2004-2005-2006-2007

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

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# TAX LAWS AMENDMENT (2007 MEASURES No. 4) BILL 2007

# TAXATION (TRUSTEE BENEFICIARY NON-DISCLOSURE TAX) BILL (No. 1) 2007

# TAXATION (TRUSTEE BENEFICIARY NON-DISCLOSURE TAX) BILL (No. 2) 2007

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EXPLANATORY MEMORANDUM

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

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# 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 |
| DGR | deductible gift recipient |
| FBT | fringe benefits tax |
| GST | goods and services tax |
| Inoperative Provisions Act | *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006* |
| ITAA 1936 | *Income Tax Assessment Act 1936* |
| ITAA 1997 | *Income Tax Assessment Act 1997* |
| MDO | medical defence organisation |
| OECD | Organisation for Economic Co-operation and Development |
| PAYG | pay as you go |
| RSA | retirement savings account |
| SCT | Superannuation Complaints Tribunal |
| SG | superannuation guarantee |
| TAA 1953 | *Taxation Administration Act 1953* |
| TFN | tax file number |
| UK | United Kingdom of Great Britain and Northern Ireland |
| US | United States of America |

# General outline and financial impact

## New foreign income tax offset rules

Schedule 1 to this Bill amends the income tax law to abolish foreign loss and foreign tax credit quarantining and to streamline the remaining foreign tax credit rules. This is achieved by repealing the existing foreign loss and foreign tax credit quarantining rules and replacing them with new simplified foreign income tax offset rules. These rules allow taxpayers to claim relief for foreign income taxes paid on an amount included in their assessable income. These amendments also include transitional rules for the treatment of existing quarantined foreign losses and credits.

These amendments provide a systemic mechanism to allow the Commissioner of Taxation to give effect to Australia's tax treaty obligations to provide relief from economic double taxation arising from transfer pricing adjustments.

Further, certain taxpayers operating within the foreign investment fund rules will be given the option to calculate attributable income using the controlled foreign company rules. The current treatment of a foreign company, as an Australian financial institution subsidiary, will be extended to subsidiaries of Australian financial institutions that choose to calculate foreign investment fund income using the controlled foreign company rules.

***Date of effect***: These changes will apply to income years beginning on or after the 1 July following Royal Assent.

***Proposal announced***: This measure was announced in the Treasurer's Press Release No. 044 of 10 May 2005.

***Financial impact***: The cost to revenue of this measure is expected to be $40 million per annum over the forward estimates period.

***Compliance cost impact***: These amendments will reduce ongoing compliance costs for taxpayers that conduct foreign business or earn foreign income. There will be some transitional costs, however, it is expected these will be quickly exceeded by the ongoing benefits.

## Capital gains tax roll-over for medical defence organisations

Schedule 2 to this Bill amends the *Income Tax Assessment Act 1997* to provide a capital gains tax (CGT) roll-over for membership interests in medical defence organisations (MDOs). The roll-over will generally be available when a membership interest in an MDO is replaced with a similar membership interest in another MDO and both MDOs are companies limited by guarantee.

***Date of effect***: These amendments apply to CGT events that happen on or after 14 February 2007.

***Proposal announced***: These amendments were announced in the Minister for Revenue and Assistant Treasurer's Press Release No. 011 of 14 February 2007.

***Financial impact***: Nil.

***Compliance cost impact***: These amendments are expected to have a low impact for both implementation and ongoing compliance costs.

## Investment in instalment warrants by superannuation funds

Schedule 3 to this Bill amends the borrowing restriction contained in the *Superannuation Industry (Supervision) Act 1993* to allow superannuation funds to invest in instalment warrants of a limited recourse nature over any asset a fund would be permitted to invest in directly.

The in-house asset rules contained in the *Superannuation Industry (Supervision) Act 1993* are also amended to provide that an investment in a related trust forming part of an eligible instalment warrant arrangement will only be an in-house asset where the underlying asset would itself be an in-house asset of the fund if it were held directly.

***Date of effect***: These amendments will apply from the day this Bill receives Royal Assent.

***Proposal announced***: This measure was announced in the Minister for Revenue and Assistant Treasurer's Press Releases No. 078 of 3 November 2006 and No. 066 of 22 May 2007.

***Financial impact***: This measure will have these revenue implications:

| ***2006-07*** | ***2007-08*** | ***2008-09*** | ***2009-10*** |
|---|---|---|---|
| –$50m | –$90m | –$100m | –$110m |

***Compliance cost impact***: Minimal.

## Trustee beneficiary reporting rules

Schedule 4 to this Bill amends the *Income Tax Assessment Act 1936* (ITAA 1936) so that trustees of closely held trusts are not required to report to the Commissioner of Taxation (Commissioner) the details of the ultimate beneficiaries of trust income. Instead, trustees of closely held trusts may be required to report the details of trustee beneficiaries that are presently entitled to certain income of the trust and tax-preferred amounts.

Trusts that are covered by a family trust election, or an interposed entity election, or wholly-owned by a family trust are not covered by these trustee beneficiary reporting requirements. These trusts are restricted in the range of beneficiaries they can distribute to without penalty tax. Any distributions outside the family group are subject to penalty tax at a rate of 46.5 per cent via the family trust distribution tax. Therefore, it is not necessary to include family trusts (or their related trusts) in these reporting rules. The Commissioner already has an avenue for obtaining information about these trusts and their beneficiaries. In addition, any distributions by these trusts to non-resident trustee beneficiaries will be subject to taxation at 45 per cent under subsection 98(4) of the ITAA 1936.

The trustee of a closely held trust must report to the Commissioner the tax file number and name of resident trustee beneficiaries that are presently entitled to a share of the income or a tax-preferred amount, together with details of the share within a specified period after the end of the year of income. For non-resident trustee beneficiaries the trustee of a closely held trust will have to disclose the name and address of the trustee beneficiary and details of the share of net income or tax-preferred amount, except for net income that is subject to taxation under subsection 98(4) of the ITAA 1936 or Subdivision 12-H in Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953).

The Commissioner may make a determination that a specified class of trustees is not required to make a correct trustee beneficiary statement annually in certain circumstances.

Where the trustee of the closely held trust fails to correctly identify the trustee beneficiaries within the specified period, the trustee is liable for trustee beneficiary non-disclosure tax at the rate of 46.5 per cent (in respect of the share of net income). For tax-preferred amounts such a failure may produce offences under the TAA 1953.

***Date of effect***: These amendments will apply to the first income year starting on or after the day on which this Bill receives Royal Assent and later income years.

***Proposal announced***: This measure was announced in the Treasurer's Press Release No. 039 of 9 May 2006.

***Financial impact***: The overall cost to revenue of these amendments is unquantifiable but expected to be minimal against the forward estimates.

***Compliance cost impact***: These amendments will reduce ongoing compliance costs for trustees of closely held trusts that are required to report, although there will be a small transitional cost.

## Summary of regulation impact statement

### Regulation impact on business

***Impact***: The trustee beneficiary rules will reduce compliance costs for trustees of closely held trusts by removing the requirement to trace amounts through a chain of trusts to the ultimate beneficiary.

***Main points***:

- Trustees of closely held trusts are generally required to report the details of trustee beneficiaries that are entitled to certain income of the trust and tax-preferred amounts, therefore reducing costs in having to trace amounts to the ultimate beneficiary.

- Where a trustee of the closely held trust fails to disclose the details of a trustee beneficiary, the trustee will be liable to trustee beneficiary non-disclosure tax. The integrity of the tax system will therefore be maintained.

- This measure will reduce ongoing compliance costs for trustees and beneficiaries when compared with the costs imposed under the existing ultimate beneficiary rules. This should lead to a reduction in recordkeeping, information collection and planning effort.
- This measure is expected to have benefits for the Australian Taxation Office in terms of administration as it should reduce the volume of paperwork required to be collected.

## Superannuation amendments

Schedule 5 to this Bill amends various Acts to assist in the smooth transition to the *Simplified Superannuation* regime. This Schedule limits strategies which could circumvent the minimum drawdown requirements for account-based pensions, facilitates the provision of tax file numbers (TFNs) to superannuation and retirement savings account (RSA) providers, and revises the application provision for small business capital gains tax relief under the regime. The readability of provisions rewritten as part of the reforms is also further improved to ensure the policy intent underpinning the provisions is clear.

***Date of effect***: *Simplified Superannuation* commences on 1 July 2007. However, an individual's TFN is taken to have been quoted by the individual, for notices given to superannuation and RSA providers by the Commissioner of Taxation, from 1 June 2007.

***Proposal announced***: These amendments have not previously been announced.

***Financial impact***: The amendments to prevent individuals circumventing the minimum drawdown requirements for account-based pensions will result in a revenue gain of $20 million over the forward estimates.

| ***2007-08*** | ***2008-09*** | ***2009-10*** | ***2010-11*** |
| --- | --- | --- | --- |
| $4m | $5m | $5m | $6m |

The other amendments have no financial impact.

***Compliance cost impact***: These amendments are expected to have a small impact on compliance costs.

## Deductible gift recipients

Schedule 6 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to update the list of deductible gift recipients (DGRs).

***Date of effect***: Deductions for gifts to the following organisations that are listed as DGRs under this Schedule, apply as follows:

- Australian Peacekeeping Memorial Project Incorporated from 30 April 2007 until 31 December 2008; and
- Social Ventures Australia Limited from 4 May 2007.

In addition, this Schedule reflects a name change of one organisation (listed as a DGR under section 30-55 of the ITAA 1997) to Mawson's Huts Foundation Limited.

***Proposal announced***: The deductibility of gifts to the Australian Peacekeeping Memorial Project Incorporated was announced in the Minister for Revenue and Assistant Treasurer's Press Release No. 040 of 30 April 2007.

The deductibility of gifts to Social Ventures Australia Limited was announced in the Minister for Revenue and Assistant Treasurer's Press Release No. 043 of 4 May 2007.

***Financial impact***: This measure will have these revenue implications:

| ***2007-08*** | ***2008-09*** | ***2009-10*** | ***2010-11*** | ***2011-12*** |
|---|---|---|---|---|
| –$0.62m | –$2.4m | –$2.2m | –$2.3m | –$2.3m |

***Compliance cost impact***: Nil.

## Minor amendments

Schedule 7 to this Bill makes technical corrections and other minor amendments to the taxation laws. These amendments are part of the Government's ongoing commitment to improve the quality of the taxation laws.

***Date of effect***: These corrections, amendments and improvements generally commence from Royal Assent to this Bill but some apply prospectively or retrospectively.

***Proposal announced***: These amendments have not previously been announced.

***Financial impact***: The change in the definition of 'tertiary course' in the *A New Tax System (Goods and Services Tax) Act 1999* results in a small reduction in income tax collections because it allows a deduction for gifts to funds for scholarships for masters or doctoral courses. This change results in no change in goods and services tax revenue.

The change in the car depreciation rate in the *Fringe Benefits Tax Assessment Act 1986* is expected to result in a gain to revenue as follows:

| ***2007-08*** | ***2008-09*** | ***2009-10*** | ***2010-11*** | ***2011-12*** |
|---|---|---|---|---|
| Nil | $4m | $8m | $9m | $8m |

The change in the capital gains tax treatment of 'not-for-profit' mutuals in the *Income Tax Assessment Act 1997* is a revenue protection measure. As such, the revenue impact is zero but there would be a potential revenue loss if the amendment were not made.

The other amendments have no financial impact.

***Compliance cost impact***: Nil to small.

## Increasing flexibility for family trusts

Schedule 8 to this Bill amends the trust loss regime in Schedule 2F to the *Income Tax Assessment Act 1936* (ITAA 1936) to allow family trust elections and interposed entity elections to be revoked or varied in certain limited circumstances.

These amendments also broaden the definition of 'family' in section 272-95 in Schedule 2F to the ITAA 1936 to include lineal descendants of family members. In addition, spouses, former widows/widowers and former step-children are exempted from the family trust distribution tax by including them in the definition of 'family group' in section 272-90 in Schedule 2F to the ITAA 1936.

***Date of effect***: The changes take effect from the start of the income year in which this Bill receives Royal Assent.

***Proposal announced***: This measure was announced in the 2006-07 Budget and the Treasurer's Press Release No. 039 of 9 May 2006.

***Financial impact***: This measure will have these revenue implications:

| ***2006-07*** | ***2007-08*** | ***2008-09*** | ***2009-10*** |
|---|---|---|---|
| Nil | –$8m | –$8m | –$8m |

***Compliance cost impact***: These amendments will result in minimal impact for both implementation and ongoing compliance costs.

# Chapter 1
# New foreign income tax offset rules

## Outline of chapter

1.1 Schedule 1 to this Bill inserts Division 770 into the *Income Tax Assessment Act 1997* (ITAA 1997).

1.2 This Schedule:

- outlines the operation of the new foreign tax offset provisions, which allow taxpayers to claim relief — in the form of a tax offset — for foreign income tax paid on an amount included in their assessable income;
- repeals Divisions 18, 18A and 19 and sections 79D, 79DA, 424 and 430 of the *Income Tax Assessment Act 1936* (ITAA 1936); and
- repeals and amends various other provisions in the ITAA 1936 and the ITAA 1997.

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

## Context of amendments

1.4 The decision to remove the quarantining of foreign losses and foreign tax credits emanates from the Board of Taxation's report to the Government on international taxation (*International Taxation,* 28 February 2003). The Government conducted a *Review of International Taxation Arrangements* to address the issues identified by the Board of Taxation. After consultation with the business community, it was acknowledged that the quarantining of foreign losses and foreign tax credits could no longer be justified.

1.5 The foreign tax credit and foreign loss quarantining rules formed part of the tax reforms introduced in 1986 and were justified on the basis of protecting Australia's tax base. As foreign source income became generally assessable, the foreign tax credit system provided relief from double tax. In particular, a credit was allowed for foreign income tax paid

on an amount of foreign income included in assessable income. This credit was capped at the *lesser* of the Australian tax that would be payable on the foreign income *or* the actual foreign tax paid. Relief in excess of the foreign tax credit cap is not double tax relief and in such a situation, Australian revenue would effectively be subsidising the tax base of (generally high taxing) foreign countries.

1.6 The original justification to quarantine foreign tax credits was to protect the integrity of the foreign tax credit cap. In the event that a taxpayer had paid foreign tax over and above the Australian tax liability, excess credits were generated and could not be utilised. Without quarantining, it would be possible to move mobile income to a low-foreign-tax jurisdiction to soak up any excess foreign tax generated on the high-foreign-taxed (generally active) foreign income. This would be inconsistent with the intent of the foreign tax credit system, which was to provide relief to the extent that Australian residents would otherwise be subject to double, and excessive, taxation.

1.7 It was also felt necessary to implement rules quarantining foreign losses from domestic income, otherwise the foreign loss could be used to decrease Australian tax payable on Australian source income. The quarantining of foreign losses from domestic assessable income was further justified on the basis of a tax asymmetry that existed at the time. The asymmetry allowed taxpayers — mining companies in particular — to circumvent their Australian tax liability. A foreign branch would be established to conduct operations in a foreign jurisdiction. Due to the exploratory nature of mining companies, foreign losses would be generated in the start-up years and would be deducted from domestic income. When profitable, the taxpayer would incorporate the branch into a foreign company, allowing the profits to accumulate offshore, avoiding Australian tax. The foreign loss quarantining rules guarded against the exploitation of this tax asymmetry.

1.8 Different classes of foreign losses ensured that mobile income could not be moved offshore to utilise active foreign losses. Similarly, such classes for foreign tax credit purposes prevented taxpayers moving mobile income offshore to soak up losses generated from foreign (generally active) operations.

1.9 A number of circumstances were recognised as supporting the removal of the foreign loss and foreign tax credit quarantining rules. Recent changes to expand the active income exemption for foreign branches owned by resident companies had the effect of removing almost all active foreign income from Australia's tax base. With active income exempt, the propensity to generate active losses (as well as foreign tax credits on active income) diminishes. The expansion of the non-portfolio dividend exemption in 2004, together with the introduction of the capital

gains exemption for disposals of non-portfolio interests in foreign active-business companies, resulted in the reduction of some creditable foreign taxes. Further, modifications made to Australia's thin capitalisation laws in 2001 were responsible for carving out debt deductions from foreign income deductions (allowing them to be applied against domestic assessable income) thereby reducing the potential for foreign losses to be generated.

1.10 The shift in Australia, since 1986, towards a participation exemption system removes the tax asymmetries that once prompted the need for the quarantining of foreign losses and foreign tax credits. The risks to Australia's tax base have diminished, reducing the need to have complex rules that quarantine foreign losses from Australian assessable income and divide foreign tax credits into different classes of assessable foreign income.

1.11 The decision to abolish foreign loss and foreign tax credit quarantining, announced by the Treasurer in Press Release No. 044 of 10 May 2005, prompted a review of the remaining complexity in the foreign tax credit rules. Consistent with Government practice to reduce complexity and the cost of complying with the tax law, the legislation is being rewritten as part of the ITAA 1997.

1.12 The new foreign tax offset rules will provide greater certainty to taxpayers and will reduce compliance and administration costs through:

- the abolition of foreign loss and foreign tax credit quarantining;
- the inclusion of a $1,000 *de minimis* cap; and
- the removal of attributed tax accounts.

1.13 The changes will assist small and medium enterprises looking to expand offshore, by removing the need to implement systems to perform the tracking and collection of different classes of income, deductions and taxes when they try to penetrate a foreign market. The new rules will improve the relative attractiveness of Australia as a destination for international capital. The regional headquarters of a foreign group will no longer need to establish and maintain costly systems to comply with the redundant quarantining rules.

1.14 The changes in this Schedule also enhance the competitiveness and reduce the compliance costs of Australian based managed funds. The removal of quarantining will assist Australians in using Australian managed funds to diversify their investments overseas. It will also

improve the competitiveness of Australian managed funds in attracting the management of funds from other countries.

1.15 The rewrite of the foreign tax credit rules also facilitated a review of the way correlative relief was provided for economic double taxation arising from a transfer pricing adjustment made by another country. In particular, the Government has taken the opportunity to align Australia's correlative relief practice more closely to that of the Organisation for Economic Co-operation and Development (OECD). This change will reduce the administrative costs confronting the Australian Taxation Office (ATO) and will advantage taxpayers, alleviating double taxation directly by adjusting taxable income.

1.16 Finally, with the removal of credits for underlying foreign taxes, an option has been introduced, as part of this Schedule, for certain taxpayers operating within the foreign investment fund rules to calculate attributable income using the controlled foreign company rules. This will give those taxpayers access to branch-equivalent calculations, the active income test and certain exemptions and modifications that apply within those rules.

1.17 Related to this option, a further change will effectively extend the current treatment of a foreign company, as an Australian financial institution subsidiary, to subsidiaries of Australian financial institutions that choose to calculate foreign investment fund income using the controlled foreign company rules. This will further encourage the expansion of the Australian banking industry into emerging offshore markets and ensure that certain income of the foreign financial intermediary business is treated as active, thereby reducing the extent of attribution under the current rules.

## Summary of new law

1.18 Taxpayers will be entitled to a non-refundable tax offset for foreign income tax paid on an amount included in assessable income (a 'double-taxed amount'). This offset effectively reduces the potential Australian tax that would be payable on double-taxed amounts. The potential Australian tax will be reduced by the amount of the foreign income tax already paid on those double-taxed amounts or reduced to zero where the foreign income tax paid exceeds the potential Australian tax payable.

1.19 Entitlement to a tax offset will arise for taxpayers in the year an amount on which foreign income tax has been paid is included in their assessable income. It is not necessary for the taxpayer to pay the foreign income tax in the same income year that the amount is included in assessable income. To ensure the usual amendment periods do not restrict a taxpayer's right to claim double tax relief, the taxpayer will have four years from the time foreign income tax is paid in which to claim an offset.

1.20 In ascertaining the amount of foreign tax offset, taxpayers will no longer be required to quarantine assessable foreign income amounts into four separate classes. Rather, a taxpayer can combine all assessable foreign income amounts when working out a tax offset entitlement, allowing the taxpayer a greater averaging capacity than under the old foreign tax credit rules. This greater averaging capacity will minimise the amount of foreign income tax that goes unrelieved. Consequently, the mechanism allowing the carry-forward of excess foreign income tax will be removed.

1.21 Economic double taxation arising as a result of a transfer pricing adjustment by another country will no longer be remedied with a foreign tax credit. Australia will adopt OECD practice and allow the Commissioner of Taxation (Commissioner) to adjust the taxpayer's taxable income (or tax loss) in the event of a transfer pricing adjustment in the other country, so as to relieve potential double taxation.

1.22 Double tax relief, in the form of a foreign tax offset, will continue to be available for taxpayers using the foreign investment fund calculation method to ascertain their attributable income where the attributable taxpayer holds a direct interest in the foreign investment fund (the first-tier foreign investment fund company or trust).

1.23 A foreign tax credit will no longer be available for foreign tax paid by a second-tier foreign investment fund company or trust. This change is in line with the broad objective of these new rules to provide an offset only for foreign income taxes paid on the distribution of profits of the foreign company or trust (usually a withholding tax), which comprise amounts included in a taxpayer's assessable income. The removal of this credit for second-tier foreign investment funds using the calculation method will effectively leave the Australian taxpayer with a deduction for the foreign taxes paid.

1.24 To mitigate the impact of this change, a further option is included within the foreign investment fund rules. In calculating the income attributed to a taxpayer from a foreign investment fund that is a company, certain taxpayers will have an opportunity to use the controlled foreign company rules to calculate attributable income.

1.25 Taxpayers with previously attributed income will no longer be entitled to claim relief for the underlying foreign taxes paid on the distribution. They will, however, be able to offset, without limitation, the final withholding tax on the distribution (ie, the direct foreign income tax on the distribution).

1.26 Excess foreign income deductions — foreign losses — will no longer be quarantined from domestic assessable income (or from assessable foreign income of a different class). Resident taxpayers will no longer be required to make an election to offset domestic losses against assessable foreign income. Therefore, in utilising deductions, no distinction is made in respect of the source of the assessable income, whether foreign or domestic. A taxpayer combines both foreign and domestic deductions. Where the combined deductions exceed assessable income, the excess is a tax loss and applied against assessable income of a future income year.

1.27 Taxpayers that earn attributed income through controlled foreign companies will no longer quarantine revenue losses into separate classes. However, controlled foreign company losses will continue to be quarantined in the entity that incurred them.

1.28 These amendments will apply from income years, statutory accounting periods and notional accounting periods starting on or after the 1 July following Royal Assent. A taxpayer's excess foreign tax credits from earlier years or prior-year overall foreign losses that exist at commencement will be treated in accordance with the transitional rules. In particular, a taxpayer will amalgamate and convert existing excess foreign tax credits from the four classes of assessable foreign income into pre-commencement excess foreign income tax. Utilisation of pre-commencement excess foreign income tax will then be subject to the limits calculated under the new foreign tax offset rules.

1.29 Generally, overall foreign losses for a particular earlier income year will be grouped together and converted to a tax loss. Utilisation of the converted tax loss will be restricted for the first four years after commencement. Subsequent to the transitional period, any remaining tax loss will be subject to the ordinary loss utilisation rules.

## Comparison of key features of new law and current law

| *New law* | *Current law* |
|---|---|
| Both Australian and foreign resident taxpayers are entitled to claim a tax offset for an amount included in the taxpayer's assessable income on which they have paid foreign income tax (a 'foreign tax offset').<br>An exception applies for certain residence-based foreign income taxes of foreign residents. | A foreign tax credit is available if the assessable income of a resident taxpayer includes foreign income in respect of which the taxpayer has paid foreign income tax.<br>Foreign tax credit entitlement arises for foreign residents only in respect of certain foreign film income. |
| Foreign tax offsets are determined on a whole-of-income basis and *not* on a class of income basis. | The entitlement to a foreign tax credit and the amount of the credit is determined separately for four classes of foreign income.<br>The classes of foreign income are:<br>• passive income;<br>• offshore banking income;<br>• an amount included in assessable income under section 307-50; and<br>• other income. |
| A tax offset is only available for foreign income tax paid on an amount included in assessable income. | A foreign tax credit is only available for foreign tax paid on assessable foreign income. |
| Foreign income tax is a tax imposed by a law, other than an Australian law, on income profits or gains.<br>The taxpayer must have paid the foreign income tax before an offset is available. An offset will not be available for credit absorption taxes or unitary taxes.<br>The taxpayer is deemed, in some circumstances, to have paid the foreign income tax when in fact it has been paid by someone else — for example, a spouse, trustee, partnership or foreign company — or if the foreign income tax has been withheld from the income at its source. | Foreign tax is a tax imposed by a law of a foreign country on income, profits or gains (excluding credit absorption taxes and unitary taxes).<br>The taxpayer must have paid *and have been personally liable* for the foreign tax before credit entitlement accrues.<br>The taxpayer is deemed, in some circumstances, to have paid *and have been personally liable* for the foreign tax when in fact it has been paid by someone else — for example, a spouse, trustee, partnership or foreign company — or if the foreign tax has been withheld from the income at its source. |

| ***New law*** | ***Current law*** |
|---|---|
| Foreign income tax paid on assessable offshore banking income is reduced by the offshore banking eligible fraction (one-third) before being eligible for relief. | No equivalent. |
| No equivalent. | Foreign tax paid on an amount assessed under section 305-70 is reduced by the fraction that the assessable amount bears to the gross payment. |
| No equivalent. | Foreign tax paid is reduced proportionately where the taxpayer could have elected (under the laws of the foreign country) to have the tax liability determined on an assessment basis. |
| The amount of the tax offset equals the sum of each amount of eligible foreign income tax paid, subject to a limit (or 'cap').<br>The foreign tax offset cap is based on the amount of Australian tax payable on the double-taxed amounts and other assessable income amounts that do not have an Australian source. | The amount of foreign tax credit is equal to the lesser of the foreign tax paid (reduced by any relief granted by the foreign jurisdiction) and the Australian tax payable in respect of the foreign income, profit or gain (the 'foreign tax credit cap').<br>Australian tax payable is calculated by applying the average rate of Australian tax of the taxpayer to the adjusted net foreign income of the taxpayer and deducting from this, the sum of any rebates that relate exclusively to the foreign income. |
| The taxpayer does not need to calculate the foreign tax offset cap if they elect to use the $1,000 *de minimis* cap. In this case, they cannot claim more than $1,000 of foreign income tax. | No equivalent. |

| *New law* | *Current law* |
| --- | --- |
| A tax offset is available for the foreign income tax paid on amounts not assessable under section 23AI or 23AK of the ITAA 1936 — that is, the distribution is made out of previously attributed income. The offset is limited to the foreign income tax paid on the distribution (normally the *final foreign income tax levied*). The foreign tax paid at the attribution stage will not reduce the amount of the offset. | A credit is available for the foreign income tax paid on amounts not assessable under section 23AI or 23AK of the ITAA 1936. The credit is the foreign income tax paid on the distribution (normally the *direct foreign income tax*) as well as any *underlying foreign income tax* deemed paid with a reduction for the foreign tax paid at the attribution stage. |
| A tax offset is allowed for foreign income tax, Australian income tax and Australian withholding taxes paid by a *foreign company* where an amount is attributed under the controlled foreign company provisions in Part X of the ITAA 1936 or the foreign investment fund provisions in Part XI of the ITAA 1936 (under the calculation method).<br>If the attributable taxpayer is an Australian company it must have an *attribution percentage* of 10 per cent or more in the foreign company. | A credit is allowed for foreign and Australian taxes paid by a foreign company where an amount is attributed under the controlled foreign company provisions in Part X or the foreign investment fund provisions in Part XI of the ITAA 1936 (under the calculation method).<br>If the attributable taxpayer is an Australian company, it must be *related* to the foreign company. |
| Taxpayers using the foreign investment fund calculation method to determine attributable income are only entitled to a tax offset for the foreign income tax, Australian income tax and Australian withholding tax paid by the foreign company or trust in which the taxpayer holds a direct interest (the first level foreign investment fund company or trust). | Taxpayers using the foreign investment fund calculation method to determine attributable income are entitled to a credit for foreign and Australian taxes paid by the first level foreign investment fund company or trust. A credit is also available for foreign and Australian taxes paid by a foreign company or trust in which that first level fund holds a direct interest (the second level foreign investment fund). |

| ***New law*** | ***Current law*** |
|---|---|
| Certain taxpayers using the foreign investment fund calculation method to determine income to be attributed from a foreign company will have a further choice (within that method) to calculate that income using the controlled foreign company rules.<br>These taxpayers will then have access to full branch-equivalent calculations, the active income test and exemption. The income will still be attributed under Part XI of the ITAA 1936, thereby maintaining access to the tax offset for income attributed under Part XI of the ITAA 1936. | No equivalent. |
| There is no carry-forward of excess foreign income tax for use in a later year. An exception applies to excess foreign tax pertaining to the five years prior to commencement of the new rules. | Where foreign tax is in excess of the foreign tax credit cap for each class of assessable foreign income, that excess may be carried forward for five years. The excess foreign tax can only be used where the foreign tax credit cap in a later year (for the same class of assessable foreign income) is greater than the foreign tax paid on that class of income. |
| A foreign tax offset forms part of an assessment and the taxpayer has four years from the time foreign income tax is paid (or, if subsequently adjusted, from that time) to amend an assessment. | A foreign tax credit does not form part of an assessment. A taxpayer or the Commissioner may amend a foreign tax credit determination within four years from the original date of the determination, unless the amendment is to correct an error in calculation or a mistake in fact. |

| *New law* | *Current law* |
|---|---|
| Foreign losses are no longer quarantined from domestic income or from other foreign losses of a different class. A taxpayer is no longer required to elect to apply domestic losses against foreign income. There is no distinction between a foreign loss and a domestic loss for the purpose of calculating taxable income.<br>A transitional rule applies in relation to existing foreign losses. | Foreign losses are quarantined from domestic income and the amount of the loss is determined separately for four classes of assessable foreign income.<br>The classes of income for foreign loss purposes are:<br>• interest income;<br>• modified passive income;<br>• offshore banking income; and<br>• all other assessable foreign income.<br>Domestic losses can only be applied against foreign income at the taxpayer's election. |
| Controlled foreign company losses continue to be quarantined in the entity that incurred them but are no longer quarantined on a class of income basis. | Controlled foreign company losses are quarantined in the same classes as for Australian resident taxpayers.<br>Controlled foreign company losses are also quarantined in the entity that incurred them. |
| The Commissioner has the discretion to adjust the taxable income or tax loss of a resident taxpayer to remove the incidence of double taxation as a result of a transfer pricing adjustment by another country. | A Division 19 (Part III of the ITAA 1936) foreign tax credit is available to a resident taxpayer for foreign tax paid by an associated foreign entity as a result of a transfer pricing adjustment by another country. |

## Detailed explanation of new law

### Tax offset for foreign income tax paid on amounts included in assessable income — foreign tax offset

***What is a foreign tax offset?***

1.30 Pursuant to Australia's tax laws, resident taxpayers may be assessed on both their foreign and domestic sourced income. To prevent the double taxation of worldwide income that has been taxed in another country, resident taxpayers will be entitled to a non-refundable tax offset for foreign income tax paid on an amount included in their assessable income (a 'double-taxed amount') ***[Schedule 1, item 1, subsections 770-5(1)***

***and (2)].*** This tax offset will extend to foreign residents where certain requirements are satisfied.

1.31 The tax offset has the effect of reducing the Australian tax that would otherwise be payable on the double-taxed amount. The tax offset is limited to the lesser of foreign income tax paid or the foreign tax offset cap (the 'cap') ***[Schedule 1, item 1, sections 770-70 and 770-75].*** In the event that the total foreign income tax paid exceeds the cap, no offset or deduction is allowed for the extra foreign income tax.

1.32 The cap is based on the Australian tax that would be payable on the double-taxed amounts and other assessable amounts that do not have an Australian source. (It is no longer a requirement to establish that a double-taxed amount has a foreign source.) The taxpayer may refrain from calculating the cap and instead choose to use the $1,000 *de minimis* cap. This *de minimis* cap is discussed further in paragraphs 1.127 and 1.128.

1.33 A taxpayer can only claim an offset for the income year in which the double-taxed amount is included in assessable income. It is possible that the taxpayer pays the foreign income tax in a different income year and so, to this end, the usual amendment periods do not apply. Rather, a taxpayer will have four years from the time they pay foreign income tax to claim a tax offset. Amendment period rules are discussed further in paragraphs 1.154 to 1.159.

1.34 Entitlement to an offset will only arise for foreign income taxes that are, in essence, imposed on a basis substantially equivalent to income tax imposed under Australian law, that is, generally a tax on income, profits or gains.

1.35 There are some circumstances where a taxpayer has not paid the foreign income tax. Entitlement will arise in these cases where another entity (including an individual) has paid the foreign income tax on behalf of the taxpayer.

1.36 The rules allowing company attributable taxpayers relief for income attributed under the controlled foreign company rules and foreign investment fund rules are tightened marginally. In particular, the attributable taxpayer will need, at a minimum, a 10 per cent attribution percentage in the foreign company before it is eligible for relief.

1.37 Further, the rules prescribing double tax relief for taxpayers that use the foreign investment fund calculation method to determine attributable income will be simplified. Attributable taxpayers will only be entitled to relief for foreign income taxes paid in respect of an interest in a first-tier foreign investment fund.

1.38 Entitlement to double tax relief will be simplified for distributions of income that has already been attributed to, and included in, the assessable income of a resident taxpayer ('previously attributed income'). Only the (final) foreign income tax imposed on these distributions will give rise to offset entitlement (namely, the direct tax on the distribution). The underlying foreign tax paid by the foreign company, or any interposed entity, is no longer eligible for a tax offset.

### *Who is entitled to a foreign tax offset?*

*General entitlement*

1.39 A foreign tax offset is available to a taxpayer for foreign income tax paid on an amount that is all or part of an amount included in assessable income. There is no intention to stipulate whether the taxpayer is required to be a resident for entitlement purposes nor that the assessable amount has a foreign source. However, as the tax offset relates to foreign income tax paid in relation to assessable income, it will normally be the case (although not expressly specified in the law) that the taxpayer claiming the tax offset is a resident taxpayer ***[Schedule 1, item 1, subsection 770-10(1)].*** Further, only the taxpayer that is assessed on the amount is entitled to the offset, even if in some cases, the foreign income tax has been paid by another entity.

1.40 Entitlement to the tax offset will only arise when, and to the extent that, the foreign income tax has been *paid* on an amount included in assessable income ***[Schedule 1, item 1, subsection 770-10(1)].*** Foreign income tax paid on non-assessable non-exempt amounts (except for section 23AI and 23AK amounts) is disregarded. Only where the taxpayer has paid foreign income tax on an amount included in assessable income will double taxation, and consequently relief from double taxation, arise. If only part of an amount on which an amount of foreign income tax has been paid is included in assessable income (eg, foreign income tax paid on the foreign branch income of an Australian company), only the same fraction of the foreign income tax counts towards the tax offset ***[Schedule 1, item 1, note 2 in subsection 770-10(1)].***

1.41 A tax offset will only be available for the income year in which the double-taxed amount is included in the taxpayer's assessable income ***[Schedule 1, item 1, subsection 770-10(1)].*** This will be the case regardless of when the foreign income tax is actually paid. That is, there is no requirement that the taxpayer paid the foreign income tax in the same income year in which the double-taxed amount is included in their assessable income. Consequently, if the taxpayer does not pay foreign income tax until a later year, on an amount included in their assessable income or if the foreign income tax paid is subsequently altered, they may need to lodge an amended assessment ***[Schedule 1, item 1, subsection 770-10(1)].***

Rules pertaining to amendment periods are discussed in paragraphs 1.154 to 1.159.

**Example 1.1**

> A resident taxpayer holds an annuity as 'qualifying security' (as defined in Division 16E of Part III of the ITAA 1936) for income years 1 July 2009 through 30 June 2015. The taxpayer pays foreign income tax on the annuity income in the income year ending 30 June 2015.
>
> The taxpayer will include in their assessable income (for income years 1 July 2009 through to 30 June 2015) those annuity amounts. Only when the taxpayer pays the foreign income tax will they be eligible for a tax offset. The tax offset will arise in each of the income years that an annuity amount was included in assessable income after foreign income tax is paid in respect of that amount.
>
> The taxpayer is required to apportion the paid foreign income tax among the income years that led to the annuity amount being included in the taxpayer's assessable income. As a result, the taxpayer will be required to lodge amended assessments for the earlier income years.

1.42 In general, the new law maintains the current treatment with respect to net capital gains. Only foreign income tax paid on the whole or part of a capital gain (or capital gains) that is (are) included in the taxpayer's net capital gain in accordance with section 102-5 will be eligible for a tax offset ***[Schedule 1, item 1, subsection 770-10(1)].*** Namely, where the taxpayer has paid foreign income tax on the whole or part of a capital gain that is included in their net capital gain, the requirement that the foreign income tax be paid in respect of an amount that is all or part of an amount included in assessable income will be satisfied.

1.43 If the taxpayer has a net capital loss for the year, the taxpayer will not be able to offset any of the foreign income tax paid on any particular capital gain because there is no net capital gain included in assessable income. That is, the taxpayer is not subject to double taxation on its capital gain. ***[Schedule 1, item 1, subsection 770-10(1)]***

**Example 1.2**

> A resident taxpayer makes a gain of $10,000 on the sale of a foreign asset which is subject to tax in a foreign country at a rate of 20 per cent.
>
> The taxpayer also realises a capital loss of $10,000 in respect of the disposal of an Australian asset.

As there is no net capital gain included in the taxpayer's assessable income, the taxpayer is not eligible for a tax offset in respect of the foreign income tax paid on the sale of the foreign asset.

1.44 A foreign taxed gain that is treated as a capital loss in Australia (due to differences in the calculation of gains and losses), will not be regarded as a double-taxed amount nor will the foreign income tax be eligible for a tax offset. This is because the capital loss is not included in the taxpayer's assessable income, consequently, there is no double taxation of the loss and entitlement to a tax offset does not arise. ***[Schedule 1, item 1, subsection 770-10(1)]***

1.45 Under the current law (subsection 102-5(1)), a taxpayer can choose the order in which capital gains are reduced by any capital losses. A taxpayer can continue to apply any capital loss or prior-year net capital loss firstly against those capital gains on which no foreign tax is paid and to which no Australian discount applies. The taxpayer may then apply the excess (if any) against those capital gains that attract an Australian discount and finally against those gains that have been subject to foreign tax. Ordering the application of capital losses in this way will yield the greatest foreign tax offset benefit for the taxpayer.

### Example 1.3

The taxpayer realises the following capital gains and losses during the income year:

**Foreign country D assessment**

| | |
|---|---|
| Purchase price of foreign asset D | $70,000 |
| Proceeds from sale of foreign asset D | $200,000 |
| Net foreign gain on sale of foreign asset D | $130,000 |
| | |
| Foreign tax payable (30%) | $39,000 |

**Foreign country B (nil assessment)**

| | |
|---|---|
| Purchase price of foreign asset B | $50,000 |
| Proceeds from sale of foreign asset B | $65,000 |
| Gain on sale of foreign asset B | $15,000 |

*Foreign country B does not impose tax on capital gains made on the disposals of assets*

**Foreign country L**

| | |
|---|---|
| Purchase price of foreign asset L | $90,000 |
| Proceeds from sale of foreign asset L | $50,000 |
| Loss on sale of foreign asset L | ($40,000) |

**Australia**

| | |
|---|---|
| Cost base of asset A | $90,000 |
| Capital proceeds from sale price of asset A | $150,000 |
| Gain on sale of asset A | $60,000 |
| | |
| Reduced cost base of asset H | $65,000 |
| Capital proceeds of asset H | $25,000 |
| Loss on sale of asset H | ($40,000) |

**Australian assessment**

| **Income** | **Domestic** | **Foreign** | **Total** |
|---|---|---|---|
| Machinery sales — revenue | $60,000 | | $60,000 |
| Net capital gain * | | $125,000 | $125,000 |
| Gross assessable income | | | $185,000 |
| *Less* | | | |
| Allowable deductions from sales revenue (under Australian law) | | | $20,000 |
| **Taxable income** | | | **$165,000** |
| Australian tax (30%) | | | $49,500 |
| *Less* | | | |
| Foreign tax offset entitlement ** | | | $37,500 |
| Net Australian tax payable | | | $12,000 |

---

* The net capital gain is calculated as follows (assuming gains and losses on foreign assets are the same under Australian tax law as under the foreign laws):

| | | |
|---|---|---|
| Capital gain on sale of foreign asset D | | $130,000 |
| *Plus* | | |
| Capital gain on sale of foreign asset B | $15,000 | |
| Capital gain on sale of Australian asset A | $60,000 | |
| Capital loss on sale of foreign asset L | ($40,000) | |

| | | |
|---|---|---|
| Capital loss on sale of Australian asset H | ($40,000) | ($5,000) |
| **Net capital gain** | | **$125,000** |

The taxpayer calculates net capital gain to ensure maximum allowable foreign tax offset.

- First, the taxpayer adds the domestic capital loss and the foreign capital loss together.
- Second, the taxpayer deducts this from the sum of the domestic capital gain and the foreign capital gain on which no foreign tax has been paid.
- Finally, since this yields a capital loss, the taxpayer deducts this amount from the foreign capital gain in respect of which foreign tax has been paid.

** For the calculation of the foreign tax offset cap see Example 1.20.

*Australian residents — foreign income tax paid on non-assessable non-exempt income*

1.46 The current foreign tax credit system provides taxpayers with a credit for certain foreign income taxes paid on distributions made out of previously attributed income that are treated as non-assessable non-exempt income under either section 23AI or 23AK of the ITAA 1936. The current mechanism that provides relief for foreign income taxes paid on this previously attributed income is voluminous, highly complex and disproportionate to its degree of utilisation and compliance. Currently, to claim a credit for foreign income tax paid on previously attributed income, taxpayers are required to maintain attributed tax accounts. These accounts effectively trace the foreign tax paid on the attributed amounts and on the distribution as it makes its way to the taxpayer through a chain of offshore entities. These attributed tax accounts give rise to significant complexity and compliance costs for relatively small benefit in return.

1.47 For these reasons, entitlement to relief for foreign income taxes paid on previously attributed income has been substantially rewritten and simplified. In particular, taxpayers will no longer need to maintain complex and costly attributed tax accounts. ***[Schedule 1, items 77, 79 to 81, 89, 91 to 93, 123 to 126, 164 to 175, section 317, paragraphs 401(1)(d) and 461(1)(f) of the ITAA 1936, section 717-200, paragraph 717-205(c), section 717-235, paragraph 717-240(c)]***

1.48 A resident taxpayer that receives non-assessable non-exempt income under either section 23AI or 23AK of the ITAA 1936 will be entitled to a non-refundable tax offset for the foreign income tax paid on the distribution. ***[Schedule 1, item 1, subsection 770-10(2)]***

1.49 The foreign income tax in respect of these amounts refers only to the final or direct foreign income tax paid, and this will usually be a withholding tax. ***[Schedule 1, item 1, note 2 in subsection 770-10(2)]***

1.50 The requirement that the foreign income tax be *paid by the taxpayer*, will be satisfied by the general rules prescribing when a taxpayer is regarded as having paid an amount of foreign income tax. ***[Schedule 1, item 1, section 770-130]***

1.51 If the taxpayer otherwise qualifies for a foreign tax offset, then the amount of the tax offset will be increased by the foreign income tax paid in respect of the non-assessable non-exempt income. ***[Schedule 1, item 1, subsection 770-10(2)]***

1.52 Entitlement to this tax offset is effectively limited to Australian residents since only Australian residents can receive a distribution out of previously attributed income that is non-assessable non-exempt income under either section 23AI or 23AK of the ITAA 1936.

**Example 1.4**

Aust Co. is an attributable taxpayer in relation to For Co. which is a controlled foreign company in an unlisted country. Aust Co. has an attribution account surplus in relation to For Co. of $1 million, having previously been subject to tax on attribution under section 456 of the ITAA 1936. For Co. subsequently declares and pays a dividend of $1 million to Aust Co. upon which withholding tax of $100,000 is imposed. As this amount does not exceed the attribution account surplus of Aust Co. in relation to For Co., it is treated as non-assessable non-exempt income of Aust Co. pursuant to section 23AI of the ITAA 1936. Aust Co. is also entitled to a foreign tax offset for the $100,000 foreign income tax as it is paid in respect of the dividend of $1 million.

*Exception for certain foreign residents*

1.53 Currently, only foreign residents that pay foreign tax on certain foreign film income which is assessed in Australia qualify for a foreign tax credit (under current Division 18A, Part III of the ITAA 1936). These amendments ensure that foreign residents will be entitled to an offset for some foreign income taxes paid that relate to their assessable income. ***[Schedule 1, item 1, subsection 770-10(1)]***

1.54 The purpose for extending entitlement to foreign residents more generally is two-fold. First, the tax treaty concluded with the United Kingdom of Great Britain and Northern Ireland (UK) includes rules on non-discrimination. This may require Australia to provide double tax relief to (an Australian permanent establishment of) a UK resident where third-country income is derived (and taxed in that country) in connection with the carrying on of a business at or through an Australian permanent establishment. In this situation, Australia, as the country in which the permanent establishment is situated, could be obliged to provide relief for the third-country tax paid on the basis that an Australian resident entity deriving the same third-country income would be entitled to double tax relief.

1.55 Although the UK treaty is currently the only tax treaty that contains rules on non-discrimination (Finland and Norway have similar rules but are not yet in force), it is Australian tax treaty practice that rules on non-discrimination be agreed to in future Australian tax treaties.

1.56 Secondly, a broader approach to the inclusion of foreign residents in the new foreign tax offset rules can be rationalised on the grounds that Australia has some responsibility to grant double tax relief when choosing to assess foreign residents on their foreign source income. This may be the case in some situations with film income (see section 26AG of the ITAA 1936).

1.57 As an integrity measure, a foreign resident will not be able to claim a tax offset for foreign income tax it pays as a resident of a foreign country for the purpose of the foreign country's tax law (namely, residence-based taxation). One object of this provision is to avoid giving an offset for foreign income tax paid as a resident of another country on Australian source income. ***[Schedule 1, item 1, paragraph 770-10(3)(a)]***

1.58 A foreign resident will, however, be entitled to a tax offset for foreign income tax it pays to its country of residence where it is paid on the basis of source. That is, where the foreign country levies tax on the income on a source basis (eg, a withholding tax paid to a permanent establishment in Australia), the foreign resident will be entitled to a tax offset where the taxpayer is also assessed on that income in Australia. ***[Schedule 1, item 1, paragraph 770-10(3)(b)]***

1.59 This qualification to the foreign resident entitlement is also needed to continue the full operation of double tax relief found in current Division 18A, Part III of the ITAA 1936 for film income. However, a systemic approach ensures that any foreign resident in receipt of income that has been subject to tax in its country of residence, or in a third country, on a source basis will have access to double tax relief where Australia also assesses the income ***[Schedule 1, item 1, subsection 770-10(3)].***

As a result of this systematic approach, this Schedule repeals sections 121EI and 160ZZY of the ITAA 1936 ***[Schedule 1, items 59 and 67]***. A taxpayer that currently qualifies for a deduction for foreign tax under these provisions will now be entitled to an offset.

1.60 As well as applying to foreign residents, this restriction also applies to Australian residents who are also residents of one or more other countries and also pay foreign income tax because of that foreign residency.

1.61 This situation, of Australia assessing foreign residents on their foreign source income, will be rare (particularly in light of Australia's tax treaty obligations). It arises in respect of film income purely for integrity reasons. In particular, it relates to certain film tax concessions that accrue to Australian resident taxpayers who then depart Australia. The film income that relates to the earlier film tax concessions provided to the former Australian resident is generally assessed in Australia.

**Example 1.5**

> Film Co. is a company resident in the foreign country A receiving income from the use of a film copyright. Film Co. was previously an Australian resident whose capital expenditure on the film qualified for deduction under a film concession (in particular, a section 124ZAFA (of the ITAA 1936) film concession).
>
> Film Co. exhibits the film in foreign country B and under Australian law, foreign country A is regarded as the country of source. Foreign country B does not impose tax on the income from the exhibition of the film. Foreign country A does however impose tax on Film Co. for the exhibition of the film.
>
> Film Co. is assessed on the income in Australia by virtue of section 26AG of the ITAA 1936. Film Co. is entitled to a tax offset in this situation because the foreign income tax paid is source-based taxation of a foreign resident.

