acquired a share or right at the time it was acquired by an employee share trust, if, at the time it was acquired by the trust, it was possible to determine that the share or right would later be provided to the ESS participant. This treatment will also apply to shares or rights which are treated as continuations of original shares or rights acquired by an employee share trust. ***[Schedule 5, item 16, subsection 130-80(4)]***

Application and transitional provisions

8.69 These amendments will apply to corporate restructures which occur on or after Royal Assent. ***[Schedule 5, item 20]***

Chapter 9
Allow the offsetting of a late payment of contributions against an employer's superannuation guarantee charge

Outline of chapter

9.1 Schedule 6 to this Bill amends the *Superannuation Guarantee (Administration) Act 1992* to allow the offsetting of a late payment of contributions against an employer's superannuation guarantee charge.

Context of amendments

9.2 Where an employer fails to meet its superannuation guarantee obligations by the due date, and subsequently pays the relevant contributions to a complying superannuation fund or retirement savings account, a double payment problem may occur. A superannuation guarantee charge liability still arises, which includes the full amount of any shortfall, even though contributions relating to the relevant period had subsequently been paid into an employee's superannuation fund or retirement savings account by the employer.

9.3 Where the relevant employee's employment is ongoing, the late contribution can be used as an advance payment in respect of that employee for a future contribution period. Where the employment is non-ongoing, the employer will effectively make contributions twice for that employee.

Summary of new law

9.4 The amendments introduce an offsetting rule so employers that make a late contribution to a complying superannuation fund or retirement savings account *after* the due date (the due date being 28 days from the end of the relevant quarter), can offset the late payment against the components of the superannuation guarantee charge liability that relate to the relevant

employee's entitlements. The late contribution must, however, be made before the end of the 28th day of the second month after the end of the quarter. Employee-related components of the superannuation guarantee charge are the individual superannuation guarantee shortfall and nominal interest components.

9.5 In order to access the offsetting rule, an employer must elect to do so by providing the Commissioner of Taxation (Commissioner) a completed 'approved form', within 4 years of the superannuation guarantee charge for the relevant quarter becoming payable. The employer must indicate to which quarter the payment relates. The election is irrevocable.

9.6 Amounts paid late into a complying superannuation fund or retirement savings account, and used to offset a resulting superannuation guarantee charge, will not be tax deductible. This is to ensure that employers who incur and correctly pay the superannuation guarantee charge to the Australian Taxation Office (ATO) by the superannuation guarantee statement due date, are not disadvantaged compared to those employers who make late contributions before the end of the 28th day of the second month after the end of the quarter and utilise the offset rule.

Comparison of key features of new law and current law

New law	***Current law***
A contribution paid late to a complying superannuation fund or retirement savings account before the end of the 28th day of the second month after the end of the quarter can be used to offset the employee related components of the corresponding superannuation guarantee charge. The offsetting contributions are not tax deductible.	A contribution paid late to a superannuation fund or retirement savings account after the due date (28 days after the end of the quarter), cannot be used to offset the employee related components of the corresponding superannuation guarantee charge. The employer will be liable for the entire superannuation guarantee charge, even though the late contribution has been paid.

Detailed explanation of new law

9.7 Schedule 6 to this Bill inserts section 23A which allows amounts paid to a superannuation fund or retirement savings account *after* the due

date (the due date being 28 days from the end of the relevant quarter), but before the end of the 28th day of the second month after the end of the quarter, to offset the corresponding superannuation guarantee charge. Employers must elect that this contribution be offset, in the approved form, within 4 years of the superannuation guarantee charge becoming payable. This election is irrevocable. ***[Schedule 6, item 5, subsections 23A(1) and (2)]***

9.8 Only amounts relating to the employee's individual superannuation guarantee shortfall and the employee's nominal interest component can be offset. The late contribution will be offset against the nominal interest component before any remainder is offset against the employer's individual superannuation guarantee shortfall for the employee for the quarter. Any amount used as an offset cannot be taken into account for any other quarter, or be used to reduce the charge percentage under sections 22 and 23 of the *Superannuation Guarantee (Administration) Act 1992*. ***[Schedule 6, item 5, subsections 23A(3) to (5)]***