*Exception for previously complying funds and previously foreign funds*

1.62 As with the existing law, the new law imposes a limit on the amount of foreign tax offset that is allowed for foreign income taxes paid by a:

- trustee of a pooled superannuation trust; or
- superannuation provider in relation to a superannuation fund or approved deposit fund,

to the extent the fund changes from a complying superannuation fund to a non-complying superannuation fund or from a non-resident superannuation fund to a resident superannuation fund. ***[Schedule 1, item 1, paragraph 770-10(4)(a)]***

1.63 Where a superannuation fund changes from a complying fund to a non-complying fund or from a non-resident fund to a resident fund, the assessable income of the fund for that year includes the market value of the fund's assets (reduced for undeducted contributions made by fund members) at the start of the income year.

1.64 Where a non-complying fund or a resident fund includes an amount in assessable income under section 295-320 and the provider paid foreign income tax in respect of that amount (before the start of the income year), the fund is not entitled to a tax offset for the foreign income tax paid by the provider. ***[Schedule 1, item 1, subsection 770-10(4)]***

1.65 Foreign income tax paid by the provider does not give rise to tax offset entitlement because the amount assessed under section 295-320 reflects the value of the fund's assets at the start of the income year and implicitly recognises a notional deduction for the foreign income tax paid before the start of the income year. To allow a tax offset for the foreign income tax paid by the provider in these circumstances would amount to a duplication of double tax relief.

*Exception for credit absorption tax and unitary tax*

1.66 Consistent with the current rules for foreign tax credits, an offset will be denied for unitary or credit absorption taxes. However, in the new law this is achieved by an explicit rule rather than by excluding those taxes from the definition of 'foreign income tax'. ***[Schedule 1, item 1, subsections 770-10(5) and 770-15(2) and (3)]***

1.67 The definitions of 'unitary tax' and 'credit absorption tax' have the same effect as in current subsection 6AB(6) of the ITAA 1936. The slight change in wording is needed to incorporate the ITAA 1936 definition of 'law' which covers a law imposed by any part or place within a country.

*Attributable taxpayers — controlled foreign company rules*

1.68 In general, a foreign tax offset will continue to be available for company attributable taxpayers that are assessed under the controlled foreign company rules. In particular, where an amount is included in such an attributable taxpayer's assessable income under section 456 or 457 of the ITAA 1936, and the controlled foreign company paid foreign income tax, or Australian tax (income tax or withholding tax) in respect of that

amount, the attributable taxpayer may be entitled to a tax offset ***[Schedule 1, item 1, subsection 770-135(1), subparagraphs 770-135(2)(a)(i) and (ii) and paragraphs 770-135(3)(a) and (b)].*** Taxes taken to be paid by the controlled foreign company under subsection 393(4) will also continue to qualify for offset entitlement ***[Schedule 1, item 1, subsection 770-135(4)].*** Paragraphs 1.113 to 1.115 discuss further the rules for what, and the extent to which, taxes paid by a controlled foreign company are treated as having been paid by an attributable taxpayer.

1.69 Section 770-135 replaces, but is not identical to, current sections 160AFCA and 160AFCB of the ITAA 1936 (which this Schedule is repealing). ***[Schedule 1, item 64]***

1.70 Pursuant to this new provision, entitlement to a foreign tax offset will only arise where the attributable taxpayer's attribution percentage (direct and/or indirect) in relation to the controlled foreign company is 10 per cent or more (the association condition) ***[Schedule 1, item 1, subsection 770-135(5)].*** The time at which this attribution percentage is tested will differ depending on whether the attributable taxpayer is attributed under section 456 or 457 of the ITAA 1936. For income attributed under section 456, the company will need to satisfy the attribution percentage requirement at the end of the controlled foreign company's statutory accounting period ***[Schedule 1, item 1, paragraph 770-135(5)(a)].*** For income attributed under section 457, the requirement will need to be satisfied at the residence change time ***[Schedule 1, item 1, paragraph 770-135(5)(b)].***

1.71 This new method for determining how the attributable taxpayer is related to the controlled foreign company is a change from how the current rules operate. The current rules have a related foreign company requirement. It is intended that this change will simplify the rules granting a tax offset in this circumstance, as well as reduce the cost to taxpayers of having to comply with the current requirements.

1.72 The new attribution percentage requirement of 10 per cent will be a slight tightening for those attributable taxpayers that have less than a 10 per cent attribution percentage in the foreign company. These taxpayers are attributed income under section 456 or 457 of the ITAA 1936 because they are Australian controllers of a foreign company which is taken to be a controlled foreign company within the meaning of paragraph 340(c) of the ITAA 1936. The two other control tests for controlled foreign companies result in an amount being included in the attributable taxpayer's assessable income (under sections 456 and 457) only in circumstances where the taxpayer has an attribution percentage of at least 10 per cent. Therefore, the new attribution percentage will not affect attributable taxpayers in these two cases as they already satisfy the 10 per cent requirement.

1.73 It is expected that this change — to a straight 10 per cent attribution percentage — will have minimal (if any) effect, since it is rare for an attributable taxpayer to be attributed under Part X of the ITAA 1936 where the attribution percentage is less than 10 per cent. Further, this new requirement will more closely align the tax laws to the changes contained in the *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004*, which rationalised the section 23AJ (of the ITAA 1936) non-portfolio dividend exemption.

*Attributable taxpayers — foreign investment fund rules*

1.74 The current foreign tax credit system provides attributable taxpayers with a credit for foreign income tax, or Australian tax (income tax or withholding tax) paid on income attributed under the foreign investment fund calculation method. The mechanism that provides relief for the foreign tax paid on this type of attributable income is voluminous, highly complex and disproportionate to its degree of utilisation and compliance.

1.75 For these reasons, double tax relief for foreign income taxes paid on income attributed under the foreign investment fund calculation method will be substantially simplified.

1.76 In line with current foreign tax credit rules, a foreign tax offset will only be available for taxpayers that are attributed with income under section 529 of the foreign investment fund rules where the calculation method is used to determine their attributable income.

1.77 However, the foreign tax offset in these cases is limited to situations where:

- the foreign company or foreign trust has paid the tax ***[Schedule 1, item 1, paragraph 770-135(3)(c)]***;
- the association condition is met (in the case of a foreign company only) ***[Schedule 1, item 1, paragraph 770-135(5)(c)]***; and
- the calculation method is used ***[Schedule 1, item 1, subsection 770-135(6)].***

1.78 The first condition is the same as the existing requirement in the case of a first-tier foreign investment fund and the final condition is consistent with the current law. The new tax offset is limited to foreign income tax, or Australian tax (income tax or withholding tax) paid by first-tier foreign investment funds only. This can be contrasted to the current rules which also allow for a credit in the case of certain taxes paid

by second-tier foreign investment funds, where the attributable income of the first-tier fund includes income from the second-tier fund.

1.79 A tax offset is no longer allowed in respect of second-tier foreign investment funds. The attributable taxpayer will instead receive a deduction for any foreign or Australian tax paid by the second-tier foreign company or trust. This change will reduce compliance costs for taxpayers and administration costs for the ATO, together with simplifying the tax law. The new rules are also consistent with the general move to deny a tax offset for foreign income tax paid by an entity in which the taxpayer holds an indirect interest where income is not received or attributed directly.

1.80 Like the case of attributable taxpayers in relation to controlled foreign companies, the second condition for foreign investment fund companies (the association condition) requires an attribution percentage (within the meaning of section 581 of the ITAA 1936) of 10 per cent or more. The definition of 'attribution percentage' has been amended such that it is now defined in relation to a controlled foreign company or a controlled foreign trust as well as a foreign investment fund that is a company ***[Schedule 1, item 188, the definition of 'attribution percentage' in subsection 995-1(1)].*** This attribution percentage is tested at the end of the notional accounting period ***[Schedule 1, item 1, paragraph 770-135(5)(c)].***

1.81 Where the foreign investment fund is a trust, there is no attribution percentage requirement. These attributable taxpayers will continue to be entitled to relief (in the form of a tax offset) in respect of foreign income tax, or Australian tax (income tax or withholding tax) paid by the first-tier foreign trust proportionate to their interest in the trust. ***[Schedule 1, item 1, paragraph 770-135(7)(c)]***

1.82 Paragraphs 1.116 to 1.118 discuss further the rules for what taxes paid by a foreign investment fund are treated as having been paid by an attributable taxpayer.

***What foreign taxes are eligible for a tax offset?***

1.83 A tax offset will be available for those foreign income taxes that are substantially equivalent to Australian income tax. That is, the foreign income tax must be levied on the taxpayer's income, profits or gains of an income or capital nature, or be similar to Australian withholding tax that is imposed in place of a tax on the net amount of income. ***[Schedule 1, item 1, subparagraphs 770-15(1)(b)(i) and (ii)]***

1.84 Inheritance taxes, annual wealth taxes or net worth taxes are not taxes on income, profits or gains and therefore will not be eligible for a tax offset. Further, foreign tax based on receipts, turnover or production, are not considered foreign income tax.

1.85 Foreign taxes specified within any of Australia's tax treaties, for which Australia is obliged to provide relief, will be considered to be foreign income taxes for the purpose of allowing a tax offset ***[Schedule 1, item 1, subparagraph 770-15(1)(b)(iii)].*** For example, the Philippines tax treaty has rules pertaining to tax sparing. These tax sparing amounts will be treated as a foreign income tax under the *International Tax Agreements Act 1953*.

1.86 Consistent with the current rules for foreign tax credits, an offset will be denied for unitary or credit absorption taxes (see the discussion in paragraphs 1.66 and 1.67).

1.87 In order to give rise to entitlement, the foreign income tax must be imposed by a law other than an Australian law ***[Schedule 1, item 1, paragraph 770-15(1)(a)].*** It must be a law validly made by or under an authority recognisable by the Commonwealth of Australia. The foreign income tax can be imposed under a law of a national or supra-national government, a state or province, or at the local or municipal level of government.

1.88 The new definition of 'foreign income tax' no longer requires the tax to be imposed by a foreign country. The removal of this criterion broadens the scope of entitlement to cater for foreign income taxes imposed by supra-national confederations such as the European Union.

1.89 A resident taxpayer assessed on income received from a European Union institution will be eligible for a tax offset to the extent foreign income tax has been paid. Specifically, where a taxpayer has paid foreign income tax to the European Union on income included in their Australian assessable income, they will be entitled to a tax offset. These taxpayers are not currently entitled to relief because the requirement that the foreign tax be imposed by a foreign country is not satisfied (current paragraph 6AB(2)(a) of the ITAA 1936).

**Example 1.6**

> Trixie is a retired employee of the European Central Bank who now resides in Australia. Trixie receives a pension from the European Central Bank and pays foreign income tax to the European Union on that pension. As a resident of Australia, Trixie also pays Australian tax on her pension.
>
> Trixie will be entitled to a tax offset against the Australian tax payable on her pension for the foreign income tax she has paid to the European Union.

*Requirement to reduce foreign income tax paid on assessable offshore banking income*

1.90 Foreign income tax paid on assessable offshore banking income of an offshore banking unit will be adjusted by the (offshore banking) eligible fraction.

1.91 Entitlement to an offset for foreign income tax paid on assessable offshore banking income will therefore only arise for a fraction (currently one-third) of the amount of foreign income tax paid. This is consistent with the treatment afforded to assessable offshore banking income as well as the allowable offshore banking deductions. ***[Schedule 1, item 1, subsection 770-10(1) and items 55 to 61, paragraph 121B(3)(d), subsection 121EG(3A) and paragraph 121EH(e), subsection 121EJ(1) of the ITAA 1936]***

1.92 The reduction of foreign income tax recognises that two-thirds of foreign income tax paid in respect of offshore banking income relates to offshore banking income that is non-assessable non-exempt income. Double tax does not arise to the extent that the foreign income tax paid relates to non-assessable non-exempt income.

1.93 Although this treatment is not currently applied to foreign tax paid on assessable offshore banking income, the consequences are less prevalent. This is because the foreign tax currently paid on assessable offshore income is quarantined from that paid on all other assessable foreign income. Moreover, an offshore banking unit would seldom have an opportunity to utilise the additional foreign income tax. With the removal of foreign tax credit quarantining, the offshore banking unit could use this additional foreign tax to shelter other types of low-taxed foreign source income, which is not the desired outcome.

### Example 1.7

Big Bank Ltd is an Australian resident bank that is declared an offshore banking unit. Big Bank Ltd derives offshore banking income as follows:

| Source | Income (A$) | Expenses (A$) | Foreign tax paid (A$) |
|---|---|---|---|
| Borrowing and lending activity — commission | 15,000 | 900 | 1,500 |
| Borrowing and lending activity — interest | 20,000 | 600 | 3,000 |
| Advisory activity | 50,000 | 6,000 | 16,500 |
| **Total assessable offshore banking income** | **85,000** | **7,500** | **21,000** |

**Australian assessment**

| | | |
|---|---|---|
| Assessable offshore banking income | (85,000 × 10/30) | 28,333 |
| Allowable offshore banking deductions | (7,500 × 10/30) | 2,500 |
| **Taxable income** | | **25,833** |
| Australian tax | (25,833 × 0.30) | 7,750 |
| *Less* | | |
| Offset entitlement * | (21,000 × 10/30) | 7,000 |
| **Net Australian tax payable** | | **750** |

* The offset entitlement is equal to the lesser of foreign income tax paid and Australian tax payable. The amount of foreign income tax paid in respect of the assessable portion of offshore banking income is the amount of foreign income tax paid multiplied by the eligible fraction:

$21,000 × 10/30 = $7,000

This is less than the Australian tax payable of $7,750. Big Bank is therefore entitled to an offset equal to the amount of foreign income

tax paid in respect of the assessable component of offshore banking income.

***Requirement to gross-up assessable income amount***

1.94 The requirement to gross-up a double-taxed amount by the foreign income tax paid in respect of that amount is fundamental to any foreign tax offset system. The amount of income that is subject to tax in a taxpayer's country of residence is the gross amount of the income, before any payment of foreign income tax.

1.95 There will be some circumstances in which a taxpayer will not have to do anything to achieve that outcome, namely, where foreign income tax is paid on a net assessment basis. In this situation, the taxpayer determines the double-taxed amount before the payment of foreign income tax and it is this amount that is included in assessable income. There is no requirement to expressly gross-up the double-taxed amount in these cases because foreign income tax has not been deducted from the amount included in assessable income. However, where the foreign income tax is withheld from the amount paid or credited to the taxpayer, that tax amount must be added to the net amount received by the taxpayer before including it in assessable income.

1.96 Where a taxpayer has paid foreign income tax (or is treated as having paid foreign income tax) on an amount included in their assessable income, pursuant to general tax law principles, the amount included in the taxpayer's assessable income is the amount before the payment of that foreign income tax. That is, the amount is grossed-up, by the amount of foreign income tax paid, before being included in assessable income. Therefore, notwithstanding that current section 6AC of the ITAA 1936 is being repealed, there is no change in the policy intent ***[Schedule 1, item 26]***. General tax law principles dictate that in this situation the amount included in assessable income is the grossed-up amount (eg, subsections 6-5(2) and (4)). It would make little sense to allow both a deduction and a credit for the amount of foreign income tax by taxing only the net amount of income and then allowing an offset for the foreign income tax.

1.97 The attributable income of a controlled foreign company and foreign investment fund is calculated net of any foreign income tax paid, and it is this net amount that is included in the attributable taxpayer's assessable income. Thus, the attributable taxpayer is effectively entitled to a deduction for foreign taxes (and Australian taxes) paid on an amount included in the controlled foreign company's or foreign investment fund's notional assessable income. It is only where the attributable taxpayer is eligible for a foreign tax offset that there is a requirement to gross-up the attributable income amount. The amount will be grossed-up by the

amount of foreign income tax, income tax or withholding tax they are deemed to have paid. ***[Schedule 1, item 1, subsection 770-135(8)]***

**Example 1.8**

> A resident taxpayer invests directly in a foreign company. The foreign company pays a dividend of $100 and deducts $15 withholding tax, thereby making a net distribution of $85 to the resident taxpayer.
>
> The taxpayer will gross-up the net distribution for foreign tax paid under common law concepts. The amount included in the taxpayer's assessable income is therefore $100. The taxpayer may then be entitled to claim a tax offset for the $15 withholding tax.
>
> The amount of the tax offset will be determined in accordance with the foreign tax offset limit rules.

***When will foreign income tax be treated as paid by the taxpayer?***

1.98 Consistent with the current rules (in subsection 6AB(3) of the ITAA 1936), a taxpayer will be treated as having paid foreign income tax on an amount included in their assessable income where the foreign income tax has effectively been paid by someone else on their behalf under an arrangement with the taxpayer or under the law relating to the foreign income tax ***[Schedule 1, item 1, subsections 770-130(1) and (2)]***. The current requirement that the taxpayer be personally liable for the foreign tax has been removed to simplify the law. The requirement that the taxpayer 'paid' the foreign income tax (on an amount included in assessable income) effectively achieves the same outcome. Accordingly, where one taxpayer has paid foreign income tax on behalf of another taxpayer, relief from double tax will continue to be denied for the first taxpayer because the foreign income tax paid by them is not in respect of an amount included in their assessable income. Rather, the taxpayer that includes the double-taxed amount in assessable income may be entitled to relief.

1.99 The intention of the foreign income tax paid deeming provisions, is to ensure that the right taxpayer obtains the foreign tax offset. For example, where an entity (including an individual) has paid foreign income tax in a representative capacity for a taxpayer, but the taxpayer has actually borne the economic burden of the foreign income tax, it is the taxpayer who will be taken to have paid the foreign income tax and be entitled to the tax offset.

1.100 The foreign income tax must be paid by another entity under an arrangement with the taxpayer or under a law relating to the foreign income tax ***[Schedule 1, item 1, subsection 770-130(2)]***. It is intended that foreign income taxes paid by the taxpayer will include those taxes paid

indirectly by the taxpayer or paid by someone else and covers foreign income tax that has been paid by:

- deduction or withholding;
- a trust in which the taxpayer is a beneficiary;
- a partnership in which the taxpayer is a partner; or
- the taxpayer's spouse.

1.101 The foreign income tax paid in these circumstances must have some material connection with the amount included in the taxpayer's assessable income (or with an amount that is non-assessable, non-exempt income under section 23AI or 23AK of the ITAA 1936). This nexus or link between the foreign income tax paid and the income included in the taxpayer's ordinary income or statutory income arises from the phrase '…in respect of a taxed amount…'. ***[Schedule 1, item 1, subsections 770-130(1) and (2)]***

**Example 1.9**

> A resident individual, Barry, invests directly in a foreign company (For Co.). For Co. pays a dividend of $100 and deducts $15 withholding tax, making the net distribution $85.
>
> Barry will include $100 in assessable income and will also be entitled to claim a tax offset for the $15 withholding tax deducted by For Co. as Barry is deemed to have paid the withholding tax.
>
> Barry will determine the amount of the tax offset in accordance with the foreign tax offset limit rules.

1.102 The link between foreign income tax paid by someone else and the income included in the taxpayer's ordinary income or statutory income will also be met in cases where foreign entities elect for flow-through treatment of taxation. For instance, an Australian resident taxpayer who is a member of a US limited liability company that has elected to be treated as a partnership in the US will be entitled to a tax offset for foreign income tax imposed by the US on distributions from the limited liability company.

1.103 Even where the Australian resident has not elected for the US limited liability company to be a foreign hybrid, the Australian resident will be entitled to a tax offset for the US withholding tax imposed on the distribution of the profits of the limited liability company. The tax offset will be in respect of the gross amount (pre-US tax) paid to the Australian resident. This is irrespective of the fact that the amount is regarded as a

'dividend' under Australian tax law and a 'distribution of partnership profits' under US law.

**Example 1.10**

> Aust Super Fund is a trustee of a complying superannuation entity and an Australian resident taxpayer that holds a 2 per cent interest in a US limited partnership (a foreign investment fund interest).
>
> The US limited partnership elects for flow-through treatment to apply to it under the laws of the US. That is, it is not taxed on its profits but rather tax is borne by the partners on their share of the partnership distribution.
>
> The taxpayer's share of partnership profits for the year of income is $1 million which is US-sourced income (the tax treaty Australia has with the US determines this).
>
> Tax of $350,000 is withheld by the US limited partnership (in compliance with US tax law) in respect of the distribution it makes to the taxpayer. (The tax has been properly imposed in accordance with the US Convention.)
>
> The taxpayer does not make an election under subsection 485AA(1) of the ITAA 1936 to treat the US limited partnership as a foreign hybrid limited partnership. Accordingly, the US limited partnership is taxed under Australian tax law as a company in accordance with Division 5A of Part III of the ITAA 1936.
>
> Although the absence of an election pursuant to section 485AA means that the interest held by the taxpayer in the US limited partnership is still a foreign investment fund interest, the taxpayer (being a trustee of a complying superannuation entity) is exempt from foreign investment fund taxation by virtue of Division 11A of Part XI of the ITAA 1936.
>
> The amount (the distribution of partnership profits characterised as a dividend) of $1 million is included in Aust Super Fund's assessable income (and the distribution of partnership profits is characterised as a dividend). Aust Super Fund, although not having paid the US tax of $350,000 personally (since the US limited partnership has been taxed on the distribution on a withholding basis), will be treated as having paid the foreign income tax in respect of the amount included in its assessable income and so will be entitled to a tax offset.
>
> The amount of the tax offset will be subject to the tax offset limiting rules.

1.104 The link between foreign income tax paid by someone else and the income included in the taxpayer's ordinary income or statutory income is not however, boundless. A taxpayer receiving dividends from a

foreign company will not satisfy the nexus in respect of foreign company tax paid on the profits from which the dividend was distributed.

1.105 A taxpayer in receipt of a foreign pension from a foreign superannuation fund will also not satisfy the nexus in respect of any foreign income tax paid by the foreign superannuation fund on its income.

1.106 Although the foreign income tax in these two scenarios reduces the amount of income that a taxpayer receives, the foreign company and the superannuation fund are not regarded as flow-through entities under Australian law. Rather, they are liable to tax in their own right and that foreign income tax is commonly referred to as underlying tax. This is distinguishable from the situation in which a partnership or trust pays foreign income tax on partnership or trust income that is taxed in the hands of the resident taxpayer under Australian tax law on a flow-through basis, thus reducing the amount distributed or credited to the taxpayer. In these cases, while the partnership or trust pays the foreign income tax, it is the resident partner or beneficiary that bears the economic burden (under Australian law) of that foreign income tax.

1.107 The phrase '…in respect of an amount (a ***taxed amount***) that is all or part of an amount included in your ordinary income or statutory income…' is also intended to allow an apportionment or slicing of foreign income tax for conduit or flow-through entities such as trusts and partnerships. This apportionment is intended to guard against more than one taxpayer claiming a tax offset for the same amount of foreign income tax. ***[Schedule 1, item 1, subsections 770-130(1) and (2)]***

**Example 1.11**

A partnership (that comprises two Australian partners with equal shares) earns $1,000 of partnership net income and pays $100 of foreign income tax on that income.

The two partners include $500 each in their assessable income. They will both be entitled to a tax offset to the extent that foreign income tax is paid in respect of the amount included in their assessable income. Each partner is deemed to have paid some of the foreign income tax.

As the $100 of foreign income tax cannot be paid in respect of both taxpayers' assessable income, the foreign income tax paid is apportioned according to each partner's share of partnership net income that is included in their assessable income. Therefore, both partners can each claim an offset for $50 of foreign income tax, because this is the proportionate amount of foreign income tax paid in respect of the amount included in their assessable income (ie, (500/1,000) × $100).

*When foreign income tax is treated as paid by the taxpayer — beneficiaries of trust estates*

1.108 Subsection 770-130(3) replaces current subsection 6AB(4) of the ITAA 1936. Subsection 770-130(3) continues to ensure the flow-through of tax offset entitlement where a beneficiary receives a trust distribution that includes income received by the trust on which foreign income tax has already been paid — that is, the trust itself has not paid the foreign income tax ***[Schedule 1, item 1, paragraph 770-130(3)(b)].*** This is distinct from the deeming provision discussed in paragraph 1.100. In that case, the foreign income tax is paid by the trust ***[Schedule 1, item 1, subsection 770-130(2)].***

1.109 When applied in conjunction with section 6B of the ITAA 1936, it also guarantees that the character and source of income flows through a trust (or multiple trusts or a combination of trusts and partnerships) to a beneficiary. The language of section 6B '…attributable to…' in addition to '…derived from a particular source…', ensures that the character of the distribution as well as the source of the income remains unchanged. ***[Schedule 1, item 1, paragraph 770-130(3)(a)]***

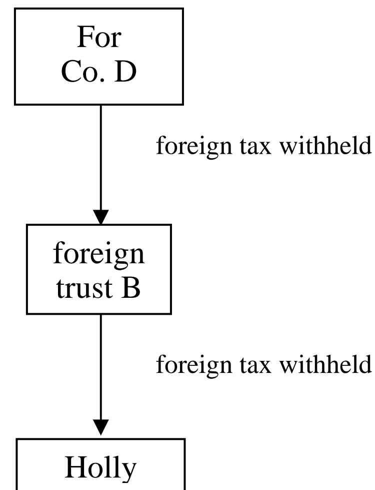
1.110 Two common scenarios in which subsection 770-130(3) may be used to deem a beneficiary to have paid foreign income tax are:

- where the trust receives income on which foreign income tax is paid by deduction; and
- where the trust is a beneficiary in another trust and the other trust paid the foreign income tax.

**Example 1.12**

Holly is the sole beneficiary of foreign trust B. Holly is presently entitled to all the income of foreign trust B. Foreign trust B owns shares in a foreign company, For Co. D.

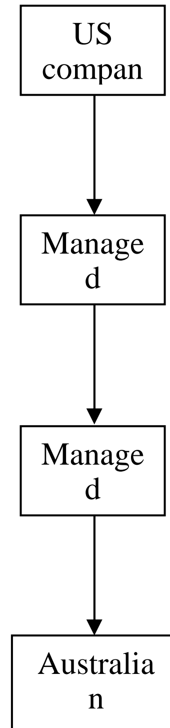
For Co. D pays a dividend to foreign trust B and the dividend is subject to foreign withholding tax. Foreign trust B distributes the income to Holly and the distribution is subject to further foreign withholding tax. Since Holly has not paid the foreign income tax on the distribution from For Co. D to foreign trust B; and since foreign trust B has not paid the foreign income tax, Holly will rely on subsection 770-130(3) to treat the foreign income tax paid by For Co. D to be foreign income tax that she paid. Further, Holly will rely on subsection 770-130(2) to treat the foreign income tax paid by foreign trust B as tax she paid.




1.111 The foreign income tax paid is intended to flow through to the taxpayer in the scenario contained in Example 1.12. Ultimately, the double-taxed amount is the beneficiary's ordinary income or statutory income and consequently, the beneficiary should be entitled to claim an offset for the foreign income tax paid by someone else. It is irrelevant whether there are one or more tiers of trusts or partnerships interposed.

**Example 1.13**

Consider the following investment structure:




A resident individual invests directly in Managed Fund A. Managed Fund A in turn invests in Managed Fund B, which has a direct interest in a US company.

The US company pays a dividend of $100 and deducts $15 withholding tax, making the net distribution $85. The amount distributed to the individual is ultimately attributable to the dividend paid by the US company. The individual will include $100 in assessable income and will be entitled to claim a tax offset for the $15 withholding tax.

The taxpayer will determine the amount of the tax offset in accordance with the foreign tax offset limit rules.

**Example 1.14**

Assume the same investment structure as outlined in Example 1.13.

The US company pays a dividend of $100 and deducts $15 withholding tax, making the net distribution $85. Managed Fund B has $30 of deductible expenses and consequently distributes $55 to Managed Fund A. The amount distributed to the individual is ultimately attributable to the dividend paid by the US company. The individual will receive the $55 from Managed Fund A and will be deemed to have paid the withholding tax and will be deemed to have paid the withholding tax and so will include $70 in its assessable income. The individual will be entitled to claim a tax offset for the $15 withholding tax.

The taxpayer will determine the amount of the tax offset in accordance with the foreign tax offset limit rules.

**Example 1.15**

Assume the same investment structure as outlined in Example 1.13.

The US company pays a dividend of $100 and deducts $15 withholding tax, making the net distribution $85. Managed Fund B has $110 of deductible expenses, resulting in a net loss of $10, and consequently does not make any distribution for the income year.

Because the individual does not receive the dividend, entitlement to a tax offset does not arise (ie, the taxpayer is not subject to any double taxation). The foreign income tax (deemed) paid by Managed Fund B is *not* carried forward for use in a later year.

1.112 The amount of foreign income tax that the taxpayer may claim as an offset is the amount by which the income they included in assessable income has been reduced because of the foreign income tax. ***[Schedule 1, item 1, paragraph 770-130(3)(c)]***

*Foreign income tax treated as paid by the taxpayer — controlled foreign companies*

1.113 Current subparagraphs 6AB(2)(b)(i), (ii) and (v) of the ITAA 1936 have been rewritten but continue to ensure that certain attributable taxpayers are treated as having paid foreign income tax on amounts attributed under section 456, 457 or 529 of the ITAA 1936. ***[Schedule 1, item 1, section 770-135]***

1.114 For amounts attributed to an Australian company under section 456, the amount of foreign income tax taken to be paid by the company is the *sum* of foreign income tax, Australian income tax and Australian withholding taxes paid by the controlled foreign company *multiplied* by the company's interest in the controlled foreign company ***[Schedule 1, item 1, paragraphs 770-135(3)(a) and (7)(a) and subsection 770-135(4)].*** This is intended to represent the portion of income tax borne by the foreign company that is relevant to the taxpayer.

1.115 For amounts attributable under section 457, the amount of foreign income tax is taken to be the sum of the amounts of the foreign income tax, and Australian tax (income tax and withholding tax) paid by the controlled foreign company to the extent they are attributable to the amount included in the attributable taxpayer's assessable income. ***[Schedule 1, item 1, paragraphs 770-135(3)(b) and (7)(b) and subsection 770-135(4)]***

**Example 1.16**

> Aust Co. is a resident company which owns 70 per cent of the paid-up share capital of For Co., a controlled foreign company resident in an unlisted country. Therefore, Aust Co. has a 70 per cent direct attribution interest in For Co. and an attribution percentage of 70 per cent in relation to For Co.
>
> During the statutory accounting period ending 31 March 2009, For Co. derives income of $100,000 comprised of capital gains (on the disposal of tainted assets) and royalty income. This means that For Co. fails the active income test and all of its income is included in its notional assessable income (sections 384 and 432 of the ITAA 1936).
>
> For Co. pays tax on its income in the unlisted country at the rate of 20 per cent. The tax of $20,000 is a notional allowable deduction of the controlled foreign company under section 393 of the ITAA 1936, resulting in attributable income of $80,000 for For Co. Aust Co. includes in its assessable income (under section 456 of the ITAA 1936) the attributable income of For Co. multiplied by the attribution percentage (ie, 70% × $80,000 or $56,000). Aust Co. is also deemed to have paid foreign income tax of $14,000 (70% of $20,000). Aust Co. must gross-up its assessable income by $14,000, but can claim a tax offset for the same amount, subject to the tax offset limit rules.

*Foreign income tax treated as paid by the taxpayer — foreign investment funds*

1.116 Where an attributable taxpayer includes an amount in their assessable income under section 529 of the ITAA 1936 and meets the conditions set out in subsection 770-135(1), the amount of foreign income tax the attributable taxpayer is taken to have paid is worked out under

paragraph 770-135(7)(c) ***[Schedule 1, item 1, subsection 770-135(1), subparagraph 770-135(2)(a)(iii) and paragraph 770-135(2)(b)].*** The amount of foreign income tax the attributable taxpayer is taken to have paid is the *sum* of all the tax amounts paid by the foreign investment fund for the notional accounting period *multiplied* by the attributable taxpayer's percentage share of the total calculated profit of the foreign investment fund ***[Schedule 1, item 1, paragraph 770-135(7)(c)].***

1.117 The tax amounts include amounts of foreign income tax, and Australian tax (income tax and withholding tax) paid by the foreign investment fund in respect of an amount included in its notional assessable income ***[Schedule 1, item 1, paragraph 770-135(3)(c)].*** The attributable taxpayer's percentage share of the total calculated profit of the fund is the taxpayer's own share of the calculated profit divided by the fund's total calculated profit for the notional accounting period ***[Schedule 1, item 1, paragraph 770-135(7)(c)].***

1.118 Where the foreign investment fund is a trust, the amount of foreign income tax is the amount of foreign income tax, or Australian tax (income tax or withholding tax) paid by the trust, commensurate with the attributable taxpayer's interest in the trust. ***[Schedule 1, item 1, paragraphs 770-135(2)(b) and (7)(c)]***

**Example 1.17**

Aust Co. owns 30 per cent of the paid-up capital in For Co., a foreign investment fund. Aust Co. works out its foreign investment fund income under section 529 of the ITAA 1936 by using the calculation method. For Co.'s calculated profit under the calculation method is $1 million after a notional deduction of $300,000 is allowed for foreign income tax paid. Aust Co.'s share of the calculated profit of For Co. is 30% × $1 million or $300,000, based on its shareholding in For Co.

As Aust Co.'s share of the calculated profits of For Co. is 30 per cent, it is deemed to have paid 30 per cent of the foreign income tax paid by For Co. which is calculated as 30% × $300,000 or $90,000 and the amount included in assessable income is $390,000.

Accordingly, Aust Co. can claim a tax offset for that amount, subject to the tax offset limit rules.

*When foreign income tax is not treated as paid by the taxpayer*

1.119 A taxpayer is not entitled to a tax offset for paid foreign income tax if the tax is refunded to the taxpayer or to any other entity ***[Schedule 1, item 1, paragraph 770-140(a)].*** Further, entitlement to an offset will not arise if the taxpayer (or any other entity) receives any other benefit as a direct

result of the payment of foreign income tax ***[Schedule 1, item 1, paragraph 770-140(b)].***

1.120 The current subsection 6AB(5A) of the ITAA 1936 was introduced to target arrangements entered into that allowed a taxpayer to generate false foreign tax credits. The new law continues to deny an offset in these circumstances, but is not limited to the generation of a false tax offset.

1.121 Section 770-140 is intended to uphold the integrity of the core principle underpinning the foreign tax offset rules. That is, a taxpayer is only entitled to an offset for foreign income tax paid on an amount included in their assessable income. To the extent that a taxpayer receives a refund of foreign income tax, or a taxpayer is the recipient of a benefit resulting in the removal (or reduction) of double taxation, the obligation (on Australia) to provide double tax relief diminishes.

1.122 It is not a requirement that the refund of foreign income tax or the benefit calculated by reference to the foreign income tax be provided to the taxpayer that actually paid the foreign income tax. A tax offset will also be denied if the refund or benefit is provided to an entity other than the taxpayer that paid the foreign income tax. ***[Schedule 1, item 1, section 770-140]***

1.123 Consistent with the current rules, an offset will not be denied where the only benefit is a reduction in the tax liability of the taxpayer or another entity. This is to ensure that entitlement is still available where a foreign country provides an imputation credit, a rebate of tax or similar type of concession. The offset will however be denied if the concession results in a refund to the taxpayer (or other entity). ***[Schedule 1, item 1, paragraph 770-140(b)]***

1.124 An offset will be denied to the taxpayer if they, or any other entity, receive a benefit because of the payment of foreign income tax and the benefit is calculated by reference to the amount of foreign income tax paid. It is not a requirement that the benefit results in the generation of a false tax offset. A benefit may arise from the exploitation of arbitrage opportunities resulting from mismatches in debt and equity classifications and the different status granted to foreign hybrid entities. For example, where an enhanced yield is obtained by a taxpayer entering into a structured finance arrangement.

**Example 1.18**

Austco (an Australian resident company) derives certain income in a foreign country. Under the rules of that country, advance corporation tax is levied on the basis of a particular formula. For the income year, Austco pays advance tax of $50,000 and treats the amount as foreign income tax for the purposes of Division 770.

Austco later finds out that it is entitled to a special concession under the rules of the foreign country which has the effect of fully refunding the tax of $50,000 that was previously paid. Since Austco has received a refund in respect of the advance tax of $50,000, Austco is taken to not have paid the foreign income tax on that income.

*How is the foreign tax offset limited or capped?*

1.125 The starting point for a taxpayer in determining the amount of tax offset entitlement is to ascertain the total foreign income tax paid on amounts included in their assessable income. ***[Schedule 1, item 1, section 770-70]***

1.126 It will then be necessary to ensure that the amount of the tax offset only relieves double taxation. The foreign tax offset is not intended to relieve all foreign taxation by subsidising the tax base of a foreign jurisdiction. The tax offset is therefore limited to the potential amount of Australian tax on the double-taxed amount (this translates to the foreign tax offset cap) ***[Schedule 1, item 1, subsection 770-75(1)]***. There is one exception to the calculation of this cap and it is the $1,000 *de minimis* cap ***[Schedule 1, item 1, paragraph 770-75(2)(a)]***. This $1,000 cap threshold is an alternative to the calculated cap and promotes simplicity and reduced compliance costs.

*What is the $1,000 de minimis cap?*

1.127 If the total foreign income tax paid is less than or equal to $1,000 (the $1,000 *de minimis* cap), the taxpayer is not required to calculate the foreign tax offset cap ***[Schedule 1, item 1, paragraph 770-75(2)(a) and note 1 in subsection 770-75(2)]***. Provided the requirements in section 770-10 are satisfied, the taxpayer's tax offset will equate to the total foreign income tax paid on the double-taxed amounts included in assessable income ***[Schedule 1, item 1, section 770-70]***.

1.128 Further, where the taxpayer has also paid foreign income tax in respect of an amount that is non-assessable non-exempt income under either section 23AI or 23AK of the ITAA 1936, the offset (either capped at $1,000 or less, depending on the amount of foreign income tax paid), will be increased by the amount of foreign income tax paid in respect of those amounts. ***[Schedule 1, item 1, section 770-80]***

*Requirement to calculate the foreign tax offset cap*

1.129 If the total foreign income tax paid is greater than $1,000, the taxpayer has two options. First, the taxpayer may elect to offset only $1,000 of foreign income tax paid ***[Schedule 1, item 1, subsection 770-75(2)]***. In this case, the taxpayer is not required to calculate the foreign tax offset cap. However, any foreign income tax paid in excess of the $1,000 cap will be wasted. It cannot be used in any future income year or by any other taxpayer.

1.130 Alternatively, if the taxpayer wishes to offset more than $1,000 of foreign income tax paid, they will be required to calculate the foreign tax offset cap ***[Schedule 1, item 1, paragraph 770-75(2)(b)]***. The taxpayer will then be entitled to offset foreign income tax paid up to the amount of the cap. If the calculation yields a result less than $1,000 the taxpayer may disregard the calculated foreign tax offset cap and instead offset foreign income tax paid up to the $1,000 *de minimus* cap.

1.131 In the event that the tax offset limit (whether worked out as $1,000 or the calculated cap) is greater than the total foreign income tax paid on double-taxed amounts included in assessable income, the taxpayer can increase the offset, up to the amount of the tax offset limit, by any pre-commencement excess foreign tax they may have ***[Schedule 1, item 5, subsection 770-230(2) of the Income Tax (Transitional Provisions) Act 1997]***. For an explanation of the utilisation of this pre-commencement foreign income tax, see paragraphs 1.299 to 1.326.

*How to calculate the foreign tax offset cap*

1.132 The foreign tax offset cap is the Australian tax payable on a taxpayer's double-taxed amounts and other assessable amounts that do not have an Australian source.

1.133 The Australian tax payable is the extra amount of Australian income tax that the taxpayer would have to pay because of the double-taxed amounts (and other assessable amounts that do not have an Australian source). The Australian tax payable is therefore the difference between income tax *including* the double-taxed amounts and other assessable amounts that do not have an Australian source, and income tax *excluding* those amounts. ***[Schedule 1, item 1, paragraph 770-75(2)(b)]***

1.134 The taxpayer is therefore required to calculate two different amounts in order to determine the limit on the amount of tax offset entitlement. The first amount is the income tax payable by the taxpayer for the income year before any tax offsets or penalties are applied. The second amount is the income tax payable by the taxpayer for the income year before any tax offsets or penalties are applied and assuming certain

other amounts are disregarded. The taxpayer subtracts the second amount from the first amount to determine the cap and consequently, the maximum amount of tax offset allowable. ***[Schedule 1, item 1, paragraph 770-75(2)(b) and subsection 770-75(3)]***

1.135 This approach ensures that the taxpayer is using their highest marginal rate of tax, effectively resulting in a top-slice of income approach in ascertaining the Australian tax payable on the double-taxed amounts (and other assessable amounts that do not have an Australian source). This is a change from the current approach of calculating the cap based on an *average* tax rate.

1.136 Tax offsets are disregarded in the calculation of income tax payable for simplicity as well as clarity ***[Schedule 1, item 1, subsection 770-75(3)].*** Where a taxpayer has paid foreign income tax and is entitled to a tax offset, the determination of the cap would become circular if the calculations took account of tax offsets available to a taxpayer. In particular, the taxpayer would need to know the amount of the foreign tax offset in order to calculate the cap, however, in many cases the cap will determine the amount of foreign tax offset.

1.137 In calculating the second amount of income tax payable, the taxpayer is required to disregard certain amounts of assessable income and certain deductions. ***[Schedule 1, item 1, subparagraph 770-75(2)(b)(ii) and subsection 770-75(4)]***

1.138 The amounts taken out of the taxpayer's assessable income are:

- so much of any amount in respect of which the taxpayer paid foreign income tax ***[Schedule 1, item 1, subparagraph 770-75(4)(a)(i)]***; and
- ordinary income or statutory income that is not from an Australian source and in respect of which no foreign income tax has been paid ***[Schedule 1, item 1, subparagraph 770-75(4)(a)(ii)].***

1.139 The first of the income-disregarding rules captures the double-taxed amounts, that are the assessable income upon which foreign income tax has been paid or deemed to have been paid. The words 'so much of any amount' ensure that only the relevant part of the assessable income upon which foreign income tax has been paid is disregarded for the purposes of the cap calculation.

1.140 In the event that a taxpayer has paid foreign income tax on a capital gain that comprises part of their net capital gain, only that capital gain on which foreign income tax has been paid will be disregarded ***[Schedule 1, item 1, subparagraph 770-75(4)(a)(i)].*** That is, the taxpayer in this

situation does not disregard the entire net capital gain. This is consistent with the current treatment afforded to foreign tax paid on capital gains which form all or part of a taxpayer's net capital gain. If the disregarded amount in this example was the entire net capital gain, the proxy for the Australian tax payable would be inaccurate and in particular, the result would give rise to an increased cap. It follows that only those deductions that reasonably relate to the disregarded capital gain will be disregarded ***[Schedule 1, item 1, subparagraph 770-75(4)(b)(ii)].*** That is, the taxpayer does not disregard all deductions that reasonably relate to the entire net capital gain.

**Example 1.19**

> Aust Co. derives a capital gain of $2 million (on which foreign income tax is paid) and a gain in respect of the disposal of an Australian asset of $1 million (on which no foreign income tax is paid). Aust Co. therefore includes $3 million in its assessable income as a net capital gain. For the purposes of the first income-disregarding rule, only the capital gain of $2 million is disregarded, since this represents the part of the assessable income of Aust Co. upon which foreign income tax has been paid.

1.141 The inclusion of foreign source income that has not been subject to foreign income tax as the second of the income-disregarding rules is consistent with the current approach of including within the cap, for a particular class of assessable foreign income, all assessable foreign income of that class, irrespective of whether foreign tax has been paid in respect of that income. This has the effect of increasing the amount of the foreign tax offset cap ***[Schedule 1, item 1, subparagraph 770-75(4)(a)(ii)].*** The inclusion of all foreign source income, although inconsistent with a pure double-tax-relief approach, allows the taxpayer a greater averaging capacity, in that all high foreign taxed amounts are amalgamated with low foreign taxed amounts. Note that assessable offshore banking income upon which no foreign income tax has been paid is deemed to have an Australian source pursuant to section 121EJ of the ITAA 1936. Accordingly, it is not included in the second income-disregarding rule.

1.142 Specific mention is no longer made for section 305-70 amounts; or ITAA 1936, section 102AAZD, 456, 457, 459A or 529 amounts that are included in the taxpayer's assessable income because they will fall within the first two income amount categories. In particular, if a taxpayer has not paid foreign income tax on an amount included in their assessable income under these sections the amount would be expected to be classified as not having an Australian source under judicial rules of source.

1.143 The income-disregarding rules are designed to apply cumulatively. That is, income that is disregarded under subparagraph 770-75(4)(a)(i) cannot be disregarded a second time where it also falls within the scope of subparagraph 770-75(4)(a)(ii).

1.144 The second element in the cap calculation requires the taxpayer to assume that they are not entitled to certain deductions. The expenses that are 'disregarded' are:

- debt deductions, to the extent they are attributable to the taxpayer's overseas permanent establishments ***[Schedule 1, item 1, subparagraph 770-75(4)(b)(i)]***;

- other deductions that reasonably relate to the disregarded income amounts for the income year ***[Schedule 1, item 1, subparagraph 770-75(4)(b)(ii)]***; and

- during the transitional period, any convertible foreign loss deducted by the taxpayer in the income year ***[Schedule 1, item 5, section 770-35 of the Income Tax (Transitional Provisions) Act 1997].***

1.145 Whether a deduction *reasonably relates* to the disregarded income amounts will be a question of fact depending on the circumstances of the taxpayer. Expenses that relate *exclusively* to the disregarded income amounts will be ignored in calculating the second element of the cap calculation. Deductions that relate to both the disregarded income amounts and other assessable income will need to be apportioned on a reasonable basis between the different income amounts. ***[Schedule 1, item 1, subparagraph 770-75(4)(b)(ii)]***

1.146 The nature and size of the taxpayer's business, the type of income concerned and the methods used by the taxpayer to account for foreign income and expenses may be relevant in determining how the taxpayer should apportion deductions. A common example of the type of deduction a taxpayer will need to apportion would be head office expenses incurred by a taxpayer who operates both in Australia and overseas and which are relevant to the operation of both activities.

1.147 Provided the approach adopted is objective and results in a reasonable apportionment of the deductions, it will (generally) be acceptable. To the extent such expenses are considered to reasonably relate to the disregarded income amounts, they will be ignored in calculating the second element of the cap calculation. ***[Schedule 1, item 1, subparagraph 770-75(4)(b)(ii)]***

1.148 The exclusion of debt deductions that are attributable to the taxpayer's overseas permanent establishment is consistent with the thin capitalisation changes introduced in 2001 (the *New Business Tax System (Thin Capitalisation) Act 2001*) ***[Schedule 1, item 1, subparagraph 770-75(4)(b)(i)].*** This does not include expenses (including financing costs) incurred by an Australian company in earning income that is non-assessable under section 23AH of the ITAA 1936. In contrast, other debt deductions are not disregarded for the purposes of the second element of the cap calculation. This preserves the existing treatment of debt deductions as falling outside the cap calculation, consistent with the thin capitalisation changes referred to above.

1.149 The exclusion of deducted convertible foreign losses when calculating the second income tax payable amount has the effect of reducing the foreign tax offset cap by the tax effect of the amount of utilised convertible foreign loss. Of course, the deducted foreign losses will also reduce the first tax payable figure. A convertible foreign loss is subject to special deductibility rules during the five-year transitional period. (See paragraphs 1.228 to 1.298, which deal with the transitional rules for converting a foreign loss of a particular class of assessable foreign income into a tax loss and the utilisation of such losses.) Consequently, utilised convertible foreign losses will only influence the calculation for this five-year period.

1.150 This is an integrity rule ensuring that the tax offset limit reflects the reduced amount of assessable income upon which foreign tax has been paid, after taking into account utilised convertible foreign losses in that year. This approach is similar to existing subsection 160AFD(4) of the ITAA 1936 which reduces the assessable foreign income of a particular class for the purposes of the cap rule to the extent that a loss of that particular class has been applied to reduce assessable foreign income of that class in the relevant income year.

**Example 1.20**

Assume the same facts from Example 1.3.

The amount of net capital gain included in the taxpayer's assessable income relates solely to the foreign capital gain in respect of which foreign tax has been paid. Therefore, the whole amount of foreign income tax is counted for foreign tax offset purposes.

The taxpayer is entitled to an offset for the lesser of the foreign tax paid ($39,000) and the Australian tax payable in respect of the foreign net capital gain that is included in assessable income (even though only part of the capital gain on foreign asset D is included in the taxpayer's net capital gain). The Australian tax payable is calculated as follows:

$$\$125,000 \times 0.30 = \$37,500$$

Therefore, the taxpayer is entitled to an offset of $37,500.

### Example 1.21

Austco is an Australian resident company that derives the following taxable income for the 2008-09 income year:

| | |
|---|---|
| Portfolio dividend (from Foreign Country A)<br>(foreign income tax paid of $100,000) | $1,000,000 |
| Interest income (from Foreign Country B)<br>(no foreign tax paid) | $1,000,000 |
| Australian-sourced income | $1,000,000 |
| **Total assessable income** | **$3,000,000** |
| *Less:* | |
| Interest expense * | $500,000 |
| Other expenses related to Australian-sourced income | $500,000 |
| **Total allowable deductions** | **$1,000,000** |
| **Taxable income** | **$2,000,000** |
| **Australian tax payable** | **$600,000** |

* Debt deduction — not attributable to an overseas permanent establishment of Austco — incurred in relation to dividend income.

Austco calculates its tax offset cap in the following way (assuming Austco does not choose the $1,000 cap):

**Step 1 — Work out the amount of tax payable by Austco**

$600,000

**Step 2 — Work out the tax payable by Austco if the assumptions in subsection 770-75(4) were made**

Assume that Austco's assessable income did not include the following amounts:

- Portfolio dividend $1,000,000

  This is an amount in respect of which foreign income tax was paid.

- Interest income $1,000,000

  This is ordinary income from a source other than an Australian source.

Even though the debt deduction of $500,000 is incurred in relation to the dividend income from Foreign Country A, it is not disregarded for the purposes of the cap calculation since it is not attributable to an overseas permanent establishment of Austco.

Therefore, the tax payable by Austco based on the assumptions in subsection 770-75(4) is nil (ie, taxable income of $2,000,000 *less* exclusion of interest and dividend amounts of $2,000,000).

**Step 3 — Work out the amount of tax payable at Step 1, less the tax payable at Step 2**

$600,000 – $0

This amount of $600,000 is the tax offset limit.

As the foreign income tax paid of $100,000 is less than the tax offset limit of $600,000, Austco is entitled to a tax offset of $100,000.

1.151 In the event that the first calculation (before any tax offsets or penalties are applied) that a taxpayer calculates is nil (eg, the taxpayer is in a loss position), the taxpayer's tax offset limit will also be nil. In this case, the taxpayer will not be in a position to offset any of the foreign income tax paid on amounts included in assessable income. Further, because there is no carry-forward mechanism, this foreign income tax cannot be used to reduce Australian tax. It cannot be refunded nor transferred to another taxpayer.

1.152 The amount of the calculated cap will be increased to the extent the taxpayer has paid foreign income tax on amounts that are non-assessable non-exempt income under either section 23AI or 23AK of the ITAA 1936. The amount of the increase in the offset will be the amount of the foreign income tax paid in respect of the non-assessable non-exempt income ***[Schedule 1, item 1, section 770-80]***. This foreign income tax will usually be the final (direct) withholding tax imposed by the

foreign country from which the distribution is paid. That is, the taxpayer will no longer be entitled to claim an offset for the underlying foreign income taxes paid on such a distribution. However, there is effectively no cap on the foreign income tax paid in respect of these amounts, nor any effort made to relate them to the Australian tax paid on the relevant attributed income.

1.153 Following on from paragraph 1.151, if the taxpayer is in a loss position, resulting in a calculated cap of nil, and also has foreign income tax paid on an amount that is non-assessable non-exempt income under either section 23AI or 23AK of the ITAA 1936, entitlement to an offset will not arise even though the calculated cap is non-zero. Further, because there is no carry-forward mechanism, this foreign income tax cannot be used. It cannot be refunded or transferred to another taxpayer.

***Amendment of assessments — contingent amendment period***

1.154 Entitlement to a tax offset for foreign income tax paid on an amount included in assessable income arises when the foreign income tax has been paid in relation to the income year in which the double-taxed amount is included in the taxpayer's assessable income. However, it may be that the taxpayer paid the foreign income tax in a different income year to when the amount is included in assessable income due to differences between the tax systems of foreign countries and Australia. ***[Schedule 1, item 1, section 770-190]***

1.155 To ensure the usual amendment periods do not restrain the taxpayer's ability to claim an offset for foreign income tax paid, section 770-190 will modify the usual amendment period. For foreign tax offset purposes, the taxpayer will have four years from the time they pay foreign income tax to lodge an amended assessment ***[Schedule 1, item 1, section 770-190].*** That is, the amendment period does not depend upon when the double-taxed amount was included in assessable income.

1.156 If a taxpayer includes an amount in assessable income for an income year but paid foreign income tax in a subsequent year of income, they may need to lodge an amended assessment when the foreign income tax is paid. However, the amendment to allow the taxpayer to claim a foreign tax offset is in relation to the income year in which the amount was included in the taxpayer's assessable income and *not* the income year the foreign income tax was paid. Accordingly, the modified amendment rules permit the taxpayer to lodge an amendment for that earlier income year within a period of four years from the time of payment of the foreign income tax. In the absence of this modified amendment rule, the normal amendment rules contained in section 170 of the ITAA 1936 may prevent the taxpayer from claiming a foreign tax offset.

1.157 In the event that the taxpayer paid foreign income tax that is subsequently increased or reduced, then the four-year amendment period will commence from the latter point in time ***[Schedule 1, item 1, subsection 770-190(1) and paragraphs 770-190(2)(a) to (c)].*** Foreign income tax may subsequently be reduced if the foreign jurisdiction allows the carry-back of losses. In this case, the loss that is carried-back will reduce the amount of tax levied on the taxpayer in the foreign jurisdiction, namely, the amount of foreign income tax paid for tax offset purposes is reduced. The four-year period commences when the taxpayer receives a foreign tax refund or is given a credit because the deduction for the loss is allowed.

1.158 Alternatively, a taxpayer that lodges an assessment with a foreign jurisdiction as well as Australia may acquire new information after lodgement. If the taxpayer was required to lodge an amended assessment in the foreign jurisdiction and was subject to additional foreign income tax, the amendment period will commence from the subsequent payment of foreign income tax. ***[Schedule 1, item 1, subsection 770-190(1) and paragraph 770-190(2)(b)]***

1.159 The modified amendment rules do not apply if the foreign tax offset is amended because of changes to the calculation of the foreign tax offset limit (as distinct from an increase or decrease in the amount of foreign tax paid) ***[Schedule 1, item 1, subsection 770-190(2)].*** A change to the calculation of the offset limit is not one of the specified amendment events. The Commissioner may conduct an audit of a taxpayer and determine that the taxpayer has inflated the tax offset limit, which in turn affects the amount of the foreign tax offset. In this situation, the usual amendment periods will apply.

**Example 1.22**

Aust Co. (an Australian resident company) holds a rental property in the US. Aust Co. sells the property and makes a gain in the 2009-10 income year. The gain is taxed in the US and Aust Co. pays the tax before lodging its return for 2009-10.

Subsequently, the US tax is reduced because of the favourable outcome of a dispute over deductions and Aust Co. receives a refund in February 2012. Aust Co. has until 2016 to amend its tax for the 2009-10 income year. As a result, Aust Co. may be required to pay additional Australian tax.

## Method of relieving double tax resulting from a transfer pricing adjustment

1.160 Australia is obliged, under most of its international agreements (including tax treaties), to provide relief (to a resident company) from economic double taxation that arises as a result of a transfer pricing adjustment by a tax treaty partner country. Relief from economic double taxation in these circumstances ('correlative relief') is usually provided in the rules on associated enterprises (generally Article 9 of Australia's tax treaties).

1.161 Economic double taxation will occur where two companies resident in different countries — that is, two separate legal entities — are effectively taxed on the same income, without either country providing relief for the tax imposed by the other (eg, a parent company resident in Italy and a subsidiary company resident in Australia). This is in contrast to juridical double taxation, which occurs where a company pays tax on the same income in two different countries without either country providing relief for the tax imposed by the other. For example, a single legal entity that has its head office in its country of residence and a permanent establishment located in another country.

1.162 Generally, the amount of correlative relief will be determined in accordance with the treaty and in particular by the rules governing the mutual agreement procedure. There are two stages to this process: the first stage involves the resident company presenting its case to the Australian competent authority who then considers whether the case is justified, and if so, whether it can reach a satisfactory solution. The second stage is where the Australian competent authority must endeavour to resolve the case by mutual agreement with the competent authority of the tax treaty partner country. Stage two will be relevant when the Australian competent authority is not able to arrive at a satisfactory solution itself.

1.163 At the conclusion of the mutual agreement procedure, the Australian competent authority advises the taxpayer of the result. In the event that the taxpayer is not satisfied with the outcome reached, they can usually activate their domestic appeal rights. In such cases, the agreement reached under the mutual agreement procedure will not be implemented.

1.164 Currently, in the majority of transfer pricing cases, correlative relief is granted by way of a credit pursuant to section 160AI of Division 19 of Part III of the ITAA 1936 (a 'Division 19 credit'). Where the resident company is in a loss position, entitlement to correlative relief does not arise at that time. Consequently, the Commissioner will only allow a Division 19 credit when the resident company returns to profit and otherwise has some Australian tax to pay.

1.165 To give effect to international obligations arising from Australia's international agreements, these amendments will allow the Commissioner to make an appropriate adjustment to taxable income, or a tax loss, to relieve the double taxation (or potential future double taxation if the taxpayer is in a loss position) arising from a transfer pricing adjustment ***[Schedule 1, items 128 and 211, item 6 in the table in subsection 4-15(2), subsection 24(3) of the International Tax Agreements Act 1953].*** This aligns Australia's tax practice with that of the international community.

1.166 This principle will apply equally to all tax treaties irrespective of whether the treaty has a specific correlative relief provision provided in the rules on associated enterprises ***[Schedule 1, item 211, subsections 24(1) and (2) of the International Tax Agreements Act 1953].*** This does not require the Commissioner to provide correlative relief to relieve economic double taxation in non-treaty cases.

1.167 The Commissioner will have recourse to section 24 of the *International Tax Agreements Act 1953* to prevent economic double taxation arising from a transfer pricing adjustment for all treaty countries, notwithstanding that the Commissioner may not be under an obligation to do so in all cases ***[Schedule 1, item 211, subsection 24(2) of the International Tax Agreements Act 1953].*** Currently, the German, Italian and Swiss tax treaties do not have correlative relief provisions. Consequently, where a transfer pricing adjustment in one of these three countries indirectly affects an Australian taxpayer, the Commissioner will be in a position to prevent economic double taxation and determine the amount of the taxpayer's taxable income or tax loss ***[Schedule 1, item 211, subsection 24(3) of the International Tax Agreements Act 1953].***

1.168 The Commissioner will determine the amount of the adjustment in the same way, irrespective of whether the treaty has a correlative relief provision provided in the rules on associated enterprises. ***[Schedule 1, item 211, subsections 24(2) and (3) of the International Tax Agreements Act 1953]***

1.169 The taxpayer will lodge a mutual agreement procedure request and if the Australian competent authority agrees with the primary adjustment, the Commissioner will make a corresponding adjustment to reduce the taxpayer's taxable income (even to the extent of giving rise to a tax loss) or increase a tax loss. Where the Australian competent authority is not able to arrive at a solution itself, they will commence negotiations under the mutual agreement procedure with the competent authority of the treaty partner country responsible for the primary adjustment. The Commissioner will then reduce the taxpayer's taxable income, even to the extent of giving rise to a tax loss or increase the tax loss by the amount of the adjustment that has been agreed to by both competent authorities. In the event that the two competent authorities do not reach agreement, the taxpayer's taxable income (or tax loss) will be adjusted by what the

Commissioner regards as appropriate given the circumstances of the case. ***[Schedule 1, item 211, subsections 24(2) and (3) of the International Tax Agreements Act 1953]***

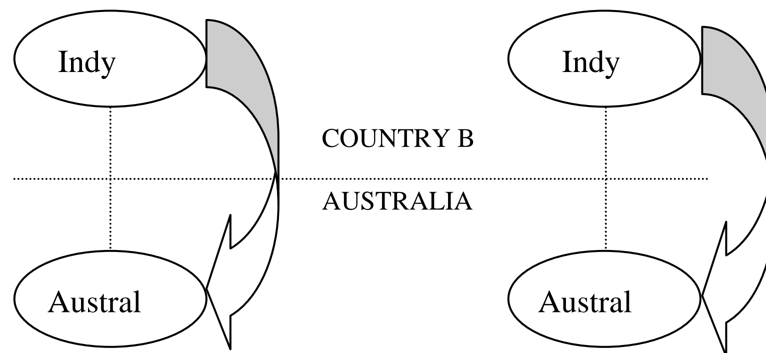
1.170 The taxpayer will always have an opportunity to initiate the mutual agreement procedure and it will always be open to the Australian competent authority to agree to the mutual agreement procedure — provided it is in accordance with the requirements of the rules on mutual agreement. That is, the absence of a provision for correlative relief does not preclude the operation of the mutual agreement procedure. Moreover, there is nothing in the domestic tax laws preventing the Commissioner from commencing the mutual agreement procedure. Because of this, the Commissioner will always proceed in the same way to determine the amount of the adjustment.

1.171 These amendments will also extend to those tax treaties that expressly specify that relief from the economic double taxation must be in the form of a credit (currently, the only tax treaty that includes a credit relief article is the Japanese tax treaty, Article 17(2)). The issue of treaty override does not arise in this situation because the treaty crediting provision has no application. Since there is no additional tax charged — the Commissioner having removed the incidence of double taxation by adjusting taxable income — there is no double taxation. Therefore, the need to comply with the tax treaty crediting provision dissipates and no issue of treaty override arises.

1.172 Currently, entitlement to correlative relief by way of a Division 19 credit is not subject to any time limits. The new mechanism for preventing double taxation will also not be subject to any domestic time limits. ***[Schedule 1, item 68, subsection 170(11) of the ITAA 1936]***

**Example 1.23**

| Before adjustment | After adjustment |
| --- | --- |
| Indy Co. provides goods to Austral Co. for no consideration | Country B determines the arm's length consideration for the goods to be $100,000 and increases the profit of Indy Co. by $100,000<br><br>($100,000 subject to economic double taxation) |




Indy Co. is a company resident in a tax-treaty partner country — Country B — and provides goods for no consideration to its wholly-owned subsidiary, Austral Co., a company resident in Australia.

Country B conducts an audit of Indy Co. and increases the profits of Indy Co. by $100,000 on the basis that if Indy Co. and Austral Co. had been dealing on an arm's length basis, Austral Co. would have paid Indy Co. $100,000 for the goods.

As a result of this primary transfer pricing adjustment effected by Country B, $100,000 of profits is subject to economic double taxation.

Austral Co. lodges a mutual agreement procedure with the Australian competent authority, asserting that it has been taxed not in accordance with the provisions of the tax treaty between Australia and Country B.

The Australian competent authority agrees that the $100,000 adjustment reflects an arm's length consideration. The Commissioner adjusts Austral Co.'s taxable income down by $100,000.

**Example 1.24**

Same facts as Example 1.23, however, the Australian competent authority does not agree with the primary adjustment. The Australian competent authority will engage the competent authority of Country B pursuant to the mutual agreement procedure.

Both competent authorities reach an agreement on what adjustment is justified both in principle and in amount. It is agreed that the arm's length price is $60,000.

The Commissioner informs Austral Co. and reduces Austral Co.'s taxable income by $60,000.

**Example 1.25**

Same facts as Example 1.23, however, the Australian competent authority does not agree with the primary transfer pricing adjustment. The Australian competent authority will engage the competent authority of Country B pursuant to the mutual agreement procedure.

Both competent authorities fail to reach an agreement as to what adjustment is justified both in principle and in amount. The competent authority of Country B believes the adjustment should be $100,000 and the Australian competent authority has reason to believe the adjustment should be $60,000.

The Australian competent authority informs Austral Co. of the result and the Commissioner proposes to reduce Austral Co.'s taxable income by $60,000, leaving $40,000 subject to economic double taxation.

If Austral Co. disagrees with the outcome then Austral Co. may commence domestic appeal rights (where available).

## Excess foreign income deductions (foreign losses)

1.173 A longstanding feature of Australia's taxation law requires resident taxpayers to offset assessable income with allowable deductions. Where the allowable deductions exceed assessable income, the excess is a tax loss that can be used to offset assessable income in a future income year (subject to the usual loss recoupment rules).

1.174 Currently, deductions incurred in deriving foreign income must be applied against assessable foreign income of the same class (of which there are four). Where the deductions exceed the assessable foreign income of the same class, current section 79D of the ITAA 1936 prevents the excess from being a deduction. These rules effectively quarantine excess foreign income deductions from domestic income and were

implemented primarily to prevent taxpayers from taking advantage of taxation asymmetries. However, recent international tax changes have largely removed these taxation asymmetries, consequently removing the original justification for the foreign loss quarantining rules.

1.175 The new rules will no longer quarantine foreign losses into four separate classes, nor will they quarantine foreign losses from domestic assessable income (also eliminating the election for a taxpayer to apply domestic losses against assessable foreign income) ***[Schedule 1, items 36, 37 and 64].*** The changes will remove the distinction between what is foreign and what is domestic for the purposes of applying deductions and prior-year losses. That is, deductions and prior-year losses that are applied by a taxpayer to reduce their assessable income may include both a foreign and domestic component.

### Example 1.26

Owen, an Australian resident taxpayer, is an economist employed by a government department and has employment income of $100,000 for the year ended 30 June 2020. Owen also has a loss of $20,000 from a failed foreign business venture, incurred in the year ended 30 June 2019 as well as a prior-year unrecouped loss of $5,000 incurred in the year ended 30 June 2018.

During the year, Owen incurred tax return expenses of $100 and paid $900 for subscriptions to economic periodicals.

Owen would calculate his taxable income for the 2019-20 tax year as follows:

| | | |
|---|---|---|
| Salary | 100,000 | |
| **Assessable income** | | **100,000** |
| *Less*: | | |
| Subscriptions | 900 | |
| Tax return expenses | 100 | |
| Loss on foreign business venture | 20,000 | |
| 2017-18 prior year tax loss | 5,000 | |
| **Total allowable deductions** | | **(26,000)** |
| **Taxable income for 2019-20** | | **74,000** |

### *Losses incurred by a controlled foreign company*

1.176 The treatment of foreign losses will be extended to losses incurred by a controlled foreign company. However, losses will continue to be quarantined in the controlled foreign company that incurred them. The four revenue classes of losses will be removed, in effect creating one revenue class for the purposes of applying deductions and prior-year losses. ***[Schedule 1, items 94 to 122, subsections 425(1) to (4), paragraph 426(a), subparagraphs 426(a)(i) and 426(a)(ii), section 426, paragraphs 427(b) and 427(ba), section 429, subsection 431(1), paragraphs 431(2)(a) and (b), subsections 431(4), (4A), (4B), (4D) and (5) of the ITAA 1936]***

1.177 Further, a controlled foreign company will be able to offset a revenue loss against a net capital gain because of the repeal of subsection 424(2) of the ITAA 1936. ***[Schedule 1, item 94]***

1.178 The controlled foreign company, in determining notional assessable income, assumes Australian residency (paragraph 383(a) of the ITAA 1936). Notional assessable income is therefore determined in accordance with Australian tax law. Since capital losses are quarantined from all other assessable income under Australian tax law (subsection 102-10(2)), a controlled foreign company will be required to quarantine capital losses from all other notional assessable income.

## Foreign investment fund calculation method — option for notional calculation using the controlled foreign company rules

1.179 Currently, a taxpayer with an interest in a foreign investment fund (a foreign company or foreign trust) can use one of three calculation methods within Division 18 of Part XI of the ITAA 1936 to determine if any income accrued from that fund to the taxpayer.

1.180 One of those methods is the calculation method. This method can be applied to determine if any foreign investment fund income accrued to the taxpayer from a particular foreign investment fund (a foreign company or a foreign trust). In calculating this income the calculation method can also be used for any interest that this company or trust has in another foreign company or trust (a second-tier foreign investment fund). The calculation method is not available for any entities below this second-tier foreign investment fund.

1.181 To mitigate the impact of removing credits for foreign taxes paid by a second-tier foreign investment fund, a further option is available to a taxpayer that uses the calculation method to determine foreign investment fund income. Certain taxpayers will have an opportunity to base this calculation on the controlled foreign company rules in Part X of the ITAA 1936. ***[Schedule 1, item 3, section 559A of the ITAA 1936]***

1.182 This will provide these taxpayers access to branch-equivalent calculations, the active income test and exemptions that relate to the calculation of the notional assessable income and notional allowable deductions of a foreign company that is a controlled foreign company.

***When can a choice be made to make notional controlled foreign company calculations under the foreign investment fund calculation method?***

1.183 A choice to work out notional income and notional deductions under Part X of the ITAA 1936 can only be made once the taxpayer has first elected to apply the calculation method in respect of the interest in the foreign investment fund. The calculation method is in Subdivision D of Division 18 of Part XI of the ITAA 1936, and may be used to determine whether any foreign investment fund income accrued from a particular foreign investment fund to a taxpayer. ***[Schedule 1, item 3, section 559A of the ITAA 1936]***

1.184 This Schedule also inserts subsection 535(4A) in the ITAA 1936. The existing restriction on the use of the calculation method for taxpayers who have previously elected to use the calculation method in respect of a foreign investment fund, but have not continued to use that method in subsequent years, is relaxed. ***[Schedule 1, item 2, subsection 535(4A) of the ITAA 1936]***

1.185 A taxpayer to which this rule would apply, can again choose to apply the calculation method in relation to that interest in the foreign investment fund, but only where the taxpayer is also making an election for notional controlled foreign company calculation treatment under section 559A of the ITAA 1936. This is to ensure that a taxpayer who now wishes to make the choice under section 559A is not precluded from doing so purely because that taxpayer has previously elected into, and then out, of the calculation method in relation to a particular foreign investment fund. ***[Schedule 1, item 2, subsection 535(4A) of the ITAA 1936]***

1.186 The main points to note about the ability to make the choice (within the calculation method of the foreign investment fund rules) to work out notional assessable income and notional allowable deductions of a foreign investment fund under Part X of the ITAA 1936 are as follows:

- it is only available to a taxpayer with an interest in a foreign company;
- it is only available where the taxpayer has an attribution percentage (as defined in Part X of the ITAA 1936) of 10 per cent or more in the foreign company; and

- once the choice is made in relation to a certain year, it can only be made for a subsequent year if it has been made for each intervening year.

***[Schedule 1, item 3, subsection 559A(1) of the ITAA 1936]***

*The requirement for a 10 per cent attribution percentage in the foreign company*

1.187 The first condition for the choice to be made in relation to a foreign investment fund under section 559A of the ITAA 1936 is that the fund must be a foreign company ***[Schedule 1, item 3, paragraph 559A(1)(a) of the ITAA 1936].*** The choice cannot be made in relation to a foreign investment fund that is a foreign trust because the controlled foreign company rules only deal with the calculation of notional assessable income and notional allowable deductions in relation to a foreign company.

1.188 The second condition is that the taxpayer must have an attribution percentage of 10 per cent or more in relation to the company at the end of the company's notional accounting period ***[Schedule 1, item 3, paragraph 559A(1)(b) of the ITAA 1936].*** The test is applied at the end of the notional accounting period, consistent with the determination of the calculated profit or calculated loss of the foreign company in respect of a notional accounting period under section 580 of the ITAA 1936.

1.189 The attribution percentage takes its meaning from Part X of the ITAA 1936 ***[Schedule 1, item 3, subsection 559A(9) of the ITAA 1936].*** The Part X definition has been adopted (as opposed to the 'attribution percentage' definition in Part XI) in order to adequately deal with the second-tier foreign company case. The 10 per cent test applies in respect of the indirect interest held by the actual (attributable) taxpayer in the second-tier foreign investment fund. The 10 per cent test does not apply separately for the direct interest held by the actual taxpayer and the first-tier foreign investment fund and again for the direct interest held by the first-tier foreign investment fund in the second-tier foreign investment fund. ***[Schedule 1, item 3, paragraph 559A(8)(a) of the ITAA 1936]***

1.190 The 10 per cent requirement is set as an indirect interest to ensure the election is only available in respect of those foreign companies for which the actual taxpayer is likely to have access to the financial information of the subsidiary company to be able to sufficiently calculate the foreign investment fund income using the rules in Part X of the ITAA 1936. Further, the indirect 10 per cent requirement is consistent with other measures that require an analysis of the financial information of a subsidiary company. For example, the total voting percentage requirement under the participation exemption rules in Subdivision 768-G is specified in a similar way.

1.191 The Part X definition of 'attribution percentage' achieves this result as it combines the direct attribution interest in the company and the aggregate of the indirect attribution interests in the company. The 'attribution percentage' definition in Part XI of the ITAA 1936 would not achieve this result in the second-tier foreign investment fund case because it only applies in respect of a direct interest held in a foreign investment fund.

1.192 The consequential amendment to this Schedule to change the definition of attribution percentage in subsection 995-1(1) will not impact on these changes. Those changes are discussed in paragraph 1.80. ***[Schedule 1, item 3, subsection 559A(9) of the ITAA 1936]***

1.193 The actual attribution of the foreign investment fund income (calculated under Part XI of the ITAA 1936 using the choice provided within the calculation method under section 559A of that Act) to the taxpayer, still occurs under Part XI itself (through the operation of section 580 of the ITAA 1936). The controlled foreign company rules are only used to work out the notional income and notional deductions of the foreign investment fund.

1.194 As the taxpayer is required to determine the direct attribution interest in qualifying to make the choice in relation to the foreign company, it is not expected that the taxpayer will be subject to any additional compliance costs as a result of using the Part X attribution percentage in paragraph 559A(1)(b) of the ITAA 1936. This is because the attribution percentage under section 581 of the ITAA 1936 (which is broadly similar to the direct attribution interest for Part X purposes) is used to determine the taxpayer's *share* of the calculated profit of a company.

*Does a taxpayer's choice in a prior year impact on whether a choice can be made in the current year?*

1.195 The final condition to be met for the choice to be made in relation to a foreign company is that the choice must be made in relation to each notional accounting period subsequent to the first notional accounting period for which the choice is made ***[Schedule 1, item 3, paragraph 559A(1)(c) of the ITAA 1936]***. This rule applies even if the taxpayer is unable to make the choice (if, for example, the taxpayer's attribution percentage in relation to the company falls below 10 per cent). This rule is consistent with the general rule that applies in relation to elections to use the calculation method under section 535 of the ITAA 1936.

1.196 In the case of applying the foreign investment fund calculation method to a second-tier foreign investment fund (a discussion of which appears in paragraphs 1.221 to 1.227), it is the Australian (attributable) taxpayer that actually makes the election under:

- subsection 390(1) of the ITAA 1936 if the taxpayer made a choice for notional controlled foreign company calculation in relation to the first-tier foreign investment fund; or

- paragraph 577(1)(a) of the ITAA 1936 if the taxpayer did not make that choice in relation to the first-tier foreign investment fund.

***What is the effect of making a choice?***

1.197 Once a taxpayer makes a choice in relation to a foreign investment fund under section 559A of the ITAA 1936, certain assumptions are made to ensure Part X of the ITAA 1936 can be applied effectively, namely:

- the foreign investment fund is treated as a foreign investment fund that is a controlled foreign company;

- the taxpayer is treated as an attributable taxpayer under Part X of the ITAA 1936;

- the notional accounting period is treated as a statutory accounting period;

- the notional income of the foreign company is treated as notional assessable income under Part X of the ITAA 1936;

- the notional deductions of the foreign company are treated as notional allowable deductions worked out under Part X of the ITAA 1936; and

- if the taxpayer is an Australian financial institution at a particular time in the year, the foreign company in relation to whom the choice is made is treated as an Australian financial institution subsidiary at that time.

*Why are the assumptions relating to the foreign company, the taxpayer and the notional accounting period made?*

1.198 Division 7 of Part X of the ITAA 1936 deals with the calculation of attributable income of a controlled foreign company for its statutory accounting period. Attributable income is calculated separately for each

attributable taxpayer with requirements that a company is a controlled foreign company and there are one or more attributable taxpayers in relation to the company.

1.199 The terms controlled foreign company (eligible controlled foreign company), statutory accounting period (the eligible period) and attributable taxpayer (the eligible taxpayer) all feed into the provisions dealing with notional assessable income and notional allowable deductions for the eligible controlled foreign company.

1.200 To ensure the relevant provisions in Part X of the ITAA 1936 dealing with the notional assessable income and notional allowable deductions can be applied, the foreign investment fund is treated as a foreign investment fund that is a controlled foreign company. The taxpayer, choosing to apply section 559A of the ITAA 1936, is treated as an attributable taxpayer in relation to the foreign investment fund. In the case of a first-tier foreign investment fund choosing to apply section 559A in relation to a second-tier foreign investment fund, it is the first-tier foreign investment fund that is treated as an attributable taxpayer and the second-tier foreign investment fund is treated as a foreign investment fund that is a controlled foreign company. ***[Schedule 1, item 3, paragraphs 559A(2)(a) and (b) of the ITAA 1936]***

1.201 Further, the calculation of attributable income under the controlled foreign company rules relies on the statutory accounting period of the controlled foreign company. This is generally each 12-month period finishing at the end of 30 June, but with an option to use some other 12-month period (section 319 of the ITAA 1936). Under the foreign investment fund rules, foreign investment fund income accrues to the taxpayer in respect of a notional accounting period of the foreign investment fund. The notional accounting period of the foreign investment fund is generally a period that is a year of income of the attributable taxpayer, with the choice of an election for a 12-month period based on the period for which the foreign investment fund's accounts are made out. Therefore, the notional accounting period may differ from the statutory accounting period.

1.202 The new rules treat the notional accounting period of the foreign investment fund as the statutory accounting period. This allows the foreign investment fund in relation to which a choice is made under section 559A of the ITAA 1936 to continue using the actual notional accounting period of the foreign investment fund to determine the notional assessable income and notional allowable deductions under Part X of the ITAA 1936. ***[Schedule 1, item 3, paragraph 559A(2)(c) of the ITAA 1936]***

1.203 A flow-on effect of this approach is that when the income is actually attributed under Part XI of the ITAA 1936, the number of days in the notional accounting period throughout which the taxpayer had the interest can continue to be applied. Further, if in a later year the taxpayer does not choose to apply section 559A of the ITAA 1936 in relation to a foreign investment fund, the foreign investment fund will continue to use the same notional accounting period it used when applying section 559A of the ITAA 1936 for the earlier period.

*Replacement of notional income with notional assessable income, and notional deductions with notional allowable deductions under Part X of the ITAA 1936*

1.204 Once the taxpayer has elected to use the calculation method in relation to a foreign investment fund and has made a choice under section 559A of the ITAA 1936, the taxpayer will determine the notional assessable income under Part X of that Act. This is instead of using the provisions in Part XI of that Act. ***[Schedule 1, item 3, paragraph 559A(3)(a) of the ITAA 1936]***

1.205 Therefore, the notional income rules in Part XI of the ITAA 1936 are effectively 'turned off' and the notional assessable income rules in Part X of the ITAA 1936 apply. As with notional income, similar rules apply in respect of notional deductions. The notional deduction rules in Part XI are effectively 'turned off' and the notional allowable deduction rules in Part X apply. ***[Schedule 1, item 3, paragraphs 559A(3)(a) and (b) of the ITAA 1936]***

1.206 However, there are five specific rules that alter the treatment of notional income and notional deductions. Three of these specific rules reapply certain provisions in Part XI of the ITAA 1936 to effectively deal with an interest a foreign investment fund may have in a second-tier foreign investment fund which, in turn, may have an interest in a third-tier foreign investment fund. These three rules are discussed in paragraphs 1.221 to 1.223.

1.207 The remaining two general rules relate to the calculation of capital gains of the foreign investment fund, and the utilisation of losses of the foreign investment fund from a prior year.

Special rules for profits or gains of a capital nature

1.208 Instead of applying the special rules in Subdivision C of Division 7 of Part X of the ITAA 1936 (dealing with certain modifications around the commencing day and commencing day asset) in the calculation of any capital gains that would be included in notional assessable income under Part X of the ITAA 1936, any profits or gains of a capital nature are

instead determined on the basis of the period that would have been used under Part XI of that Act. ***[Schedule 1, item 3, subsection 559A(5) of the ITAA 1936]***

1.209 This rule ensures that any choice in relation to a foreign investment fund under section 559A of the ITAA 1936 will not:

- refresh the cost base of assets that are held by the foreign investment fund;
- change the time of acquisition of an asset held by a foreign investment fund; or
- impact on the events that result in a capital gain being ignored.

<u>A special rule for the utilisation of prior-period losses of the foreign investment fund</u>

1.210 In working out the notional deductions of the foreign investment fund under paragraph 559A(3)(b), sections 431 and 429 of Part X of the ITAA 1936 will be ignored ***[Schedule 1, item 3, paragraph 559A(4)(a) of the ITAA 1936]***. These sections provide a notional allowable deduction for:

- a loss of the controlled foreign company in respect of an earlier period; and
- certain losses that arise in respect of certain exempt income (a concept known as sometimes-exempt income loss which is specific to the modified loss rules in Subdivision D of Division 7 of Part X of the ITAA 1936).

1.211 The effect of disregarding these sections is that the main operative provisions in Subdivision D of Division 7 of Part X of the ITAA 1936 (the Subdivision being modified by this Schedule to the Bill) will not apply in relation to the foreign investment fund. There will be no need to calculate the sometimes-exempt-income gain or loss under section 425 of the ITAA 1936, because the provisions where those calculations apply (sections 429 and 431 of the ITAA 1936) are disregarded in working out the notional allowable deductions of the foreign investment fund.

1.212 Instead, section 572 of Part XI of the ITAA 1936 will apply to include any notional deduction for any calculated loss of an earlier period (where it has not previously been applied) in working out the foreign investment fund's notional allowable deductions. Conceptually, a loss of an eligible controlled foreign company will not actually arise under

section 426 of the ITAA 1936. This is because the notional calculations of notional assessable income and notional allowable deductions merely feed into the calculated loss calculation in Part XI of that Act. In any case, any 'loss' of a foreign investment fund that is treated as a controlled foreign company because of an election under section 559A of the ITAA 1936 will not be able to be taken into account under Part X of that Act if, in a later period, the foreign company in which the taxpayer has an interest becomes a controlled foreign company. This is because of the operation of subsection 431(3) of the ITAA 1936 (despite the application of section 428 of the ITAA 1936).

1.213 Where a taxpayer makes a choice to apply section 559A of the ITAA 1936 in relation to a foreign investment fund, a calculated loss may arise in respect of that foreign investment fund. Section 430 of the ITAA 1936 is being repealed (as a consequential amendment to the repeal of section 79D of the ITAA 1936) ***[Schedule 1, item 116].*** Therefore, all notional allowable deductions will be able to be included in notional deductions under subsection 559(2) of the ITAA 1936. This then feeds into the calculated loss under subsection 559(4) of the ITAA 1936 which, in respect of future periods, impacts on the stock of prior-period calculated losses under section 572 of that Act.

*Why are certain foreign companies treated as an Australian financial institution subsidiary?*

1.214 As a consequence of the new choice within the calculation method, the rules for what foreign companies are treated as a subsidiary of an Australian financial institution entity have been expanded. Where a taxpayer that makes an election for this new calculation method treatment in relation to a foreign company is an Australian financial institution, the foreign company will be treated as an Australian financial institution subsidiary under Part X of the ITAA 1936. ***[Schedule 1, item 3, paragraph 559A(3)(c) of the ITAA 1936]***

1.215 The modifications in Subdivision F of Division 8 of Part X of the ITAA 1936 for Australian financial institution subsidiaries may then apply in determining attributable income of the company if the foreign company is carrying on a banking business or a business whose income is principally derived from the lending of money.

1.216 This will ensure that Australian financial institutions that are making non-controlling investments into foreign markets (including emerging markets) may no longer be subject to attribution on certain business income that would otherwise be treated as passive income (such as interest income). This will particularly benefit those Australian financial institutions whose investments currently do not qualify for exemption under the foreign investment fund rules.

1.217 The rule to treat the foreign investment fund as an Australian financial institution subsidiary applies to both the first-tier foreign investment fund and the second-tier foreign investment fund. ***[Schedule 1, item 2, paragraphs 559A(3)(c) and (8)(a) of the ITAA 1936]***

1.218 Consistent with the current foreign investment fund calculation method rules in Division 18 of Part XI of the ITAA 1936, it is not possible for a third-tier foreign investment fund to be treated as an Australian financial institution subsidiary. This is because the choice for notional controlled foreign company calculation treatment relies on the ability to use the calculation method to determine the foreign investment fund income that accrues to a taxpayer. The calculation method can only ever be applied in relation to a first-tier and a second-tier foreign investment fund (subject to certain qualifying rules). It can never be applied in relation to a third-tier foreign investment fund.

1.219 As a consequence of these foreign companies being afforded treatment as an Australian financial institution subsidiary, an amendment is made to the participation exemption rules in Subdivision 768-G. This amendment provides for similar 'active' treatment in relation to the assets of the foreign company. These amendments are further discussed in paragraph 1.345.

1.220 The approach of 'superimposing' the controlled foreign company calculation of attributable income on the foreign investment fund calculation method ensures that the foreign company is not actually a controlled foreign company as defined in Part X of the ITAA 1936. Therefore, if a taxpayer chooses the notional controlled foreign company calculation within the foreign investment fund calculation method the equity interest in the foreign investment fund will not be 'controlled foreign entity equity' for thin capitalisation purposes under Division 820.

**Example 1.27**

Oz Bank holds a 20 per cent foreign investment fund interest in Sing Co. which in turns holds a 50 per cent interest in Malay HoldCo. Malay HoldCo in turn holds a 100 per cent interest in Malay Co.

Oz Bank makes a choice under section 559A of the ITAA 1936 in relation to its interest in Sing Co. As Oz Bank is an Australian financial institution, Sing Co. is treated as an Australian financial institution subsidiary for the purposes of working out its notional income and notional deductions under Part X of the ITAA 1936.

Oz Bank's attribution percentage in relation to Malay HoldCo is 10 per cent, therefore the choice under section 559A can be made by Sing Co. in relation to Malay HoldCo.

Malay HoldCo itself is treated as an Australian financial institution subsidiary for the purposes of working out its notional income and notional deductions under Part X of the ITAA 1936.

Although the attribution percentage (as defined in Part X of the ITAA 1936) of Oz Bank in Malay Co. is 10 per cent, a choice for the calculation method cannot be made by Malay Hold Co because of the operation of subparagraph 579(b)(ii) in relation to a third-tier foreign investment fund.

***How does the choice rule apply to second and third-tier foreign investment funds?***

1.221 Three special rules are included to ensure that the choice for notional controlled foreign company calculation within the calculation method applies to second-tier foreign investment funds as it applies to a direct interest in a foreign company (first-tier foreign investment funds).

1.222 The first special rule is relevant for the purposes of working out the notional income of the foreign investment fund under Part XI of the ITAA 1936. It applies where a foreign investment fund has an interest in a second-tier foreign investment fund. It also applies where a second-tier foreign investment fund has an interest in a third-tier foreign investment fund. In those cases the existing rules in sections 575 to 579 of the ITAA 1936 apply in relation to the actual (attributable) taxpayer. This is despite the assumptions under subsection 559A(3) of the ITAA 1936. ***[Schedule 1, item 3, subsection 559A(6), paragraph 559A(7)(b) and subparagraph 559A(8)(b)(ii) of the ITAA 1936]***

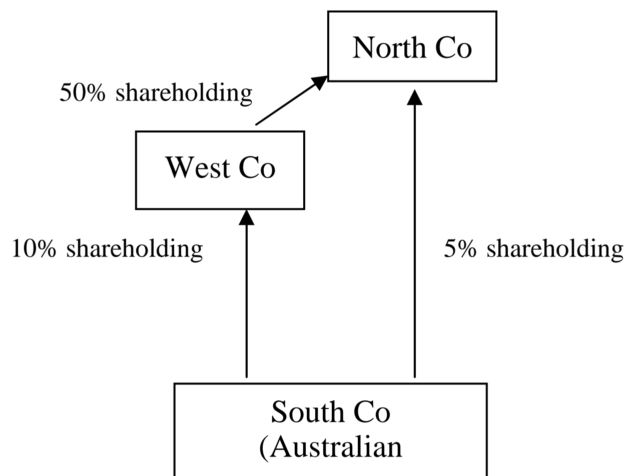
1.223 The second and third special rules apply to 'turn off' the rules in Part X of the ITAA 1936 that also calculate any foreign investment fund income accruing under Part XI of that Act. As sections 576 and 579 of the ITAA 1936 apply in relation to a second-tier and third-tier foreign investment fund, paragraphs 384(2)(ca) and 385(2)(ca) (which deal with notional assessable income of a controlled foreign company from an interest in a foreign investment fund under Part XI of the ITAA 1936) are disregarded. This ensures there is no double counting of income accruing from any second-tier and third-tier foreign investment fund. ***[Schedule 1, item 3, paragraph 559A(7)(a) and subparagraph 559A(8)(b)(i) of the ITAA 1936]***

1.224 This approach of maintaining the operation of sections 575 to 579 is consistent with maintaining the operation of the rules in Part XI of the ITAA 1936 more generally and simply 'superimposing' the notional assessable income and notional allowable deduction calculations from Part X of the ITAA 1936.

1.225 The two general exceptions to the broad rules of working out the notional income and notional deductions of a foreign investment fund in subsection 559A(3) also apply to a second-tier foreign investment fund. These rules are discussed in paragraphs 1.208 to 1.213.

**Example 1.28**

At the end of year 1, an Australian taxpayer, South Co holds a 10 per cent direct shareholding in foreign company West Co and a 5 per cent direct interest in foreign company North Co. West Co has a 50 per cent interest in North Co as indicated in the following diagram.




Assume the direct shareholding percentages equate to direct attribution interest percentages under Part X of the ITAA 1936.

Under the foreign investment fund calculation method, South Co elects, under section 559A of the ITAA 1936 to use the notional controlled foreign company calculation to work out the notional income and notional deductions of West Co. In the process of determining the notional income of West Co, the notional income of North Co must be determined. This is determined by applying section 576 and not paragraph 384(2)(ca) or 385(2)(ca) of the ITAA 1936.

In determining the notional income of North Co in respect of West Co's 50 per cent interest, section 575 of the ITAA 1936 applies and West Co can make the choice under section 559A to use the notional controlled foreign company calculation to work out the notional income and notional deductions of North Co, as South Co's attribution percentage in North Co is 10 per cent (5 per cent direct and 5 per cent indirect attribution interest).

Assuming South Co makes the election in relation to its indirect interest in West Co (because of the operation of subsections 390(1) and 559A(1) of the ITAA 1936), West Co's notional assessable income includes the 50 per cent share of the calculated profit of North Co.

South Co must make a separate election for its direct 5 per cent interest in North Co. This is a separate process to the election that it makes in relation to West Co's interest in North Co. However, the indirect attribution interest in North Co held through West Co ensures the 10 per cent attribution percentage in paragraph 559A(1)(b) of the ITAA 1936 is met.

If, at the end of year 2, South Co's interest in West Co dropped to 5 per cent it would not be able to make a choice under section 559A of the ITAA 1936 in relation to either West Co or North Co in relation to year 2 (because the 10 per cent attribution percentage in paragraph 559A(1)(b) is not met). In subsequent years, South Co is not able to make a choice under section 559A in relation to its interest in West Co or North Co.

1.226 Note that the choice under section 559A of the ITAA 1936 cannot be made in relation to a third-tier foreign investment fund. This is consistent with the operation of section 579 of that Act and the fact that the calculation method can only ever be used in relation to a first-tier and second-tier foreign investment fund of a taxpayer. ***[Schedule 1, item 3, subparagraph 559A(8)(b)(ii) of the ITAA 1936]***

1.227 The modifications to the notional deduction rules in relation to the utilisation of a calculated loss of a prior period of a foreign investment fund equally apply in the case of a second-tier foreign investment fund. Section 578 of the ITAA 1936 ensures that any calculated loss of a second-tier foreign investment fund as determined by section 572 will be taken into account in determining the notional deductions of the second-tier foreign investment fund. These modifications are discussed in paragraphs 1.210 to 1.213. ***[Schedule 1, item 3, subsection 559A(6) and paragraph 559A(4)(b) of the ITAA 1936]***

## Transitional provisions

### Treatment of pre-commencement foreign losses

1.228 A taxpayer will be entitled to deduct existing overall foreign losses from any assessable income subject to certain restrictions. It is the intention of these restrictions to continue prevailing taxpayer behaviour and limit the impact on the Australian revenue base.

1.229 The transitional rules therefore require the taxpayer to extinguish particular overall foreign losses. The losses that the taxpayer must extinguish are those that are effectively trapped currently and cannot be utilised and those with a low or nil utilisation rate. The transitional rules also impose an annual limit on utilisation for the losses that remain for the first four years after commencement. A taxpayer may disregard the deduction limit in each of the first four years after commencement if they have a small amount of foreign losses. The purpose of this deduction limit is to closely mimic the rate of loss utilisation that would occur under the current rules.

***What is a convertible foreign loss?***

1.230 When the amendments commence at the start of a taxpayer's commencement year (see paragraph 1.330), taxpayers will be required to convert any overall foreign loss of a particular class (excluding capital losses) that have not yet been utilised (under current section 160AFD of the ITAA 1936) to a tax loss. When an overall foreign loss of a particular class is converted, the income year in which it was made will remain the same — it will not be refreshed.

1.231 A taxpayer is not required to satisfy the general loss recoupment tests when converting an overall foreign loss of a particular class to a tax loss. Rather, a taxpayer will need to satisfy these tests when they go to deduct the loss from assessable income in the commencement year or a subsequent year of income.

1.232 A taxpayer will have a convertible foreign loss, for an earlier income year, if:

- they have an unrecouped overall foreign loss of a particular class of assessable income (within the meaning of current section 160AFD of the ITAA 1936) ***[Schedule 1, item 5, paragraph 770-5(1)(a) of the Income Tax (Transitional Provisions) Act 1997]***;
- the overall foreign loss was made in any of the most recent 10 income years ending before the start of the commencement year ***[Schedule 1, item 5, subsection 770-5(2) of the Income Tax (Transitional Provisions) Act 1997]***; and
- an overall foreign loss remains after disregarding certain amounts ***[Schedule 1, item 5, paragraph 770-5(1)(b) of the Income Tax (Transitional Provisions) Act 1997].***

1.233 The amount of the convertible foreign loss for each earlier year is the sum (across the income classes) of each overall foreign loss for the earlier year after disregarding certain amounts ***[Schedule 1, item 5, subsection 770-5(3) of the Income Tax (Transitional Provisions) Act 1997].*** That is, for each of the most recent 10 income years ending before the commencement year:

- the taxpayer reduces each overall foreign loss in respect of a particular class of assessable foreign income consistent with section 770-10 of the *Income Tax (Transitional Provisions) Act 1997*; and
- for each earlier income year, the taxpayer sums the amount of each overall foreign loss that remains after applying section 770-10 of the *Income Tax (Transitional Provisions) Act 1997*.

1.234 The result is the amount of the convertible foreign loss for the earlier income year. In effect, this removes the classes of assessable foreign income, leaving the taxpayer with a single convertible foreign loss (of no particular class). A taxpayer could potentially have 10 convertible foreign losses, one for each of the most recent 10 income years ending before the commencement year. ***[Schedule 1, item 5, subsection 770-5(3) of the Income Tax (Transitional Provisions) Act 1997]***

***How does a taxpayer reduce an overall foreign loss of a particular class of assessable foreign income?***

1.235 Before summing together each overall foreign loss of a particular class of assessable foreign income for an earlier income year, the taxpayer is required to reduce each overall foreign loss for certain events ***[Schedule 1, item 5, section 770-10 of the Income Tax (Transitional Provisions) Act 1997].*** These events are set out in a method statement.