Example 9.1

PLR Pty Ltd pays a superannuation contribution of $1,200 for its employee, Jennifer, after the due date, but before the end of the 28th day of the second month after the end of the quarter (payment made on 30 April for the March quarter). This late payment can offset PLR Pty Ltd's superannuation guarantee charge for the quarter for which the payment was late (March quarter). The superannuation guarantee charge (say $1,300) still arises, but the portion of the superannuation guarantee charge that relates to Jennifer's entitlements (shortfall of $1,200 and nominal interest of $80) can be offset to the extent of the amount of the late payment. Therefore, PLR Pty Ltd can offset the superannuation guarantee charge by $1,200 ($80 for the nominal interest first, then the remaining $1,120 can be used to offset the individual superannuation guarantee shortfall for Jennifer). PLR Pty Ltd would still be required to pay the remainder of the superannuation guarantee charge (remaining individual superannuation guarantee shortfall of $80, and administration of $20) to the ATO. The ATO will deposit the individual superannuation guarantee shortfall ($80) in Jennifer's superannuation fund or retirement savings account, and retain the administration component ($20).

9.9 Any amount of a late contribution made before the end of the 28th day of the second month after the end of the quarter, that is in excess of the employee's individual superannuation guarantee shortfall and nominal interest component for the relevant quarter, cannot be offset. Instead, this excess amount can be applied to the current quarter, or to a future quarter under subsection 23(7) of the *Superannuation Guarantee (Administration) Act 1992*.

Example 9.2

> In Example 9.1, if the amount of the late contribution had been $1,400, $1,280 of this could be used to offset PLR Pty Ltd's superannuation guarantee charge for the March quarter. The remaining $120 of the late contribution could be used as a contribution for the June quarter, or for any subsequent quarter beginning within 12 months of the date the contribution was made. PLR Pty Ltd would still be required to pay the $20 administration charge to the ATO.

9.10 The amendments will insert the definition of 'approved form' in subsection 6(1) of the *Superannuation Guarantee (Administration) Act 1992*, giving it the same meaning as in section 388-50 of the *Taxation Administration Act 1953*. ***[Schedule 6, item 4, subsection 6(1)]***

9.11 Penalties under Part 7 of the *Superannuation Guarantee (Administration) Act 1992* will apply to the full amount of the initial superannuation guarantee charge, before the effect of any offset under section 23A is taken into account. ***[Schedule 6, item 9, section 62A]***

Example 9.3

> In Example 9.1, any penalties under Part 7 will be applied to the full $1,300 superannuation guarantee charge, and not the amount remaining after the offset has been applied ($100).

9.12 Any amount offset under section 23A will not be deductible. ***[Schedule 6, items 1 and 2, sections 12-5 and 26-85]***

9.13 The due date for the lodgement of the superannuation guarantee statement will be extended, to align with the end of the additional offset period. This will reduce the likelihood of an employer lodging a superannuation guarantee statement, then subsequently making a contribution to an employee's fund that can be offset against the superannuation guarantee charge in that superannuation guarantee statement. This will simplify the administration of the offset rule for the ATO. It will also reduce complexity in the legislation, and will make the

system easier for employers to understand. ***[Schedule 6, items 3, 6, 7 and 8, subsections 5(3) and 33(1), paragraph 35(1)(d) and subsection 46(2)]***

9.14 As a result, the nominal interest charge in respect of the lodgement of the superannuation guarantee statement will be calculated up until the extended date. That is, nominal interest will be calculated until the 28th of the second month after the end of the quarter, instead of until the 14th as previously applied. Nominal interest is charged until the superannuation guarantee statement due date, even if the employer lodges the statement and makes the payment *before* the due date for the lodgement of the superannuation guarantee statement.