1.236 Step 1 in the method statement requires company taxpayers that have existing overall foreign losses in the 'all other assessable income' class to reduce the loss (worked out under paragraph 770-5(1)(a) of the *Income Tax (Transitional Provisions) Act 1997*) to the extent it is a loss or outgoing incurred in gaining or producing income that would be the company's non-assessable non-exempt income if it were gained or produced in the commencement year ***[Schedule 1, item 5, step 1 in the method statement in section 770-10 of the Income Tax (Transitional Provisions) Act 1997].*** This will mainly affect companies that incurred losses prior to 2004 through branches in what were then unlisted countries. For example, a company taxpayer that has an existing overall foreign loss in the 'all other assessable income' class that was incurred in earning what is now exempt

foreign branch income (under section 23AH of the ITAA 1936) will be required to disregard that loss.

1.237 The intent of this restriction is to uphold the integrity of the changes introduced as part of the *New International Tax Arrangements (Participation and Other Measures) Act 2004*. This Act had the effect of exempting foreign income of companies comprising non-portfolio dividends, active capital gains and active branch income, (such income became non-assessable non-exempt income) by broadening the exemptions to all countries and not just previously listed countries.

1.238 An overall foreign loss made in producing such income (usually quarantined in the 'all other assessable income' class) is effectively trapped since there is no (or little) assessable foreign income (of that class) against which it can be deducted. To allow taxpayers the ability to deduct an overall foreign loss that they cannot currently deduct would be to provide them with a windfall gain (and the Australian revenue base with a windfall loss). Therefore, an overall foreign loss made in producing what is now non-assessable non-exempt income will be extinguished. ***[Schedule 1, item 5, step 1 in the method statement in section 770-10 of the Income Tax (Transitional Provisions) Act 1997]***

1.239 This treatment does not extend to deductions that are allowed for expenses incurred in earning non-assessable non-exempt income under section 23AI or 23AK of the ITAA 1936. This is because those deductions should have been allocated to the 'modified passive income' class and because they were incurred in producing what may still be attributable income.

1.240 For all other taxpayers, there is no reduction under step 1 and the result of step 1 will simply be the amount worked out under paragraph 770-5(1)(a) of the *Income Tax (Transitional Provisions) Act 1997*. ***[Schedule 1, item 5, step 1 in the method statement in section 770-10 of the Income Tax (Transitional Provisions) Act 1997]***

1.241 Step 2 in the method statement requires a taxpayer with an overall foreign loss older than seven years, but not more than 10 years (when measured from the first income year starting on or after the 1 July after commencement), to halve the loss (that remains after step 1) ***[Schedule 1, item 5, step 2 in the method statement in section 770-10 of the Income Tax (Transitional Provisions) Act 1997]***. The new regime will provide for an increased rate of utilisation due to the removal of all quarantining. Therefore, consistent with the intention of maintaining current taxpayer utilisation rates, it is necessary to halve existing overall foreign losses that are between eight and 10 years in age.

1.242 Although not expressly mentioned in the method statement, there is no change from the current law in respect of the commercial debt forgiveness rules. This is because the commercial debt forgiveness rules have already been applied in determining the 'recouped' portion of the overall foreign loss in respect of a particular class of assessable foreign income. The unrecouped portion of the overall foreign loss, to the extent that it is convertible, will then be subject to the commercial debt forgiveness rules upon utilisation.

1.243 There is also no change in the treatment of capital losses.

***What happens to a taxpayer's convertible foreign loss?***

1.244 The purpose of section 770-1 of the *Income Tax (Transitional Provisions) Act 1997* is to permit a taxpayer to convert, to a tax loss, convertible foreign losses for the purpose of determining taxable income for income years starting on or after the commencement year. Subdivision 36-A sets out the general rules governing the deductibility of prior-year tax losses. The taxpayer must demonstrate the existence of a tax loss before the Subdivision has any application. Since a convertible foreign loss will not satisfy the definition of a 'tax loss' in section 36-10, section 770-1 of the *Income Tax (Transitional Provisions) Act 1997* deems the convertible foreign loss to be a tax loss. ***[Schedule 1, item 5, subsection 770-1(1) of the Income Tax (Transitional Provisions) Act 1997]***

1.245 By deeming the convertible foreign loss to be a tax loss for the earlier income year, the convertible foreign loss effectively forms part of a taxpayer's tax loss (if any) ***[Schedule 1, item 5, subsection 770-1(1) of the Income Tax (Transitional Provisions) Act 1997].*** Therefore, the taxpayer's tax loss for the earlier year is the sum of:

- any tax loss for that year arising under section 36-10, 165-70, 175-35 or 701-30 ***[Schedule 1, item 5, paragraph 770-1(1)(a) of the Income Tax (Transitional Provisions) Act 1997]***; and
- the amount of convertible foreign loss for that earlier year ***[Schedule 1, item 5, paragraph 770-1(1)(b) of the Income Tax (Transitional Provisions) Act 1997].***

1.246 The amount of the taxpayer's tax loss will be this amount rather than the amount worked out in section 36-10, 165-70, 175-35 or 701-30 ***[Schedule 1, item 5, subsection 770-1(1) of the Income Tax (Transitional Provisions) Act 1997].*** However, to the extent that a taxpayer has already deducted a tax loss it cannot be deducted again (see subsection 36-15(6) for non-corporate tax entities and subsection 36-17(8) for corporate tax entities).

1.247 Where the taxpayer had an amount of taxable income for an earlier year and an overall foreign loss in that year, and the overall foreign loss is converted to a tax loss under these rules, it will not reduce the amount of that taxable income. ***[Schedule 1, item 5, subsections 770-1(1) and (3) of the Income Tax (Transitional Provisions) Act 1997]***

1.248 In this scenario, the taxpayer will have an amount of taxable income as well as a (converted) tax loss. These transitional rules do not allow a taxpayer to deduct an overall foreign loss, made in an income year prior to the commencement of these rules, in any income year prior to the commencement year ***[Schedule 1, item 5, subsection 770-1(3) of the Income Tax (Transitional Provisions) Act 1997]***. An overall foreign loss cannot currently be utilised in this way, because of section 79D of the ITAA 1936, and there is no intention to alter this treatment for income years beginning prior to the commencement year.

1.249 A convertible foreign loss for an earlier year will therefore be deductible as a tax loss (deemed to be incurred in the same earlier year) *only* in respect of the commencement year and later income years ***[Schedule 1, item 5, subsection 770-1(3) of the Income Tax (Transitional Provisions) Act 1997]***. (An exception to this rule for consolidated groups is discussed in paragraphs 1.270 to 1.274) This guarantees that a taxpayer does not deduct the convertible foreign loss from domestic assessable income in any income year prior to the commencement year.

1.250 Notwithstanding a convertible foreign loss is treated as a tax loss that may be deducted in income years beginning on or after commencement, each overall foreign loss that comprises the convertible foreign loss will retain its ownership history. By treating an earlier income year as a loss year, each overall foreign loss of a particular class of assessable foreign income that comprises the convertible foreign loss is treated as being made in that earlier income year for the purposes of applying Subdivision 36-A. ***[Schedule 1, item 5, subsection 770-1(2) of the Income Tax (Transitional Provisions) Act 1997]***

1.251 Once a convertible foreign loss is deemed to be a tax loss, the usual deductibility rules apply (see Subdivision 36-A). In particular, section 36-25 directs the taxpayer to the relevant loss recoupment provisions. A taxpayer will only need to satisfy these provisions when deducting the (converted) tax loss from assessable income. Once the recoupment tests are satisfied, the taxpayer can immediately deduct (subject to sufficient income) the total of the convertible foreign losses up to a $10,000 limit or the amount stipulated by the deduction limit. These deductibility rules are discussed in paragraphs 1.254 to 1.260.

### *What is the starting total for a loss parcel?*

1.252 Once a taxpayer has reduced the relevant overall foreign losses and the amount is summed together for each eligible earlier income year, they are required to aggregate the additional tax losses resulting from convertible foreign losses to arrive at a starting total for all those losses taken together (namely, the *loss parcel*) ***[Schedule 1, item 5, section 770-20 of the Income Tax (Transitional Provisions) Act 1997].*** That is, the loss parcel calculation does not take into account other tax losses that the entity may have under the existing law. It is simply the aggregate of all the overall foreign losses for the preceding 10 income years (reduced according to the method statement).

1.253 The starting total cannot be affected by subsequent events, other than an amendment of an earlier year overall foreign loss figure.

**Example 1.29**

At the end of the commencement year Loss Co. determines that it has incurred the following tax losses:

- year ended 30 June 2004: $50,000 (with no amount of convertible foreign loss);
- year ended 30 June 2005: $60,000 (with an amount of $20,000 being the convertible foreign loss); and
- year ended 30 June 2006: $70,000 (with the entire amount being a convertible foreign loss).

Loss Co.'s loss parcel consists of the tax losses incurred in the year ended 30 June 2005 and the year ended 30 June 2006 (the tax loss incurred in the year ended 30 June 2004 is not affected by the operation of section 770-1 of the *Income Tax (Transitional Provisions) Act 1997* and is therefore not included in the loss parcel).

The starting total for the loss parcel is $90,000 (being the sum of the convertible foreign loss amounts of the relevant tax losses).

### *How to deduct a converted foreign loss*

1.254 Where a taxpayer's starting total for their loss parcel is $10,000 or less, no special deductibility rules are applicable. Further, where a taxpayer has a starting total for their loss parcel of more than $10,000, they may choose to reduce one or more of their convertible foreign losses such that their starting total equals $10,000. In that case too, no special deductibility rules would apply, but the excess of the starting total over $10,000 would never be deductible. This election must be made in the

commencement year. ***[Schedule 1, item 5, section 770-15 of the Income Tax (Transitional Provisions) Act 1997]***

1.255 The effect of this threshold is to avoid the special rules on deductibility. In effect, the taxpayer can deduct the entire (converted) tax loss at the end of the first income year beginning on or after commencement (provided there is sufficient taxable income and the general loss recoupment tests are satisfied).

1.256 A taxpayer that does not apply the $10,000 limit will be subject to special rules on utilisation, which intend to closely mimic current taxpayer utilisation rates for these losses. The special rules only apply to a component of the tax loss. This component, the *foreign loss component*, is the amount of the tax loss that comprises the convertible foreign loss. ***[Schedule 1, item 5, section 770-25 of the Income Tax (Transitional Provisions) Act 1997]***

1.257 The taxpayer divides the starting total of the loss parcel into five equal portions ***[Schedule 1, item 5, section 770-30 of the Income Tax (Transitional Provisions) Act 1997].*** The calculation of each portion is not contingent on how many losses fail the general loss recoupment tests or how many losses are reduced under the commercial debt forgiveness rules for forgiveness years commencing with or following the commencement year.

1.258 For example, if a taxpayer has a foreign loss component that does not satisfy the loss recoupment tests, or if a taxpayer's foreign loss component is reduced because of the commercial debt forgiveness rules, they will not be required to recalculate the starting total of the loss parcel. At the end of the commencement year, the taxpayer can use a maximum of one portion of the starting total (subject to the usual tax loss deductibility rules). ***[Schedule 1, item 5, item 1 in the table in subsection 770-30(1) of the Income Tax (Transitional Provisions) Act 1997]***

**Example 1.30**

> Heidi (an Australian resident taxpayer) has a starting total for her loss parcel of $12,000 and does not elect to reduce the quantum of any of the losses to bring the starting total to within the $10,000 threshold. The loss parcel contains four overall foreign losses, each worth $3,000.
>
> The maximum amount of the foreign loss component that Heidi can deduct in the commencement year is $2,400 (one-fifth of $12,000).

One of the overall foreign loss components converted to a tax loss permanently fails the loss recoupment test so it can no longer be deducted. However, this does not reduce the starting total below the $10,000 limit. The maximum amount of the foreign loss component Heidi can deduct as a tax loss is still calculated by reference to the sum of the tax losses in the loss parcel. The maximum amount that Heidi can deduct in the commencement year remains $2,400, even though she will only ever be able to deduct $9,000 of the foreign losses.

**Example 1.31**

Lauren (an Australian resident taxpayer) has a starting total for her loss parcel of $100,000. At the end of her commencement year, Lauren deducts $20,000 ($100,000 × 1/5). She must have sufficient assessable income to deduct the $20,000.

In the first income year after commencement, Lauren has a debt that is forgiven under the commercial debt forgiveness rules. The net forgiven amount is $40,000 which reduces the foreign losses she has to $40,000. However, the starting total of the loss parcel remains unchanged at $100,000.

At the end of the first income year after commencement, Lauren deducts $20,000 (($100,000 × 2/5) – $20,000).

At the end of the second income year after commencement, Lauren deducts another $20,000 (($100,000 × 3/5) – ($20,000 + $20,000)). After which, Lauren has no further convertible foreign loss to deduct and the transitional rules in Division 770 of the *Income Tax (Transitional Provisions) Act 1997* no longer have application to Lauren.

1.259 The taxpayer can use another portion in each of the three income years ending after the commencement year ***[Schedule 1, item 5, items 2 to 4 in the table in subsection 770-30(1) of the Income Tax (Transitional Provisions) Act 1997].*** Further, the taxpayer is able to deduct the remaining amount of a portion that it was unable to use in a prior income year, if for example it had insufficient assessable income ***[Schedule 1, item 5, items 2 to 4 in the table in subsection 770-30(1) of the Income Tax (Transitional Provisions) Act 1997].*** In the fourth income year ending after the commencement year (and subsequent income years), the taxpayer can deduct any remaining foreign loss component without restriction (subject to those restrictions that apply generally to the deductibility of tax losses) ***[Schedule 1, item 5, subsection 770-30(2) of the Income Tax (Transitional Provisions) Act 1997].***

### Example 1.32

Jess Co. (an Australian company) has a tax loss with a foreign loss component of $50,000 (and does not elect to apply the limit). The maximum amount of tax loss that Jess Co. can deduct in the commencement year is $10,000 (1/5 × $50,000). Assume for the purposes of this example that Jess Co. has no other undeducted pre-commencement tax losses.

Jess Co. has assessable income *less* deductions (other than prior-year losses) of $8,000 in the commencement year. Jess Co. satisfies the general loss recoupment tests and can therefore deduct up to $8,000 of its foreign loss component.

Jess Co. makes a tax loss of $2,000 in the first income year after the commencement year and cannot deduct any of its converted foreign losses.

Jess Co. has assessable income *less* deductions (other than prior-year losses) of $20,000, in the second income year ending after the commencement year. The maximum amount of the foreign loss component that Jess Co. can deduct is three-fifths of the starting total, *less* the amount of losses deducted in years 1 and 2. That is, the maximum foreign loss component Jess Co. can deduct in the income year is capped at $30,000 – $8,000 = $22,000. Jess Co. satisfies the general loss recoupment tests and deducts $20,000 of the foreign loss component.

Jess Co. has assessable income *less* deductions (other than prior-year losses) of $10,000, in the third income year after the commencement year. The maximum amount of tax loss Jess Co. can deduct is four-fifths of the starting total, *less* the amount of losses utilised in the previous three income years. That is, the maximum foreign loss component Jess Co. can deduct in the income year is capped at $40,000 – ($8,000 + $20,000) = $12,000. Jess Co. satisfies the general loss recoupment tests and can therefore deduct $10,000 of the foreign loss component.

Jess Co. makes a loss of $5,000 in the fourth income year after the commencement year and cannot deduct any of its tax loss.

In the fifth year after commencement, Jess Co. has assessable income *less* deductions (other than prior-year losses) of $30,000. Because the deduction limit no longer applies to Jess Co., the remaining foreign loss component can be deducted without restriction. Jess Co. satisfies the general loss recoupment tests and can therefore deduct the remaining $12,000 of the foreign loss component.

(Provided Jess Co. satisfied the general loss recoupment tests, the tax losses made in the first and fourth year after the commencement year

could also be deducted. This is consistent with the first-in first-out basis of application.)

*How does the deduction of a foreign loss component affect the foreign tax offset cap?*

1.260 By allowing a deduction for some or all of the starting foreign loss component, some assessable income is being sheltered from Australian tax. Consistent with the current regime, that assessable income is assumed to be an amount that has borne foreign income tax. In relieving double taxation of such amounts it is appropriate that the foreign tax offset cap amount be reduced by the Australian tax payable on the amount of the foreign loss deduction. ***[Schedule 1, item 5, section 770-35 of the Income Tax (Transitional Provisions) Act 1997]***

### Example 1.33

Marshall Co. is an Australian resident company and in the commencement year has a starting total for its loss parcel of $30,000. Marshall Co. does not choose to reduce its convertible foreign losses to $10,000 in order to disregard the deduction limit.

Marshall Co. claims a deduction for $6,000 ($30,000 × 1/5) of the foreign loss component in the commencement year.

Marshall Co. has also paid $30,000 of foreign income tax on an amount ($150,000) included in its assessable income and has other deductions relating to the double-taxed amounts of $24,000.

The change in taxable income, for the purposes of working out the foreign tax offset cap is therefore $120,000 ($150,000 – ($24,000 + $6,000)) and not $126,000 ($150,000 – $24,000).

***Application of transitional foreign loss rules to consolidated groups***

1.261 To ensure the transitional foreign loss rules can apply to consolidated groups in the same way as they apply to all other taxpayers, additional provisions are required.

*When were transferred overall foreign losses made?*

1.262 The loss year in which a head company is taken to have made an overall foreign loss, by virtue of subsection 707-140(1), is not relevant when applying the reduction provisions in sections 770-5 and 770-10 of the *Income Tax (Transitional Provisions) Act 1997*. ***[Schedule 1, item 5, subsection 770-80(1) of the Income Tax (Transitional Provisions) Act 1997]***

1.263 A head company must only have regard to a transferred overall foreign loss, where that loss was incurred by the transferring entity in any

of the most recent 10 income years ending before the commencement year (see paragraph 1.330). ***[Schedule 1, item 5, subsection 770-80(2) of the Income Tax (Transitional Provisions) Act 1997]***

1.264 A head company must reduce a transferred overall foreign loss by half, where that loss was incurred in an income year other than the most recent seven income years ending before the commencement year. ***[Schedule 1, item 5, subsection 770-80(3) of the Income Tax (Transitional Provisions) Act 1997]***

**Example 1.34**

> Join Co. became a subsidiary member of the Head Co.'s consolidated group on 1 July 2003 (the joining time). At the joining time, an overall foreign loss (which had been incurred by Join Co. in the income year ended 30 June 1995) was transferred, under Subdivision 707-A, to Head Co. from Join Co.
>
> Head Co. will not have regard to the overall foreign loss transferred from Join Co. as it was made (disregarding the operation of section 707-140) in an income year ending more than 10 years before the commencement year.
>
> That is, even though Head Co. is taken (under subsection 707-15(1)) to have made the loss in the year ended 30 June 2004 (the year in which the loss was transferred to Head Co.), it is the income year in which Join Co. actually incurred the loss (the year ended 30 June 1995) that is relevant in determining whether the loss was made in the most recent 10 income years ending before the commencement year.

*How much of a converted foreign loss may be transferred?*

1.265 The purpose of section 770-85 of the *Income Tax (Transitional Provisions) Act 1997* is to ensure a joining entity is able to transfer a tax loss that has a foreign loss component to the head company of a consolidated group.

1.266 The deduction limit imposed on the foreign loss component of a tax loss will not prevent the whole of the tax loss (or the undeducted amount) from being transferred from a joining entity to a head company (or from the head company to a new head company in a subsequent transfer). ***[Schedule 1, item 5, section 770-85 of the Income Tax (Transitional Provisions) Act 1997]***

1.267 The amount of a tax loss that can be transferred from a joining entity to a head company is prescribed by paragraph 707-5(1)(b) as the amount of the loss that could be utilised in the trial year, disregarding the joining entity's income or gains. In the case of a tax loss that has a foreign loss component, the amount of the foreign loss component that

could be utilised is the amount calculated under section 770-30 of the *Income Tax (Transitional Provisions) Act 1997*. This would have the effect of limiting the amount of the transferred tax loss.

1.268 The intention of section 770-85 of the *Income Tax (Transitional Provisions) Act 1997* is therefore to ensure the joining entity can transfer the entire foreign loss component to the head company. This treatment will also extend to subsequent transfers when the head company of a consolidated group joins another consolidated group.

1.269 Section 770-85 of the *Income Tax (Transitional Provisions) Act 1997* does not disrupt the application of the general loss recoupment tests, which are required as part of paragraph 707-5(1)(b). The loss recoupment tests will apply when a joining entity transfers a tax loss that has a foreign loss component to a head company, in the same way they apply when a joining entity transfers all other tax losses to a head company.

*What happens to convertible foreign losses if an entity joins a consolidated group during the commencement year?*

1.270 The purpose of section 770-90 of the *Income Tax (Transitional Provisions) Act 1997* is to ensure a joining entity is able to transfer a tax loss, that has a foreign loss component, to the head company of a consolidated group where part of the trial year occurs before commencement, that is, where the joining time is in the commencement year.

1.271 Subdivision 707-A sets out the rules governing the transfer of previously unutilised tax losses from a joining entity to a head company. The Subdivision only has application in respect of a 'sort of loss' (see paragraph 707-115(1)(a)). Since a convertible foreign loss is treated as a tax loss, this requirement will be satisfied.

1.272 In addition, the 'sort of loss' must be made by the joining entity in an income year ending before the joining time — the trial year (see paragraph 707-115(1)(b)). Since section 770-1 of the *Income Tax (Transitional Provisions) Act 1997* only treats the convertible foreign loss of an earlier income year as a tax loss for the purposes of the commencement year and later income years, the joining entity will not be in a position to satisfy the requirement where the joining time is in the commencement year. ***[Schedule 1, item 5, section 770-1 of the Income Tax (Transitional Provisions) Act 1997]***

1.273 Therefore, where an entity that has a tax loss with a foreign loss component joins a consolidated group during the commencement year of the head company, such that part of the trial year occurs before the start of

the commencement year, section 770-90 of the *Income Tax (Transitional Provisions) Act 1997* ensures that section 770-1 of that Act operates in relation to the trial year. ***[Schedule 1, item 5, section 770-90 of the Income Tax (Transitional Provisions) Act 1997]***

1.274 The convertible foreign loss is therefore treated as a tax loss for an income year beginning prior to the commencement year. This is the only exception to section 770-1 of the *Income Tax (Transitional Provisions) Act 1997*.

*What happens to the starting total and foreign loss component when an entity joins a consolidated group?*

1.275 A head company inherits the starting total and foreign loss component of a joining entity when that joining entity transfers a tax loss (that has a foreign loss component). This ensures that the head company does not recalculate or refresh the starting total of a transferred loss parcel at the joining time. Even where one of the losses making up the loss parcel cannot be transferred to a head company because of the application of the loss recoupment tests, the starting total will not be affected. Therefore, a transferred tax loss will retain:

- its foreign loss component;
- the starting total for the loss parcel to which the tax loss belongs; and
- the deduction history.

***[Schedule 1, item 5, section 770-95 of the Income Tax (Transitional Provisions) Act 1997]***

1.276 The transferred losses from a joining entity remain in a separate bundle and the head company will have a separate bundle for each joining entity that joins the consolidated group. The starting totals for all bundles the head company may have (in addition to the starting total for the group) are not aggregated. Subdivision 707-C of Part 3-90 (in conjunction with these new rules), then prescribe how the head company can utilise the transferred losses.

*What happens to the deduction limit where an entity joins a consolidated group part-way through the head company's income year and the joining entity has utilised part of its foreign loss component in its non-membership period?*

1.277 Special rules apply where an entity (that has a tax loss with a foreign loss component) has a non-membership period before it joins a

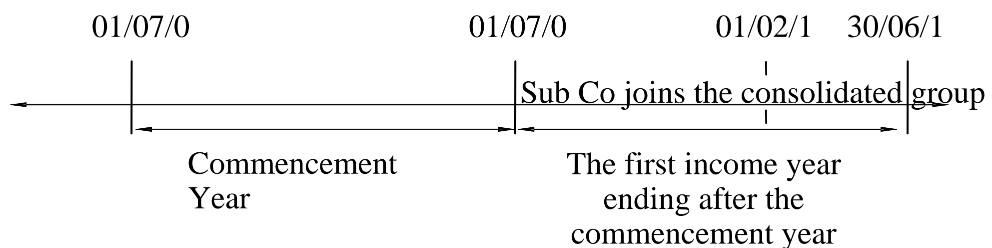
consolidated group ***[Schedule 1, item 5, section 770-100 of the Income Tax (Transitional Provisions) Act 1997].*** In that case, it will deduct its converted foreign loss up to the deduction limit (subject to the usual loss recoupment tests) in that non-membership period. This is because a non-membership period is treated as an income year under subsection 701-30(3).

1.278 The table in subsection 770-30(1) of the *Income Tax (Transitional Provisions) Act 1997* only operates to identify deductions allowed to the entity that incurred the loss. In a consolidation context, a special rule is required to ensure deductions claimed by joining entities in respect of the loss are taken into account in determining the deduction limit for the head company.

1.279 Consequently, if a non-membership period ends before the end of the head company's income year mentioned in an item in the table in subsection 770-30(1) of the *Income Tax (Transitional Provisions) Act 1997*, the head company must reduce its deduction limit by the amount utilised by the joining entity in that non-membership period ***[Schedule 1, item 5, subsections 770-100(2) and (3) of the Income Tax (Transitional Provisions) Act 1997].*** This is an integrity measure to ensure there is no potential for double deductions in the same income year. In particular, because the joining entity has already exhausted the portion (or part thereof) for the non-membership period, which ends within the head company's income year, it cannot be deducted again.

1.280 The head company, in this situation, will only be able to deduct the remaining portion (if any) at the end of its income year, pursuant to section 770-30 of the *Income Tax (Transitional Provisions) Act 1997*.

**Example 1.35**




Sub Co., on 1 July 2008 (the start of its commencement year) calculates it has a tax loss in respect of the 2007 income year with a foreign loss component of $100 million. This foreign loss component constitutes the starting total in respect of Sub Co.'s loss parcel.

Sub Co. is able to deduct 1/5 of the starting total — $20 million — in the commencement year.

Sub Co. joins the Head Co. consolidated group on 1 February 2010. As a result, Sub Co. has a non-membership period from 1 July 2009 to 31 January 2010. Sub Co. is able to deduct 2/5 of the starting total *less* the amount deducted in the commencement year ($40m – $20m = $20m). Due to insufficient income, Sub Co. can only deduct $10 million.

The remaining 2007 tax loss of $70 million transfers to Head Co. on 1 February 2010. When Head Co. seeks to utilise the tax loss in its 2010 income year (which ends on 30 September 2010) it must take into account the amounts utilised by Sub Co. in respect of income years or non-membership periods ending before 30 September 2010.

Head Co.'s deduction limits in respect of the transferred 2007 tax loss are calculated as follows:

- 2010 income year (Head Co.'s first income year ending after the commencement year): $40m – ($20m + $10m) = $10m. In this case, the reduction is achieved entirely under section 770-100.
- 2011 income year (Head Co.'s second income year ending after the commencement year): $60m – ($20m + $10m + $10m) = $20m. In this case, the first two reductions are achieved under section 770-100 and the third reduction is achieved under section 770-30 (ie, the portion deducted by Head Co. in its preceding income year).

*How does the available fraction method apply to the transferred foreign loss component?*

1.281 A foreign loss component is not subject to the available fraction method of utilisation whilst it is also subject to the deduction limit in section 770-30 of the *Income Tax (Transitional Provisions) Act 1997* ***[Schedule 1, item 5, subsection 770-105(2) of the Income Tax (Transitional Provisions) Act 1997]***. Also, the head company applies the available fraction for each bundle to income or gains that have been reduced by deductions for all foreign loss components (both group and transferred) ***[Schedule 1, item 5, subsection 770-105(3) of the Income Tax (Transitional Provisions) Act 1997]***.

1.282 This section applies to a bundle of losses irrespective of whether the transfer took place before or after the start of the commencement year for the joining entity. It is irrelevant whether, at the time of transfer, the bundle included a tax loss that had a foreign loss component or an overall foreign loss in respect of a particular class of assessable foreign income. As long as a head company has a transferred tax loss that has a foreign loss component, which is subject to the deduction limit in section 770-30 of the *Income Tax (Transitional Provisions) Act 1997*, Subdivision 707-C

will have modified application. ***[Schedule 1, item 5, paragraph 770-105(1)(b) of the Income Tax (Transitional Provisions) Act 1997]***

1.283 Since the utilisation of a foreign loss component is restricted by the deduction limit, any further restriction on the utilisation by the available fraction would be unnecessary (given the goal of the deduction limit is to maintain current taxpayer utilisation rates). Subdivision 707-C will therefore be disregarded in the first four income years after commencement when determining the amount of foreign loss component that may be utilised. ***[Schedule 1, item 5, subsection 770-105(2) of the Income Tax (Transitional Provisions) Act 1997]***

### Example 1.36

The Consolidated Group is working out the group's taxable income for the 2008-09 income year.

The group's assessable income in the other category is $120,000. Its deductions relating to that income are $70,000.

The group has a carried-forward tax loss incurred in the 2006-07 income year with a foreign loss component of $96,000. The starting total for the loss parcel containing the tax loss is $120,000.

The group's remaining transferred losses as at the start of the 2008-09 income year are set out in the table. Assume that the loss recoupment tests are passed in respect of all the losses sought to be deducted.

| ***Loss bundle*** | ***Available fraction*** | ***Unused transferred losses*** | ***Year originally incurred*** |
|---|---|---|---|
| Bundle 1 | 0.2 | $50,000 tax loss (100% foreign loss component) | 2004 |
| | | $20,000 tax loss | 2007 |

The transferred tax loss with the foreign loss component is in a loss parcel with a starting total of $60,000 (ie, $10,000 of the foreign loss component was deducted in an income year or non-membership period ending before the end of the Consolidated Group's 2008-09 income year).

The available fraction method determines the amount of losses that can be used from bundle 1.

**Step 1: Work out the categories of group income or gains**

Category: other assessable income

Reduce other assessable income by current year deductions and deductions for the foreign loss component of group and transferred tax losses:

$120,000 − ($70,000 + $24,000 + $14,000) = $12,000

Where the deductions for the foreign loss component are worked out as follows:

| *Tax loss* | *Starting total* | *Multiplied by 2/5* | *Less amounts previously deducted* | *equals allowable deduction* |
|---|---|---|---|---|
| $96,000 group tax loss | $120,000 | $48,000 | $24,000 | $24,000 |
| $50,000 transferred tax loss | $60,000 | $24,000 | $10,000 | $14,000 |

**Step 2: Apply bundle 1's available fraction to each category**

Category: other assessable income

0.2 × $12,000 = $2,400

**Step 3: Work out a (notional) taxable income for bundle 1**

| *Assessable income ($)* | | *Deductions ($)* | |
|---|---|---|---|
| Other assessable income | 2,400 | Tax losses (bundle 1) | 2,400 |
| **Total** | **2,400** | **Total** | **2,400** |

Therefore, Consolidated Group is able to use $2,400 of the $20,000 tax loss in bundle 1.

**Work out Consolidated Group's actual taxable income**

| *Assessable income ($)* | | *Deductions ($)* | |
|---|---|---|---|
| Other assessable income | 120,000 | Deductions | 70,000 |
| | | Group loss (foreign loss component) | 24,000 |
| | | Transferred tax loss (foreign loss component) | 14,000 |
| | | Transferred tax loss | 2,400 |
| **Total** | **120,000** | **Total** | **110,400** |

Consolidated Group's taxable income is $9,600.

*Application of the transitional foreign loss rules to multiple entry consolidated groups*

1.284 Section 770-110 of the *Income Tax (Transitional Provisions) Act 1997* provides that Subdivision 770-B of that Act has effect in relation to a multiple entry consolidated group in the same way it has effect in relation to a consolidated group. ***[Schedule 1, item 5, section 770-110 of the Income Tax (Transitional Provisions) Act 1997]***

***Application of transitional foreign loss rules to controlled foreign companies***

1.285 To ensure the transitional foreign loss rules can apply to controlled foreign companies in the same way as they apply to all other taxpayers, special provisions are required.

1.286 A controlled foreign company will no longer be required to quarantine losses into classes of notional assessable income. Rather, the four classes of notional assessable income will be collapsed into one class. The new rules will continue to quarantine controlled foreign company losses in the entity that incurred the loss.

*What is a convertible controlled foreign company loss?*

1.287 When the amendments apply, a controlled foreign company will be required to convert to a (classless) loss, any loss in relation to notional assessable income of a particular class that has not yet been taken into account (under current section 431 of the ITAA 1936).

1.288 A controlled foreign company will have a loss, for an earlier statutory accounting period, if:

- they have an undeducted loss in relation to notional assessable income of a particular class (under current section 426 of the ITAA 1936);
- the loss was made in any of the most recent 10 statutory accounting periods ending before the commencement period (see paragraph 1.330); and
- a loss remains after disregarding certain amounts.

***[Schedule 1, item 5, section 770-165 of the Income Tax (Transitional Provisions) Act 1997]***

1.289 The amount of the loss is the sum of each loss in relation to notional assessable income of a particular class for the earlier period after disregarding certain amounts ***[Schedule 1, item 5, subsection 770-165(3) of the Income Tax (Transitional Provisions) Act 1997].*** That is, for each of the most recent 10 statutory accounting periods ending before the commencement period for the controlled foreign company:

- the controlled foreign company reduces each loss in relation to notional assessable income of a particular class consistent with section 770-170 of the *Income Tax (Transitional Provisions) Act 1997*; and
- for each earlier statutory accounting period, the controlled foreign company sums the amount of each loss that remains after applying section 770-170 of the *Income Tax (Transitional Provisions) Act 1997*.

1.290 The result is the amount of the convertible controlled foreign company loss for the earlier statutory accounting period. In effect, this removes the classes of notional assessable income, leaving the controlled foreign company with a single convertible controlled foreign company loss for some or all of the most recent 10 statutory accounting periods ending before the commencement period. ***[Schedule 1, item 5, section 770-165 of the Income Tax (Transitional Provisions) Act 1997]***

1.291 This process is essentially the same as for a resident taxpayer applying Subdivision 770-A of the *Income Tax (Transitional Provisions) Act 1997*.

*How does a controlled foreign company reduce a loss of a particular class of notional assessable income?*

1.292 Before summing together each loss of a particular class of notional assessable income, the controlled foreign company is required to reduce each loss subject to the conversion rules set out in a method statement in section 770-170 of the *Income Tax (Transitional Provisions) Act 1997*. ***[Schedule 1, item 5, section 770-170 of the Income Tax (Transitional Provisions) Act 1997]***

1.293 Step 1 of the method statement applies only to a controlled foreign company that has an existing loss in respect of the 'all other amounts' class of notional assessable income. The controlled foreign company must reduce the loss (worked out under paragraph 770-165(1)(a) of the *Income Tax (Transitional Provisions) Act 1997*), except to the extent it is attributable to income that would be the company's notional assessable income or sometimes-exempt income. ***[Schedule 1, item 5, step 1 in the method statement in section 770-170 of the Income Tax (Transitional Provisions) Act 1997]***

1.294 Step 2 of the method statement requires a controlled foreign company with a loss older than seven years, but not more than 10 years (when measured from the first statutory accounting period starting on or after the 1 July following commencement), to halve the loss (that remains after step 1). ***[Schedule 1, item 5, step 2 in the method statement in section 770-170 of the Income Tax (Transitional Provisions) Act 1997]***

***What happens to a convertible controlled foreign company loss?***

1.295 A controlled foreign company has a loss for an earlier statutory accounting period equal to its convertible controlled foreign company loss for that period when determining its attributable income for the commencement period and later statutory accounting periods. ***[Schedule 1, item 5, subsection 770-160(1) of the Income Tax (Transitional Provisions) Act 1997]***

1.296 Subdivision D of Division 7 of Part X of the ITAA 1936 sets out the general rules governing the deductibility of a controlled foreign company loss. The controlled foreign company must have a loss under section 426 of that Act before the Subdivision has any application.

1.297 The amount of the controlled foreign company's loss for an earlier period (being a period before the commencement year) will be the amount worked out under Subdivision 770-C of the *Income Tax (Transitional Provisions) Act 1997*. The controlled foreign company then deducts the loss in accordance with the rules prescribed in section 431 of the ITAA 1936.

1.298 A convertible controlled foreign company loss will be treated as a loss *only* for the purpose of applying Part X of the ITAA 1936 to statutory accounting periods beginning on or after the commencement period ***[Schedule 1, item 5, subsection 770-160(2) of the Income Tax (Transitional Provisions) Act 1997]***. This guarantees that the controlled foreign company does not deduct the convertible controlled foreign company loss from notional assessable income in any statutory accounting period prior to the commencement period.

### Treatment of pre-commencement excess foreign tax

1.299 Currently, a taxpayer has the ability to utilise excess foreign tax in an income year so long as it is in accordance with section 160AFE of the ITAA 1936. The amendments in this Schedule will continue to provide taxpayers with this facility *only* in respect of excess foreign tax — pre-commencement excess foreign income tax — that exists at the time these foreign tax offset rules commence (see paragraph 1.330).

1.300 The carry-forward facility found in current section 160AFE will be removed from the tax law for all other purposes ***[Schedule 1, item 64]***. The reason for this is two-fold. Currently, in order to use excess foreign tax, a taxpayer is required to maintain detailed records, outlining the class of assessable foreign income to which it belongs, the year in which it arose and the amount that remains (if part of the excess has already been applied). The removal of the carry-forward facility will relieve taxpayers of this burden, resulting in a compliance cost saving.

1.301 Further, due to the removal of foreign tax credit quarantining, taxpayers will have greater income averaging capabilities. That is, only one foreign tax offset limit is calculated, compared to the four currently required. With this increased foreign tax offset limit, taxpayers will rarely generate excess foreign tax, thus removing the need for a carry-forward facility.

1.302 These amendments provide for the possibility of an increase in the taxpayer's foreign tax offset amount when the taxpayer has pre-commencement excess foreign income tax. As discussed (see paragraphs 1.125 to 1.153), entitlement to a tax offset will be limited to the lesser of the foreign income tax paid or the foreign tax offset cap (or, where the taxpayer does not calculate the cap, the $1,000 *de minimis* cap). To the extent that the foreign income tax paid by the taxpayer is less than $1,000 or the calculated cap, a foreign tax shortfall will exist. A taxpayer can reduce this shortfall (and top up the foreign income tax paid) by utilising eligible pre-commencement excess foreign income tax.

### *What pre-commencement excess foreign income tax can be utilised if there is a foreign tax shortfall?*

1.303 When the new foreign tax offset rules commence all taxpayers must convert existing excess foreign tax credits from the previous five income years to a classless bundle of pre-commencement excess foreign income tax — to the extent they have not already been applied ***[Schedule 1, item 5, subsection 770-220(1) of the Income Tax (Transitional Provisions) Act 1997].*** The conversion of excess foreign tax from the five income years preceding commencement is a continuation of the current five year restriction found in paragraph 160AFE(3)(a) of the ITAA 1936.

1.304 The amount of pre-commencement excess foreign income tax will be the *sum* of all eligible excess foreign tax credits. ***[Schedule 1, item 5, subsection 770-220(2) of the Income Tax (Transitional Provisions) Act 1997]***

*Company taxpayers*

1.305 Company taxpayers that have existing excess foreign tax credits in the 'other income' class can only convert a portion of them to the bundle of pre-commencement excess foreign income tax. To the extent that the excess has arisen in earning what is now non-assessable non-exempt income, it cannot be converted ***[Schedule 1, item 5, item 4 in the table in subsection 770-220(3) and section 770-225 of the Income Tax (Transitional Provisions) Act 1997].*** The intent of this restriction is to uphold the integrity of the changes introduced as part of the *New International Tax Arrangements (Participation and Other Measures) Act 2004*. This Act had the effect of making additional active branch income non-assessable non-exempt income. Because this income is not assessable in Australia, double taxation does not arise. Therefore, excess foreign tax on (what is now) non-assessable non-exempt income will not contribute to the foreign tax offset.

*Offshore banking units*

1.306 Taxpayers that have existing excess foreign tax credits in the 'offshore banking income' class are also restricted in the amount that they can convert to the bundle of pre-commencement excess foreign income tax. The amount converted will be the amount of excess foreign tax credits (in the offshore banking income basket) *multiplied* by the offshore banking eligible fraction ***[Schedule 1, item 5, item 2 in the table in subsection 770-220(3) of the Income Tax (Transitional Provisions) Act 1997].*** The eligible fraction is currently one-third (see subsection 121EG(4) of the ITAA 1936).

1.307 This restriction is intended to uphold the integrity of the new foreign tax offset rules and promote consistency within the offshore banking regime. To encourage offshore banking through Australia, the income from the offshore banking activities of an offshore banking unit carried on in Australia is taxed at a concessional rate and the allowable deductions are reduced proportionately. There is currently no provision that reduces the foreign income tax paid on assessable offshore banking income commensurate to the reduction in assessable offshore banking income and allowable offshore banking deductions. However, any excess foreign tax in this class is currently quarantined from income in other classes thereby preventing that foreign tax from being used to shelter other income, which is subject to low foreign tax, from Australian tax.

1.308 To ensure that any excess foreign tax in respect of assessable offshore banking income cannot be used to shelter other low foreign taxed income earned by the offshore banking unit, the foreign income tax paid on assessable offshore banking income will be reduced in accordance with the eligible fraction ***[Schedule 1, item 5, item 2 in the table in subsection 770-220(3) of the Income Tax (Transitional Provisions) Act 1997]***. This reduction will apply for both excess foreign tax credits in this class carried forward under the current regime and for future foreign income tax paid on assessable offshore banking income under the new regime ***[Schedule 1, item 5, item 2 in the table in subsection 770-220(3) of the Income Tax (Transitional Provisions) Act 1997 and item 57, subsection 121EG(3A) of the ITAA 1936]***.

### *How can a taxpayer utilise pre-commencement excess foreign income tax?*

1.309 A taxpayer can utilise pre-commencement excess foreign income tax in any one of the five income years subsequent to commencement, provided foreign income tax paid by the taxpayer is less than the $1,000 *de minimus* cap or the calculated cap — namely, to the extent there is a foreign tax shortfall ***[Schedule 1, item 5, subsection 770-230(2) of the Income Tax (Transitional Provisions) Act 1997]***. The amount utilised cannot exceed the extent of the shortfall ***[Schedule 1, item 5, subsection 770-230(4) of the Income Tax (Transitional Provisions) Act 1997]***. In effect, the taxpayer is topping up the amount of foreign income tax paid to the maximum allowed, whether it is the $1,000 *de minimis* cap or the calculated tax offset cap ***[Schedule 1, item 5, subsection 770-230(3) of the Income Tax (Transitional Provisions) Act 1997]***.

1.310 To the extent a taxpayer utilises pre-commencement excess foreign income tax (or has utilised carried-forward excess foreign tax credits under the current section 160AFE of the ITAA 1936), it cannot be utilised again at any time in the future. ***[Schedule 1, item 5, subsection 770-230(5) of the Income Tax (Transitional Provisions) Act 1997]***

1.311 It is expected that the taxpayer would utilise pre-commencement excess foreign income tax on a first-in first-out basis. This basis of utilisation will be the most advantageous for the taxpayer given the five year life span of the excess foreign tax. For example, if a taxpayer has pre-commencement excess foreign income tax that relates to the 2003-04 income year as well as pre-commencement excess foreign income tax that relates to the 2005-06 income year, the taxpayer will utilise those that relate to the 2003-04 income year first because they will expire after the 2008-09 income year.

1.312 For the first five years of the new regime, a taxpayer who has a foreign tax shortfall will be able to utilise pre-commencement excess foreign income tax that has not already been utilised (and provided it has not already expired) ***[Schedule 1, item 5, subsection 770-230(5) of the Income Tax (Transitional Provisions) Act 1997].*** Consistent with the current rules, pre-commencement excess foreign income tax (for an earlier income year) has a five year life span and if it is not used within the five years, it can never be used by the taxpayer. Thereafter, a taxpayer who has a foreign tax shortfall will not be entitled to utilise pre-commencement excess foreign income tax. Due to the five year life span, no excess foreign tax will exist beyond that time ***[Schedule 1, item 5, paragraph 770-230(2)(b) of the Income Tax (Transitional Provisions) Act 1997].***

**Example 1.37**

Austco is an Australian resident company that converts excess foreign tax credits of $5,000 relating to the 2005-06 income year, into pre-commencement excess foreign income tax of $5,000 for that income year.

For the 2009-10 income year, Austco pays foreign income tax of $7,000 in respect of an amount included in its assessable income and calculates its foreign tax offset limit as $10,000. As the tax offset of $7,000 (before the application of the pre-commencement excess foreign income tax) is *less* than the tax offset limit of $10,000, Austco can add pre-commencement excess foreign tax of $3,000 to the tax offset for the year of income.

This leaves $2,000 of unused pre-commencement excess foreign tax.

For the 2010-11 income year, Austco pays foreign income tax of $4,000 in respect of an amount included in its assessable income and calculates its foreign tax offset limit as $5,000. As the tax offset of $4,000 (before the application of any pre-commencement excess foreign income tax) is *less* than the tax offset limit of $5,000, Austco can add pre-commencement excess foreign income tax of $1,000 to the tax offset for the year of income.

This leaves $1,000 of unused pre-commencement excess foreign income tax.

For the 2011-12 income year, Austco pays foreign income tax of $8,000 in respect of an amount included in its assessable income and calculates its foreign tax offset limit as $10,000. Although the tax offset of $8,000 (before the application of any pre-commencement excess foreign income tax) is *less* than the tax offset limit by $2,000, the remaining amount of $1,000 pre-commencement excess foreign income tax cannot be used to increase the tax offset for the income year since it relates to the 2005-06 income year which is not one of the five most recent years before the current year.

***Application of transitional foreign tax offset rules to consolidated groups***

1.313 The purpose of these amendments is to ensure the current consolidation rules pertaining to the transfer of excess foreign tax credits are broadly continued in the transitional rules for the transfer of pre-commencement excess foreign income tax. The relevant sections within Division 717 are thus replicated (with some minor modifications to reflect the change in terminology) into the *Income Tax (Transitional Provisions) Act 1997*.

1.314 As described in section 770-285 of the *Income Tax (Transitional Provisions) Act 1997*, the main object of Subdivision 770-E of that Act is to allow the head company of a consolidated group to apply pre-commencement excess foreign income tax of any joining entity that becomes a subsidiary member of the group at an appropriate time ***[Schedule 1, item 5, paragraph 770-285(a) of the Income Tax (Transitional Provisions) Act 1997].*** The second object is to prevent any entity other than the head company from using pre-commencement excess foreign income tax that has been transferred to the head company of a consolidated group by an entity that becomes a subsidiary member of the group ***[Schedule 1, item 5, paragraph 770-285(b) of the Income Tax (Transitional Provisions) Act 1997].***

*Transferring pre-commencement excess foreign income tax from a subsidiary member to a head company*

1.315 Where an entity becomes a subsidiary member of a consolidated group, the single entity principle dictates the transfer of all income, deductions and offsets from the joining entity to the head company. These transitional rules operate to ensure consistent treatment for pre-commencement excess foreign income tax. Where an entity joins a consolidated group any pre-commencement excess foreign income tax a joining entity may have will be transferred to the head company of a consolidated group at the joining time. It is a condition that the joining entity join the consolidated group before or at the start of the head

company's income year in which it wishes to use the transferred excess foreign income tax. ***[Schedule 1, item 5, subsections 770-290(1) and (2) of the Income Tax (Transitional Provisions) Act 1997]***

1.316 The transferred pre-commencement excess foreign income tax will be pooled with the head company's own pre-commencement excess foreign income tax and any other transferred pre-commencement excess foreign income tax from other subsidiary members ***[Schedule 1, item 5, paragraph 770-290(2)(b) of the Income Tax (Transitional Provisions) Act 1997].*** Because of the five year life span for pre-commencement excess foreign income tax, the years in which any pre-commencement excess foreign income tax of the head company, and any transferred to it by joining entities, must be separately identified. These amendments deem the foreign income tax to be paid by the head company in order to satisfy the basic requirement in Division 770 of the *Income Tax (Transitional Provisions) Act 1997* that the foreign income tax be paid by the taxpayer claiming the offset ***[Schedule 1, item 5, subsection 770-290(2) of the Income Tax (Transitional Provisions) Act 1997].*** If, subsequently, the head company becomes the joining entity of another consolidated group, any remaining pre-commencement excess foreign income tax from a previous year will be transferred to the new head company, and the new head company is deemed to have paid that tax in that earlier year ***[Schedule 1, item 5, subsection 770-290(3) of the Income Tax (Transitional Provisions) Act 1997].***

1.317 The head company cannot use the transferred pre-commencement excess foreign income tax of a subsidiary member until the end of the head company's income year following the year in which the entity joined the group. This will be the case whether or not the entity is still a member of the group at the time. Utilisation will then be subject to the same conditions described in paragraphs 1.303 to 1.312. That is, a head company will only use pre-commencement excess foreign income tax (from any five of the preceding income years) to the extent there is a foreign tax shortfall.