Application and transitional provisions

9.15 The amendments made by items 1, 2, 4, 5 and 9 apply to late payments of contributions made on or after 1 January 2006. The amendments made by items 3, 6, 7 and 8 of this Schedule apply to superannuation guarantee obligations relating to the quarter ending on 31 December 2005 and later quarters. ***[Schedule 6, item 10]***

Chapter 10
Applying superannuation guarantee to back payments of wages

Outline of chapter

10.1 Schedule 7 to this Bill amends the *Superannuation Guarantee (Administration) Act 1992* to clarify that mandatory employer contributions under the superannuation guarantee arrangements are payable on wages or salary paid in a quarter following the termination of an employment relationship.

Context of amendments

10.2 When calculating an individual shortfall under section 19 of the *Superannuation Guarantee (Administration) Act 1992*, there must be salary or wages paid by an employer to an employee. Therefore, in order for there to be a shortfall, and a liability to the superannuation guarantee charge, there must be an employer/employee relationship.

10.3 It is unclear under section 19 of the *Superannuation Guarantee (Administration) Act 1992* whether 'employee' includes former employee. If a former employee is not treated as an employee for the purposes of the *Superannuation Guarantee (Administration) Act 1992*, there cannot be a superannuation guarantee shortfall, and therefore, no superannuation guarantee charge liability. The result being that even though a payment would have formed part of the former employee's notional earnings base had it been paid in the quarter in which it was derived, if the payment is not made until a subsequent quarter, when the employment relationship had ceased, no superannuation guarantee obligation arises.

10.4 The Australian Taxation Office's (ATO) view of the law is that there is a superannuation guarantee obligation for employers that make payments of salary or wages to former employees. However, amendments are required to put the issue beyond doubt.

Summary of new law

10.5 The amendments to the *Superannuation Guarantee (Administration) Act 1992* clarify that salary or wages paid to former employees give rise to a superannuation guarantee obligation. This ensures employees do not lose superannuation entitlements as a result of being underpaid during their employment.

10.6 Former employees and former employers are deemed to be employees and employers (respectively), in those sections that deal with; the calculation of superannuation guarantee shortfalls, the reduction of the superannuation guarantee charge percentage by employers, and the distribution of any superannuation guarantee charge by the ATO.

10.7 The deduction provisions for superannuation contributions have been amended to ensure that employers are entitled to a deduction for compulsory superannuation contributions made for former employees under the *Superannuation Guarantee (Administration) Act 1992*, and for contributions made for 'superannuation guarantee employees' (as defined in section 12 of the *Superannuation Guarantee (Administration) Act 1992*).

Comparison of key features of new law and current law

New law	***Current law***
Employers have a superannuation guarantee obligation in respect of salary or wages paid to a former employee in a quarter following the termination of the employment relationship.	It is unclear whether employers have a superannuation guarantee obligation in respect of salary or wages paid to a former employee in a quarter following the termination of the employment relationship.

Detailed explanation of new law

10.8 These amendments insert section 15B of the *Superannuation Guarantee (Administration) Act 1992*, which ensures that Part 3 of that Act applies to former employees and former employers. ***[Schedule 7, item 17, section 15B]***

10.9 Part 3 raises the individual superannuation guarantee shortfall, which in turn raises the superannuation guarantee charge. Part 3 also allows employers to reduce their superannuation guarantee charge percentage, and therefore avoid the superannuation guarantee charge, by contributing to an employee's superannuation fund or retirement savings account by the superannuation guarantee due date.