*What happens if a subsidiary member of a consolidated group is not a member of a consolidated group for part of an income year?*

<u>Rules for the joining entity</u>

1.318 Consistent with the current rules in Subdivision 717-A, special rules are required where an entity (a joining entity) joins a consolidated group during the entity's income year, to ensure the joining entity can use some of its pre-commencement excess foreign tax and transfer the rest to the head company of the consolidated group.

1.319 Section 770-295 of the *Income Tax (Transitional Provisions) Act 1997* operates where an entity joins a consolidated group in an income year and there is a period in that year in which the entity is not a member of any consolidated group. ***[Schedule 1, item 5, subsection 770-295(1) of the Income Tax (Transitional Provisions) Act 1997]***

1.320 Where the joining entity has a foreign tax shortfall for the non-membership period that starts at the beginning of its income year, the joining entity can use pre-commencement excess foreign income tax from earlier years as calculated under the new section 770-220 of the *Income Tax (Transitional Provisions) Act 1997* ***[Schedule 1, item 5, subsection 770-295(3) of the Income Tax (Transitional Provisions) Act 1997].*** The joining entity will not be able to use that pre-commencement excess foreign income tax for earlier years if it has another, later non-membership period in the joining year ***[Schedule 1, item 5, subsection 770-295(3) of the Income Tax (Transitional Provisions) Act 1997].*** This is because the head company of the consolidated group which it joined and left will be treated as having the pre-commencement excess foreign tax for earlier years not used by the joining entity ***[Schedule 1, item 5, subsection 770-290(2) of the Income Tax (Transitional Provisions) Act 1997].***

1.321 Where an entity is a subsidiary member of a consolidated group at the start of an income year and then leaves the group before the end of the income year, the entity will not have access to any pre-commencement excess foreign income tax from earlier years that it may have had before joining the consolidated group. This will have become pre-commencement excess foreign income tax of the head company when the entity joined the group. ***[Schedule 1, item 5, subsection 770-295(3) of the Income Tax (Transitional Provisions) Act 1997]***

Rules for the head company

1.322 Generally, the head company of a consolidated group will not be able to use pre-commencement excess foreign income tax for a non-membership period of a joining entity at the end of the head company's income year in which the non-membership period ends. However, in the year after a joining year the head company can use the pre-commencement excess foreign income tax for the non-membership period that accrued to the entity that joined the group the previous year. Of course, the joining entity can only have pre-commencement excess foreign income tax for a non-membership period if that period commenced before the beginning of the commencement income year for the joining entity. ***[Schedule 1, item 5, section 770-290 of the Income Tax (Transitional Provisions) Act 1997]***

*What happens if a subsidiary member leaves the consolidated group?*

1.323 Where an entity joins a consolidated group, only the head company of the consolidated group can use the pre-commencement excess foreign income tax of the joining entity. ***[Schedule 1, item 5, section 770-300 of the Income Tax (Transitional Provisions) Act 1997]***

1.324 Where an entity subsequently leaves the consolidated group, it will not be able to use the pre-commencement excess foreign income tax it had prior to joining the group or any that the head company otherwise had. This is because a leaving entity cannot take any pre-commencement excess foreign income tax with it when it leaves the consolidated group. ***[Schedule 1, item 5, section 770-305 of the Income Tax (Transitional Provisions) Act 1997]***

1.325 These rules apply regardless of whether the leaving entity joins another consolidated group or remains a separate entity.

*Application of the transitional foreign income tax offset rules to multiple entry consolidated groups*

1.326 The transitional foreign income tax offset rules have effect in relation to a multiple entry consolidated group in the same way they have effect in relation to a consolidated group. ***[Schedule 1, item 5, section 770-310 of the Income Tax (Transitional Provisions) Act 1997]***

## Repeal of transitional provisions

1.327 Division 770 of the *Income Tax (Transitional Provisions) Act 1997* will be repealed from 30 June 2014. The transitional provisions pertaining to overall foreign losses will not have any operation after this time. The deduction limit on utilising convertible foreign losses applies for the first four income years ending after the commencement year. Further, the transitional provisions pertaining to pre-commencement excess foreign income tax will not have any effect after this point in time. This is due to the fact pre-commencement excess foreign income tax only has a life span of five years. ***[Schedule 1, item 227]***

1.328 The repeal of these transitional rules will not impact on how a taxpayer’s tax loss or a loss of a controlled foreign company are utilised. As mentioned above, the utilisation of these losses is governed by Division 36 and Subdivision D of Division 7 of Part X of the ITAA 1936, respectively.

## Savings and application provisions

1.329 The amendments contained within this Schedule apply in relation to income years, statutory accounting periods and notional accounting periods starting on or after the 1 July following the day on which this Bill receives Royal Assent. ***[Schedule 1, item 222]***

1.330 The first period of application is called the commencement year or the commencement period in the transitional provisions.

1.331 The amendments pertaining to the relief of double tax resulting from a transfer pricing adjustment (section 24 of the *International Tax Agreements Act 1953*) apply in relation to income years ending before and after Royal Assent. However, the operation of the existing credit relief mechanism in Division 19 of Part III of the ITAA 1936 is partially preserved in relation to income years ending before Royal Assent. ***[Schedule 1, item 224]***

1.332 The amendments to the *Fringe Benefits Tax Assessment Act 1986*, which remove references to foreign income deductions, apply from when that term ceases to have meaning for the relevant employee. That time will be the start of the commencement year for that employee, which will usually be 1 July following Royal Assent. ***[Schedule 1, item 222]***

***Special application provision for section 802-40***

1.333 The amendments contained within this Schedule have a delayed application in respect of section 802-40. This is to ensure that section continues to operate as intended with a one-year lag from when a foreign tax credit is obtained. ***[Schedule 1, item 223]***

***General savings provision***

1.334 The general savings provision prevents an assessment being affected by any provision that is repealed or amended by this Bill, if the assessment relates to a period or event before the repeal or amendment. ***[Schedule 1, items 225 and 226]***

1.335 The general savings provision also preserves powers, duties, rights and obligations in relation to the time before the repeal or amendment. If a right or obligation already existed before the repeal or amendment, section 8 of the *Acts Interpretation Act 1901* would probably already preserve it. However, the savings provision goes further.

1.336 This savings provision extends to powers and duties as well as to rights and obligations. That is intended to make sure that the whole of a repealed provision's previous operation can be preserved where necessary.

1.337 It also ensures that powers, duties, rights and obligations can still come into existence after the repeal or amendment if they relate to an earlier period or event. This means, for example, that a taxpayer can object to an assessment that is made after the provision which empowered the assessment, and the provision which empowered the objection, has been repealed. ***[Schedule 1, items 225 and 226]***

***Specific savings provisions***

*Correlative relief*

1.338 Division 19 of Part III of the ITAA 1936 provides a general power to the Commissioner to make or amend a credit determination. This Schedule preserves this power in relation to income years when Division 19 was operative, where such a determination is made before Royal Assent. The power is retained to this extent whether it relates to a determination initiated by the Commissioner or a self-determination of a credit entitlement by the taxpayer. ***[Schedule 1, subitems 224(1) and (2)]***

## Consequential amendments

1.339 Provisions of the ITAA 1936 and the ITAA 1997 are amended by this Schedule to accommodate the new foreign tax offset system and the removal of the current foreign tax credit system. Amendments remove references to provisions that no longer apply, for example, attributed tax accounts, and apply prospectively from the date this Bill commences.

1.340 The new foreign tax offset continues to be non-refundable and non-transferable. In addition it can no longer be carried forward. In respect of tax offset rankings therefore, the foreign tax offset comes before the child care tax offset (item 25 in the table in subsection 63-10(1)) but after the tax offsets covered by item 20 in that subsection. ***[Schedule 1, items 143 to 145, item 22 in the table in subsection 63-10(1)]***

1.341 The definition of 'passive income' (in current Division 18, Part III of the ITAA 1936), which includes 'interest income' and 'passive commodity gains' has been amended and moved to section 6 of the ITAA 1936. This definition is currently relevant for the calculation of the mature age worker tax offset in Subdivision 61-K. The modifications

made to the definition therefore take into account that the mature age worker tax offset applies only to individual taxpayers and not corporate tax entities ***[Schedule 1, items 18 to 20, subsection 6(1) of the ITAA 1936].*** As with other definitions in subsection 6(1) of the ITAA 1936, these definitions apply as long as a contrary intention (eg, an alternative definition) is not indicated in other provisions. Therefore, they do not replace the definitions of 'passive income' in Part X of the ITAA 1936 or of 'interest' in Division 11A of Part III of the ITAA 1936.

1.342 The definition of 'voting interest' in current section 160AFB of the ITAA 1936 will be moved to Part X of the ITAA 1936. This definition continues to be relevant for the definition of a 'non-portfolio dividend'. ***[Schedule 1, items 82, 83, 88, 176 to 178, sections 317 and 334A of the ITAA 1936 and paragraph 768-550(1)(a), subsection 768-550(2)]***

1.343 Section 6D is inserted into the ITAA 1936 which provides that some offsets in the ITAA 1997 are treated as credits under the ITAA 1936. This provision is currently in section 160AHA of the ITAA 1936 (which this Bill is repealing) and continues to be relevant for other credit provisions in the ITAA 1936. ***[Schedule 1, items 28 and 66, section 6D of the ITAA 1936]***

1.344 Section 431 of the ITAA 1936 allows the past losses of a controlled foreign company to be deducted against notional assessable income of the controlled foreign company under certain conditions. As well as removing all references to the quarantining classes, the section has been amended to remove the references to statutory accounting periods starting before 1 July 1997 because losses of those periods will no longer be deductible. Subsection 431(4) of that Act has also been rewritten in a more positive manner and subsections (4A) and (4C), which both deal with changes to the list of countries, have been combined. In applying these provisions, whether the controlled foreign company was a resident of a listed country or of an unlisted country at the end of an earlier statutory accounting period is to be determined on the basis of the current list of listed countries and not on the basis of what were listed countries at that earlier time. The set of listed countries was substantially reduced (to seven countries) in 2004. ***[Schedule 1, items 117 to 122, subsection 431(1), paragraphs 431(2)(a) and (b), subsections 431(4), (4A), (4B), (4D) and (5) of the ITAA 1936]***

1.345 As a result of a taxpayer making a choice under subsection 559A(1) of the ITAA 1936, in relation to a foreign company, and that company being afforded treatment as an Australian financial institution subsidiary (discussed in paragraphs 1.214 to 1.219), the rules in Subdivision 768-G are amended by this Schedule. If the foreign company's sole or principal business is a financial intermediary business, the special rules in relation to the treatment of assets under Part X of the

ITAA 1936 also apply for the purpose of Subdivision 768-G. This will impact on the way the assets are treated for the purpose of determining the active foreign business asset percentage of a foreign company (and other related rules). ***[Schedule 1, item 4, section 768-533]***

1.346 Some provisions of the *Taxation (Interest on Overpayments and Early Payments) Act 1983* are repealed as a result of the new foreign tax offset forming part of a taxpayer's assessment. There will, however, continue to be a limit on payment of interest where the Commissioner provides correlative relief in respect of foreign income tax (see Part III of that Act). ***[Schedule 1, items 213 to 221, subsections 3A(1), 3A(1A) and 3A(2), paragraphs 3A(2)(c) and 9(1A)(b) and 11(b) of the Taxation (Interest on Overpayments and Early Payments) Act 1983]***

1.347 Changes to the foreign hybrid rules in Division 830 do not affect the operation of those rules. The changes simply reflect the new definition of 'foreign income tax' inserted into the ITAA 1997. The foreign hybrid rules will continue to operate in respect of the same types of foreign taxes as before these amendments were introduced. ***[Schedule 1, items 182 to 187, paragraphs 830-1(a), 830-10(1)(b), 830-10(1)(c), 830-15(1)(b), 830-15(2)(b) and 830-15(3)(b)]***

### *General*

1.348 Many consequential amendments result from the renaming of 'foreign tax credit' to 'foreign tax offset'. ***[Schedule 1, items 8, 25, 38 to 51, 69 to 75, 78, 133, 139, 146, 148 to 152, 179 to 181, paragraph 22(4)(c) of the Bank Integration Act 1991, subsection 6AB(6), section 102AAB, subsections 102AAM(2) to (4) and 102AAM(4A), section 102AAZC, subsection 177A(1), paragraphs 177(1)(bb), 177(1)(f), 177C(2)(d), 177C(3)(ca), 177C(3)(g), 177F(1)(d) and 177F(3)(d), section 317 of the ITAA 1936, subsections 205-20(4) and 205-70(2), paragraphs 220-400(1)(c) and 220-405(1)(d), section 802-40]***

1.349 Other consequential amendments have resulted from repealing Divisions 18, 18A and 19 of Part III of the ITAA 1936 and moving the provisions governing entitlement to a tax offset for foreign income tax paid on an amount included in assessable income to Division 770. ***[Schedule 1, items 6, 7, 9 to 17, 21 to 37, 52 to 54, 62 to 67, 76, 84 to 87, 90, 109, 127, 129 to 132, 134 to 138, 140 to 142, 144, 145, 147, 153 to 163, 195 to 210 and 212, section 195-1 of the A New Tax System (Goods and Services Tax) Act 1999, paragraph 19(1)(b), subparagraph 19(1)(ba)(ii), paragraph 24(1)(b), subparagraph 24(1)(ba)(ii), paragraph 44(1)(b), subparagraph 44(1)(ba)(ii), paragraph 52(1)(b), subparagraph 52(1)(ba)(ii) of the Fringe Benefits Tax Assessment Act 1986, subsections 6AB(1), (2) and (6), section 6D, subsections 23AI(2), 23AK(2), 46FA(11), 46FB(6), 47A(2), 102L(6) and 102T(7), sections 121K, 160ADA and 317, subsection 324(1), paragraphs 389(a) and 427(b) of the ITAA 1936, sections 10-5, 12-5, 13-1, 36-10 and 36-25, paragraph 61-570(2)(c), subsection 205-70(2), paragraphs 305-75(2)(b), 305-75(3)(b), 305-75(5)(a), 701-1(4)(c) to (g), 707-110(2)(b) and 707-110(2)(c), subsections 707-130(1), 707-310(3) and 713-225(6A), Subdivision 717-A, subsection 701D-1(1), paragraphs 701D-10(3)(a) and (b) and 707-325(1)(d), subsection 707-325(9), paragraph 707-326(1)(b),***

***subsections 707-328A(6) and 830-20(3), paragraph 830-20(4)(c), subsections 830-20(4) and 830-20(5) of the Income Tax (Transitional Provisions) Act 1997, subsections 4(2), 11FA(3) and 11FB(3) of the International Tax Agreements Act 1953, paragraph 14ZW(1)(aaa) of the Taxation Administration Act 1953]***

1.350 Further consequential amendments have resulted from removing the classes of notional assessable income from the controlled foreign company rules in Part X of the ITAA 1936. ***[Schedule 1, items 94 to 108, 110 to 122, subsections 425(1) to (4), paragraph 426(a), subparagraphs 426(a)(i) and (ii), section 426, paragraphs 427(b) and 427(ba), section 429, subsection 431(1), paragraphs 431(2)(a) and (b), subsections 431(4), (4A), (4B), (4D) and (5)]***

1.351 Definitions have also been inserted into the Dictionary for 'credit absorption tax', 'foreign income tax' and 'unitary tax' and a modification has been made to 'tax loss' ***[Schedule 1, items 189, 191, 193 and 194, subsection 995-1(1)].*** The definitions of 'foreign tax' and 'excess foreign tax credits' (in the Dictionary) have consequently been repealed ***[Schedule 1, items 190 and 192].*** However, 'foreign tax' continues to be defined in the ITAA 1936 because of the residual need for that definition in other areas of the ITAA 1936. Some parts of section 6AB of the ITAA 1936 have been repealed. Those provisions were necessary for foreign tax credit purposes and in general have been rewritten into Division 770 ***[Schedule 1, items 22 and 24, subsections 6AB(1), 6AB(1A), 6AB(1B), 6AB(2) and 6AB(6)].***

# Chapter 2
# Capital gains tax roll-over for medical defence organisations

## Outline of chapter

2.1 Schedule 2 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to provide a capital gains tax (CGT) roll-over for membership interests in medical defence organisations (MDOs). The roll-over will generally be available when a membership interest in an MDO is replaced with a similar membership interest in another MDO and both MDOs are companies limited by guarantee.

## Context of amendments

2.2 Subdivision 124-M of the ITAA 1997 provides a CGT scrip for scrip roll-over when a taxpayer disposes of shares or certain trust interests they own and those shares or trust interests are replaced with other shares or trust interests, for example, when there is a merger or a takeover. This roll-over ensures that any capital gain made on the exchange of the original shares or trust interests is deferred until after the exchange and a further CGT event happens to the replacement shares or trust interests.

2.3 The Review of Business Taxation, chaired by Mr John Ralph AC, recommended this roll-over in 1999 to achieve a better allocation of the nation's capital resources by removing CGT as an impediment to mergers and takeovers.

2.4 However, the roll-over is not available for membership interests in companies limited by guarantee. This is because members of companies limited by guarantee do not hold shares in the company but hold a membership interest instead.

2.5 These amendments will provide a roll-over for membership interests in companies limited by guarantee that are also MDOs. This will ensure that CGT need not be an impediment to mergers or takeovers of MDOs.

2.6 MDOs provide indemnity insurance to members of the medical profession through wholly-owned captive insurers.

2.7 For historical reasons, MDOs have a strong presence in particular jurisdictions but more limited claims experience in other jurisdictions. A medical indemnity insurer created through a merger or takeover of MDOs should benefit from pooled claims data in setting its premiums. It will also benefit from economies of scale.

## Summary of new law

2.8 This Schedule amends Division 124 of the ITAA 1997 by inserting Subdivision 124-P. This Subdivision will provide a CGT roll-over when a membership interest in an MDO is replaced with a similar membership interest in another MDO and both MDOs are companies limited by guarantee.

## Comparison of key features of new law and current law

| ***New law*** | ***Current law*** |
|---|---|
| A CGT roll-over will be available when a membership interest in an MDO is replaced with a similar membership interest in another MDO and both MDOs are companies limited by guarantee. | The CGT scrip for scrip roll-over is available for shares in companies and certain interests in trusts. |

## Detailed explanation of new law

2.9 An 'MDO' is defined under section 5 of the *Medical Indemnity Act 2002*.

### Exchange of membership interests in an MDO

2.10 The roll-over will be available to defer the making of a capital gain from the exchange of a membership interest, acquired on or after 20 September 1985, in an MDO for a similar interest in another MDO ***[Schedule 2, item 5, paragraphs 124-980(1)(d) and (f)].*** The roll-over is not available to defer the making of a capital loss.

2.11 Both MDOs must be companies limited by guarantee. ***[Schedule 2, item 5, paragraph 124-980(1)(b)]***

2.12 A member of an MDO can choose whether or not to obtain the roll-over. ***[Schedule 2, item 5, paragraph 124-980(1)(e)]***

**Example 2.1**

> Doctors Defence Ltd (Doctors Defence) and Practitioners Protection Ltd (Practitioners Protection) are both companies limited by guarantee. Each is an MDO. Doctors Defence proposes to merge with Practitioners Protection under an arrangement whereby membership interests in Doctors Defence are exchanged for membership interests in Practitioners Protection.
>
> Phil is a member of Doctors Defence. If the exchange of Phil's membership interest in Doctors Defence for a similar interest in Practitioners Protection realises a capital gain, and the other requirements of the roll-over are satisfied, then he may choose to roll-over the gain into the replacement interest he receives in Practitioners Protection.

2.13 The roll-over will only be available for a member who receives an interest in the acquiring MDO that is similar to their membership interest in the original MDO. ***[Schedule 2, item 5, paragraph 124-980(1)(a)]***

2.14 In determining whether the replacement interest is similar to the original interest, a difference that consists only of a right to receive distributions of income or capital is ignored. ***[Schedule 2, item 5, subsection 124-980(2)]***

**Example 2.2**

> In addition to the facts in Example 2.1, Lauren has been a continuous member of Doctors Defence since 1999. In exchange for her membership interest in Doctors Defence, she receives a membership interest in Practitioners Protection. Lauren's interest in Doctors Defence did not provide her with the right to receive distributions of income and capital from the company. However, the interest she receives in Practitioners Protection does include the right to receive distributions of income and capital.
>
> In determining whether Lauren receives a similar interest in Practitioners Protection for her interest in Doctors Defence, her right to receive distributions of income and capital from Practitioners Protection is ignored.

2.15 The exchange of a membership interest in the original MDO for a membership interest in the acquiring MDO must be in consequence of a single arrangement ***[Schedule 2, item 5, paragraph 124-980(1)(c)]***. The arrangement must result in the acquiring MDO becoming the sole member of the original MDO ***[Schedule 2, item 5, paragraph 124-980(3)(a)]***.

**Example 2.3**

For the roll-over to be available to the members of Doctors Defence who receive interests in Practitioners Protection, Practitioners Protection must become the sole member of Doctors Defence as a result of the merger.

2.16 In addition, participation in the exchange of membership interests must be on substantially the same terms for all the holders of particular interests in the original MDO. Holders of particular interests in the original MDO however, are not required to be able to participate in the exchange of membership interests on the same terms as holders of different interests. ***[Schedule 2, item 5, paragraph 124-980(3)(b)]***

**Example 2.4**

In addition to the facts in Example 2.1, Doctors Defence has two different classes of members. It has ordinary members and student members.

The roll-over will be available if:

- all the ordinary members in Doctors Defence are able to participate on substantially the same terms; and
- all the student members in Doctors Defence are able to participate on substantially the same terms.

Student members would not be required to be able to participate on substantially the same terms as ordinary members.

## Roll-over for post-CGT membership interests

2.17 If a member with a post-CGT membership interest chooses to obtain the roll-over then the CGT consequences are as follows:

- a capital gain made from the original interest is disregarded ***[Schedule 2, item 5, subsection 124-985(1)]***; and
- the first element of the cost base of the replacement interest will be the cost base of the original interest that was exchanged for it ***[Schedule 2, item 5, subsection 124-985(2)]***.

**Example 2.5**

Surgeons Services Ltd (Surgeons Services) is a company limited by guarantee that is also an MDO. It proposes to merge with Anaesthetists Assurance Ltd (Anaesthetists Assurance) under an arrangement whereby the membership interests in Surgeons Services are cancelled and the members receive similar interests in Anaesthetists Assurance. Anaesthetists Assurance is also a company limited by guarantee and an MDO.

Joe is an ordinary member of Surgeons Services. He has claimed all the costs of his membership interest as an income tax deduction. Consequently the cost base of his membership interest in Surgeons Services is zero.

Joe's membership interest in Surgeons Services is cancelled and he receives a similar membership interest in Anaesthetist Assurance.

The first element of the cost base of Joe's replacement interest in Anaesthetist Assurance will be zero.

2.18 The cost base of the original interest is its cost base just before the exchange of interests. In situations when a member receives ineligible proceeds, in addition to an interest in the acquiring MDO (similar to their interest in the original MDO), the cost base of the original interest will be reduced ***[Schedule 2, item 5, subsections 124-985(2) and (3)].*** In these circumstances a partial roll-over may be available. The availability of a partial roll-over is discussed in paragraphs 2.19 to 2.21.

## Partial roll-over

2.19 The roll-over will not be available to the extent that a member receives ineligible proceeds for their original interest. Ineligible proceeds can be anything that the member receives other than a replacement interest in the acquiring MDO that is similar to their original interest. Cash would be an example of ineligible proceeds. ***[Schedule 2, item 5, subsection 124-990(1)]***

2.20 To work out the amount of any capital gain or loss made on the cancellation or disposal of the ineligible interest, the cost base of the original interest is apportioned to reflect the ineligible proceeds received. The apportionment is done on a reasonable basis. ***[Schedule 2, item 5, subsection 124-990(2)]***

### Example 2.6

Assume the same facts as Example 2.5, except that all student members of Surgeons Services will receive $5 cash in addition to a replacement interest in Anaesthetists Assurance that is similar to their interest in Surgeons Services.

Michael is a student member of Surgeons Services. The cost base of his membership interest is $10. (Michael has not claimed the cost of his membership interest as an income tax deduction.)

Michael exchanges his interest in Surgeon Services for a similar interest in Anaesthetists Assurance and receives ineligible proceeds of $5.

The $5 ineligible proceeds cannot be rolled over.

The market value of Michael's replacement interest in Anaesthetists Assurance is $20.

In this case it will be reasonable to allocate a portion of the cost base of the original membership interest having regard to the total proceeds ($25) according to the following formula:

$$\frac{(\text{ineligible proceeds} \times \text{original cost base})}{\text{total proceeds}} = \text{apportioned cost base}$$

That is:

$$\frac{(\$5 \times \$10)}{\$25} = \$2$$

The apportioned cost base of Michael's interest in Surgeons Services will be $2.

Michael would calculate his capital gain as follows:

$$\text{Ineligible proceeds} - \text{apportioned cost base} = \text{capital gain}$$

That is:

$$\$5 - \$2 = \$3$$

Michael would determine the cost base of his membership interest in Anaesthetists Assurance as follows:

$$\frac{\text{original cost base} - \text{apportioned cost base}}{\text{number of interests}} = \text{cost base of replacement interest}$$

That is:

$$\frac{\$10 - \$2}{1} = \$8$$

Michael will make a $3 capital gain. The cost base of his membership interest in Anaesthetists Assurance will be $8.

2.21 The first element of the reduced cost base of a replacement asset is worked out similarly. ***[Schedule 2, item 5, subsection 124-985(4)]***

### Pre-CGT membership interests

2.22 The roll-over is not available for pre-CGT membership interests in the original MDO. ***[Schedule 2, item 5, paragraph 124-980(1)(f)]***

2.23 A member who exchanges a pre-CGT membership interest for a replacement membership interest in the acquiring MDO will acquire their replacement interest at the time it is issued to them. The first element of the cost base of the replacement interest will be zero. ***[Schedule 2, item 5, section 124-995]***

**Example 2.7**

Megan has a pre-CGT membership interest in Cardiologists Cover Ltd (Cardiologists Cover) which is a company limited by guarantee that is also an MDO. Cardiologists Cover merges with Immunologists Indemnity Ltd (Immunologists Indemnity) which is also a company limited by guarantee and an MDO. As part of the merger, Megan exchanges her interest in Cardiologists Cover for a similar interest in Immunologists Indemnity.

The first element of the cost base of Megan's post-CGT replacement interest in Immunologists Indemnity will be zero.

## Application and transitional provisions

2.24 These amendments will commence on Royal Assent.

2.25 These amendments will apply to CGT events that happen on or after 14 February 2007.

## Consequential amendments

2.26 Consequential amendments will also be made to the ITAA 1997 to reflect the availability of this roll-over.

- References to this roll-over will be added to Subdivision 112-B. Subdivision 112-B lists situations when the general cost base and reduced cost base rules may be modified ***[Schedule 2, items 1 and 2].***

- A reference to Subdivision 124-P will be added to the guide material of Division 124 ***[Schedule 2, item 3].***

- A reference to this roll-over will be added to the note in subsection 124-5(2) ***[Schedule 2, item 4].***

# Chapter 3
# Investment in instalment warrants by superannuation funds

## Outline of chapter

3.1 Schedule 3 to this Bill inserts an exception to the borrowing restriction contained in section 67 of the *Superannuation Industry (Supervision) Act 1993*. This will allow superannuation funds to invest in instalment warrants of a limited recourse nature over any asset a fund would be permitted to invest in directly.

3.2 It also inserts a new provision in the in-house asset rules contained in section 71 of the *Superannuation Industry (Supervision) Act 1993*. This will provide that an investment in a related trust forming part of an instalment warrant arrangement which meets the requirements of the borrowing exception will only be an in-house asset where the underlying asset would itself be an in-house asset of the fund if it were held directly.

## Context of amendments

3.3 Section 67 of the *Superannuation Industry (Supervision) Act 1993* prohibits superannuation fund trustees from borrowing money (with certain exceptions, primarily relating to short term liquidity). The borrowing prohibition has been in place since the 1980s, and is one of a number of rules in superannuation legislation designed to limit risk in superannuation fund investment.

3.4 Sections 82 and 83 of the *Superannuation Industry (Supervision) Act 1993* prohibit superannuation fund trustees from retaining or acquiring in-house assets representing more than 5 per cent of the value of all the fund's assets.

3.5 Subsection 71(1) of the *Superannuation Industry (Supervision) Act 1993* states that an investment in a related trust of the fund is an in-house asset of the fund (subject to the exceptions set out in Part 8 of the *Superannuation Industry (Supervision) Act 1993*).

3.6 Regulation 13.14 of the *Superannuation Industry (Supervision) Regulations 1994* states that a trustee must not give a charge over, or in relation to, an asset of the fund. This does not apply in relation to certain charges specified in Regulation 13.15A, however these relate only to options and futures contracts provided the superannuation fund meets certain conditions.

3.7 Over a number of years instalment warrants have been marketed to superannuation funds, particularly self-managed superannuation funds. Instalment warrants are a derivative-based investment product, in that they derive their value from the underlying asset. Traditionally, such arrangements provide the investor with the right, but not the obligation, to buy the underlying asset through the payment of instalments. Investors in instalment warrants have a beneficial interest in the underlying asset, subject to a security interest held by the issuer that secures the payment of later instalments. Once the investor has made the first instalment they are likely to be entitled to income from the underlying asset (eg, dividends from shares).

3.8 The Commissioner of Taxation (Commissioner) (responsible for regulating self-managed superannuation funds) and the Australian Prudential Regulation Authority (APRA) (responsible for regulating other superannuation funds) have come to the view that these arrangements constitute a borrowing for the purposes of section 67 of the *Superannuation Industry (Supervision) Act 1993*.

3.9 The Commissioner has also determined that an investment by a self-managed superannuation fund in an instalment warrant is an in-house asset of the fund under section 71 of the *Superannuation Industry (Supervision) Act 1993.*

3.10 The Government has decided to legislate to legitimise investment by superannuation funds in instalment warrants. The precise scope of this measure has been determined following consultation with industry. This Schedule gives effect to that decision.

3.11 Funds that invest in instalment warrants must continue to comply with other legislative requirements. Furthermore, fund trustees are still required to demonstrate the appropriateness of including instalment warrants in their investment strategy.

## Summary of new law

3.12 An exception to the prohibition on borrowing in section 67 of the *Superannuation Industry (Supervision) Act 1993* will allow a

superannuation fund trustee to borrow money in accordance with an arrangement that has the following features:

- the borrowing is used to acquire an asset that is held on trust so that the superannuation fund trustee receives a beneficial interest and a right to acquire the legal ownership of the asset (or any replacement) through the payment of instalments;
- the lender's recourse against the superannuation fund trustee in the event of default on the borrowing and related fees, or the exercise of rights by the fund trustee, is limited to rights relating to the asset; and
- the asset (or any replacement) must be one which the superannuation fund trustee is permitted to acquire and hold directly.

3.13 In addition, the in-house assets rules are amended to provide that an investment in a related trust forming part of an instalment warrant arrangement which meets the requirements of the borrowing exception will only be an in-house asset where the underlying asset would itself be an in-house asset of the fund if it were held directly.

## Comparison of key features of new law and current law

| ***New law*** | ***Current law*** |
|---|---|
| Subsection 67(4A) of the *Superannuation Industry (Supervision) Act 1993* will provide an exception to the borrowing prohibition for borrowings that meet certain conditions commonly found in instalment warrant arrangements. | Section 67 of the *Superannuation Industry (Supervision) Act 1993* prohibits superannuation fund trustees from borrowing money except in limited circumstances, primarily related to short-term liquidity. |
| Subsections 71(8) and (9) of the *Superannuation Industry (Supervision) Act 1993* will provide that an investment in a related trust forming part of an instalment warrant arrangement which meets the requirements of the borrowing exception will only be an in-house asset where the underlying asset would itself be an in-house asset of the fund if it were held directly. | Section 71 of the *Superannuation Industry (Supervision) Act 1993* defines 'in-house assets' to include an investment in a related trust of the fund. |

## Detailed explanation of new law

3.14 An exception to the prohibition on borrowing in section 67 of the *Superannuation Industry (Supervision) Act 1993* will allow a superannuation fund trustee to borrow money in accordance with an arrangement that has the following features:

- the borrowing is used to acquire an asset that is held on trust so that the superannuation fund trustee receives a beneficial interest and a right (but not an obligation) to acquire the legal ownership of the asset (or any replacement) through the payment of instalments;

- the lender's recourse against the superannuation fund trustee in the event of default on the borrowing and related fees, or the exercise of rights (typically a put option) by the fund trustee, is limited to rights relating to the asset at the time of the action. These rights may include taking possession of, or disposing of, the asset; and

- the asset (or any replacement) must be one which the superannuation fund trustee is permitted to acquire and hold directly. The asset may be any asset (eg, real property, works of art in certain circumstances or listed securities) a fund would be permitted to invest in directly. The existing investment restrictions, such as those on in-house assets and acquiring certain assets from a related party of the fund, continue to apply.

***[Schedule 3, item 1, subsection 67(4A) of the Superannuation Industry (Supervision) Act 1993]***

3.15 An investment in a related trust forming part of an instalment warrant arrangement which meets the requirements of the borrowing exception in subsection 67(4A) of the *Superannuation Industry (Supervision) Act 1993* will only be an in-house asset under section 71 where the underlying asset would itself be an in-house asset of the fund if it were held directly. ***[Schedule 3, item 2, subsections 71(8) and (9) of the Superannuation Industry (Supervision) Act 1993]***

3.16 This means an investment in an instalment warrant will not be automatically counted against the in-house asset limit. However, the new provisions will not allow fund trustees to circumvent the existing in-house asset rules. Where the underlying asset would have been an in-house asset had the superannuation fund invested in it directly, an investment in the instalment warrant will be an in-house asset. Where the acquisition of such an asset would breach the in-house asset rule if it were held directly,

the investment in an instalment warrant over that same asset will not be permitted.

### Example 3.1: Limited recourse

ABC shares currently trade for $2.

The T. Do Super Fund (the Fund) buys an instalment warrant over an ABC share for $1.10 from Bank X (the Issuer) on 1 January 2007.

The completion payment is $1 to be paid on 1 January 2008.

The Issuer acquires an ABC share for $2, effectively loaning the Fund the completion payment on a limited recourse basis. The share is held by a separate security trust.

The extra 10 cents the Fund paid constitutes a pre-payment of the interest on the $1 loan and charges to cover the Issuer's risk.

During the year, the Fund receives all dividends that ABC pays to its shareholders.

On 1 January 2008 the Fund has the option to pay the completion payment of $1 and gain full ownership of the ABC share.

Alternatively, the Fund can choose not to pay the $1 final instalment, in which case the issuer could sell the share and pay the Fund any excess in proceeds over the $1 loan. Should the ABC share sell for less than $1 (the value of the loan) the Issuer cannot recover the shortfall from the Fund.

As the rights of the Issuer are limited to the rights relating to the ABC share, the requirements of subsection 67(4A) of the *Superannuation Industry (Supervision) Act 1993* are satisfied.

### Example 3.2: In-house asset restriction

Five per cent of the Fields Family Super Fund's assets are in-house assets for the purposes of section 71 of the *Superannuation Industry (Supervision) Act 1993*.

The trustee of the fund is prohibited from acquiring further in-house assets by section 83 of the *Superannuation Industry (Supervision) Act 1993*.

Therefore, the trustee can not use an instalment warrant arrangement to acquire a beneficial interest in another in-house asset, for example, an investment in an instalment warrant over a share in a company controlled by a member of the Fields Family Super Fund, as this would breach the in-house asset restriction.

However, the trustee can use an instalment warrant arrangement to acquire a beneficial interest over an unrelated asset, for example, listed shares in an unrelated company. As the underlying asset would not be an in-house asset if held directly, the investment in the instalment warrant trust will not be an in-house asset and there will be no breach of the in-house asset restriction.

**Example 3.3: Replacement asset**

The Lees Family Super Fund buys an instalment warrant over shares in RK Company from Little Lender.

RK Company merges with JF Company. RK Company shares are reissued as shares in RKJF Co as a scrip for scrip roll-over.

The instalment warrant continues with shares in RKJF Co as the replacement asset.

This arrangement is covered by subsection 67(4A) of the *Superannuation Industry (Supervision) Act 1993*.

### Giving a charge over an asset

3.17 ‘Shareholder application’ style instalment warrants generally involve the use of a fund’s existing equity holdings (traditionally, but not limited to, listed shares) to purchase instalment warrants. That is, the fund trustee transfers the legal title of an existing asset to a security trustee in exchange for instalment warrants over that asset. The fund trustee may also receive cash, generally the difference between the price of the warrant and the market price of the asset.

3.18 The Commissioner and APRA, in their roles as regulators of superannuation funds, have determined that such an arrangement involves the fund trustee placing a charge over an asset of the fund (Joint Press Release of 16 December 2002). The operating standard set out in Regulation 13.14 of the *Superannuation Industry (Supervision) Regulations 1994* prohibits a trustee from giving a charge over, or in relation to, an asset of the fund.

## Application and transitional provisions

3.19 These amendments will apply from the day this Bill receives Royal Assent.

3.20 Existing technical breaches will continue to be managed through the discretionary powers of the Commissioner and APRA.

# Chapter 4
# Trustee beneficiary reporting rules

## Outline of chapter

4.1 Schedule 4 to this Bill amends the *Income Tax Assessment Act 1936* (ITAA 1936) so that trustees of closely held trusts are no longer required to report to the Commissioner of Taxation (Commissioner) details of the trust's ultimate beneficiaries. Instead, trustees of closely held trusts may now be required to report details of the trust's trustee beneficiaries.

## Context of amendments

4.2 The ultimate beneficiary rules in Division 6D of Part III of the ITAA 1936 were introduced in 1999 as an integrity measure aimed at preventing complex chains of trusts being used to avoid or indefinitely defer tax.

4.3 The current rules may require the trustee of a closely held trust to provide the Commissioner with an ultimate beneficiary statement where one or more trustee beneficiaries are interposed between the closely held trust and its ultimate beneficiaries. That statement must disclose the identity of the ultimate beneficiaries in respect of the trust's net income and tax-preferred amounts. In order to meet this requirement, the trustee must trace these through trustee beneficiaries to ultimate beneficiaries.

4.4 The trustee is liable to pay ultimate beneficiary non-disclosure tax at the top marginal tax rate plus the Medicare levy if they fail to correctly identify the ultimate beneficiaries and their entitlements within the specified period, or where there are no ultimate beneficiaries. Failure to provide information about the entitlement of ultimate beneficiaries to tax-preferred amounts may trigger an offence under the *Taxation Administration Act 1953* (TAA 1953).

4.5 These amendments will reduce the costs of complying with the ultimate beneficiary rules by requiring trustees of closely held trusts to only report to the Commissioner details of trustee beneficiaries, rather than trace amounts through to ultimate beneficiaries.

## Summary of new law

4.6 Ultimate beneficiary statements will be replaced by trustee beneficiary statements in the approved form.

4.7 A trustee of a closely held trust must make a correct trustee beneficiary statement to the Commissioner in respect of each trustee beneficiary who has a share of the trust's net income or is presently entitled to tax-preferred amounts. Trustee beneficiary statements must be provided by the due date for the trust's tax return (or within a further time allowed by the Commissioner). However, the Commissioner can make a determination not to require statements in certain circumstances.

4.8 Trusts that are covered by a family trust election, or an interposed entity election, or wholly-owned by the family trust are not covered by these trustee beneficiary reporting requirements. These trusts are restricted in the range of beneficiaries they can distribute to without penalty tax. Any distributions outside the family group are subject to penalty tax at a rate of 46.5 per cent via the family trust distribution tax. Therefore, it is not necessary to include family trusts (or their related trusts) in these reporting rules. The Commissioner already has an avenue for obtaining information about these trusts and their beneficiaries. In addition, any distributions by these trusts to non-resident trustee beneficiaries will be subject to taxation at 45 per cent under subsection 98(4) of the ITAA 1936.

4.9 A statement in respect of a resident trustee beneficiary will be a correct trustee beneficiary statement if it discloses the beneficiary's name and tax file number (TFN) and their share of the trust's net income or tax-preferred amounts. The requirements are the same for non-resident trustee beneficiaries, except that the statement must disclose their address rather than their TFN.

4.10 However, a trustee need not report amounts to the extent they have been taxed to the trustee of the closely held trust, or to an earlier trustee in the chain, under certain other provisions of the tax law. For example, a trustee need not report any part of the trustee beneficiary's share of trust net income upon which the trustee, or an earlier trustee, has been assessed and liable to pay tax under subsection 98(4) of the ITAA 1936. That provision taxes a trustee on behalf of a trustee beneficiary who is a non-resident at the end of the income year. However, it only taxes a share of net income to the extent it is attributable to Australian sources. It is therefore possible for Division 6D to apply to that same share of net income to the extent it is attributable to foreign sources.

4.11 Where the trustee of the closely held trust does not make a correct trustee beneficiary statement within the specified period in respect of a trustee beneficiary's share of the trust's net income, the trustee is liable for trustee beneficiary non-disclosure tax under the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 1) 2007. Tax is levied on the trustee beneficiary's share of net income at 46.5 per cent. Failure to provide a correct trustee beneficiary statement within the specified period in respect of a trustee beneficiary's share of the trust's tax-preferred amounts may be an offence under the TAA 1953.

4.12 Penalty tax is also imposed where a share of the net income of a closely held trust is included in the assessable income of a trustee beneficiary and the share (or part of it) 'comes back' to the closely held trust in the sense that the trustee of the closely held trust becomes presently entitled to income attributable to the share (or part of it). This penalty tax is imposed, on the share or part that 'comes back', under the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 2) 2007. Again, the penalty tax is 46.5 per cent.

## Comparison of key features of new law and current law

| *New law* | *Current law* |
|---|---|
| The trustee of a closely held trust must advise the Commissioner of certain details about each trustee beneficiary that is entitled to a share of the trust's net income or tax-preferred amounts. This advice is contained in a trustee beneficiary statement (in the form approved by the Commissioner) and must be provided by the due date for lodgment of the closely held trust's tax return (or further period allowed by the Commissioner). However, the Commissioner can make a determination not to require statements in certain circumstances. | The trustee of a closely held trust that has a trustee beneficiary which is entitled to a share of the trust's net income or a tax-preferred amount, must advise the Commissioner of certain details about the trust's ultimate beneficiaries. This advice is contained in an ultimate beneficiary statement and must be provided by the due date for lodgment of the closely held trust's tax return (or further period allowed by the Commissioner). |
| Trusts that are covered by a family trust election, or an interposed entity election, or wholly-owned by the family trust are not covered by these trustee beneficiary reporting requirements. | No equivalent. |

| ***New law*** | ***Current law*** |
|---|---|
| The trustee of a closely held trust need not report amounts to the extent that they have been taxed to the trustee of the closely held trust, or to an earlier trust in the chain, under certain other provisions of the tax law. | No equivalent. |
| Where required, if the trustee of the closely held trust does not make a correct trustee beneficiary statement in respect of a share of net income within the specified period, the trustee is liable for trustee beneficiary non-disclosure tax. | The current provisions impose ultimate beneficiary non-disclosure tax where the trustee of the closely held trust does not provide a correct ultimate beneficiary statement where there are one or more ultimate beneficiaries presently entitled to the share. |
| Trustee beneficiary non-disclosure tax is payable where a share of the net income of a closely held trust is included in the assessable income of a trustee beneficiary and the share (or a part of it) 'comes back' to the closely held trust. | Ultimate beneficiary non-disclosure tax is payable by a closely held trust where a share of its net income is included in the assessable income of a trustee beneficiary and there is no ultimate beneficiary in respect of the whole or part of the share. |
| Where a trustee beneficiary is presently entitled to tax-preferred amounts, the trustee of the closely held trust must provide a correct trustee beneficiary statement for those amounts (unless the Commissioner has made a determination that a statement is not required). | Where a trustee beneficiary is presently entitled to tax-preferred amounts, the trustee of the closely held trust must provide a correct ultimate beneficiary statement or a correct statement in writing that there is no ultimate beneficiary. |

## Detailed explanation of new law

4.13 Amendments are made to Division 6D of Part III of the ITAA 1936 to reflect the replacement of ultimate beneficiary statements by trustee beneficiary statements in the approved form.

4.14 The broad structure of Division 6D has not been changed. However, the core penalty provisions (sections 102UK, 102UM and 102UT) have been rewritten, as has the definition of an 'ultimate beneficiary statement' in section 102UG (now called a 'trustee beneficiary statement').

4.15 Further, the concept of an 'untaxed part' has been introduced, primarily to prevent double taxation as a result of the introduction, in Tax Laws Amendment (2007 Measures No. 3) Bill 2007, of subsection 98(4) of the ITAA 1936 and Subdivision 12-H of the TAA 1953 both of which, like Division 6D, may tax a trustee in respect of a trustee beneficiary's share of the trust's net income. For completeness, the overview in subsection 102UA(1) is amended to reflect the shift in focus from ultimate beneficiaries to trustee beneficiaries. ***[Schedule 4, item 1, subsection 102UA(1) of the ITAA 1936]***

## Requirement to report the details of the trustee beneficiary in a trustee beneficiary statement

4.16 Where a share of the net income of a 'closely held trust' for a year of income is included in the assessable income of a trustee beneficiary under section 97 of the ITAA 1936 and:

- the share comprises or includes an 'untaxed part'; or
- if a trustee beneficiary of a closely held trust is presently entitled at the end of a year of income to a share of a tax-preferred amount of the trust,

the trustee of the closely held trust must make a correct trustee beneficiary statement (unless the Commissioner has made a determination under subsection 102UK(1A) not to require a correct trustee beneficiary statement).

4.17 A 'closely held trust' is defined in section 102UC of the ITAA 1936, and by amendment to the definition of 'excluded trust', does not include a trust:

- that is covered by a family trust election or an interposed entity election; or
- that is member of the family group of a family trust within the meaning of subsection 272-90(5) of Schedule 2F to the ITAA 1936.

4.18 Consequently, these trusts are not covered by these trustee beneficiary reporting requirements. ***[Schedule 4, item 13, definition of 'excluded trust', subsection 102UC(4) of the ITAA 1936]***

4.19 'Tax preferred amount' is defined in section 102UI of the ITAA 1936. This definition remains unchanged.

4.20 The Commissioner may make a determination under subsection 102UK(1A) that a specified class of trustees is not required to make a correct trustee beneficiary statement. The determination may be expressed to be subject to conditions and may cover more than one year of income. The determination power will allow the requirement for an annual statement to waived if, for example, the Commissioner is satisfied with other information provided by trustees or held by the Commissioner about the trustee of the closely held trust or its trustee beneficiaries, that would allow net income or tax-preferred amounts to be traced to relevant taxpayers. Another example may be where a trustee of a closely held trust has given the Commissioner a correct trustee beneficiary statement in a year of income, and in future years, the only change may be to the amounts paid to the trustee beneficiaries.

4.21 Where required to make a correct trustee beneficiary statement, the trustee must give the Commissioner the following details:

- if the trustee beneficiary is a resident at the end of the year of income — the name and TFN of the trustee beneficiary and the amount of the 'untaxed part' of their share or the amount of their share of the tax-preferred amount; or
- if the trustee beneficiary is a non-resident at the end of the year of income — the name and address of the trustee beneficiary and the amount of the 'untaxed part' of their share or the amount of their share of the tax-preferred amount.

***[Schedule 4, items 4, 15 and 19, definition of 'correct TB statement' in sections 102UB, 102UG and subsection 102UK(1A) of the ITAA 1936]***

4.22 The trustee beneficiary statement must be in the approved form; therefore the Commissioner may require the details to be provided in the trust's tax return.