10.10 These amendments insert subsection 63A(1A) of the *Superannuation Guarantee (Administration) Act 1992*, which ensures that Part 8 of that Act applies to former employees and former employers. Part 8 explains how the ATO is to distribute superannuation guarantee charge amounts (received from employers) amongst benefiting employees. ***[Schedule 7, item 18, subsection 63A(1A)]***

10.11 Amendments to subsection 82AAC(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) clarify that a deduction is allowed for contributions made for all superannuation guarantee employees. These amendments also ensure employers are entitled to a deduction for compulsory superannuation contributions made for former employees under the *Superannuation Guarantee (Administration) Act 1992*, to the extent that the contribution reduces the employer's superannuation guarantee charge percentage. ***[Schedule 7, item 1, subsection 82AAC(1)]***

10.12 Subsection 82AAF(1) of the ITAA 1936 has been amended to clarify that a deduction is allowed for deposits made for all superannuation guarantee employees under the *Small Superannuation Accounts Act 1995*. These amendments also ensure employers are entitled to a deduction for deposits made for former employees under the *Small Superannuation Accounts Act 1995*. The deduction for deposits for former employees is only allowable to the extent that the deposit reduces the employer's superannuation guarantee charge percentage. ***[Schedule 7, item 8, subsection 82AAF(1)]***

10.13 Subsections 82AAR(1), (2) and (4) of the ITAA 1936 have been amended to deny a deduction for contributions made to former employees or superannuation guarantee employees, except as stated in Subdivision AA of the ITAA 1936. ***[Schedule 7, items 12 and 13, subsections 82AAR(1), (2) and (4)]***

10.14 Other references to 'employee' in Subdivision AA of the ITAA 1936 have been changed to 'person', to ensure the related provisions apply to former employees and superannuation guarantee employees. ***[Schedule 7, items 2 to 7 and 9 to 11, subsections 82AAC(2) and (2A), paragraphs 82AAC(2A)(a) and (b), paragraph 82AAD(1)(a), section 82AADA, subsections 82AAF(2) and 82AAQ(1), paragraph 82AAQ(2)(a)]***

10.15 Similarly, references to 'employee' in section 26-80 of the *Income Tax Assessment Act 1997* have been changed to 'person', to ensure the related provisions apply to former employees and superannuation guarantee employees. ***[Schedule 7, items 14 to 16, paragraphs 26-80(2)(b), 26-80(4)(b), 26-80(5)(b) and 26-80(5)(c)]***

Application and transitional provisions

10.16 These amendments apply to payments made on or after the first day of the first full quarter after Royal Assent. ***[Schedule 7, item 20]***

10.17 These amendments are not to be taken to affect by implication the interpretation of a provision amended by this Schedule at a time before the commencement of this Schedule. ***[Schedule 7, item 19]***

Index

Schedule 1: Loss recoupment rules for companies etc.

Bill reference	*Paragraph number*
Items 1 and 2, sections 80B and 160ZNRA of the ITAA 1936; items 73 and 78, sections 165-208 and 165-250 of the ITAA 1997	3.9
Items 1 and 2, subsections 80B(8A) and 160ZNRA(1) of the ITAA 1936; item 73, subsection 165-208(1) of the ITAA 1997	3.5
Items 1 and 2, subsections 80B(8B) and 160ZNRA(2) of the ITAA 1936; item 73, subsection 165-208(2) of the ITAA 1997	3.5
Items 4 to 9, 13, 18, 22, 27, 31, 41, 53, 59, 63, 66, 80, 89 and 98	2.56
Item 7, section 36-25	3.55
Items 10 and 11, subsection 125-60(2) and subparagraph 125-60(3)(a)(i)	3.64
Items 12, 14, 19 to 21, 24 to 26, 28, 33, 35, 36, 40, 43 to 45, 52, 55, 62, 65, 67, 74, 75, 81, 90, 107, 108, 110, 113, 115, 119 to 132, 137, 138 and 140	2.57
Items 14, 28, 42, 54 and 113	1.165
Items 16, 29, 46, 49 and 57, subsections 165-12(6), 165-37(3), 165-115C(3), 165-115L(4) and 165-123(6)	3.43
Item 17, subsection 165-12(7A)	3.29
Items 23, 32, 34, 51, 64, 82 to 86, 92, 94 to 97, 99 to 101 and 105	3.65
Item 30, subsection 165-37(4A)	3.29
Items 37, 38, 77, 87, 88 and 104, subsections 165-96(1), 165-235(2), 175-40(1) and 180-5(2)	3.54
Items 39 and 90, subsections 165-96(1) and 175-40(2)	3.56
Item 47, subsection 165-115C(4A)	3.29
Item 50, subsection 165-115L(5)	3.29
Item 58, subsection 165-123(7A)	3.29
Item 68	3.50
Items 69 and 70	3.49
Item 71, subsection 165-202(1)	3.34
Item 71, subsection 165-202(2)	3.35
Item 71, section 165-203	3.38