4.23 Where a closely held trust has more than one trustee beneficiary presently entitled to income of the trust, the trustee of the closely held trust must provide the relevant details for each trustee beneficiary and their respective share of net income or tax-preferred amounts. ***[Schedule 4, item 15, subsection 102UG(3) of the ITAA 1936]***

## A trustee beneficiary may quote their tax file number to the trustee of a closely held trust

4.24 Where a trustee beneficiary has a share of the net income of a closely held trust, or is presently entitled to a tax-preferred amount of the trust, the trustee beneficiary may quote his or her TFN to the trustee of the

closely held trust in order for it to make a correct trustee beneficiary statement about that share. ***[Schedule 4, item 41, section 102UU of the ITAA 1936]***

4.25 Where a trustee of a closely held trust has to make a correct trustee beneficiary statement, section 102UV applies to override section 8WB of the TAA 1953 so that the trustee can, in connection with making the statement:

- record the TFN or maintain such a record;
- use the TFN in a manner connecting it with the identity of the trustee beneficiary; or
- divulge or communicate the TFN to a third person.

***[Schedule 4, item 41, section 102UV of the ITAA 1936]***

## Amounts to which Division 6D applies (the 'untaxed part')

4.26 Section 102UE defines the 'untaxed part' of a share of the net income of a closely held trust. The use of this concept removes the requirement for a closely held trust to provide details to the Commissioner in respect of a share of net income that has been taxed under certain other provisions of the law (or has been taxed under a previous application of Division 6D). That is, only untaxed amounts are subject to the trustee beneficiary reporting rules. The aim of section 102UE is to remove the potential for double taxation.

4.27 Therefore, a trustee does not need to include in a trustee beneficiary statement details of any share of net income covered by subsection 102UE(2). A share of net income is covered by subsection 102UE(2) if:

- the trustee of the closely held trust is assessed and liable to pay tax under subsection 98(4) of the ITAA 1936 in respect of the share (which applies where a trustee beneficiary that is non-resident at year end has a share of net income attributable to Australian sources);
- the share is reasonably attributable to a part of the net income of another trust estate in respect of which the trustee of the other trust estate is assessed and liable to pay tax under subsection 98(4);
- the share is represented by or reasonably attributable to an amount from which an entity was required to withhold an amount under Subdivision 12-H in Schedule 1 to the

TAA 1953 (which applies where an Australian managed fund or custodian pays certain amounts to non-residents including non-resident trustees); or

- the share is reasonably attributable to a part of the net income of another trust estate in respect of which the trustee of the other trust estate was liable to pay trustee beneficiary non-disclosure tax.

4.28 If the net income is subject to tax under Division 6D, paragraph 102UK(2)(b) or paragraph 102UM(2)(b) operate so that the net income will not be included in the assessable income of the trustee beneficiary, except for the purpose of sections 99, 99A, 99B and Division 6D. Therefore, subsection 98(4) will not operate to tax it again. ***[Schedule 4, items 12 and 14, definition of 'untaxed part' in sections 102UB and 102UE, items 19 and 23, paragraphs 102UK(2)(b) and 102UM(2)(b) of the ITAA 1936]***

**Example 4.1**

A trustee of a closely held trust (Trust A) has three trustee beneficiaries. The trustee of Trust B is a resident and their share of the closely held trust's net income is $5,000. The trustee of Trust C is a resident and is presently entitled to a tax-preferred amount of $2,000. The trustee of Trust D is a non-resident and their share of the closely held trust's net income is $4,000, all of which is attributable to foreign sources.

To make a correct trustee beneficiary statement, in respect of each trustee beneficiary, the trustee of the closely held trust (Trust A) must report:

- the name and TFN of the trustee of Trust B and their share of the trust's net income ($5,000);
- the name and TFN of the trustee of Trust C and the share of the trust's tax-preferred amount to which they are presently entitled ($2,000); and
- the name and address of the trustee of Trust D and their share of the trust's net income ($4,000) — foreign source income is not taxed under subsection 98(4) of the ITAA 1936 and therefore the trustee of Trust D's share of net income is not excluded from the trustee beneficiary reporting requirements under subsection 102UE(2).

**Example 4.2**

A trustee of a closely held trust (Trust A) has two trustee beneficiaries. The trustee of Trust B is a resident and their share of the closely held trust's net income is $3,000. The trustee of Trust C is a non-resident and their share of the closely held trust's net income is $10,000, all of which is attributable to Australian sources. Under subsection 98(4) of the ITAA 1936, the trustee of Trust A is assessed and liable to pay tax on the trustee of Trust C's share of the net income ($10,000).

To make a correct trustee beneficiary statement the trustee of Trust A must report the name and TFN of the trustee of Trust B and their share of the closely held trust's net income ($3,000).

There is no need for the trustee of Trust A to report the name and address of the trustee of Trust C or its share of the trust's net income ($10,000) as the whole of the share has been taxed under subsection 98(4) of the ITAA 1936 and is therefore excluded by virtue of paragraph 102UE(2)(a).

**Example 4.3**

Following on from Example 4.2, Trust C (which is not a closely held trust) has a resident trustee beneficiary (Trust D) whose share of Trust C's net income is $10,000. Trust D is a closely held trust and has other income of $5,000 from Australian sources. Its net income is therefore $15,000. Trust D has a resident trustee beneficiary (trustee of Trust E) whose share of Trust D's net income is this $15,000.

The trustee of Trust D must provide the name and TFN of the trustee of Trust E and disclose the amount of $5,000 of net income from Australian sources included in Trust E's assessable income.

The trustee of Trust D need not report on the $10,000 share of net income from non-resident Trust C as it is reasonably attributable to an amount taxed to the trustee of Trust A under subsection 98(4) in Example 4.2 (and is therefore excluded by virtue of paragraph 102UE(2)(b)).

**Example 4.4**

A managed investment trust (MIT Fund) makes a distribution to a non-resident trustee beneficiary (OS Trust) of $10,000. The trustee of MIT Fund is liable to withhold tax on that distribution at 30 per cent under Subdivision 12-H in Schedule 1 to the TAA 1953. OS Trust's net income is $10,000. OS Trust has a resident trustee beneficiary (trustee of Trust A) whose share of OS Trust's net income is $10,000.

Trust A is a closely held trust that has a resident trustee beneficiary (the trustee of Trust B). The trustee of Trust A is not required to report

the details of Trust B's share of trust net income because it is reasonably attributable to an amount subject to withholding under Subdivision 12-H in Schedule 1 to the TAA 1953 and is therefore excluded from the operation of the trustee beneficiary reporting rules by virtue of paragraph 102UE(2)(c).

## 'Trustee beneficiary statement period'

4.29 Where the trustee of a closely held trust is required to make and give to the Commissioner a correct trustee beneficiary statement, it must be given within the trustee beneficiary statement period. The 'TB statement period' is the period from the end of the year of income until the end of the period within which the trustee is required to give the Commissioner the trust's return of income for the year of income (or such further period as the Commissioner allows). ***[Schedule 4, items 7 and 16, definition of 'TB statement period' in sections 102UB and 102UH of the ITAA 1936]***

## The trustee beneficiary non-disclosure tax is payable if a correct trustee beneficiary statement is not made

4.30 Where a share of the net income of a closely held trust for a year of income is included in the assessable income of a trustee beneficiary of the trust under section 97 and, during the trustee beneficiary statement period, the trustee of the closely held trust is required to give the Commissioner a correct trustee beneficiary statement about the share, but it does not, a liability to tax is imposed by the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 1) 2007 on the share of the net income at the rate of 46.5 per cent. ***[Schedule 4, item 8, definition of 'trustee beneficiary non-disclosure tax' in section 102UB, and item 19, section 102UK of the ITAA 1936; Schedule 4, items 3 and 4, of the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 1) 2007]***

4.31 Where the trustee of the closely held trust is a corporate trustee, the trustee and the directors of the company are jointly and severally liable to pay the tax. This is consistent with the current law. ***[Schedule 4, item 19, paragraph 102UK(2)(a) of the ITAA 1936]***

### Example 4.5

A trustee of a closely held trust (Trust A) has one trustee beneficiary (the trustee of Trust B) whose share of the closely held trust's net income is $5,000. The trustee of the closely held trust fails to make a correct trustee beneficiary statement about the share in the trustee beneficiary statement period.

The trustee of the closely held trust (Trust A) is therefore liable to trustee beneficiary non-disclosure tax under the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 1) 2007 on the share of the net income at the rate of 46.5 per cent.

4.32 Where a trustee beneficiary's share of net income is subject to trustee beneficiary non-disclosure tax, the share is not included in the assessable income of the trustee beneficiary under section 97, except for the purposes of sections 99, 99A and 99B, and Division 6D of the ITAA 1936. ***[Schedule 4, items 19 and 23, paragraphs 102UK(2)(b) and 102UM(2)(b) of the ITAA 1936]***

**Example 4.6**

> Following on from Example 4.5, Trust B's assessable income for Division 6D purposes includes the $5,000 of Trust A's net income.
>
> Trust B has a resident trustee beneficiary (trustee of Trust C) who has a share of Trust B's net income. The trustee of Trust B is not required to report in respect of the $5,000 as it is excluded by virtue of paragraph 102UE(2)(d) — that is, the trustee of Trust A was liable to pay trustee beneficiary non-disclosure tax on the net income.

4.33 The trustee of a closely held trust may amend an incorrect statement that does not meet the requirements of section 102UG. Generally, this is where the trustee, at the time of making the statement, believed on reasonable grounds it was a correct trustee beneficiary statement about a share of the net income of the trust, and:

- the trustee could not have reasonably foreseen the event that caused the statement not to be a correct trustee beneficiary statement; or
- the statement is not a correct trustee beneficiary statement because of an inadvertent error.

4.34 The amendment must be made within a specified period. This is largely consistent with the existing provisions which allow the trustee of a closely held trust to amend an incorrect statement in certain limited circumstances, however, the scope of the provision now also covers inadvertent errors. ***[Schedule 4, item 19, subsection 102UK(2A) of the ITAA 1936]***

### Amounts that the trustee of a closely held trust are presently entitled to from a trustee beneficiary

4.35 Section 102UM applies where a share of the net income of a closely held trust is included in the assessable income of a trustee beneficiary of the trust under section 97 and the trustee of the closely held trust becomes presently entitled to income that is reasonably attributable to a part or the whole of the untaxed part of the share. An exclusion applies where trustee beneficiary non-disclosure tax is payable by the trustee of a closely held trust on the untaxed part of the share under

paragraph 102UK(2)(a). ***[Schedule 4, item 23, subsection 102UM(1) of the ITAA 1936]***

4.36 The purpose of section 102UM is to discourage the use of a chain of trusts to channel income through a circular chain of trusts to disguise the identity of the final beneficiary in receipt of the income. In such a round robin arrangement, amounts are included in the assessable income of a trustee beneficiary of a closely held trust under section 97 and the amount (or part of it) 'comes back' to the trustee of a closely held trust.

4.37 Where this section applies, penalty tax is payable by the trustee of a closely held trust on the whole or that part of the untaxed part as imposed by the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 2) 2007 at a rate of 46.5 per cent. ***[Schedule 4, items 8 and 23, definition of 'trustee beneficiary non-disclosure tax' in section 102UB and subsection 102UM(2) of the ITAA 1936; Schedule 4, items 3 and 4 of the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 2) 2007]***

**Example 4.7**

A chain of four Trusts exists (Trusts A to D) each of which is a closely held trust.

Trust A has net income of $100,000 in an income year. The trustee of Trust A makes a correct trustee beneficiary statement advising the Commissioner that the trustee of Trust B's share of that net income is $100,000. The trustee of Trust A is therefore not liable to tax under the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 1) 2007.

The trustee of Trust B also makes a correct trustee beneficiary statement advising the Commissioner that the trustee of Trust C's share of Trust B's net income is $100,000. The trustee of Trust B is therefore not liable to tax under the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 1) 2007.

The trustee of Trust C also makes a correct trustee beneficiary statement advising the Commissioner that the trustee of Trust D's share of Trust C's net income is $100,000. The trustee of Trust C is therefore not liable to tax under the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 1) 2007.

The trustee of Trust A is presently entitled to income of Trust D that is reasonably attributable to the share of trust income reported by the trustee of Trust A in respect of trustee beneficiary B (ie, the trustee of Trust B).

> The trustee of Trust A will be liable to pay tax under the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 2) 2007 on this net income as the trustee is presently entitled to an amount that is reasonably attributable to the whole or a part of the untaxed part of the share and trustee beneficiary non-disclosure tax is not payable on the untaxed part of the share under paragraph 102UK(2)(a).

4.38 Where the trustee of the closely held trust is a corporate trustee, the trustee and the directors of the company are jointly and severally liable to pay the tax. This is consistent with the current law. ***[Schedule 4, item 23, paragraph 102UM(2)(a) of the ITAA 1936]***

## The recovery of trustee beneficiary non-disclosure tax from trustee beneficiaries providing incorrect information

4.39 These amendments to section 102USA reflect the change in focus to requiring closely held trusts to report details of trustee beneficiaries, rather than details of ultimate beneficiaries. The trustee of a closely held trust may sue to recover trustee beneficiary non-disclosure tax from a trustee beneficiary in certain circumstances.

4.40 In brief, this is where:

- the trustee beneficiary, when requested to do so, refused or failed to give information to the trustee of the closely held trust; or
- the trustee beneficiary provided incorrect information and the trustee of the closely held trust honestly believed on reasonable grounds that the information was correct,

and the trustee of the closely held trust has distributed to the trustee beneficiary an amount representing some or all of the share of the net income without withholding an amount under section 254 of the ITAA 1936 in respect of the recoverable amount. ***[Schedule 4, item 36, subsections 102USA(1) to (3) of the ITAA 1936]***

4.41 In these circumstances, the trustee of the closely held trust or the persons liable to pay trustee beneficiary non-disclosure tax may, in a court of competent jurisdiction, sue for the recoverable amount and recover it from the trustee beneficiary. ***[Schedule 4, item 36, subsection 102USA(4) of the ITAA 1936]***

## Trustee beneficiaries: tax-preferred amounts

4.42 Section 102UT applies if, at the end of the income year, a trustee beneficiary of a closely held trust is presently entitled to a share of a tax-preferred amount of the trust. Unless the Commissioner has made a

determination under subsection 102UK(1A) to not require a correct trustee beneficiary statement, the trustee of the closely held trust must provide to the Commissioner a correct trustee beneficiary statement covering the share of the tax-preferred amount during the trustee beneficiary statement period. ***[Schedule 4, item 38, subsection 102UT(1) of the ITAA 1936]***

4.43 The trustee of a closely held trust may commit an offence under section 8C of the TAA 1953 if the trustee is required to provide a correct trustee beneficiary statement to the Commissioner about tax-preferred amounts but does not.

**Example 4.8**

A trustee of a closely held trust (Trust A) has one trustee beneficiary (Trust B). The trustee of Trust B is a resident and they are presently entitled to a tax-preferred amount of $4,000 from Trust A. The trustee of the closely held trust (Trust A) makes a correct trustee beneficiary statement to the Commissioner by reporting the name and TFN of the trustee beneficiary (Trust B) and the tax-preferred amount to which the trustee is presently entitled.

**Example 4.9**

Following on from Example 4.8, Trust B has two trustee beneficiaries (Trust C and Trust D). The trustee of Trust C (is a non-resident) and is presently entitled to a tax-preferred amount of $2,000 from Trust B. The trustee of Trust D is a resident and is also presently entitled to a tax preferred amount of $2,000 from Trust B.

The trustee of Trust B fails to provide the Commissioner with a correct trustee beneficiary statement that includes the name and address of the non-resident trustee beneficiary (the trustee of Trust C) and the tax-preferred amount to which the beneficiary is entitled. The trustee also fails to make a correct trustee beneficiary statement about the tax-preferred amount to which the trustee of Trust D is entitled. Accordingly, the trustee of Trust B has committed two offences under section 8C of the TAA 1953.

4.44 The trustee of a closely held trust will not be taken to have committed an offence against section 8C of the TAA 1953 if:

- the trustee did not know all the information required to be included in the required statements;
- the trustee had taken reasonable steps to ascertain the information that he or she did not know; and

- if the trustee did know some of the information, he or she included it in a statement that he or she sent to the Commissioner during the trustee beneficiary statement period.

***[Schedule 4, items 39 and 40, subsection 102UT(3) and paragraph 102UT(3)(c) of the ITAA 1936]***

**Example 4.10**

Following on from Example 4.9, the trustee of Trust B took reasonable steps to obtain the TFN of the trustee of Trust D, who is a resident. The trustee of Trust D failed to provide this information. During the trustee beneficiary statement period, the trustee of Trust B advises the Commissioner that they could not obtain the TFN of the trustee of Trust D. Because of actions of the trustee of Trust B and subsection 102UT(3) of the ITAA 1936, the trustee of Trust B will not be guilty of an offence under section 8C of the TAA 1953 in relation to its reporting obligations in regard to the trustee of Trust D.

## Repeal of Acts

4.45 To reflect the new reporting requirements for closely held trusts, the following Acts are repealed:

- the *A New Tax System (Ultimate Beneficiary Non-disclosure Tax) Act (No. 1) 1999*; and

- the *A New Tax System (Ultimate Beneficiary Non-disclosure Tax) Act (No. 2) 1999*.

***[Schedule 4, items 49 and 50]***

4.46 They are replaced by:

- the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 1) 2007; and

- the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 2) 2007.

## Application and transitional provisions

4.47 The amendments made by Schedule 4 apply to the first income year starting on or after the day on which this Bill receives Royal Assent and later income years. ***[Schedule 4, item 51]***

4.48 The amendments to Division 6D discussed earlier in this chapter ensure that trustee beneficiary non-disclosure tax is not payable in respect of an amount that is liable to taxation under subsection 98(4) of the ITAA 1936 or subject to withholding under Subdivision 12-H in Schedule 1 to the TAA 1953. The purpose of the transitional rule in item 52 is to ensure that the same outcome arises in respect of ultimate beneficiary non-disclosure tax payable under the current rules, because the new trustee beneficiary rules in this Schedule take effect at a later time.

4.49 This transitional rule is needed because it is expected that subsection 98(4) and Subdivision 12-H in Schedule 1 to the TAA 1953, inserted by the Tax Laws Amendment (2007 Measures No. 3) Bill 2007, will apply before the amendments to Division 6D take effect (depending on the date of Royal Assent of that Bill).

4.50 Therefore, the trustee of a closely held trust will not be liable to pay ultimate beneficiary non-disclosure tax on a share of net income under current section 102UK or 102UM to the extent that the share has been taxed under subsection 98(4) of the ITAA 1936 or Subdivision 12-H in Schedule 1 to the TAA 1953. In addition, the trustee will not be liable to pay tax on a share of income to the extent that the share is represented by or reasonably attributable to an amount which was liable to tax under section 255 of the ITAA 1936 (this is effectively the precursor to new Subdivision 12-H in Schedule 1 to the TAA 1953, under which managed investment trusts currently withhold tax on distributions to non-residents). ***[Schedule 4, item 52]***

## Consequential amendments

4.51 As the reporting requirement on trustees of closely held trusts is being changed from reporting details of ultimate beneficiaries to the details of trustee beneficiaries, a number of references to 'ultimate beneficiary' or 'UB' are being omitted or being substituted with references to 'trustee beneficiary' or 'TB' respectively. In addition, a number of provisions are being repealed as they are no longer applicable, for example, the definitions of 'ultimate beneficiary', 'correct UB statement', presently entitled indirectly' and 'listed person'. ***[Schedule 4, items 2, 4 to 11, 18, 20 to 22, 24 to 35, 37, 39, 40, 42 to 48, paragraph 102UA(2)(a), section 102UB and definition of 'correct TB statement', 'correct UB statement', 'listed person', 'TB statement period', 'trustee beneficiary non-disclosure tax', 'UB statement***

***period', 'ultimate beneficiary' and 'ultimate beneficiary non-disclosure tax', heading 'Subdivision 6DC — Trustee beneficiary non-disclosure tax on share of net income', subsection 102UL(2), paragraphs 102UL(3)(a), (4)(a), (4)(c) and (5)(a), subparagraphs (102UL(5)(b)(i) and (ii), heading 'Subdivision 6DD — Payment etc, of trustee beneficiary non-disclosure tax', subsections 102UN(1) and (2), subsection 102UO(1), paragraph 102UO(1)(a), subsections 102UO(2) to (4), note under subsection 102UO(4), section 102UP, paragraph 102UR(1)(a), subsections 102UR(2) and 102URA(1), paragraph 102US(1)(d), heading 'Subdivision E — Making correct TB statement about trustee beneficiaries of tax-preferred amounts', subsection 102UT(3), paragraph 102UT(3)(c), sub-subparagraph 47A(18)(d)(i)(G), subparagraph 102AAE(2)(c)(i), sub-subparagraph 102AAU(1)(c)(i)(C), item 18 in the table in subsection 170(10) and paragraph 254(3)(a) of the ITAA 1936 and item 1AA in the table in subsection 8AAB(4) and item 5 in the table in subsection 250-10(1) of the TAA 1953]***

# REGULATION IMPACT STATEMENT

## Background

4.52 The ultimate beneficiary rules (Part III, Division 6D of the ITAA 1936) were announced in the Government's *A New Tax System* package and came into effect in July 1999. The amendments were aimed at addressing arrangements whereby taxpayers used complex chains of trusts to effectively obscure the ultimate beneficiary of the assessable trust income.

4.53 Under these rules, the trustee of a closely held trust with any trustee beneficiaries must disclose to the Commissioner the identity (including the TFN) of the ultimate beneficiaries of certain net income and tax-preferred amounts of the trust. This requires the trustee to trace each distribution made to a trustee beneficiary through to the final recipient(s) of the distribution. This information must be disclosed to the Commissioner within a specified period after the year of income through the preparation of an ultimate beneficiary statement. The intention was that this information would then allow the Australian Taxation Office (ATO) to check whether the assessable income of the ultimate beneficiaries correctly includes the share of net income disclosed by the trustee.

4.54 When the trustee of the closely held trust fails to correctly identify the ultimate beneficiaries within the specified time period, or where there are no ultimate beneficiaries of net income, then the trustee is liable to pay 'ultimate beneficiary non-disclosure tax' at the rate of 46.5 per cent, which is equivalent to the top marginal tax rate plus the Medicare levy.

4.55 In response to taxpayer complaints about the compliance burden imposed by the ultimate beneficiary rules, in 2001 the Commissioner released Law Administration Practice Statement PS LA 2001/12, which stated that for 2000-01 and subsequent income years, trustees are to indicate on their trust return if they are notionally required to lodge a ultimate beneficiary statement under the income tax legislation. However, lodgment of an ultimate beneficiary statement is only required where the trustee has an ultimate beneficiary non-disclosure tax liability for the year under consideration or the Commissioner requests an ultimate beneficiary statement. The practical effect of this Practice Statement has been that many trustees have not been required to lodge an ultimate beneficiary statement since 2000-01. In spite of this, many taxpayers have continued to argue that their compliance costs have not been reduced as they still need to go through a tracing process to ascertain whether they have an ultimate beneficiary non-disclosure tax liability.

## Policy objective

4.56 The objective of the changes is to reduce the compliance burden and cost for taxpayers of complying with the reporting requirements under the ultimate beneficiary rules in Division 6D of Part III of the ITAA 1936.

4.57 The size and complexity of the ultimate beneficiary statements prepared by taxpayers have created an unnecessary compliance burden. Furthermore, there are concerns that these provisions have been triggered inadvertently by taxpayers who have not been seeking to avoid tax through the use of more than one trust.

## Implementation options

4.58 Only one option has been analysed in detail — that the trustee of a closely held trust need identify only the first-tier trustee beneficiaries, rather than the ultimate beneficiaries.

4.59 The option of repealing the ultimate beneficiary rules was not considered feasible. While this option would remove the burden of complying with the provisions, it would also leave a gap in the integrity provisions. There is a risk that some taxpayers would start using complex chains of trusts to avoid paying tax. On this basis this option was not assessed further.

## Option 1 — Simplifying the reporting requirements

4.60 The preferred option is to amend the ultimate beneficiary rules so that a trustee of a closely held trust is only required to identify the relevant details of first-tier trustee beneficiaries through the lodgment with the ATO of a 'trustee beneficiary statement'. Relevant details include the trustee beneficiary's name, TFN and their share of the trust's net income or tax-preferred amounts. The trustee beneficiary statement will replace the old ultimate beneficiary statement, but can form part of a trust income tax return.

4.61 A provision is also included that will allow the Commissioner to make a determination that allows him not to require trustees to lodge annual trustee beneficiary statements in circumstances where he considers it unnecessary (eg, because he already has sufficient information on the trust and its beneficiaries). This provision will allow the general effect of his current Practice Statement 2001/12 (as currently applied to ultimate beneficiary statements) to be maintained for trustee beneficiary statements.

4.62 A trust that has made a family trust election (or an entity that has made an interposed entity election to be in the family group) will not be subject to the trustee beneficiary reporting rules. These trusts are restricted in the range of beneficiaries they can distribute to, and any distributions outside the family group are subject to the family trust distribution tax, which is levied at 46.5 per cent.

4.63 The new rules replace the current situation where the trustee has to trace the distribution through what potentially could be multiple layers of trusts and beneficiaries in order to provide the information to the Commissioner in an ultimate beneficiary statement. Under the current provisions, a trustee could be liable to pay ultimate beneficiary non-disclosure tax or a penalty if a mistake is made in completing the ultimate beneficiary statement by any trust anywhere along the chain. Making each trust responsible for correctly reporting only the first-tier trustee beneficiaries will address this concern.

4.64 As is currently the case, if a trustee of a closely held trust does not provide the correct information to the Commissioner in a trustee beneficiary statement by the required time, they will be subject to a non-disclosure tax, now called 'trustee beneficiary non-disclosure tax', which is levied on the trustee beneficiary's share of net income at 46.5 per cent, as is the case with the old ultimate beneficiary non-disclosure tax.

4.65 Penalty tax is currently in place where there are in fact no ultimate beneficiaries. As the reporting focus is changing, penalty tax at the rate of 46.5 per cent will now be imposed where a share of the net income of a closely held trust is included in the assessable income of a trustee beneficiary and the share (or part of it) 'comes back' to the closely held trust in the sense that the trustee of a closely held trust becomes presently entitled to income attributable to the share (or part of it). Penalty tax is imposed at 46.5 per cent.

## Assessment of impacts

### Impact group identification

4.66 The proposal will impact on trustees of closely held trusts which distribute to trustee beneficiaries. There are closely held trusts spread across micro, small, medium and large businesses across different industries. Precise data on how many of these trusts distribute to trustee beneficiaries is not available.

### Analysis of costs / benefits

***Taxpayers***

4.67 The proposal will reduce significantly ongoing compliance costs for trustees and beneficiaries when compared with the costs imposed under the existing ultimate beneficiary rules. Instead of having to trace distributions through multiple layers of trusts and beneficiaries to the final recipient, trustees will only have to report first-tier trustee beneficiaries. This should lead to a reduction in record keeping, information collection, and planning effort.

4.68 In many cases, the identity of any first-tier trustee beneficiary is already being provided by trustees in the distribution statement which is attached to the trust tax return.

4.69 The provision allowing the Commissioner to make a determination that allows him not to require trustees to lodge annual trustee beneficiary statements in circumstances where he considers it unnecessary, would remove the need for a large number of trustees to prepare a trustee beneficiary statement. This will further reduce significantly ongoing compliance costs for taxpayers.

4.70 Trusts that have made a family trust election (or have made an interposed entity election to be in the family group, or owned by a family group within the terms of section 272-90 of Schedule 2F to the ITAA 1936) will be excluded from being subject to the trustee beneficiary reporting rules. This eliminates the compliance costs for trustees of these trusts, with respect to these rules.

4.71 There may be a small increase in transitional compliance costs for trustees, beneficiaries and their agents as they familiarise themselves with the simplified reporting requirements under the new trustee beneficiary rules.

***Australian Taxation Office***

4.72 The proposal is expected to have benefits for the ATO in terms of administration as it should reduce the volume of paperwork required to be collected. The provisions currently result in the ATO receiving large amounts of duplicated information due to multiple trusts in a chain reporting the same information.

4.73 It is expected that there will be small increase in transitional costs for the ATO to administer the new trustee beneficiary rules.

4.74 The revenue impact for this proposal is unquantifiable but expected to be minimal against the forward estimates. In any case, the ultimate beneficiary rules were designed to change behaviour, not to generate tax revenue. This remains the case with the trustee beneficiary rules.

## Consultation

4.75 Consultation on the draft legislation was undertaken on a confidential basis with the ATO, major accounting groups, and some tax practitioners.

4.76 The provision allowing the Commissioner to make a determination that allows him to not require trustees to lodge annual statements in circumstances where he considers it unnecessary, and the decision to exclude family trusts from the trustee beneficiary reporting requirements, reflect deliberations after the consultation process.

## Conclusion and recommended option

4.77 Simplifying the reporting requirements for the ultimate beneficiary rules by removing the need to trace ultimate beneficiaries and instead identify only first-tier trustee beneficiaries will significantly reduce compliance costs for taxpayers. The additional steps of allowing the Commissioner to make a determination that allows him to not require trustees to lodge annual statements where he considers it unnecessary, and excluding family trusts from the trustee beneficiary reporting requirements will further reduce ongoing compliance costs.

4.78 This change will maintain the integrity of the tax system and will also assist the ATO in the administration of the provisions.

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

4.80 This measure may be subject to review five years after introduction, if not reviewed beforehand.

# Chapter 5
# Superannuation amendments

## Outline of chapter

5.1 Schedule 5 to this Bill amends various Acts to assist in the smooth transition to the *Simplified Superannuation* regime and ensure the intended policy outcome is reflected in the legislation.

5.2 These amendments limit strategies which could circumvent the minimum drawdown requirements for account-based pensions, facilitate the provision of tax file numbers (TFNs) to superannuation and retirement savings account (RSA) providers, change the treatment of no-TFN contributions income under the pay as you go (PAYG) regime, and revise the application of the small business capital gains tax (CGT) relief amendments.

5.3 These amendments further improve the readability of provisions rewritten as part of the *Simplified Superannuation* reforms and clarify the intended operation of the reforms.

## Context of amendments

### Tax file numbers

5.4 The *Tax Laws Amendment (Simplified Superannuation) Act 2007* inserted Subdivision 295-I into the *Income Tax Assessment Act 1997* (ITAA 1997). This Subdivision establishes a new category of income for superannuation and RSA providers, consisting of superannuation contributions which are included in their assessable income where no TFN is attached to the receiving member's account. Such income is known as no-TFN contributions income and taxed at a higher rate than would normally apply where a TFN is quoted.

***Quotation of tax file numbers***

5.5 The Government announced on 5 September 2006 that the Australian Taxation Office (ATO) will use its systems to match TFNs to members where non-quotation has occurred and contact members to

organise for a TFN to be provided to their superannuation or RSA provider.

5.6 The amendments in this Schedule ensure that where the Commissioner of Taxation (Commissioner) gives notice of a TFN to a superannuation or RSA provider it is taken to have been quoted by the individual and thus the higher rate of tax is not applied to contributions for that individual. The Commissioner may provide a TFN to a superannuation or RSA provider under the general administration provisions of existing legislation.

***Pay as you go instalments***

5.7 Without special rules, superannuation and RSA providers would be required to reflect the tax on no-TFN contributions income in their PAYG instalments as well as their annual tax assessment.

5.8 It is not possible for superannuation and RSA providers to determine whether a particular contribution is no-TFN contributions income under Subdivision 295-I of the ITAA 1997 until the end of an income year. These amendments will ensure that superannuation and RSA providers do not need to take account of their no-TFN contributions income when working out their PAYG instalments.

## Segregated pension assets

5.9 Pensions receive concessional tax treatment in the form of a tax-exemption for income derived from the assets supporting the pension under section 295-385 of the ITAA 1997. This section gives complying superannuation funds an exemption for income derived from assets which, at the time of derivation, are segregated current pension assets.

5.10 In return for this concessional tax treatment, pensions are subject to rules designed to ensure that the capital in the pension is drawn down over time. In the case of account-based pensions, these rules require that a payment of at least a minimum amount be made each year. The minimum payment amount is calculated as a set proportion of the income stream account balance at the commencement of each financial year.

5.11 These amendments clarify that, in the case of account-based pensions, assets which are not included in the income stream account balance will be ineligible for the tax concession available to segregated current pension assets.

### Capital gains tax small business relief

5.12 Relief from CGT is available for qualifying small businesses on proceeds of CGT events that are used for retirement. Under *Simplified Superannuation* reforms the relevant CGT provisions were amended to exclude references to eligible termination payments and allow for the payment of a contribution to a complying superannuation fund or RSA. These changes applied to CGT events occurring in the 2007-08 income year or later income years.

5.13 The application provision is amended to provide for CGT events which occur before the 2007-08 income year where either an individual makes the choice to take advantage of this relief, or the proceeds from the CGT events are received, after 30 June 2007. The provisions are also amended to apply to a company or trust that makes a payment to a CGT concession stakeholder under Subdivision 152-D of the ITAA 1997, after 30 June 2007.

5.14 These amendments are to the application provisions which incorporate new CGT concepts introduced by the *Tax Laws Amendment (2006 Measures No. 7) Act 2007* that apply to CGT events happening in the 2006-07 and later income years.

### Rewrite of superannuation tax law

5.15 As part of the *Simplified Superannuation* reforms, the provisions dealing with the taxation of superannuation in the *Income Tax Assessment Act 1936* (ITAA 1936) were rewritten and consolidated into the ITAA 1997 by the *Tax Laws Amendment (Simplified Superannuation) Act 2007*.

5.16 The relevant provisions in the ITAA 1936 were repealed by the *Superannuation Legislation Amendment (Simplification) Act 2007*.

5.17 These amendments ensure the rewritten provisions operate in a manner consistent with the original policy.

## Summary of new law

### Tax file numbers

5.18 New provisions in the ITAA 1997, the *Superannuation Industry (Supervision) Act 1993*, and the *Retirement Savings Accounts Act 1997* ensure that where a TFN is provided by the Commissioner to a

superannuation or RSA provider, the individual is taken to have quoted their TFN. This ensures that the higher rate of tax that may otherwise apply in respect of contributions made for the benefit of the individual will not be applied where the Commissioner has supplied the TFN.

5.19 Amendments to provisions in the *Taxation Administration Act 1953* (TAA 1953) will ensure the tax attributable to no-TFN contributions income under Subdivision 295-I of the ITAA 1997 and the offset for no-TFN contributions income under Subdivision 295-J of the ITAA 1997 are not included when working out a superannuation or RSA provider's PAYG notional tax or benchmark tax.

### Segregated pension assets

5.20 Section 295-385 of the ITAA 1997 is amended so that assets supporting superannuation income stream benefits being paid as allocated pensions, market-linked pensions or account-based pensions, will not be considered 'segregated current pension assets' (as defined in that section) to the extent that the value of those assets exceeds the value of the account balance or balances supporting those income stream benefits.

### Capital gains tax small business relief

5.21 The application of the CGT small business relief provisions is amended to provide for CGT events which occur either before the *Simplified Superannuation* transitional period or the 2007-08 income year, but the choice to take advantage of this relief is made, or the proceeds from the CGT events are received, after 30 June 2007.

5.22 The application provision is also amended to apply to a company or trust that makes a payment to a CGT concession stakeholder under Subdivision 152-D of the ITAA 1997 after 30 June 2007.

5.23 The *Simplified Superannuation* reforms also provided for changes in CGT terminology that were introduced in the *Tax Laws Amendment (2006 Measures No. 7) Act 2007*. This Schedule amends the application provision to apply the changed terminology to CGT events happening in the 2006-07 income year and later income years.

### Rewrite of superannuation tax law

5.24 These amendments:

- require amounts of a superannuation income stream purchased with amounts rolled over prior to 1 July 1994, and

any tax-free components a member has received since 1 July 2007, to be considered in the calculation of the tax-free component at a trigger event as set out in section 307-125 of the *Income Tax (Transitional Provisions) Act 1997*;

- provide certain circumstances where a death benefit paid under section 307-5 of the ITAA 1997 can be paid outside of the specified timeframe and still be treated as a superannuation death benefit;
- insert section 307-290 into the *Income Tax (Transitional Provisions) Act 1997* so that deductions claimed for insurance premiums under sections 279 and 279B of the ITAA 1936 are considered when calculating the element untaxed in the fund under the ITAA 1997;
- provide that a deduction claimed under section 295-485 of the ITAA 1997 can include an amount equal to the contributions tax paid under the ITAA 1936;
- enable employers to claim a deduction for contributions on behalf of a person who is considered to be an employee for superannuation guarantee (SG) purposes but who is not considered to be an employee under the common law;
- ensure the policy intent of provisions giving effect to *Simplified Superannuation* is properly reflected (including to the definitions of 'non-complying superannuation fund' and 'average superannuation liabilities'); and
- improve the readability of the rewritten provisions.

## Comparison of key features of new law and current law

| ***New law*** | ***Current law*** |
|---|---|
| **Tax file numbers** | |
| An individual is taken to have quoted their TFN to a superannuation or RSA provider where the Commissioner gives notice of their TFN to the provider. | The law does not specifically provide that if the Commissioner provides a TFN to a superannuation or RSA provider that the individual is taken to have quoted their TFN to the provider. |

| ***New law*** | ***Current law*** |
| --- | --- |
| The tax attributable to no-TFN contributions income, and the tax offset for no-TFN contributions income, are ***not*** taken into account when working out a superannuation or RSA provider's PAYG notional tax or benchmark tax. | The tax attributable to no-TFN contributions income, and the tax offset for no-TFN contributions income, are taken into account when working out a superannuation or RSA provider's PAYG notional tax or benchmark tax. |
| **Segregated pension assets** | |
| Assets which are not included in a pension account balance will not be considered segregated current pension assets and income derived from these assets will not be exempt from tax. | The ITAA 1997 provides a tax exemption to complying superannuation funds for income derived from assets which are segregated current pension assets. |
| **Capital gains tax small business relief** | |
| Relief from CGT for qualifying small businesses on the proceeds of CGT events that are used for retirement are also available where the CGT events occur before the *Simplified Superannuation* transitional period or the 2007-08 income year, but the choice to take advantage of this relief is made or the proceeds from the CGT events are received, after 30 June 2007. | Relief from CGT is available for qualifying small businesses on the proceeds of CGT events that are used for retirement where the CGT events occur in either: the 2007-08 income year or later income years, or, during the *Simplified Superannuation* transitional period. |
| **Rewrite of superannuation tax law** | |
| The tax-free component of a superannuation income stream at a trigger event, where the income stream commenced prior to 1 July 2007, is worked out under subsections 307-125(6) and (6A) of the *Income Tax (Transitional Provisions) Act 1997*. | The tax-free component of a superannuation income stream at a trigger event, where the income stream commenced prior to 1 July 2007 is worked out under subsection 307-125(6) of the *Income Tax (Transitional Provisions) Act 1997*. |
| In certain circumstances, more time is allowed for a benefit to be paid and still be treated as a superannuation death benefit. | A superannuation benefit that results from the commutation of a superannuation income stream after the death of the receiving member must be paid within six months of the death, or three months of the grant of probate, in order to be treated as a superannuation death benefit. |

| *New law* | *Current law* |
| --- | --- |
| New section 307-290 is added to the *Income Tax (Transitional Provisions) Act 1997* which provides that for the purposes of section 307-290 of the ITAA 1997, a deduction claimed under former section 279 or 279B of the ITAA 1936 is to be treated as a deduction under section 295-465 or 295-470 of the ITAA 1997 respectively. | Section 307-290 of the ITAA 1997 provides a method for working out the taxed and untaxed elements of death benefit superannuation lump sums. The section applies where a deduction has been, or is to be, claimed (under section 295-465 or 295-470 of the ITAA 1997) for insurance premiums paid for life insurance on behalf of the member. |
| A deduction claimed under section 295-485 of the ITAA 1997 for contributions tax paid on superannuation death benefits allows for amounts included in assessable income under former section 274 of the ITAA 1936. | A deduction claimed under section 295-485 of the ITAA 1997 for contributions tax paid on superannuation death benefits does not apply to contributions included in the assessable income of a superannuation entity prior to the 2007-08 income year. |
| An employer is able to claim a deduction for superannuation contributions made on behalf of an employee who is an SG employee, or engaged in producing the entity's assessable income or engaged in the entity's business. | An employer is able to claim a deduction for superannuation contributions made on behalf of an employee who is either engaged in producing the entity's assessable income or engaged in the entity's business. |

## Detailed explanation of new law

### Tax file numbers

***Income Tax Assessment Act 1997***

*Meaning of 'quoted (for superannuation purposes)'*

5.25 Section 295-610 of the ITAA 1997 specifies that no-TFN contributions income is included in a superannuation provider's assessable income by Subdivision 295-C of the ITAA 1997, for the income year in which 1 July 2007 occurs (or later income years) *only* if the contributions are made on or after 1 July 2007 and the individual has not quoted their TFN to their superannuation or RSA provider by the end of the income year in which the contribution is made.

5.26 Currently, section 295-615 of the ITAA 1997 specifies that a TFN will be taken to have been quoted (for superannuation purposes) under section 295-610 of the ITAA 1997 where it has been quoted by the individual or is taken to have been quoted by the individual under the ITAA 1997, the *Superannuation Industry (Supervision) Act 1993* or the *Retirement Savings Accounts Act 1997*.

5.27 This Schedule ensures that where the Commissioner gives notice of an individual's TFN to a superannuation or RSA provider, the individual will be taken to have quoted their TFN to the superannuation or RSA provider for superannuation purposes. ***[Schedule 5, items 7 and 8, subsection 295-615(2) of the ITAA 1997].*** Accordingly, the higher rate of tax that may otherwise apply if no TFN has been quoted will not apply in respect of contributions for that individual.

***Retirement Savings Accounts Act 1997***

*The holder is taken to have quoted their TFN where the Commissioner gives notice*

5.28 The current law does not specifically deal with the situation where the Commissioner provides a TFN to an RSA provider, except in the limited circumstances involving the incorrect quotation of a TFN (see Division 4A of Part 11 of the *Retirement Savings Accounts Act 1997).* However, the Commissioner's power to provide a TFN to an RSA provider is not limited to the specific circumstances where an incorrect TFN has been provided. Rather the Commissioner may provide a TFN to an RSA provider under the Commissioner's general administration powers.

5.29 These amendments ensure that where a TFN is provided by the Commissioner to an RSA provider, an individual is taken to have quoted their TFN in connection with the operation or the possible future operation of the *Retirement Savings Accounts Act 1997* and the other 'Superannuation Acts'. ***[Schedule 5, item 26, subsection 140A(1) of the Retirement Savings Accounts Act 1997]***

5.30 Section 16 of the *Retirement Savings Accounts Act 1997* specifies 'Superannuation Acts' to mean the:

- *Retirement Savings Accounts Act 1997*;
- *Superannuation Contributions Tax (Assessment and Collection) Act 1997*;

- *Superannuation Contributions Tax (Members of Constitutionally Protected Funds) Assessment and Collection Act 1997*;

- *Superannuation (Unclaimed Money and Lost Members) Act 1999*; and

- *Termination Payments Tax (Assessment and Collection) Act 1997*.

5.31 This Schedule ensures that where the Commissioner gives notice of an individual's TFN to an RSA provider, the RSA holder will be taken to have quoted their TFN to the RSA provider for superannuation purposes at the time it is provided by the Commissioner. Accordingly, the RSA provider will be able to accept member contributions from the time the individual is taken to have quoted their TFN to the RSA provider. ***[Schedule 5, item 26, subsection 140A(2) of the Retirement Savings Accounts Act 1997]***

***Superannuation Industry (Supervision) Act 1993***

*The beneficiary is taken to have quoted their TFN where the Commissioner gives notice*

5.32 The current law does not specifically deal with the situation where the Commissioner provides a TFN to a trustee, except in the limited circumstances involving the incorrect quotation of a TFN (see Division 3A of Part 25A of the *Superannuation Industry (Supervision) Act 1993)*. However, the Commissioner's powers to provide a TFN to a trustee are not limited to the specific circumstances where an incorrect TFN has been provided. Rather the Commissioner may provide a TFN to a trustee under the Commissioner's general administration powers.

5.33 These amendments ensure that where a TFN is provided by the Commissioner to a trustee of an entity or scheme, an individual is taken to have quoted their TFN in connection with the operation or the possible future operation of the *Superannuation Industry (Supervision) Act 1993* and the other 'Superannuation Acts'. ***[Schedule 5, item 27, subsection 299SA(1) of the Superannuation Industry (Supervision) Act 1993]***

5.34 Section 299W of the *Superannuation Industry (Supervision) Act 1993* specifies 'Superannuation Acts' to mean the:

- *Superannuation Industry (Supervision) Act 1993*;

- *Superannuation Contributions Tax (Assessment and Collection) Act 1997*;

- *Superannuation Contributions Tax (Members of Constitutionally Protected Funds) Assessment and Collection Act 1997*;
- *Superannuation (Unclaimed Money and Lost Members) Act 1999*; and
- *Termination Payments Tax (Assessment and Collection) Act 1997*.

5.35 These amendments ensure that where the Commissioner gives notice of an individual's TFN to a trustee of an entity or scheme, the individual will be taken to have quoted their TFN to the entity or scheme for superannuation purposes at the time it is provided by the Commissioner. Accordingly, the entity or scheme will be able to accept member contributions from the time the individual is taken to have quoted their TFN to the entity or scheme. ***[Schedule 5, item 27, subsection 299SA(2) of the Superannuation Industry (Supervision) Act 1993]***

### *Taxation Administration Act 1953*

5.36 The tax attributable to no-TFN contributions income and the tax offset for no-TFN contributions income will not be taken into account when working out a superannuation or RSA provider's notional tax or benchmark tax. This will ensure that any extra tax that a superannuation or RSA provider has to pay, or any tax offset it can claim, because of no-TFN contributions income will be taken into account in the entity's income tax assessment and not in its PAYG instalments.

### *Notional tax if you have no-TFN contributions income*

5.37 The Commissioner works out the instalment rate or GDP-adjusted (gross domestic product) notional tax amount for superannuation and RSA providers from the entity's notional tax under section 45-325 of Schedule 1 to the TAA 1953. The calculation of the superannuation or RSA provider's notional tax will be modified to ensure that no-TFN contributions income and the tax offset for no-TFN contributions income are not taken into account. However the contributions are still assessable contributions that are taken into account when working out the provider's notional tax and base assessment instalment income. This amendment does not affect how a superannuation or RSA provider works out their instalment income. The provider must still include all contributions that are assessable contributions in their instalment income for a period. ***[Schedule 5, item 29, subsection 45-325(1A) of the TAA 1953]***

### *Benchmark tax if you have no-TFN contributions income*

5.38 The application of section 45-365 of Schedule 1 in working out a superannuation or RSA provider's benchmark tax is modified to ensure that no-TFN contributions income and the tax offset for no-TFN contributions income are not taken into account. This will ensure that the superannuation or RSA provider can ignore the effect of the no-TFN contributions income measures when considering whether to vary its PAYG instalments for a year. However the contributions are still assessable contributions that are taken into account when working out the provider's benchmark tax and variation year (instalment income). ***[Schedule 5, item 30, subsection 45-365(1A) of the TAA 1953]***

## Segregated pension assets

5.39 Under section 295-385 of the ITAA 1997, income of a complying superannuation fund that is derived from 'segregated current pension assets' (as defined in that section) is exempt from tax.

5.40 These amendments provide that assets supporting a superannuation income stream benefit which is being paid as an allocated pension, a market-linked pension or an account-based pension, are not considered segregated current pension assets to the extent that the value of those assets exceeds the value of the account balance supporting the income stream benefit. ***[Schedule 5, item 5, subsection 295-385(6) of the ITAA 1997]***

5.41 The effect of this integrity change is that assets which are not included in a pension account balance will not be considered segregated current pension assets and therefore any income derived from those assets will not be exempt from tax.

## CGT small business relief

5.42 With the replacement of the concept of eligible termination payments from 1 July 2007, consequential amendments were made to CGT provisions in Division 152 of the ITAA 1997. These provisions provide relief from CGT to qualifying small businesses where the proceeds of CGT events are used for retirement.

5.43 The application provisions currently contained in item 12 of Schedule 2 to the *Superannuation Legislation Amendment (Simplification) Act 2007* apply to CGT events that happen in the 2007-08 income year or later income years only.