Bill reference	***Paragraph number***
Item 72, subsection 165-207(2)	3.23
Item 72, subsection 165-207(3)	3.23
Item 72, subsection 165-207(4)	3.24
Item 73, section 165-209	3.51
Item 76, section 165-212A	1.28, 1.34
Item 76, subsection 165-212B(1)	2.18, 2.21
Item 76, paragraph 165-212B(2)(a)	2.22
Item 76, paragraph 165-212B(2)(b)	2.23
Item 76, section 165-212C	2.16
Item 76, subsection 165-212C(1)	2.25
Item 76, subsection 165-212C(2)	2.26
Item 76, subsection 165-212C(3)	2.28
Item 76, section 165-212D	3.21
Item 76, section 165-212E	3.17
Items 76 and 172, section 165-212A	2.10
Item 78, section 165-250	3.7
Item 78, subsection 165-255(1)	3.46
Item 78, subsection 165-255(2)	3.47
Item 79, section 166-3	1.7
Item 79, section 166-5	1.20, 1.23
Item 79, subsections 166-5(1), 166-20(1), 166-40(1) and 166-80(1) and section 166-220	1.12
Item 79, subsections 166-5(2) to (4)	1.24
Item 79, subsections 166-5(3), 166-20(2), 166-40(3) and 166-80(2)	1.21, 1.61
Item 79, subsection 166-5(5)	1.26
Item 79, subsection 166-5(6)	1.27
Item 79, sections 166-15, 166-35, 166-50 and 166-90	1.22
Item 79, section 166-20	1.20
Item 79, subsections 166-20(2) and (3)	1.40
Item 79, subsections 166-20(4) and (5)	1.43
Item 79, section 166-25	1.44
Item 79, section 166-40	1.20
Item 79, subsection 166-40(1)	1.45
Item 79, subsection 166-40(2)	1.47, 1.48
Item 79, subsection 166-40(3)	1.46, 1.47, 1.48

Bill reference	***Paragraph number***
Item 79, subsections 166-40(4) and (5)	1.49
Item 79, subsection 166-40(6)	1.50
Item 79, section 166-80	1.20
Item 79, subsection 166-80(1)	1.51
Item 79, subsections 166-80(2) and (3)	1.52
Item 79, subsections 166-80(4) to (6)	1.54
Item 79, section 166-135	1.20
Item 79, section 166-145	1.55
Item 79, subsection 166-145(2)	1.56
Item 79, subsection 166-145(3)	1.56
Item 79, subsection 166-145(4)	1.56
Item 79, subsection 166-145(5)	1.25
Item 79, section 166-165	1.58
Item 79, paragraphs 166-175(1)(a) and (2)(a)	1.62
Item 79, paragraphs 166-175(1)(b) and (2)(b)	1.62
Item 79, paragraphs 166-175(1)(c) and (2)(b)	1.62
Item 79, paragraphs 166-175(1)(d) and (2)(c)	1.62
Item 79, paragraph 166-175(1)(e) and subsection 166-175(2)	1.63
Item 79, section 166-225	1.65, 1.65
Item 79, paragraph 166-225(2)(c) and section 166-265	1.68
Item 79, subsections 166-225(3) and 166-255(3)	3.25
Item 79, section 166-230	1.65
Item 79, subsection 166-230(1)	1.72
Item 79, subsection 166-230(2)	1.73
Item 79, paragraph 166-230(2)(d)	1.76
Item 79, subsection 166-230(3)	1.80
Item 79, subsection 166-230(4)	1.81
Item 79, subsection 166-235(7)	1.70, 1.75
Item 79, section 166-240	1.65, 1.82
Item 79, subsection 166-240(4)	1.87, 1.94
Item 79, subsection 166-240(5)	1.88
Item 79, section 166-245	1.65
Item 79, subsection 166-245(1)	1.90
Item 79, paragraph 166-245(1)(b)	1.97
Item 79, subsection 166-245(2)	1.91