5.44 The application provisions relating to the removal of the eligible termination payment mechanisms are amended to provide for a CGT event that occurs in an earlier income year to the income year in which the proceeds are received, where the CGT event and the receipt of the proceeds crossover with a start date for the *Simplified Superannuation* reforms (ie, either 10 May 2006 or 1 July 2007). For example, a CGT event occurs on 1 April 2006 but the proceeds are not received until 14 October 2006. The new mechanisms for receiving a CGT amount and contributing it to superannuation will apply, despite the CGT event occurring before the transitional period.

5.45 The amended application provisions apply to the period in which the choice is made or the proceeds are received by an individual, or a payment is made by a company or trust, not the period in which the CGT event occurred. ***[Schedule 5, item 28; item 12 of Schedule 2 to the Superannuation Legislation Amendment (Simplification) Act 2007]***

5.46 The *Simplified Superannuation* reforms also provided for changes in CGT terminology introduced in the *Tax Laws Amendment (2006 Measures No. 7) Act 2007* which applied to CGT events occurring in either: the 2007-08 income year or later income years, or, during the *Simplified Superannuation* transitional period, 10 May 2006 to 30 June 2007.

5.47 This Schedule amends the application provisions to provide for CGT events happening in the 2006-07 income year and later income years. ***[Schedule 5, item 28; item 12 of Schedule 2 to the Superannuation Legislation Amendment (Simplification) Act 2007]***

## Rewrite of superannuation tax law

### *The tax-free component worked out under the Income Tax (Transitional Provisions) Act 1997*

5.48 After 1 July 2007, the tax-free component of pensions which commenced before 1 July 2007 will be worked out under subsection 307-125(2) of the *Income Tax (Transitional Provisions) Act 1997*. When a pension trigger event occurs (eg, the pensioner reaches age 60), the tax-free component is then calculated under subsection 307-125(6).

5.49 Subsection 307-125(6) currently defines the ‘tax-free component’ as being the *sum* of the unused undeducted purchase price (within the meaning of section 27A of the ITAA 1936) and the pre-July 1983 component of the pension. The pre-July 1983 component is nil where at least one superannuation income stream benefit was paid from the superannuation income stream before 1 July 1994.

5.50 Subsection 307-125(6) is amended, and subsection 307-125(6A) inserted into the *Income Tax (Transitional Provisions) Act 1997*, to amend the calculation of the tax-free component (for the purposes of paragraph 307-125(4)(b)) and to make the section easier to read. The reference in paragraph 307-125(4)(b) is also updated to refer to both subsection (6) and the new subsection (6A). ***[Schedule 5, item 19, paragraph 307-125(4)(b) of the Income Tax (Transitional Provisions) Act 1997]***

5.51 Paragraph 307-125(6)(b) is amended to refer to only paragraph (a) of the definition of 'unused undeducted purchase price' in subsection 27A(1) of the ITAA 1936 ***[Schedule 5, item 20, paragraph 30-125(6)(b) of the Income Tax (Transitional Provisions) Act 1997].*** The references in that paragraph to paragraphs (b) and (c) of the definition are also excluded for the purposes of the operation of the calculation ***[Schedule 5, item 21, paragraph 307-125(6)(b) of the Income Tax (Transitional Provisions) Act 1997].***

5.52 The amount worked out in paragraph 307-125(6)(b) will be the unused undeducted purchase price amount, reduced by the amount of any tax-free components (worked out under subsection 307-125(2)) of any benefits paid from the superannuation income stream after 1 July 2007. ***[Schedule 5, item 22, paragraph 307-125(6)(b) of the Income Tax (Transitional Provisions) Act 1997]***

5.53 Paragraph 307-125(6)(c) is amended to remove the reference to treating the pre-July 1983 component as nil ***[Schedule 5, item 23, paragraph 307-125(6)(c) of the Income Tax (Transitional Provisions) Act 1997].*** This component of the calculation is being moved to subsection 307-125(6A). Subsection 307-125(6) is amended so the tax-free component is worked out under subsections (6) and (6A) ***[Schedule 5, item 24, subsection 307-125(6A) of the Income Tax (Transitional Provisions) Act 1997].***

5.54 The tax-free component will be the unused undeducted purchase price (*less* any tax-free components of any benefits paid from the superannuation income stream after 1 July 2007) where:

- at least one superannuation income stream benefit was paid from the superannuation income stream before 1 July 1994; or
- the superannuation income stream was purchased after 1 July 1994 with the roll-over of a commutation of a pension that commenced before 1 July 1994.

5.55 Where this is not the case, the tax-free component will be equal to the sum of the unused undeducted purchase price (*less* any tax-free components (worked out under subsection 307-125(2)) of any benefits

paid from the superannuation income stream after 1 July 2007) and the pre-July 1983 component.

***Payment of death benefits***

5.56 Currently, a superannuation benefit that results from the commutation of a superannuation income stream after the death of the receiving member must be paid within six months of the death, or three months of the grant of probate, in order to be treated as a superannuation death benefit.

5.57 Section 307-5 of the ITAA 1997 is amended to allow, in certain circumstances, more time for a benefit to be paid and still be treated as a superannuation death benefit.

5.58 The time periods currently in section 307-5 of the ITAA 1997 are extended where they can not be met due to legal action (including dispute resolution processes), or reasonable delays in the process of identifying and contacting potential beneficiaries.

5.59 The time period is extended to six months after the cessation of legal action or after contact is made with potential beneficiaries. ***[Schedule 5, items 9 to 12, paragraph 307-5(3)(c) of the ITAA 1997]***

5.60 The term 'reasonable delays' covers situations where the payer has genuinely attempted to identify the potential recipients *and* the potential recipients do not unreasonably delay the process.

5.61 If the benefit is not paid within this period, the Commissioner may make a decision in writing that the payment is not a superannuation member benefit. ***[Schedule 5, item 13, paragraph 307-5(3)(d) of the ITAA 1997 and item 14, subsection 307-5(3A) of the ITAA 1997]***

5.62 In making this decision, the Commissioner must have regard to:

- whether there was any action taken to try to pay the benefit, and the nature of that action (for instance the thoroughness of attempts to locate and communicate with potential beneficiaries);
- the circumstances and actions of the person to whom the benefit was paid; and
- any other factors beyond the control of the fund or beneficiary which prevented the timeframe being met.

***[Schedule 5, item 14, subsection 307-5(3B) of the ITAA 1997]***

5.63 This mechanism is intended to ensure that where reasonable attempts are made to pay the benefit within the specified time period, but due to factors beyond the control of the parties the benefit is not paid within time, the benefit can still be treated as a superannuation death benefit. However, the intent is not that payers or recipients are able to delay payment in order to keep money within the superannuation system.

**Example 5.1**

The superannuation fund trustee determines that Nicholas is entitled to the entirety of a benefit payable upon the death of his father. The payment of a death benefit to Nicholas is delayed because his step-sister, Emma, takes action in the Superannuation Complaints Tribunal (SCT) in an attempt to receive some of the benefit. Emma is unsuccessful in the SCT, and five months later, Nicholas receives the payment. Section 307-5 would operate to treat this payment as a superannuation death benefit.

**Example 5.2**

Mat's father dies, and shortly after, Mat moves to Japan. His father's superannuation fund makes several attempts to contact him by letter and by telephone, but is unable to locate him. One year later, Mat returns to Australia and sees a letter from his father's superannuation fund. He contacts the fund, and one month later receives the payment. Section 307-5 would operate to treat this payment as a superannuation death benefit.

**Example 5.3**

Geeta receives a letter from her deceased father's superannuation fund identifying her as the beneficiary of her father's superannuation. Geeta writes back to the superannuation fund providing details of how she would like to be paid. However, Geeta inadvertently omits a digit from her bank account number, and the superannuation fund cannot make the payment. Both parties attempt to rectify the mistake as quickly as possible, but by the time the money is paid, it has been seven months since the superannuation fund first contacted Geeta.

The actions of Geeta and the superannuation fund in attempting to rectify the mistake as quickly as possible are relevant in determining that the benefit should be treated as a superannuation death benefit. It is intended that in these circumstances, the Commissioner would exercise his discretion to treat the benefit as a superannuation death benefit.

**Example 5.4**

Modifying Example 5.3, Geeta decides to ignore the letter from her father's superannuation fund because she does not need the money. One year later, Geeta decides she does need the money, contacts the fund and receives the benefit.

In this situation it is not intended that the Commissioner would exercise his discretion to allow the payment to be treated as a superannuation death benefit as there was a deliberate choice to delay payment of the benefit.

***Deductions for insurance premiums***

5.64 Section 307-290 of the ITAA 1997 provides a method for working out the taxed and untaxed elements of death benefit superannuation lump sums. The section applies where a deduction has been, or is to be, claimed (under section 295-465 or 295-470 of the ITAA 1997) for insurance premiums paid for life insurance on behalf of the member.

5.65 Section 307-290 is inserted into the *Income Tax (Transitional Provisions) Act 1997* to provide that for the purposes of section 307-290 of the ITAA 1997, a deduction claimed under section 279 or 279B of the ITAA 1936 is to be treated as a deduction under section 295-465 or 295-470 of the ITAA 1997 respectively. ***[Schedule 5, item 25, section 307-290 of the Income Tax (Transitional Provisions) Act 1997]***

5.66 The note after subsection 307-290(1) of the ITAA 1997 is amended to refer to new section 307-290 of the *Income Tax (Transitional Provisions) Act 1997*. ***[Schedule 5, item 15, subsection 307-290(1) (note) of the ITAA 1997]***

***Deductions for tax paid on contributions***

5.67 As part of the *Simplified Superannuation* reforms section 279D of the ITAA 1936 was rewritten as section 295-485 of the ITAA 1997.

5.68 Section 295-485 of the ITAA 1997 provides that certain superannuation death benefits are not reduced because of tax paid for contributions included in the assessable income of the superannuation entity. Under this section, complying superannuation funds or complying approved deposit funds are able to claim a deduction for an increased amount of a superannuation lump sum death benefit paid to the trustee of the deceased's estate or a spouse or former spouse or child of the deceased. The increased amount is equal to the tax paid for contributions included in the assessable income of the superannuation entity.

5.69 These amendments include a provision in the *Income Tax (Transitional Provisions) Act 1997* that modifies the effect of paragraph 295-485(1)(b) to allow for amounts included in assessable income under former section 274 of the ITAA 1936. ***[Schedule 5, item 18, section 295-485 of the Income Tax (Transitional Provisions) Act 1997]***

5.70 The amendments also include a note at the end of section 295-485 of the ITAA 1997 referring to the new transitional provision. ***[Schedule 5, item 6, note to subsection 295-485(1) of the ITAA 1997]***

5.71 These amendments ensure that the rewritten section operates as intended.

### *Deductions for employer superannuation contributions*

5.72 Paragraph 290-70(aa) is inserted into the ITAA 1997 to enable an employer to claim a deduction for superannuation contributions made on behalf of a person who is an employee ('employee', as defined in section 12 of the *Superannuation Guarantee (Administration) Act 1992*). ***[Schedule 5, items 1 and 2, section 290-70 of the ITAA 1997]***

5.73 This will enable employers to claim a deduction for contributions made on behalf of SG employees who are not engaged in producing the assessable income of the business, nor engaged in the business for the employer.

5.74 However, individuals who are not SG employees will still need to be engaged in producing the assessable income of the business or engaged in the business before a deduction can be claimed.

5.75 An employer still needs to satisfy the conditions in sections 290-75 and 290-80 of the ITAA 1997 in order to claim a deduction.

5.76 Paragraph 290-90(4)(aa) is inserted into the ITAA 1997 to allow an employer to claim a deduction for superannuation contributions made on behalf of an SG employee of the company, where the employer has a controlling interest in the company ***[Schedule 5, items 3 and 4, subsection 290-90(4) of the ITAA 1997]***. The employer will still need to satisfy the conditions in sections 290-75 and 290-80, as well as the other conditions in section 290-90, before claiming a deduction.

## Minor technical amendments

### *Definition of 'non-complying superannuation fund'*

5.77 The current definition of a 'non-complying superannuation fund' in the ITAA 1997 is a superannuation fund that is not a complying superannuation fund.

5.78 The definition of 'non-complying superannuation fund' is amended so that a non-complying superannuation fund is a superannuation fund that is a fund, but is not a complying superannuation fund ***[Schedule 5, item 16, subsection 995-1(1) of the ITAA 1997].*** This change is intended to reflect the definition of non-complying superannuation fund as it stood before 1 July 2007.

### *Income Tax (Former Non-resident Superannuation Funds) Act 1994*

5.79 A reference is updated to clarify that the section being referred to at the end of section 3 of the *Income Tax (Former Non-resident Superannuation Funds) Act 1994* is section 295-320 of the ITAA 1997, not section 295-320 of the *Income Tax (Former Non-resident Superannuation Funds) Act 1994* itself. ***[Schedule 5, item 17, section 3 of the Income Tax (Former Non-resident Superannuation Funds) Act 1994]***

### *Formula for the average value of superannuation liabilities for the segregated pension asset calculation*

5.80 Section 295-390 of the ITAA 1997 sets out the exempt income of a superannuation entity used to meet current pension liabilities. Subsection 295-390(3) of the ITAA 1997 provides a formula to determine the proportion of assets that are exempt.

5.81 The formula for 'average value of superannuation liabilities' in the ITAA 1997 only refers to 'superannuation income stream benefits' and as a result does not include in the calculation any liabilities to pay non-pension benefits (ie, lump sums) in the future.

5.82 The definition of 'average superannuation liabilities' in subsection 295-390(3) of the ITAA 1997 is amended to replace 'superannuation income stream benefits' with 'superannuation benefits' (which refers to subsection 995-1(1) and section 307-5). ***[Schedule 5, item 43, subsection 295-390(3) of the ITAA 1997]***

5.83 This amendment reflects the operation of former subsection 283(2) of the ITAA 1936.

5.84 Other minor technical amendments are made to improve the presentation of some rewritten provisions in the ITAA 1997, and to amend a number of definitions, including 'index number'. ***[Schedule 5, items 31 to 42 and 44 to 46, section 9-1 (item 9 in the table), section 9-1 (item 10 in the table, column headed 'because of this provision:'), section 9-1 (item 11 in the table), subsection 9-5(1) (item 5 in the table), subsection 9-5(1) (item 6 in the table), subsection 9-5(1) (item 7 in the table), subsection 9-5(1) (item 8 in the table), subsection 9-5(1) (item 9 in the table), subsection 9-5(1) (item 10 in the table), section 12-5 (item in the table headed 'interest'), section 20-5 (item 8 in the table), subsection 295-390(3) (definition of 'average value of superannuation liabilities'), subsection 295-485(3), subsection 295-485(3) (definition of 'low tax component tax rate'), subsection 995-1(1) (definition of 'index number') of the ITAA 1997; Schedule 5, item 47, subsection 16-165(1) of the TAA 1953]***

## Application and transitional provisions

5.85 These amendments generally apply to the 2007-08 income year and later income years. ***[Schedule 5, subitem 48(1)]***

5.86 However, amendments relating to the following commence on 1 July 2007 ***[Schedule 5, subitem 48(2)]***:

- payment of death benefits ***[Schedule 5, items 9 to 14]***;
- change to the definition of 'non-complying superannuation fund' ***[Schedule 5, item 16]***;
- the calculation of the tax free component under the *Income Tax (Transitional Provisions) Act 1997* ***[Schedule 5, items 19 to 24]***; and
- deductions for insurance premiums ***[Schedule 5, items 15 and 25].***

5.87 Amendments to section 295-615 of the ITAA 1997, section 140A of the *Retirement Savings Accounts Act 1997* and section 299SA of the *Superannuation Industry (Supervision) Act 1993* in regards to the notice of an individual's TFN, apply on or after 1 June 2007. ***[Schedule 5, subitem 48(3)]***

5.88 Amendments to subsection 45-325(1) of the TAA 1953 apply to a superannuation or RSA provider's 2007-08 base year and later base years. ***[Schedule 5, subitem 48(4)]***

5.89 Amendments to subsection 45-365(1) of the TAA 1953 apply to a superannuation or RSA provider's 2007-08 variation year and later variation years. ***[Schedule 5, subitem 48(5)]***

# Chapter 6
# Deductible gift recipients

## Outline of chapter

6.1 Schedule 6 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to update the list of deductible gift recipients (DGRs) to include two new organisations. This Schedule also reflects a name change of one organisation listed as a DGR under section 30-55 of the ITAA 1997.

## Context of amendments

6.2 The income tax law allows taxpayers to deduct gifts of $2 or more made to DGRs. To be a DGR, an organisation must fall within a category of organisations set out in Division 30 of the ITAA 1997, or be listed by name under that Division.

6.3 DGR status assists relevant funds and organisations to attract public support for their activities.

## Summary of new law

6.4 These amendments add two organisations to the list of specifically listed DGRs. Gifts of $2 or more, made to these organisations within each organisation's eligible time period, are tax deductible.

6.5 The amendments also update the ITAA 1997 to reflect a name change of one organisation specifically listed as a DGR.

## Detailed explanation of new law

6.6 Schedule 6 lists the organisations in Table 6.1 as DGRs. ***[Schedule 6, item 2]***

**Table 6.1**

| ***Name of fund*** | ***Date of effect*** | ***Special conditions*** |
|---|---|---|
| Australian Peacekeeping Memorial Project Incorporated | 30 April 2007 | The gift must be made before 1 January 2009. |
| Social Ventures Australia Limited | 4 May 2007 | |

6.7 The Australian Peacekeeping Memorial Project Incorporated was established for the construction of a national memorial in Canberra to commemorate and celebrate Australian peacekeeping. The memorial will commemorate Australia's contribution to international peacekeeping since the commitment to the first United Nation peacekeeping mission on 14 September 1947. ***[Schedule 6, items 2 and 4]***

6.8 Social Ventures Australia Limited seeks to improve the effectiveness of other charitable organisations by providing a tailored combination of financial support, business skills development and mentoring. Its focus is on helping charities to achieve sustainable outcomes for the communities they serve and to increase their effectiveness as charitable organisations. ***[Schedule 6, items 2 and 6]***

### Reflecting a name change of a specifically listed DGR

6.9 Currently, Mawson's Huts Foundation Limited is listed under its previous name, AAP Mawson's Huts Foundation Limited. Schedule 6 updates the ITAA 1997 to reflect its name change to Mawson's Huts Foundation Limited. ***[Schedule 6, items 1, 3 and 5]***

6.10 Mawson's Huts Foundation Limited was established to raise funds to preserve, restore and repair the huts at Cape Denison in the far eastern part of the Australian Antarctic Territory. The huts were built and occupied by the Australasian Antarctic Expedition of 1911-14 led by Sir Douglas Mawson. ***[Schedule 6, items 1, 3 and 5]***

## Application and transitional provisions

6.11 These amendments to list the organisations in Table 6.1 apply from the dates of effect shown in those tables. ***[Schedule 6, items 2, 4 and 6]***

# Chapter 7
# Minor amendments

## Outline of chapter

7.1 Schedule 7 to this Bill makes various minor amendments to the taxation laws.

## Context of amendments

7.2 Tax legislation is complex and wide-ranging. Therefore, errors can occur. Even minor errors can detract from the readability of the taxation laws and can confuse or mislead readers and so these errors need correcting.

7.3 These minor amendments are part of the Government's commitment to improving the quality of the taxation laws.

## Summary of new law

7.4 The amendments rectify errors such as duplicate definitions, missing asterisks from defined terms, and inoperative references.

7.5 Other amendments include:

- providing for income tax deductibility for gifts to certain scholarship funds for Masters or Doctoral courses as originally intended (see explanation of item 2);
- correcting the formula for calculating the fringe benefits tax (FBT) depreciation rate for a car, to align it with the income tax diminishing value capital allowance figure (currently, 200 per cent) rather than the previous 150 per cent (see explanation of item 7);
- preventing unintended tax file number (TFN) withholding from payments to exempt foreign superannuation funds (see explanation of item 16); and

- preventing an unintended capital gains tax (CGT) exemption for certain 'not-for-profit mutual' organisations (see explanation of item 37).

7.6 These amendments apply from the date of Royal Assent unless otherwise stated.

## Detailed explanation of new law

**Table 7.1: Amendment to the *A New Tax System (Australian Business Number) Act 1999***

| *Provision being amended* | *What the amendment does* |
|---|---|
| 41 (subparagraph (e)(ii) of *government entity* definition) | Asterisks the term 'enterprise', which is a defined term.<br>***[Schedule 7, item 1, section 41]*** |

**Table 7.2: Amendments to the *A New Tax System (Goods and Services Tax) Act 1999***

| *Provision being amended* | *What the amendment does* |
|---|---|
| 38-90(2)(a)<br>195-1 (paragraph (e) of *education course* definition)<br>195-1 (*Masters or Doctoral course* definition)<br>**195-1 (*Tertiary course* definition)**<br>195-1 (*Tertiary residential college course* definition) | Inserts a new paragraph into the goods and services tax (GST) definition of 'tertiary course' that has the same content as the definition of 'Masters or Doctoral course', which is to be repealed.<br>A consequential amendment to the GST definition of 'tertiary residential college course' is also necessary. This amendment omits the reference to a Masters or Doctoral course (as defined) as those kinds of courses now come within the definition of 'tertiary course'.<br>These amendments have no effect on the GST law except for how it is expressed. They do, however, have an effect on the income tax law, which relies on the GST definition of 'tertiary course' for provisions about the tax deductibility of gifts. |

| *Provision being amended* | *What the amendment does* |
|---|---|
| | Section 30-37 of the *Income Tax Assessment Act 1997* (ITAA 1997) refers to certain education courses including tertiary courses (as defined). The income tax definition of 'tertiary course' is defined by reference to the GST definition.<br>The purpose of expanding the GST definition of 'tertiary course' is to extend the income tax deductibility of gifts to public funds that provide money for scholarships, bursaries or prizes for education courses to include Masters or Doctoral courses.<br>This amendment gives effect to what has always been the policy intent of the extended gift deductibility arrangements that have applied since 1 July 2006.<br>A special commencement provision in clause 2 of the Bill for items 2 to 6 of this Schedule ensures that these amendments commence from 1 July 2006. This back-dated commencement provision (which favours the taxpayers affected) allows for the extended income tax deductibility of gifts to apply from 1 July 2006.<br>***[Schedule 7, items 2 to 6 and clause 2, paragraph 38-90(2)(a) and section 195-1]*** |

**Table 7.3: Amendments to the *Crimes (Taxation Offences) Act 1980***

| *Provision being amended* | *What the amendment does* |
|---|---|
| 5 and 7 (headings) | Changes the headings of sections 5 and 7 by omitting 'old sales tax' and substituting 'income tax' to reflect the content of those sections (which were amended in 2006).<br>This change is not done by formal amendment given that section headings are not part of this Act, as per subsection 13(3) of the *Acts Interpretation Act 1901*.<br>***[Schedule 7, sections 5 and 7]*** |

### Table 7.4: Amendment to the *Fringe Benefits Tax Assessment Act 1986*

| *Provision being amended* | *What the amendment does* |
|---|---|
| 11(1AA) (formula) | Amends subsection 11(1AA) to correct the formula for calculating the FBT depreciation rate for a car.<br><br>At present, the formula incorrectly uses the figure of 150 per cent. This figure is intended to be based on the income tax diminishing value capital allowance figure. It is no longer correct for a car that a person began to hold on or after 10 May 2006 given the change to the relevant figure in 2006.<br><br>The amendment ensures that whatever figure is used for working out a car's diminishing value depreciation rate for income tax purposes at the start of an FBT year is used for working out its depreciation rate for FBT purposes *throughout* that FBT year.<br><br>Any change to the income tax figure would only affect the FBT figure from the start of the *next* FBT year. A car that begins to be held during an FBT year would use the income tax figure that applied to such cars at the start of that FBT year, even though the car was not held at that time.<br><br>An application provision (item 8) ensures that this amendment applies only prospectively from the 2008-09 FBT year as it would cause an increase in FBT payable in some cases.<br><br>***[Schedule 7, items 7 and 8, subsection 11(1AA)]*** |

**Table 7.5: Amendments to the *Income Tax Assessment Act 1936***

| *Provision being amended* | *What the amendment does* |
|---|---|
| 23GA | Repeals section 23GA, which previously exempted from income tax interest on judgment debts relating to personal injury.<br>This provision only applied up to the 1996-97 income year (see the *Taxation Laws Amendment Act (No. 2) 2000*, Schedule 2, item 4). After that, it was replaced by section 51-57 of the ITAA 1997. Section 23GA is therefore inoperative.<br>(See also the explanation in Table 7.6 of item 18.)<br>***[Schedule 7, item 9, section 23GA]*** |
| 46A(8AA) | Amends section 46A(8AA) to omit a reference to section 23B of the *Income Tax Rates Act 1986*.<br>This amendment is consequential to that proposed by item 99 (see Table 7.8) to repeal section 23B of the *Income Tax Rates Act 1986*. Subsection 46A(8AA) is concerned with the 'average rate of tax' for life assurance companies.<br>***[Schedule 7, item 10, subsection 46A(8AA)]*** |
| 97A (heading) | Changes the heading to section 97A. That section is concerned with trust beneficiaries who are owners of farm management deposits. The change omits references to 'income equalization deposits' in the heading.<br>References to 'income equalization deposits' in section 97A itself were repealed by the *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006* (the Inoperative Provisions Act). Therefore, the words 'income equalization deposits' in the heading are unnecessary and potentially misleading.<br>This change is not done by formal amendment given that section headings are not part of this Act, as per subsection 13(3) of the *Acts Interpretation Act 1901*.<br>***[Schedule 7, section 97A]*** |

| ***Provision being amended*** | ***What the amendment does*** |
|---|---|
| 128B(3A) | Amends subsection 128B(3A) to correct a grammatical error.<br>Section 128B is concerned with liability to withholding tax. Subsection 128BA(3A) excludes income that is equivalent to interest on a loan if it is derived by the trustee of a trust or a partnership. The subsection refers to 'income consisting of a dividend…that is derived by the trustee of a trust, or *to* a partnership…'. This is grammatically incorrect as income is derived *by* a partnership not *to* a partnership.<br>***[Schedule 7, item 11, subsection 128B(3A)]*** |
| 139E(2) and (4) | Amends subsections 139E(2) and (4) to replace the words 'in a form approved by the Commissioner' with 'in the approved form'.<br>These subsections currently require a taxpayer making certain elections relating to employee share schemes to do so in writing 'in a form approved by the Commissioner'.<br>There has been a move towards using the defined term 'approved form' instead of 'a form approved by the Commissioner'.<br>Therefore subsections 139E(2) and (4) are being amended to bring them into line with current practice.<br>Subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) defines 'approved form' as having the meaning given by section 388-50 in Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953).<br>***[Schedule 7, item 12, subsections 139E(2) and (4)]*** |
| 139GA(3)(a) to (d) | Amends the definition of 'employer' for employee share scheme purposes to ensure that it applies as intended.<br>When the Inoperative Provisions Act was drafted, the words 'a person who receives or is entitled to receive work and income support related withholding payments and benefits' were inserted in the definition of 'employee' in subsection 139GA(1). Those words had previously been part of the repealed definition in section 221A of the |

| *Provision being amended* | *What the amendment does* |
|---|---|
| | ITAA 1936. However, the equivalent reference was not included in subsection 139GA(3) for the definition of 'employer'.<br>Unincorporated bodies, partnerships and Australian government agencies (part of the former section 221A definition) were included. These references are being removed. The references are not required in the context of employee share schemes, given the insertion in the definition of a reference to a person who pays, or is liable to pay, work and income support related withholding payments and benefits.<br>Finally, the words 'a person in foreign service' were incorrectly included instead of 'a person who engages another person in foreign service'.<br>An application provision (item 14) ensures that the amendment applies to income derived in the 2006-07 income year and later income years.<br>This date of effect ensures that the Inoperative Provisions Act did not cause an unintended substantive change to the employee share scheme provisions.<br>***[Schedule 7, items 13 and 14, paragraphs 139GA(3)(a) to (d)]*** |
| 202DDA | Repeals section 202DDA, an inoperative provision.<br>Section 202DAA treats the quotation by a corporate investor of an investment body remitter number as the quotation of a TFN in certain circumstances. Investment body remitter numbers were replaced by Australian Business Numbers in 2000.<br>***[Schedule 7, item 15, section 202DDA]*** |

| ***Provision being amended*** | ***What the amendment does*** |
|---|---|
| 202EE(1)(d) | Amends paragraph 202EE(1)(d) to prevent inappropriate TFN withholding from payments to exempt foreign superannuation funds.<br>This amendment is necessary as a result of changes made by the Inoperative Provisions Act. Those changes have resulted in payments to exempt foreign superannuation funds being technically subject to TFN withholding. This consequence was unintended.<br>An application provision (item 17) ensures that the amendment (which favours the taxpayers affected) applies to income derived in the 2006-07 income year and later income years. The 2006-07 income year is the year from which the changes made by the Inoperative Provisions Act applied.<br>***[Schedule 7, items 16 and 17, paragraph 202EE(1)(d)]*** |

**Table 7.6: Amendments to the *Income Tax Assessment Act 1997***

| ***Provision being amended*** | ***What the amendment does*** |
|---|---|
| 11-10 (item in the table headed ‘interest’) | Omits a reference to section 23GA of the ITAA 1936 as that section is being repealed by item 9 (see Table 7.5).<br>***[Schedule 7, item 18, section 11-10]*** |
| 11-15 (item in the table headed ‘foreign aspects of income taxation’)<br>12-15 (item in the table headed ‘dividends’) | Replaces references to ‘non-resident’ with references to ‘foreign resident’ to reflect the terminology used in the ITAA 1997. This only changes the way in which the law is expressed.<br>***[Schedule 7, items 19 and 20, sections 11-15 and 12-15]*** |

| ***Provision being amended*** | ***What the amendment does*** |
|---|---|
| 15-55(1)(b) and 15-60(4)(b) | Replaces references to paragraph 320-15(k) with references to paragraph 320-15(1)(k).<br><br>Section 15-55 includes in assessable income certain amounts paid under a funeral policy. Paragraph 15-55(1)(b) refers to paragraph 320-15(k), a provision that does not exist. The correct reference clearly should be to paragraph 320-15(1)(k).<br><br>Section 15-60 includes in assessable income certain amounts paid under scholarship plans. Paragraph 15-60(4)(b) also refers to the non-existent paragraph 320-15(k). Once again, the correct reference clearly should be to paragraph 320-15(1)(k).<br><br>An application provision (item 22) ensures that the amendments apply to assessments for the income year including 1 January 2003 and later income years. These amendments, if anything, favour the taxpayers affected as any substantive effect would be to reduce the amount to be included in assessable income. However, the courts would be likely to read the existing provisions in their intended form given the obvious drafting error.<br><br>***[Schedule 7, items 21 and 22, paragraphs 15-55(1)(b) and 15-60(4)(b)]*** |
| 30-60(c)<br>30-255<br>30-265(4)<br>30-270(4)<br>30-275(c)<br>30-280(1)<br>30-280(4)<br>30-285(1)<br>31-5(5)(c)<br>**995-1(1)** | Replaces references to the Minister or Secretary of 'Environment, Sport and Territories' with references to the 'Environment Minister' or 'Environment Secretary' and adds a definition of 'Environment Minister'.<br><br>There is an existing definition of Environment Secretary, which identifies the Secretary responsible for administering the *Environment Protection and Biodiversity Conservation Act 1999.*<br><br>The new definition of the Environment Minister is in similar terms. This reduces the need to amend the law if future changes are made to the portfolio name. |

| ***Provision being amended*** | ***What the amendment does*** |
|---|---|
| | There is no need to back-date these amendments as section 19BA of the *Acts Interpretation Act 1901* already makes allowance for changed administrative arrangements of this kind.<br>***[Schedule 7, items 23 to 33 and 64, paragraph 30-60(c), section 30-255, subsections 30-265(4) and 30-270(4), paragraph 30-275(c), subsections 30-280(1), 30-280(4) and 30-285(1), paragraph 31-5(5)(c) and subsection 995-1(1)]*** |
| 50-70 (heading) | Corrects a section heading so that it better reflects the section to which it relates.<br>Section 50-70 has special conditions for certain items in the tables for Subdivision 50-A. The heading at present incorrectly includes a reference to item 4.1, an item that is no longer referred to in section 50-70 itself.<br>Section headings are part of the ITAA 1997 by reason of the third dot point in subsection 950-100(1).<br>***[Schedule 7, item 34, section 50-70]*** |
| 51-57(1)<br>197-20(b) | Updates terminology.<br>Section 51-7 exempts from income tax interest on a judgment debt relating to personal injury provided certain conditions are met. Subsection 51-57(1) uses the expression 'a law of the Commonwealth, a State or Territory'.<br>Paragraph 197-20(b) is part of Division 197, which is concerned with tainted share capital accounts. It also uses the expression 'a law of the Commonwealth, a State or Territory'.<br>This expression should no longer be used given that the defined term 'Australian law' covers the same ground.<br>***[Schedule 7, items 35 and 57, subsection 51-57(1) and paragraph 197-20(b)]*** |

| *Provision being amended* | *What the amendment does* |
|---|---|
| 61-560 (note) | Corrects a grammatical error.<br>Section 61-560 provides for an entitlement to the mature age worker tax offset for individuals aged 55 or over at the end of the income year. The note to section 61-560 has a minor error in that it states 'if have you no net income' instead of 'if you have no net income'.<br>***[Schedule 7, item 36, section 61-560]*** |
| 118-12(2)(a) | Ensures that a CGT exemption does not apply where it was not intended to apply.<br>Under the mutuality principle, non-commercial dealings between members of a mutual organisation are not generally included in income.<br>The 2004 judicial decision in *Coleambally Irrigation Mutual Co-operative Ltd v Commissioner of Taxation* [2004] FCA 2 brought mutual receipts of those organisations with a prohibition on distributing surpluses to members (or 'not-for-profit mutuals') into the income tax system as assessable income.<br>In contrast, mutual receipts of those organisations without a prohibition on distribution to members (or 'true mutuals') were not affected by the judicial decision, and such receipts remained outside the income tax system.<br>The *Tax Laws Amendment (2005 Measures No. 6) Act 2005* amended the ITAA 1997 by inserting section 59-35 to ensure 'not-for-profit mutuals' are not subject to income tax on ordinary income from their members merely because they are prohibited from distributing funds to members. Section 59-35 states that these receipts are non-assessable non-exempt income. |

| ***Provision being amended*** | ***What the amendment does*** |
|---|---|
| | The intent of section 59-35 was to restore the tax treatment of 'not-for-profit mutuals' and thus ensure similar treatment to 'true mutuals'.<br>An unintended consequence of inserting section 59-35 was that CGT assets used solely to produce the mutual receipts of 'not-for-profit mutuals' became exempt from CGT because of subsection 118-12(1). That subsection ensures that a capital gain or capital loss made from a CGT asset used solely to produce exempt income or non-assessable non-exempt income is disregarded.<br>This amendment restores the intention of the original amendment that 'not-for-profit mutuals' should be taxed in the same way as 'true mutuals'.<br>An application provision (item 38) ensures that the amendment applies to assessments for income years commencing on or after 1 July 2000 (ie, when section 59-35 first applied).<br>The unintended CGT exemption would apply only in rare cases. The 'not-for-profit mutual' organisation would need to have acquired the asset on or after 1 July 2000 and not to have used it to any extent to derive non-mutual receipts.<br>***[Schedule 7, items 37 and 38, subparagraph 118-12(2)(a)(i)]*** |

| *Provision being amended* | *What the amendment does* |
|---|---|
| 165-12(7)(b)<br>165-12(8)<br>165-12(9)<br>165-37(4)(b)<br>165-37(5)<br>165-37(6)<br>165-115C(4)(b)<br>165-115C(5)<br>165-115C(6) and (7)<br>165-115GB(2)(a)<br>165-123(7)(b)<br>165-123(8)<br>165-123(9) and (10)<br>166-272(8)(b)<br>166-272(8) (note)<br>166-272(10)<br>166-272(10) (note)<br>166-272(11)<br>727-95(b)<br>995-1(1) (*direct equity interests* definition) | Standardises terminology and defined terms.<br>Subsection 165-37(6) defines 'direct equity interests' and 'indirect equity interests' but only for the purposes of subsections 165-37(4) and (5). This is undesirable under the approach generally taken for defined terms to be included in the Dictionary and to have an Act-wide application. Subsections 165-115C(6) and (7) define those terms for the whole Act but without a Dictionary entry for either of them. The definitions are the same and also appear in various other places.<br>Various amendments repeal all the definitions of 'direct equity interests' and 'indirect equity interests' throughout the ITAA 1997 and add the definitions of those terms to the Dictionary together with appropriate asterisking where the defined terms are used.<br>***[Schedule 7, items 39 to 56, 60, 63 and 66, paragraph 165-12(7)(b), subsections 165-12(8) and (9), paragraph 165-37(4)(b), subsections 165-37(5) and (6), paragraph 165-115C(4)(b), subsections 165-115C(5) to (7), paragraphs 165-115GB(2)(a) and 165-123(7)(b), subsections 165-123(8) to (10), paragraph 166-272(8)(b), subsections 166-272(8), (10) and (11), subsection 713-545(6), paragraph 727-95(b) and subsection 995-1(1)]*** |
| 197-20(b) | See explanation of item 35.<br>***[Schedule 7, item 57]*** |
| 320-85(1) (note 1) | Corrects a reference.<br>Section 320-85 allows life insurance companies to deduct increases in their liabilities under net risk components of life insurance policies. Note 1 to subsection 320-85(1) points readers to paragraph 320-15(h), a non-existent provision. The correct reference is to paragraph 320-15(1)(h).<br>***[Schedule 7, item 58, subsection 320-85(1) (note 1)]*** |

| ***Provision being amended*** | ***What the amendment does*** |
|---|---|
| 713-545(6) (*ordinary class tax rate* definition) | Corrects a cross-reference.<br>At present, the definition of 'ordinary class tax rate' directs the reader to subparagraph 23A(a)(ii) of the *Income Tax Rates Act 1986* whereas the reference is now to be to paragraph 23A(a) of that Act.<br>This amendment is consequential to that proposed by item 92 (see Table 7.8) to amend paragraphs 23A(a) and (b) of the *Income Tax Rates Act 1986*.<br>***[Schedule 7, item 59, subsection 713-545(6)]*** |
| 727-95(b) | See explanation of item 39.<br>***[Schedule 7, item 60]*** |
| 820-37(2) and (3) | Standardises terminology and defined terms.<br>These subsections provide that an Australian-owned multi-national entity that is not foreign controlled (ie, an 'outward investing entity') is not subject to the disallowance of debt deductions under the thin capitalisation rules if 90 per cent or more of the total average assets of the entity and its associates are Australian assets. In determining what are 'Australian assets', assets attributable to the entity's 'overseas permanent establishments' are disregarded (see subparagraph (a)(i) of the definition of 'average Australian assets' in section 820-37). An 'overseas permanent establishment' of an entity is defined in subsection 995-1(1) as 'a permanent establishment of the entity that is in a country other than Australia'.<br>Subsections 820-37(2) and (3) refer to 'foreign permanent establishments' of an Australian entity. However, this expression is not defined in subsection 995-1(1), nor is it used elsewhere in the ITAA 1997 (or the ITAA 1936). |

| *Provision being amended* | *What the amendment does* |
| --- | --- |
| | It is clear that the two expressions are in practical terms describing the same concept. The amendment therefore replaces '*foreign permanent establishments' with '*overseas permanent establishments'.<br>***[Schedule 7, item 61, subsections 820-37(2) and (3)]*** |
| 820-946(3) | Clarifies part of a definition.<br>Subsection 820-946(3) forms part of the definition of 'cost-free debt capital' (see subsection 820-946(2)). Subsection (3) states that it covers a debt interest or equity interest held 'at that time'. Originally, it referred to the 'particular time' mentioned in subsection (2), but the later addition of subsection (2A) has made it less clear to what it refers. This amendment clarifies (consistent with the policy intent) that it refers to the times in both subsections (2) and (2A).<br>***[Schedule 7, item 62, subsection 820-946(3)]*** |
| 995-1(1) (*direct equity interests* definition) | See explanation of item 39.<br>***[Schedule 7, item 63]*** |
| 995-1(1) (*Environment Minister* definition) | See explanation of item 23.<br>***[Schedule 7, item 64]*** |
| 995-1(1) (*GST joint venture* definition) | Removes a duplicate definition.<br>Subsection 995-1(1) at present has duplicate definitions of 'GST joint venture'. The first definition reads '***GST joint venture*** has the meaning given by section 51-5 of the *GST Act'. It was inserted by the *A New Tax System (Pay as You Go) Act 1999* and was effective from 22 December 1999.<br>The second definition reads '***GST joint venture*** has the meaning given by section 195-1 of the *GST Act'. It was inserted by the *A New Tax System (Indirect Tax and Consequential Amendments) Act 1999* effective from 1 July 2000. |

| *Provision being amended* | *What the amendment does* |
| --- | --- |
| | The definitions are essentially the same because section 195-1 of the *A New Tax System (Goods and Services Tax) Act 1999* refers to the meaning given by section 51-5.<br>This amendment repeals the second definition.<br>***[Schedule 7, item 65, subsection 995-1(1)]*** |
| 995-1(1) | See explanation of item 39.<br>***[Schedule 7, item 66]*** |
| 995-1(1) (paragraph (d) of *member* definition*)* | Standardises terminology and defined terms.<br>The current definition of 'member' uses the word 'person' in relation to a copyright collecting society. A person is a company or individual. This means that a reference to a 'person' could at present prevent the definition covering members that were trusts or partnerships.<br>The amendment replaces the words 'person who' with 'entity that'.<br>***[Schedule 7, item 67, subsection 995-1(1)]*** |
| 995-1(1) (*share* definitions) | Consolidates definitions.<br>Subsection 995-1(1) at present has three separate definitions of 'share'. This amendment consolidates the definitions without changing their meaning.<br>***[Schedule 7, item 68, subsection 995-1(1)]*** |

**Table 7.7: Amendments to the *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974***

| *Provision being amended* | *What the amendment does* |
|---|---|
| 3 | Repeals an inoperative provision.<br>Section 3 repeals the *Income Tax (Non-resident Dividends and Interest) Act 1967* and the *Income Tax (Non-resident Dividends and Interest) Act 1973*. Since that repeal occurred over 30 years ago, section 3 is now inoperative.<br>***[Schedule 7, item 69, section 3]*** |
| 4 | Updates the citation of an Act.<br>Section 4 at present refers to the '*Income Tax Assessment Act 1936-1974*', which is an outdated way of citing the ITAA 1936.<br>***[Schedule 7, item 70, section 4]*** |
| 7(a) | Omits an inoperative reference.<br>Section 7 lists rates of withholding tax. Subparagraph 7(a)(i) is inoperative because the rate it applies has been superseded by the double tax agreement with Papua New Guinea.<br>***[Schedule 7, item 71, paragraph 7(a)]*** |
| 8 | Repeals an inoperative provision.<br>Section 8 deems the *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* not to be an Act declaring rates of income tax for the purposes of section 104 and subsection 221YB(3) of the ITAA 1936. As those provisions have been repealed, the section is inoperative.<br>***[Schedule 7, item 72, section 8]*** |

**Table 7.8: Amendments to the *Income Tax Rates Act 1986***

| *Provision being amended* | *What the amendment does* |
|---|---|
| 3(1) (*AD/RLA component* definition)<br>3(1) (*CS/RA component* definition)<br>3(1) *(EIB component* definition)<br>3(1) *(general fund component* definition)<br>3(1) *(NCS component* definition)<br>3(1) *(registered organisation* definition)<br>3(1) *(RSA category A component* definition)<br>3(1) *(RSA category B component* definition)<br>3(1) *(RSA combined component* definition)<br>3(1) *(RSA component)* definition<br>3(1) (*standard component* definition)<br>23(1A)<br>23(2)(a) and (b)<br>23(2)(c), (ca) and (d)<br>23(3), (4), (4A) and (4B)<br>23(4BA), (4C), (4D), (5) and (6)<br>23(6) (as renumbered)<br>23A<br>23A(a) and (b)<br>23B and 23C<br>29(2)(c)(iii)<br>29(2)(c)(iv) | Repeals redundant definitions.<br>Subsection 3(1) of the *Income Tax Rates Act 1986* has the definitions for that Act. Several definitions are no longer needed. Some definitions require modification to remove the part of the definition that is no longer operative.<br>The provisions to be repealed relate to the former Divisions 8 and 8A of Part III of the ITAA 1936 concerning life assurance companies and the annuity and insurance business of certain organisations.<br>The repeal of paragraph 23(2)(a) and subsection 23(3) relates to the fact that there is no longer a separate tax rate for private companies.<br>These amendments apply to assessments for the 2007-08 income year and later income years. In practical terms, the provisions being repealed in relation to the former Divisions 8 and 8A have no effect in relation to assessments after the 1999-2000 income year (or the 2000-01 income year for certain entities with substituted accounting periods).<br>The repeal of these provisions does not prevent the making of amended assessments for income years for which Divisions 8 and 8A applied if the taxation law otherwise permitted the making of those amended assessments.<br>***[Schedule 7, items 73 to 96, subsections (3)(1) and 23(1A), paragraphs 23(2)(a) to (d), subsections 23(3) to (6), section 23A, paragraphs 23A(a) and (b), sections 23B and 23C, and subparagraphs 29(2)(c)(iii) and (iv)]*** |

**Table 7.9: Amendments to the *Income Tax (Transitional Provisions) Act 1997***

| *Provision being amended* | *What the amendment does* |
|---|---|
| Division 136 (heading) | Replaces the Division heading 'Non-residents' with 'Foreign residents' to reflect the terminology used in the ITAA 1997.<br>***[Schedule 7, item 97, heading to Division 136]*** |
| Note 1: section 701C-10 (heading)<br>Note 2: section 701C-15 (heading) | Replaces the word 'non-resident' in these section headings with 'foreign resident' to reflect the terminology used in the ITAA 1997.<br>These changes are not done by formal amendment given that section headings are not part of the *Income Tax (Transitional Provisions) Act 1997*, as per subsection 13(3) of the *Acts Interpretation Act 1901*.<br>***[Schedule 7, sections 701C-10 and 701C-15]*** |
| Asterisking throughout Act | Omits asterisks throughout the *Income Tax (Transitional Provisions) Act 1997* as that Act does not use asterisks to identify defined terms.<br>***[Schedule 7, item 98]*** |

**Table 7.10: Amendments to the *Taxation Administration Act 1953***

| *Provision being amended* | *What the amendment does* |
|---|---|
| 14ZQ (paragraphs (c) to (f) of *delayed administration (trustee) objection* definition)<br>14ZQ (paragraphs (b) and (g) of *delayed administration (trustee) objection* definition) | Repeals inoperative provisions.<br>Section 14ZQ of the TAA 1953 defines terms for Part IVC of that Act. It has separate definitions of 'delayed administration (beneficiary) objection' and 'delayed administration (trustee) objection'. The definitions are virtually the same and refer in part to repealed Acts.<br>The Inoperative Provisions Act repealed paragraphs (c) to (f) of the definition of delayed administration (beneficiary) objection. Paragraphs (c) to (f) of the definition of delayed administration (trustee) objection should also have been repealed and now are. |

| *Provision being amended* | *What the amendment does* |
|---|---|
| | Other amendments consequentially re-letter the remaining paragraphs.<br>***[Schedule 7, items 99 to 101, section 14ZQ]*** |
| Subsection 288-80(4) in Schedule 1 (*applicable withholding tax rate* definition) | Makes a consequential amendment as a result of the amendment made by item 71 to paragraph 7(a) of the *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974*.<br>***[Schedule 7, item 102, subsection 288-80(4) in Schedule 1]*** |

**Table 7.11: Amendment to the *Taxation (Interest on Overpayments and Early Payments) Act 1983***

| *Provision being amended* | *What the amendment does* |
|---|---|
| 9(6)(b) | Includes a missing word.<br>Section 9 is concerned with entitlements to interest. The word 'time' is currently missing from paragraph 9(6)(b). The wording at present reads, '…at a later (in this subsection called the ***offset time***), the company…'.<br>***[Schedule 7, item 103, paragraph 9(6)(b)]*** |

**Table 7.12: Penalty unit conversion**

| *Provision being amended* | *What the amendment does* |
|---|---|
| Various provisions relating to penalties | Amends various provisions in the *Fringe Benefits Tax Assessment Act 1986,* the ITAA 1936 and the TAA 1953 to change penalties expressed as dollar amounts to the equivalent number of penalty units.<br>At present, provisions that impose penalties and fines are expressed in some cases as dollar amounts and in others as penalty units.<br>Section 4AB of the *Crimes Act 1914* already notionally converts penalties expressed in dollar amounts to penalty units using a formula. For example, a penalty expressed as $50 already converts to one penalty unit (currently, $110). |

| ***Provision being amended*** | ***What the amendment does*** |
|---|---|
| | These amendments do not change the amounts payable as penalties.<br>***[Schedule 7, item 104]*** |

# Chapter 8
# Increasing flexibility for family trusts

## Outline of chapter

8.1 Schedule 8 to this Bill amends Schedule 2F to the *Income Tax Assessment Act 1936* (ITAA 1936) to provide more flexibility to family trusts in relation to the trust and company tax loss, bad debt deductions and franking credit trading rules. These amendments achieve this by allowing family trust elections and interposed entity elections to be revoked or varied in certain limited circumstances, and by broadening the definition of 'family' and 'family group'.