Bill reference	***Paragraph number***
Item 79, paragraph 166-245(2)(e)	1.92
Item 79, paragraphs 166-245(2)(e) and (3)(e)	1.104
Item 79, subsection 166-245(3)	1.18
Item 79, subparagraph 166-245(3)(a)(i)	1.98
Item 79, subparagraph 166-245(3)(a)(ii)	1.99
Item 79, paragraph 166-245(3)(b)	1.100
Item 79, paragraph 166-245(3)(c)	1.101
Item 79, paragraph 166-245(5)(b)	1.95
Item 79, subsection 166-245(6)	1.93
Item 79, section 166-255	1.65
Item 79, subsection 166-255(2)	1.108, 1.109
Item 79, subsection 166-255(3)	1.110
Item 79, section 166-260	1.65
Item 79, subsection 166-260(2)	1.114
Item 79, subsection 166-260(4)	1.115
Item 79, subsection 166-260(5)	1.111
Item 79, section 166-265	1.77, 1.85, 1.96
Item 79, section 166-270	1.130
Item 79, section 166-272	1.117
Item 79, subsection 166-272(2)	1.118
Item 79, subsections 166-272(3) to (6)	1.120
Item 79, subsections 166-272(8) and (11)	1.121
Item 79, subsection 166-272(9)	1.127
Item 79, section 166-275	1.134, 1.136
Item 79, subsection 166-280(1)	1.139
Item 79, subsection 166-280(2)	1.142
Items 79 and 151, paragraph 166-245(3)(d) and subsection 995-1(1)	1.103
Items 79 and 159, subsections 166-255(1) and 995-1(1)	1.107
Items 79 and 159, subsections 166-260(1) and 995-1(1)	1.113
Item 103, section 175-100	3.12
Item 133, paragraph 716-805(1)(a)	2.31
Item 133, paragraph 716-805(1)(b)	2.32
Item 133, subsection 716-805(2)	2.33
Item 133, subsection 716-805(3)	2.39

Bill reference	***Paragraph number***
Item 133, paragraph 716-805(4)(a)	2.45
Item 133, paragraph 716-805(4)(b)	2.42
Item 133, paragraph 716-805(4)(c)	2.44, 2.46
Items 142, 146, 150, 153, 154, 155, 157, 158 and 166	1.166
Item 148, section 995-1	1.17
Item, 156, subsection 995-1(1)	3.30
Items 162 and 163	1.167
Item 168, section 995-1	1.14, 1.16
Item 169	3.57
Item 170	3.62
Subitem 170(1)	1.150
Subitem 170(2)	1.163
Subitem 170(3)	1.164
Subitem 170(4)	1.151
Subparagraph 170(4)(a)(ii)	1.152
Subparagraph 170(4)(b)(ii)	1.153
Item 171	3.63
Subitem 172(1)	2.47
Paragraph 172(2)(a)	2.50
Paragraph 172(2)(b)	2.53
Item 173	3.61
Item 174	3.60
Item 175	3.59
Item 176	3.13, 3.58

Schedule 2: Foreign residents' income with an underlying foreign source

Bill reference	***Paragraph number***
Item 1, subsection 802-15(1)	5.34
Item 1, paragraph 802-15(1)(a)	5.15
Item 1, paragraph 802-15(1)(b)	5.15
Item 1, subsection 802-15(2)	5.15
Item 1, section 802-20	5.15
Item 1, paragraphs 802-20(1)(a) and (b)	5.77

Bill reference	***Paragraph number***
Item 1, paragraph 802-20(1)(c)	5.78, 5.79
Item 1, subsection 802-20(2)	5.81, 5.84
Item 1, subsection 802-20(3)	5.85
Item 1, subsection 802-20(4)	5.82
Item 1, subsection 802-20(5)	5.86
Item 1, section 802-25	5.17, 5.102
Item 1, subsection 802-30(1)	5.23
Item 1, subsection 802-30(2)	5.22, 5.31, 5.42
Item 1, paragraph 802-30(3)(a)	5.39, 5.71
Item 1, paragraph 802-30(3)(b)	5.40
Item 1, paragraph 802-30(3)(c)	5.41
Item 1, paragraph 802-30(4)(a)	5.43
Item 1, paragraph 802-30(4)(b)	5.43
Item 1, paragraph 802-30(4)(c)	5.48
Item 1, subsection 802-30(5)	5.49, 5.52
Item 1, subsection 802-30(6)	5.53
Item 1, subsection 802-30(7)	5.30
Item 1, paragraph 802-35(1)(a)	5.56
Item 1, paragraph 802-35(1)(b)	5.57
Item 1, paragraph 802-35(1)(c)	5.58
Item 1, paragraph 802-35(2)(a)	5.59
Item 1, paragraph 802-35(2)(b)	5.60
Item 1, paragraph 802-35(2)(c)	5.61
Item 1, subsection 802-35(3)	5.62
Item 1, section 802-40	5.64, 5.66
Item 1, section 802-45	5.68
Item 1, note to section 802-45	5.70
Item 1, subsection 802-50(1)	5.72
Item 1, subsection 802-50(2)	5.73
Item 1, section 802-55	5.88
Item 1, subsection 802-60(1)	5.90
Item 1, subsections 802-60(1) and (2)	5.91
Item 1, subsection 802-60(2)	5.90
Item 1, note to subsection 802-60(2)	5.93
Item 1, subsection 802-60(3)	5.90

Bill reference	***Paragraph number***
Item 1, subsection 802-60(4)	5.94
Items 2, 3 and 6, subsections 44(1) and 128B(1) of the ITAA 1936	5.120
Items 4, 5, 10 and 14, subsections 102AAW(1) and 121G(12) and subparagraph 159GZZZQ(4)(b)(i) of the ITAA 1936 and subparagraph 118-12(2)(a)(vi)	5.118
Items 7, 8, 9, 16 and 19 to 24, paragraph 128B(3)(gaa), section 128D and Subdivision B of Division 11A of Part III of the ITAA 1936, Subdivisions 717-J and 717-X and subsection 995-1(1)	5.117
Item 11, paragraph 202EE(1)(d) of the ITAA 1936	5.121
Item 12, section 11-55	5.122
Item 13, paragraphs 703-75(3)(c) and (d)	5.119
Item 15, section 715-875	5.103
Item 15, subsection 715-875(1)	5.105
Item 15, section 715-880	5.105
Item 17, subsection 995-1(1)	5.19
Item 18, subsection 995-1(1)	5.123
Item 25, subsection 288-80(1) of the *Taxation Administration Act 1953*	5.95
Item 25, paragraph 288-80(1)(c) of the *Taxation Administration Act 1953*	5.96
Item 25, subsection 288-80(2) of the *Taxation Administration Act 1953*	5.97
Item 25, subsection 288-80(3) of the *Taxation Administration Act 1953*	5.99
Item 25, definition of 'Australian membership interests' in subsection 288-80(3) of the *Taxation Administration Act 1953*	5.98
Item 25, subsection 288-80(4) of the *Taxation Administration Act 1953*	5.100
Item 25, definition of 'foreign membership interests' in subsection 288-80(4) of the *Taxation Administration Act 1953*	5.98
Item 26	5.106
Subitem 27(1)	5.108
Subitem 27(2)	5.109
Subitem 27(3)	5.110
Subitem 27(4)	5.111
Subitem 27(5)	5.112
Subitem 28(1)	5.113

Bill reference	Paragraph number
Subitem 28(2)	5.114
Subitem 28(3)	5.115
Subitem 28(4)	5.116

Schedule 3: Denying deductions for illegal activity

Bill reference	Paragraph number
Item 2, subsection 26-54(1)	6.8
Item 2, subsection 26-54(2)	6.13
Items 3 and 4	6.12

Schedule 4: Film copyright

Bill reference	Paragraph number
Item 1, paragraph 124PA(4)(b)	7.17
Item 2	7.16
Item 3, subsection 124UA(2)	7.15
Item 4, paragraph 40-70(2)(b)	7.9
Items 5 and 6, subsection 40-95(7)	7.8
Item 7, subsection 40-100(4)	7.10
Item 8, subsection 40-105(1)	7.11
Item 9, subsection 40-105(4)	7.12
Item 11, subsection 40-110(5)	7.13
Item 10, subsection 40-110(1)	7.19

Schedule 5: Employee share schemes

Bill reference	Paragraph number
Item 3, paragraph 26AAD(1)(a)	8.22
Item 3, paragraph 26AAD(1)(b)	8.22, 8.27
Item 3, paragraph 26AAD(1)(c)	8.22, 8.28, 8.29
Item 3, subsection 26AAD(2)	8.25, 8.26
Item 3, subsection 26AAD(3)	8.31

Bill reference	***Paragraph number***
Item 3, subsection 26AAD(4)	8.32
Item 3, subsection 26AAD(5)	8.33, 8.34
Item 3, subsection 26AAD(6)	8.39
Item 3, paragraph 26AAD(7)(a)	8.40
Item 3, paragraph 26AAD(7)(b)	8.40
Item 3, paragraph 26AAD(7)(c)	8.40
Item 3, subsection 26AAD(8)	8.35, 8.36, 8.37, 8.38
Items 4 and 5, subsections 139CE(1) and (3A)	8.62
Item 6, subsection 139DD(2A)	8.59
Item 7, subsection 139DD(3)	8.60
Item 8, subsection 139DD(3B)	8.61
Item 9, subsection 139DR(2)	8.57
Item 10	8.55, 8.56
Item 13, subsection 115-30(1A)	8.66
Item 14, subsection 130-80(1)	8.67
Item 15, subsection 130-80(3)	8.42
Item 16, subsection 130-80(4)	8.68
Items 17 and 18, subsections 130-95(3) and 130-110(5)	8.44
Item 19	8.64, 8.65
Item 20	8.69

Schedule 6: Superannuation guarantee charge

Bill reference	***Paragraph number***
Items 1 and 2, sections 12-5 and 26-85	9.12
Items 3, 6, 7 and 8, subsections 5(3) and 33(1), paragraph 35(1)(d) and subsection 46(2)	9.13
Item 4, subsection 6(1)	9.10
Item 5, subsections 23A(1) and (2)	9.7
Item 5, subsections 23A(3) to (5)	9.8
Item 9, section 62A	9.11
Item 10	9.15

Schedule 7: Superannuation on back payments

Bill reference	***Paragraph number***
Item 1, subsection 82AAC(1)	10.11
Items 2 to 7 and 9 to 11, subsections 82AAC(2) and (2A), paragraphs 82AAC(2A)(a) and (b), paragraph 82AAD(1)(a), section 82AADA, subsections 82AAF(2) and 82AAQ(1), paragraph 82AAQ(2)(a)	10.14
Item 8, subsection 82AAF(1)	10.12
Items 12 and 13, subsections 82AAR(1), (2) and (4)	10.13
Items 14 to 16, paragraphs 26-80(2)(b), 26-80(4)(b), 26-80(5)(b) and 26-80(5)(c)	10.15
Item 17, section 15B	10.8
Item 18, subsection 63A(1A)	10.10
Item 19	10.17
Item 20	10.16