8.2 All legislative references in this chapter are made to Schedule 2F to the ITAA 1936 unless otherwise stated.

## Context of amendments

8.3 The trust loss rules protect the integrity of the income tax system by preventing the tax benefits arising from the recoupment of trust losses and bad debt deductions being transferred to persons who did not bear the economic loss or bad debt when it was incurred. This measure achieves this aim by examining whether there has been a change in underlying ownership or control of a trust or whether certain schemes have been entered into to take advantage of a trust's losses.

8.4 Generally, family trusts are subject to concessional treatment and most of the specific trust loss rules do not apply to family trusts that have made a family trust election.

8.5 A trust becomes a family trust if it makes a family trust election in respect of an individual. By specifying the individual (the test individual), the family group is established to which distributions can be made without penalty. An interposed entity election may be made by a company, trust or partnership to be included in the family group. A family trust election or interposed entity election is irrevocable, although a family trust election may be revoked in certain circumstances where the trust is a fixed trust.

8.6 Family trust elections are also used for the franking credit trading rules and the company tax loss recoupment rules. Under the

franking credit trading rules, franking credits attributable to dividends paid to the trustee of a discretionary trust cannot usually be passed through to the beneficiaries of the discretionary trust, unless the total amount of franked credits received directly or indirectly by an individual beneficiary is less than $5,000 per year (ie, a 'qualified person' as a small shareholder) or the trust makes a family trust election. Under the company tax loss recoupment rules, where a discretionary trust is a shareholder of a company seeking to recoup tax losses, the company has a greater chance of passing the continuity of ownership test if the trust has made a family trust election.

8.7 These amendments increase flexibility for taxpayers with family trusts while maintaining the integrity of the income tax system. This is achieved by:

- allowing family trust elections and interposed entity elections to be revoked in certain limited circumstances;
- allowing the test individual specified in a family trust election to be changed in certain limited circumstances;
- broadening the definition of 'family' to include lineal descendants of family members;
- ensuring that the death of a family member does not by itself result in another family member ceasing to be a member of the family; and
- exempting distributions made to former spouses, former widows/widowers and former step-children from family trust distribution tax by including them within the definition of 'family group'.

## Summary of new law

8.8 These amendments will allow a family trust election to be revoked unless tax losses have been recouped (or bad debt deductions or franking credits have been claimed) during a specified period where the recoupment (or claim) was only possible because of the family trust election.

8.9 The specified period begins at the start of the income year specified in the family trust election and ends on the last day of the income year immediately prior to the income year specified in the revocation.

8.10 Also, an interposed entity election may now be revoked where the election was made for an entity that was already included in the family group of the individual specified in the family trust election at the election commencement time, or at a later time, where the entity becomes a wholly-owned member of the 'family group' (the meaning of which is amended by this Schedule).

8.11 These amendments also allow a once-off variation to the test individual specified in a family trust election. A variation will be available where the new test individual was a member of the original test individual's family at the election commencement time. However, the variation will not be available if there has been a conferral of present entitlement to (or distributions of) income or capital of the trust (or of an entity for which an interposed entity election has been made in relation to the trust) outside the new test individual's family group during the period in which the election has been in force.

8.12 These amendments also include former spouses, former widows/widowers and former step-children within the definition of 'family group' in section 272-90 thereby exempting them from family trust distribution tax. These persons however remain an 'outsider to the trust' for the purpose of the income injection test in Division 270.

8.13 The amendments also expand the definition of 'family' to include any lineal descendant of a nephew, niece or child of the test individual or the test individual's spouse. Furthermore, an amendment is made to ensure that the death of a family member does not by itself result in another family member ceasing to be a member of the family.

8.14 Finally, these amendments ensure that where trustees of different trusts have made family trust elections in respect of the same test individual, they are also included within the definition of 'family group'. They will also not be an 'outsider to the trust' for the purposes of the income injection test in Division 270.

## Comparison of key features of new law and current law

| ***New law*** | ***Current law*** |
|---|---|
| Family trust elections may be revoked where the family trust election was not required for utilisation of tax losses, bad debt deductions or accessing franking credits. | With one exception, family trust elections are generally irrevocable — in limited situations, a family trust that is a fixed trust can revoke a family trust election. |

| ***New law*** | ***Current law*** |
|---|---|
| An interposed entity election may be revoked where the election was made for an entity that was already included in the family group of the individual specified in the family trust election at the election commencement time. An interposed entity election may also be revoked at a later time where the entity becomes wholly-owned by members of the family group. | Interposed entity elections are irrevocable. |
| The test individual specified in a family trust election may be varied, once only, where the new test individual was a member of the original test individual's family provided that no conferrals of present entitlement to (or distributions of) income or capital of the trust (or an interposed entity) have been made outside the new test individual's family group. | No equivalent. |
| Conferrals on (or distributions to) former spouses, former widows/widowers and former step-children are exempt from family trust distribution tax. | Conferrals on (or distributions to) former spouses, former widows/widowers and former step-children are subject to family trust distribution tax. |
| Family trusts that have made a family trust election in respect of the same test individual are included in each others 'family group' and are not an 'outsider to the trust' for the purposes of the income injection test. | Family trusts that have specified the same test individual in their family trust elections are not members of the same family group. A family trust must make an interposed entity election to become a member of another family trust's family group. |
| The definition of 'family' is expanded to include any lineal descendant of a nephew, niece or child of the test individual or the test individual's spouse. | The definition of 'family' does not include any lineal descendants of nieces and nephews of the test individual or the test individual's spouse. |

## Detailed explanation of new law

### Revocation — family trust elections

8.15 These amendments allow family trust elections to be revoked in certain limited circumstances. Currently a revocation can only be made for a family trust that is a fixed trust provided that certain conditions are met. Under these amendments, a family trust election can now be revoked unless:

- tax losses have been recouped by the trust or another entity in an income year during the period between the start of the income year specified in the family trust election and the end of the income year immediately prior to the income year specified in the revocation and the trust or the other entity could not have recouped the losses if the election had not been in force. A 'tax loss' does not include a capital loss, as the meaning of 'tax loss' is set out in section 272-140;

- deductions for bad debts have been claimed by the trust or another entity during the same period (see above) and the trust or the other entity could not have claimed the deduction if the election had not been in force; or

- a beneficiary of the trust in an income year over the same period (see above) received a franked distribution indirectly through the trust and paragraph 207-150(1)(a) would have applied in relation to the distribution if the election had not been in force. That is, if the beneficiary was not a qualified person in relation to the distribution for the purposes of Division 1A of former Part IIIAA of the ITAA 1936.

***[Schedule 8, item 3, subsection 272-80(6A)]***

8.16 These amendments prevent a revocation of an election being made where the election allows another entity to claim a tax loss or bad debt deduction ***[Schedule 8, item 3, paragraphs 272-80(6A)(a) and (b)]***. 'Another entity' refers to a related company that the family trust has a membership interest in or a related trust that the family trust has a fixed entitlement to (see Example 8.2).

8.17 Table 8.1 outlines when the 'election is in force'. ***[Schedule 8, item 4, subsection 272-80(9)]***

**Table 8.1: When the election is in force**

| *In these circumstances…* | *the election is in force…* |
|---|---|
| If it is not revoked | at all times after the election commencement time (see paragraph 272-80(9)(a) and subsection 272-80(10)) |
| If it is revoked under the existing subsection 272-80(6) | at all times from the election commencement time until the later time specified in the revocation (see paragraph 272-80(9)(b)) |
| If it is revoked under the new amendments contained in this Schedule | at all times from the election commencement time until the end of the income year immediately prior to the income year specified in the revocation |

8.18 The revocation of a family trust election must be in respect of an income year that occurs before the end of the fourth income year after the income year specified in the family trust election. ***[Schedule 8, item 3, paragraph 272-80(6B)(a)]***

8.19 For a family trust election that was made prior to four income years before the start of the income year in which this Bill receives Royal Assent, the trustee of the family trust has until the end of the income year following the one in which this Bill receives Royal Assent to revoke the family trust election. ***[Schedule 8, item 3, paragraph 272-80(6B)(b)]***

8.20 If a revocation is to be made, it must be made by the trustee in writing and in the approved form. It must also specify the income year from which the revocation is to be effective. A revocation needs to be made in the trust's tax return for the income year in which the revocation occurs. ***[Schedule 8, item 4, subsection 272-80(8)]***

8.21 If the trustee is not required to furnish a return, the revocation needs to be given to the Commissioner of Taxation (Commissioner) by the end of two months after the end of the income year specified in the revocation. The Commissioner has a discretion to allow for a revocation to be lodged by a later date. ***[Schedule 8, item 4, subsection 272-80(8)]***

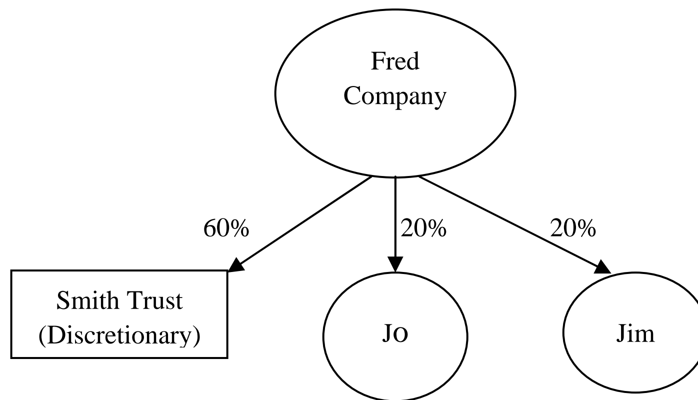
### Example 8.1

The Ton Trust is a discretionary trust that made a family trust election specifying the 1999-2000 income year with an election commencement time of 1 July 1999. For the 1999-2000 and 2000-01 income years the trust accrued tax losses of $20,000. In the 2002-03 income year, the Ton Trust recouped its $20,000 carried forward tax losses having satisfied the income injection test applicable to family trusts.

The Ton Trust has determined that had it not made the family trust election it would have satisfied the applicable non-fixed trust tests (ie, the 50 per cent stake test, the pattern of distributions test, the control test and the income injection test) and therefore would have been able to recoup the $20,000 of carried forward tax losses, without the need for the family trust election. The trustee of the Ton Trust may revoke the family trust election by the end of the second income year after the start of the income year in which this Bill receives Royal Assent. If the revocation is to be effective from the start of the income year in which Royal Assent is received, it must be made in the trust's return for that income year. If a return is not required, it must be lodged with the Commissioner by the end of two months after the end of that income year. The Commissioner can allow for the revocation to be lodged at a later date.

### Example 8.2

Assume the following structure and facts:




All legislative references in this example are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise stated.

Fred Company is owned 60 per cent by the Smith Trust, 20 per cent by Jo and 20 per cent by Jim. This existing ownership structure has been in place since the 2002-03 income year.

Smith Trust is a discretionary trust with no beneficiaries having fixed entitlements to the income and capital of the trust.

At the start of the 2005-06 income year Fred Company has carried forward tax losses of $100,000 incurred between 2002-03 and the start of the 2005-06. Fred Company has $120,000 taxable income (prior to the application of tax losses) in the 2005-06 income year.

Fred Company wants to recoup its carry forward tax losses in the 2005-06 income year.

To recoup its losses, section 165-10 requires Fred Company to satisfy either the continuity of ownership test (section 165-12) or if it fails this test, the same business test (section 165-13). For the purpose of this example, assume also that Fred Company has a change of business in the 2004-05 income year and therefore it would fail the same business test.

Generally the continuity of ownership test in section 165-12 requires that during the ownership test period, the same persons had more than 50 per cent of the voting power, rights to dividends, and rights to capital distributions. Fred Company is unable to demonstrate that it satisfies these conditions. It can only trace 40 per cent of the interests in itself, held by Jo and Jim, as there are no beneficiaries of the Smith Trust with a fixed entitlement to any part of the trust, and hence indirectly, having an interest in Fred Company that can be counted under section 165-12.

In this situation there are two options for Fred Company to satisfy the conditions in section 165-12:

- section 165-207 provides that one or more trustees of a 'family trust' that own shares, controls voting or has a right to receive a percentage of a dividend or distribution of capital is taken to own those shares beneficially:
  - therefore using this provision the trustee of the Smith Trust can make a family trust election. Fred Company could then, using section 165-207, satisfy the requirement of section 165-12; and
  - therefore this family trust election would allow Fred Company to satisfy section 165-12 and, having the benefit of the family trust election, recoup its losses in the 2005-06 income year; and
- Fred Company will also have access to the alternative test in section 165-215 and provided the four conditions in that section are met, it may be able to rely on that provision to satisfy section 165-12:
  - in this scenario section 165-215 looks at the Smith Trust and asks if it would have satisfied the non-fixed trust tests in section 267-20 of Schedule 2F to the ITAA 1936 had it incurred the losses and not the company. Essentially, if the ownership and control tests for the Smith Trust have been satisfied for the ownership test period and the other conditions in section 165-215 are met then the conditions in section 165-12 are taken to be met.

If the alternative test in section 165-215 is passed, then Smith Trust would not need to make a family trust election to allow Fred Company to recoup its losses. In this scenario, the Smith Trust is allowed to revoke its family trust election provided other conditions in subsection 272-80(6A) of Schedule 2F to the ITAA 1936 are also satisfied.

If the Smith Trust is required to make a family trust election in order for Fred Company to recoup its losses, the Smith Trust cannot revoke its family trust election.

### Example 8.3

The Ha Family Trust is a discretionary trust which holds a share portfolio acquired after 31 December 1997. For the 1999-2000 income year, there were no tax losses recouped but the trustee distributed dividends in such a way that franking credits being allocated to the beneficiaries are as follows:

- Mr Ha — $3,000;
- Mrs Ha — $5,000; and
- Lyn (child) — $5,000.

Mr Ha also received $4,000 of franking credits from holding shares directly.

If a family trust election was not made, Mrs Ha and Lyn can utilise their franking credits as they are within the $5,000 threshold for the small shareholder exemption in Division 1A of the former Part IIIAA of the ITAA 1936. Mr Ha can only utilise the $4,000 of franking credits attaching to the shares held directly if the 45-day holding period rule is satisfied.

In order for Mr Ha to also utilise his $3,000 of franking credits from the trust, the trustee made a family trust election effective from the start of the 1999-2000 income year. Consequently Mr Ha will be a qualified person in relation to the distribution for the purposes of Division 1A of former Part IIIAA of the ITAA 1936.

As paragraph 207-150(1)(a) would have applied to the franked distribution if the family trust election had not been in force the trustee cannot revoke the election.

## Revocation — interposed entity elections

8.22 An amendment is made to subsection 272-85(5) to allow an interposed entity election to be revoked where the election was made for an entity that was already included in the family group of the individual specified in the family trust election (the test individual) at the election commencement time. ***[Schedule 8, item 6, subsection 272-85(5A)]***

8.23 An interposed entity election may also be revoked where the entity is a member of the family group, within the meaning of subsection 272-90(5) or 272-90(3A) (ie, is or becomes wholly-owned by family members), of the test individual after the election commencement time. ***[Schedule 8, item 6, subsection 272-85(5A)]***

8.24 Any interposed entity elections made in respect of the family trust for which a family trust election has been revoked are automatically revoked at the same time as the family trust election revocation. ***[Schedule 8, item 6, subsection 272-85(5B)]***

8.25 Revocation of an interposed entity election must be in respect of an income year that occurs before the end of the fourth income year after the income year specified in the interposed entity election. Where the interposed entity becomes part of the family group after the election commencement time, interposed entity elections are allowed to be revoked for an income year that occurs before the end of the fourth income year after the income year the entity became part of the family group. ***[Schedule 8, item 6, subsection 272-85(5C)]***

8.26 For interposed entity elections that were made prior to four income years before the start of the income year in which this Bill receives Royal Assent, revocations can be made by the end of the income year following the one in which this Bill receives Royal Assent. ***[Schedule 8, item 6, subsection 272-85(5C)]***

8.27 If a revocation is to be made, it must be made by the company, partners in the partnership or trustee of the trust, in writing and in the approved form. It must also specify the income year from which the revocation is to be effective. A revocation needs to be made in the entity's (ie, company, partnership or trust) return for the income year specified in the revocation. ***[Schedule 8, item 6, subsection 272-85(6)]***

8.28 If the entity is not required to furnish a return, the revocation needs to be given to the Commissioner by the end of two months after the end of that income year. The Commissioner can allow for the revocation to be lodged at a later date. ***[Schedule 8, item 6, subsection 272-85(6)]***

8.29 Table 8.2 outlines when the 'election is in force'. ***[Schedule 8, item 6, subsection 272-85(6A)]***

**Table 8.2: When the election is in force**

| *In these circumstances…* | *the election is in force…* |
|---|---|
| If it is not revoked | at all times after the election commencement time |
| If it is revoked under the amendments contained in this Schedule | at all times from the election commencement time to the end of the income year immediately prior to the income year specified in the revocation |
| If the family trust election to which it relates is revoked under existing subsection 272-80(6) | at all times from the election commencement time until the later time specified in the revocation |
| If the family trust election to which the election relates is revoked under the amendments contained in this Schedule | at all times from the election commencement time to the end of the income year immediately prior to the income year specified in the family trust revocation |

8.30 The 'election commencement time' is outlined in Table 8.3. ***[Schedule 8, item 6, subsection 272-85(6B)]***

**Table 8.3: Election commencement time**

| *In these circumstances…* | *the election commencement time is…* |
|---|---|
| If the company, partnership or trust does not pass the family control test at all times in the specified income year | the later of:<br>• the beginning of the specified day; and<br>• the earliest time from which the company, partnership or trust does pass the family control test for the remainder of the specified income year |
| In any other case | the beginning of the specified day |

## Variation of a test individual

8.31 Under these amendments, a test individual specified in a family trust election is allowed to be changed, once only, where:

- the new test individual was a member of the original test individual's family at the election commencement time; and

- no conferrals of present entitlement to, and distributions of, income or capital have been made (by the trust or an interposed entity) outside the new test individual's family group during the period in which the election has been in force.

***[Schedule 8, item 2, subsection 272-80(5A)]***

8.32 This is intended to deal with the situation where a trust has chosen the wrong test individual in its family trust election but the trust had acted in the past as if the proposed new test individual was always the test individual. On this basis, the new test individual must have been alive at the election commencement time.

8.33 Table 8.4 outlines when the 'election is in force'. ***[Schedule 8, item 4, subsection 272-80(9)]***

**Table 8.4: When the election is in force**

| *In these circumstances…* | *the election is in force when…* |
|---|---|
| If it is not revoked | at all times after the election commencement time (see paragraph 272-80(9)(a) and subsection 272-80(10)) |
| If it is revoked under the existing subsection 272-80(6) | at all times from the election commencement time until the later time specified in the revocation (see paragraph 272-80(9)(b)) |
| If it is revoked under the new amendments contained in this Schedule | at all times from the election commencement time until the end of the income year immediately prior to the income year specified in the revocation |

8.34 The variation of a test individual must be made for an income year that occurs before the end of the fourth income year after the income year specified in the family trust election. ***[Schedule 8, item 3, paragraph 272-80(6B)(a)]***

8.35 For family trust elections that were made prior to four income years before the start of the income year in which this Bill receives Royal Assent, the trustee of the family trust has until the end of the income year following the one in which this Bill receives Royal Assent to vary the test individual. ***[Schedule 8, item 3, paragraph 272-80(6B)(b)]***

8.36 If a variation is to be made, it must be made by the trustee in writing and in the approved form. It must also specify the income year from which the revocation is to be effective. A variation needs to be made in the trust's return for the income year specified in the variation. ***[Schedule 8, item 4, subsection 272-80(8)]***

8.37 If the trustee is not required to furnish a return, the variation needs to be given to the Commissioner by the end of two months after the end of the income year specified in the variation. The Commissioner has a discretion to allow for a variation to be lodged by a later date. ***[Schedule 8, item 4, subsection 272-80(8)]***

8.38 The test individual may also be varied if, as a result of a family law obligation arising from a marriage breakdown, the control of the trust passes to the new test individual and/or his/her family members. Specifically, if an order, agreement or award of a kind mentioned in paragraphs 126-5(1)(a) to (f) of the ITAA 1997 results in the control of the trust passing to the new individual and members of the new individual's family, the test individual specified in the family trust election may be varied. The new individual or a group comprising the new individual and members of the new individual's family have control of the trust for this purpose if any of the paragraphs in paragraphs 272-97(2)(a) to (g) are satisfied in relation to a group consisting of the new individual or the new individual and members of the new individual's family. For example, if the group is able (directly or indirectly) to control the application of the capital or income of the trust, or if the group has more than a 50 per cent stake in the income or capital of the trust. ***[Schedule 8, item 2, subsections 272-80(5C) and (5D)]***

## Certain former family members

8.39 Any conferral of present entitlement to, or distributions of, income or capital of the trust are exempt from family trust distribution tax where the conferral is upon or the distribution is to a person who is a former spouse, a former widow/widower or a former step-child. This is achieved by including these persons in the definition of 'family group' in section 272-90. ***[Schedule 8, item 8, subsection 272-90(2A)]***

8.40 A former spouse refers to a person who was a spouse of either the primary individual or a member of the primary individual's family before a breakdown in the marriage. The definition of 'breakdown in the marriage' is contained in section 272-140. ***[Schedule 8, item 8, paragraph 272-90(2A)(a)]***

8.41 A former widow or widower is a person who was a widow or widower of either the primary individual or a member of the primary individual's family, and who has a new spouse that is not a member of the primary individual's family. ***[Schedule 8, item 8, paragraph 272-90(2A)(b)]***

8.42 A former step-child is a person who was a step-child of either the primary individual or a member of the primary individual's family, before a breakdown in the marriage of the primary individual or the

member of the primary individual's family. ***[Schedule 8, item 8, paragraph 272-90(2A)(c)]***

8.43 Despite the fact that these persons are considered to be members of the test individual's family group, they are not included in the definition of 'family' under section 272-95. ***[Schedule 8, item 8, subsection 272-90(2A)]***

## A trust with the same primary individual

8.44 An amendment has been made to the definition of an 'outsider to the trust' in section 270-25 to ensure that any trust that has made a family trust election in respect of the same test individual is not an 'outsider' for the purposes of the income injection test in Division 270. These amendments also ensure that such a trust is also a member of the primary individual's family group without the need to make an interposed entity election. ***[Schedule 8, items 1 and 9, paragraph 270-25(1)(da) and subsection 272-90(3A)]***

### Example 8.4

The trustees of the Chan Investment Trust and the Chan Trading Trust have each made a family trust election specifying Roy as the test individual in the respective family trust elections pursuant to section 272-80.

The Chan Trading Trust will be able to distribute to the Chan Investment Trust because the Chan Investment Trust will be part of the Chan Trading Trust's family group.

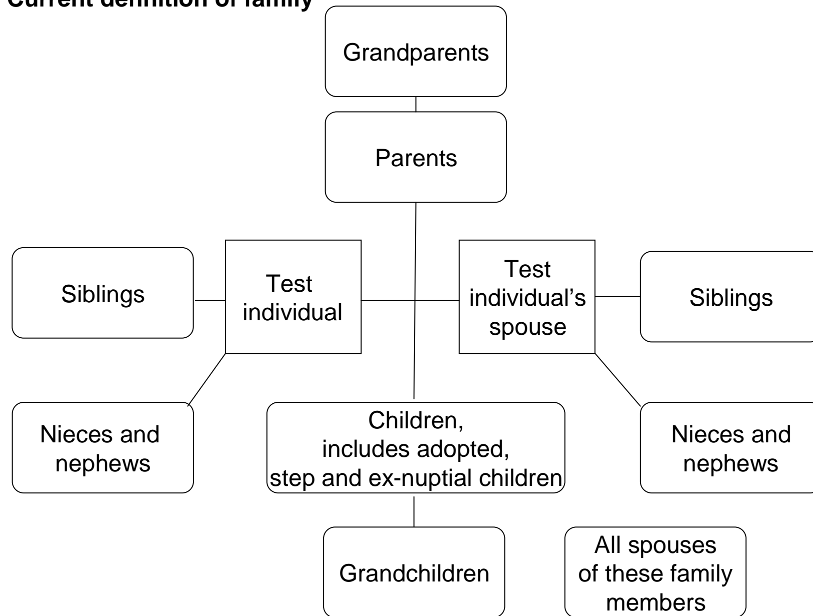
The Chan Investment Trust will be able to offset its losses against a distribution from the Chan Trading Trust because:

- as a family trust it will only be required to satisfy the income injection test in order to utilise its losses; and
- the income injection test will be satisfied because the Chan Trading Trust will not be an outsider to the trust.

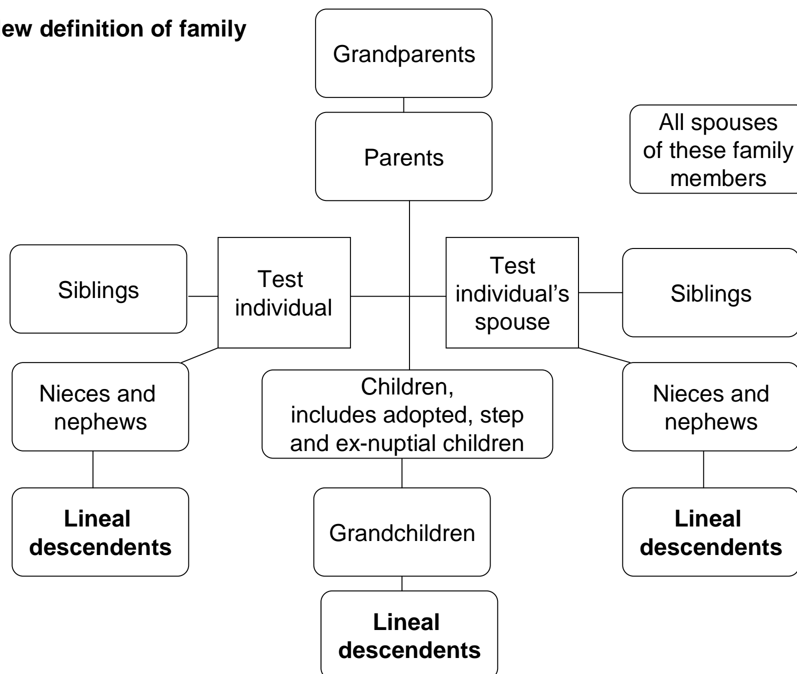
## Definition of 'family'

8.45 Amendments have been made to the definition of 'family' in section 272-95 to allow for changes in beneficiaries of the trust over time. The definition is amended to also include lineal descendants of a nephew, niece or child of the test individual or the test individual's spouse. ***[Schedule 8, item 10, section 272-95]***

**Current definition of family**




**New definition of family**



8.46 For the purposes of determining the lineal descendants within the meaning of 'family' in section 272-95, an adopted child, step-child or ex-nuptial child of a person is to be taken into account. ***[Schedule 8, item 10, subsection 272-95(3)]***

8.47 A person does not cease to be a family member merely because of the death of any other family member. ***[Schedule 8, item 10, subsection 272-95(2)]***

**Example 8.5**

The trustee of the Vu Trust has made a family trust election pursuant to section 272-80 and has specified Harry as the test individual.

Harry's spouse, Athena has a child, Jasmine, from a previous relationship, Harry's step-child. Since making the family trust election, Athena has died.

Harry has not formally adopted Jasmine under any state or territory adoption law.

Jasmine remains a step-child of Harry even after the death of Athena. However, she will cease to be a step-child at the time Harry remarries or enters into a de facto relationship. Nonetheless, Jasmine will remain a member of Harry's family group in respect of the Vu Trust, because she will be a former step-child under subsection 272-90(2A). Therefore, any distributions to Jasmine will not be subject to family trust distribution tax.

If instead Harry and Athena had divorced, Jasmine would become a former step-child, and while not a family member, would remain a member of the family group. Accordingly, any distribution to Jasmine would not be subject to family trust distribution tax.

8.48 A new definition of 'specified individual' is inserted in section 272-140 of Schedule 2F to the ITAA 1936. This provision deals with the situation when a test individual for a family trust is varied under these amendments. A reference in Schedule 2F to a person specified in a family trust election is a reference to:

- if the family trust election has not been varied — the person originally specified in the election for the purposes of subsection 272-80(3); or
- if the family trust election has been varied under these amendments — the person most recently specified.

***[Schedule 8, items 11 to 13, section 272-140]***

## Application and transitional provisions

8.49 These amendments apply to the income year in which this Bill receives Royal Assent and to later income years. ***[Schedule 8, item 14]***

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| Item 5, section 770-290 of the *Income Tax (Transitional Provisions) Act 1997* | 1.322 |
| Item 5, subsections 770-290(1) and (2) of the *Income Tax (Transitional Provisions) Act 1997* | 1.315 |
| Item 5, subsection 770-290(2) of the *Income Tax (Transitional Provisions) Act 1997* | 1.316 and 1.320 |
| Item 5, paragraph 770-290(2)(b) of the *Income Tax (Transitional Provisions) Act 1997* | 1.316 |
| Item 5, subsection 770-290(3) of the *Income Tax (Transitional Provisions) Act 1997* | 1.316 |
| Item 5, subsection 770-295(1) of the *Income Tax (Transitional Provisions) Act 1997* | 1.319 |
| Item 5, subsection 770-295(3) of the *Income Tax (Transitional Provisions) Act 1997* | 1.320 and 1.321 |
| Item 5, section 770-300 of the *Income Tax (Transitional Provisions) Act 1997* | 1.323 |
| Item 5, section 770-305 of the *Income Tax (Transitional Provisions) Act 1997* | 1.324 |
| Item 5, section 770-310 of the *Income Tax (Transitional Provisions) Act 1997* | 1.326 |

| ***Bill reference*** | ***Paragraph number*** |
|---|---|
| Items 6, 7, 9 to 17, 21 to 37, 52 to 54, 62 to 67, 76, 84 to 87, 90, 109, 127, 129 to 132, 134 to 138, 140 to 142, 144, 145, 147, 153 to 163, 195 to 210 and 212, section 195-1 of the *A New Tax System (Goods and Services Tax) Act 1999*, paragraph 19(1)(b), subparagraph 19(1)(ba)(ii), paragraph 24(1)(b), subparagraph 24(1)(ba)(ii), paragraph 44(1)(b), subparagraph 44(1)(ba)(ii), paragraph 52(1)(b), subparagraph 52(1)(ba)(ii) of the *Fringe Benefits Tax Assessment Act 1986*, subsections 6AB(1), (2) and (6), section 6D, subsections 23AI(2), 23AK(2), 46FA(11), 46FB(6), 47A(2), 102L(6) and 102T(7), sections 121K, 160ADA and 317, subsection 324(1), paragraphs 389(a) and 427(b) of the ITAA 1936, sections 10-5, 12-5, 13-1, 36-10 and 36-25, paragraph 61-570(2)(c), subsection 205-70(2), paragraphs 305-75(2)(b), 305-75(3)(b), 305-75(5)(a), 701-1(4)(c) to (g), 707-110(2)(b) and 707-110(2)(c), subsections 707-130(1), 707-310(3) and 713-225(6A), Subdivision 717-A, subsection 701D-1(1), paragraphs 701D-10(3)(a) and (b) and 707-325(1)(d), subsection 707-325(9), paragraph 707-326(1)(b), subsections 707-328A(6) and 830-20(3), paragraph 830-20(4)(c), subsections 830-20(4) and 830-20(5) of the *Income Tax (Transitional Provisions) Act 1997*, subsections 4(2), 11FA(3) and 11FB(3) of the *International Tax Agreements Act 1953*, paragraph 14ZW(1)(aaa) of the *Taxation Administration Act 1953* | 1.349 |
| Items 8, 25, 38 to 51, 69 to 75, 78, 133, 139, 146, 148 to 152, 179 to 181, paragraph 22(4)(c) of the *Bank Integration Act 1991*, subsection 6AB(6), section 102AAB, subsections 102AAM(2) to (4) and 102AAM(4A), section 102AAZC, subsection 177A(1), paragraphs 177(1)(bb), 177(1)(f), 177C(2)(d), 177C(3)(ca), 177C(3)(g), 177F(1)(d) and 177F(3)(d), section 317 of the ITAA 1936, subsections 205-20(4) and 205-70(2), paragraphs 220-400(1)(c) and 220-405(1)(d), section 802-40 | 1.348 |
| Items 18 to 20, subsection 6(1) of the ITAA 1936 | 1.341 |
| Items 22 and 24, subsections 6AB(1), 6AB(1A), 6AB(1B), 6AB(2) and 6AB(6) | 1.351 |
| Item 26 | 1.96 |
| Items 28 and 66, section 6D of the ITAA 1936 | 1.343 |
| Items 36, 37 and 64 | 1.175 |
| Items 59 and 67 | 1.59 |
| Item 64 | 1.69 and 1.300 |
| Item 68, subsection 170(11) of the ITAA 1936 | 1.172 |
| Items 77, 79 to 81, 89, 91 to 93, 123 to 126, 164 to 175, section 317, paragraphs 401(1)(d) and 461(1)(f) of the ITAA 1936, section 717-200, paragraph 717-205(c), section 717-235, paragraph 717-240(c) | 1.47 |

| ***Bill reference*** | ***Paragraph number*** |
|---|---|
| Items 82, 83, 88, 176 to 178, sections 317 and 334A of the ITAA 1936 and paragraph 768-550(1)(a), subsection 768-550(2) | 1.342 |
| Item 94 | 1.177 |
| Items 94 to 108, 110 to 122, subsections 425(1) to (4), paragraph 426(a), subparagraphs 426(a)(i) and (ii), section 426, paragraphs 427(b) and 427(ba), section 429, subsection 431(1), paragraphs 431(2)(a) and (b), subsections 431(4), (4A), (4B), (4D) and (5) | 1.350 |
| Items 94 to 122, subsections 425(1) to (4), section 426, paragraph 426(a), subparagraphs 426(a)(i) and 426(a)(ii), paragraphs 427(b) and 427(ba), section 429, subsection 431(1), paragraphs 431(2)(a) and (b), subsections 431(4), (4A), (4B), (4D) and (5) of the ITAA 1936 | 1.176 |
| Item 116 | 1.213 |
| Items 117 to 122, subsection 431(1), paragraphs 431(2)(a) and (b), subsections 431(4), (4A), (4B), (4D) and (5) of the ITAA 1936 | 1.344 |
| Items 128 and 211, item 6 in the table in subsection 4-15(2), subsection 24(3) of the *International Tax Agreements Act 1953* | 1.165 |
| Items 143 to 145, item 22 in the table in subsection 63-10(1) | 1.340 |
| Items 182 to 187, paragraphs 830-1(a), 830-10(1)(b), 830-10(1)(c), 830-15(1)(b), 830-15(2)(b) and 830-15(3)(b) | 1.347 |
| Item 188, the definition of 'attribution percentage' in subsection 995-1(1) | 1.80 |
| Items 189, 191, 193 and 194, subsection 995-1(1) | 1.351 |
| Items 190 and 192 | 1.351 |
| Item 211, subsections 24(1) and (2) of the *International Tax Agreements Act 1953* | 1.166 |
| Item 211, subsection 24(2) of the *International Tax Agreements Act 1953* | 1.167 |
| Item 211, subsections 24(2) and (3) of the *International Tax Agreements Act 1953* | 1.168 and 1.169 |
| Item 211, subsection 24(3) of the *International Tax Agreements Act 1953* | 1.167 |
| Items 213 to 221, subsections 3A(1), 3A(1A) and 3A(2), paragraphs 3A(2)(c) and 9(1A)(b) and 11(b) of the *Taxation (Interest on Overpayments and Early Payments) Act 1983* | 1.346 |
| Item 222 | 1.329 and 1.332 |
| Item 223 | 1.333 |
| Item 224 | 1.331 |
| Items 225 and 226 | 1.334 and 1.337 |
| Item 227 | 1.327 |

| ***Bill reference*** | ***Paragraph number*** |
|---|---|
| Subitems 224(1) and (2) | 1.338 |

## Schedule 2: Exchange of membership interests in MDOs

| ***Bill reference*** | ***Paragraph number*** |
|---|---|
| Items 1 to 4 | 2.26 |
| Item 5, paragraph 124-980(1)(a) | 2.13 |
| Item 5, paragraph 124-980(1)(b) | 2.11 |
| Item 5, paragraph 124-980(1)(c) | 2.15 |
| Item 5, paragraphs 124-980(1)(d) and (f) | 2.10 |
| Item 5, paragraph 124-980(1)(e) | 2.12 |
| Item 5, paragraph 124-980(1)(f) | 2.22 |
| Item 5, subsection 124-980(2) | 2.14 |
| Item 5, paragraph 124-980(3)(a) | 2.15 |
| Item 5, paragraph 124-980(3)(b) | 2.16 |
| Item 5, subsection 124-985(1) | 2.17 |
| Item 5, subsection 124-985(2) | 2.17 |
| Item 5, subsections 124-985(2) and (3) | 2.18 |
| Item 5, subsection 124-985(4) | 2.21 |
| Item 5, subsection 124-990(1) | 2.19 |
| Item 5, subsection 124-990(2) | 2.20 |
| Item 5, section 124-995 | 2.23 |

## Schedule 3: Investment by superannuation funds in instalment warrants

| ***Bill reference*** | ***Paragraph number*** |
|---|---|
| Item 1, subsection 67(4A) of the *Superannuation Industry (Supervision) Act 1993* | 3.14 |
| Item 2, subsections 71(8) and (9) of the *Superannuation Industry (Supervision) Act 1993* | 3.15 |

## Schedule 4: Trustee beneficiary reporting rules

| ***Bill reference*** | ***Paragraph number*** |
|---|---|
| Item 1, subsection 102UA(1) of the ITAA 1936 | 4.15 |
| Items 3 and 4, of the Taxation (Trustee Beneficiary Non-disclosure Tax) Bill (No. 1) 2007 | 4.30 and 4.37 |
| Items 2, 4 to 11, 18, 20 to 22, 24 to 35, 37, 39, 40, 42 to 48, paragraph 102UA(2)(a), section 102UB and definition of 'correct TB statement', 'correct UB statement', 'listed person', 'TB statement period', 'trustee beneficiary non-disclosure tax', 'UB statement period', 'ultimate beneficiary' and 'ultimate beneficiary non-disclosure tax', heading 'Subdivision 6DC — Trustee beneficiary non-disclosure tax on share of net income', subsection 102UL(2), paragraphs 102UL(3)(a), (4)(a), (4)(c) and (5)(a), subparagraphs (102UL(5)(b)(i) and (ii), heading 'Subdivision 6DD — Payment etc, of trustee beneficiary non-disclosure tax', subsections 102UN(1) and (2), subsection 102UO(1), paragraph 102UO(1)(a), subsection 102UO(2) to (4), note under subsection 102UO(4), section 102UP, paragraph 102UR(1)(a), subsections 102UR(2) and 102URA(1), paragraph 102US(1)(d), heading 'Subdivision E — Making correct TB statement about trustee beneficiaries of tax-preferred amounts', subsection 102UT(3), paragraph 102UT(3)(c), sub-subparagraph 47A(18)(d)(i)(G), subparagraph 102AAE(2)(c)(i), sub-subparagraph 102AAU(1)(c)(i)(C), item 18 in the table in subsection 170(10) and paragraph 254(3)(a) of the ITAA 1936 and item 1AA in the table in subsection 8AAB(4) and item 5 in the table in subsection 250-10(1) of the TAA 1953 | 4.51 |
| Items 4, 15 and 19, definition of 'correct TB statement' in sections 102UB, 102UG and subsection 102UK(1A) of the ITAA 1936 | 4.21 |
| Items 7 and 16, definition of 'TB statement period' in sections 102UB and 102UH of the ITAA 1936 | 4.29 |
| Item 8, definition of 'trustee beneficiary non-disclosure tax' in section 102UB, and item 19, section 102UK of the ITAA 1936 | 4.30 |
| Items 8 and 23, definition of 'trustee beneficiary non-disclosure tax' in section 102UB and subsection 102UM(2) of the ITAA 1936 | 4.37 |
| Items 12 and 14, definition of 'untaxed part' in sections 102UB and 102UE, items 19 and 23, paragraphs 102UK(2)(b) and 102UM(2)(b) of the ITAA 1936 | 4.28 |
| Item 13, definition of 'excluded trust', subsection 102UC(4) of the ITAA 1936 | 4.18 |
| Item 15, subsection 102UG(3) of the ITAA 1936 | 4.23 |

| Bill reference | Paragraph number |
|---|---|
| Item 19, paragraph 102UK(2)(a) of the ITAA 1936 | 4.31 |
| Item 19, subsection 102UK(2A) of the ITAA 1936 | 4.34 |
| Items 19 and 23, paragraphs 102UK(2)(b) and 102UM(2)(b) of the ITAA 1936 | 4.32 |
| Item 23, subsection 102UM(1) of the ITAA 1936 | 4.35 |
| Item 23, paragraph 102UM(2)(a) of the ITAA 1936 | 4.38 |
| Item 36, subsections 102USA(1) to (3) of the ITAA 1936 | 4.40 |
| Item 36, subsection 102USA(4) of the ITAA 1936 | 4.41 |
| Item 38, subsection 102UT(1) of the ITAA 1936 | 4.42 |
| Items 39 and 40, subsection 102UT(3) and paragraph 102UT(3)(c) of the ITAA 1936 | 4.44 |
| Item 41, section 102UU of the ITAA 1936 | 4.24 and 4.25 |
| Items 49 and 50 | 4.45 |
| Item 51 | 4.47 |
| Item 52 | 4.50 |

## Schedule 5: Superannuation amendments

| Bill reference | Paragraph number |
|---|---|
| Items 1 and 2, section 290-70 of the ITAA 1997 | 5.72 |
| Items 3 and 4, subsection 290-90(4) of the ITAA 1997 | 5.76 |
| Item 5, subsection 295-385(6) of the ITAA 1997 | 5.40 |
| Item 6, note to subsection 295-485(1) of the ITAA 1997 | 5.70 |
| Items 7 and 8, subsection 295-615(2) of the ITAA 1997 | 5.27 |
| Items 9 to 12, paragraph 307-5(3)(c) of the ITAA 1997 | 5.59 |
| Item 13, paragraph 307-5(3)(d) of the ITAA 1997 and item 14, subsection 307-5(3A) of the ITAA 1997 | 5.61 |
| Item 14, subsection 307-5(3B) of the ITAA 1997 | 5.62 |
| Item 15, subsection 307-290(1) (note) of the ITAA 1997 | 5.66 |
| Item 16, subsection 995-1(1) of the ITAA 1997 | 5.78 |
| Item 17, section 3 of the *Income Tax (Former Non-resident Superannuation Funds) Act 1994* | 5.79 |
| Item 18, section 295-485 of the *Income Tax (Transitional Provisions) Act 1997* | 5.69 |
| Item 19, paragraph 307-125(4)(b) of the *Income Tax (Transitional Provisions) Act 1997* | 5.50 |

| ***Bill reference*** | ***Paragraph number*** |
|---|---|
| Item 20, paragraph 30-125(6)(b) of the *Income Tax (Transitional Provisions) Act 1997* | 5.51 |
| Item 21, paragraph 307-125(6)(b) of the *Income Tax (Transitional Provisions) Act 1997* | 5.51 |
| Item 22, paragraph 307-125(6)(b) of the *Income Tax (Transitional Provisions) Act 1997* | 5.52 |
| Item 23, paragraph 307-125(6)(c) of the *Income Tax (Transitional Provisions) Act 1997* | 5.53 |
| Item 24, subsection 307-125(6A) of the *Income Tax (Transitional Provisions) Act 1997* | 5.53 |
| Item 25, section 307-290 of the *Income Tax (Transitional Provisions) Act 1997* | 5.65 |
| Item 26, subsection 140A(1) of the *Retirement Savings Accounts Act 1997* | 5.29 |
| Item 26, subsection 140A(2) of the *Retirement Savings Accounts Act 1997* | 5.31 |
| Item 27, subsection 299SA(1) of the *Superannuation Industry (Supervision) Act 1993* | 5.33 |
| Item 27, subsection 299SA(2) of the *Superannuation Industry (Supervision) Act 1993* | 5.35 |
| Item 28; item 12 of Schedule 2 to the *Superannuation Legislation Amendment (Simplification) Act 2007* | 5.45 and 5.47 |
| Item 29, subsection 45-325(1A) of the TAA 1953 | 5.37 |
| Item 30, subsection 45-365(1A) of the TAA 1953 | 5.38 |
| Items 31 to 42 and 44 to 46, section 9-1 (item 9 in the table), section 9-1 (item 10 in the table, column headed ‘because of this provision:’), section 9-1 (item 11 in the table), subsection 9-5(1) (item 5 in the table), subsection 9-5(1) (item 6 in the table), subsection 9-5(1) (item 7 in the table), subsection 9-5(1) (item 8 in the table), subsection 9-5(1) (item 9 in the table), subsection 9-5(1) (item 10 in the table), section 12-5 (item in the table headed ‘interest’), section 20-5 (item 8 in the table), subsection 295-390(3) (definition of ‘average value of superannuation liabilities’), subsection 295-485(3), subsection 295-485(3) (definition of ‘low tax component tax rate’), subsection 995-1(1) (definition of ‘index number’) of the ITAA 1997 | 5.84 |
| Item 47, subsection 16-165(1) of the TAA 1953 | 5.84 |
| Item 43, subsection 295-390(3) of the ITAA 1997 | 5.82 |
| Subitem 48(1) | 5.85 |
| Subitem 48(2) | 5.86 |
| Subitem 48(3) | 5.87 |

| Bill reference | Paragraph number |
|---|---|
| Subitem 48(4) | 5.88 |
| Subitem 48(5) | 5.89 |

## Schedule 6: Specific listings of deductible gift recipients

| Bill reference | Paragraph number |
|---|---|
| Items 1, 3 and 5 | 6.9 and 6.10 |
| Item 2 | 6.6 |
| Items 2 and 4 | 6.7 |
| Items 2, 4 and 6 | 6.11 |
| Items 2 and 6 | 6.8 |

## Schedule 7: Minor Amendments

| Bill reference | Paragraph number |
|---|---|
| Item 1, section 41 | Table 7.1 |
| Items 2 to 6 and clause 2, paragraph 38-90(2)(a) and section 195-1 | Table 7.2 |
| Items 7 and 8, subsection 11(1AA) | Table 7.3 |
| Item 9, section 23GA | Table 7.5 |
| Item 10, subsection 46A(8AA) | Table 7.5 |
| Item 11, subsection 128B(3A) | Table 7.5 |
| Item 12, subsections 139E(2) and (4) | Table 7.5 |
| Items 13 and 14, paragraphs 139GA(3)(a) to (d) | Table 7.5 |
| Item 15, section 202DDA | Table 7.5 |
| Items 16 and 17, paragraph 202EE(1)(d) | Table 7.5 |
| Item 18, section 11-10 | Table 7.6 |
| Items 19 and 20, sections 11-15 and 12-15 | Table 7.6 |
| Items 21 and 22, paragraphs 15-55(1)(b) and 15-60(4)(b) | Table 7.6 |
| Items 23 to 33 and 64, paragraph 30-60(c), section 30-255, subsections 30-265(4) and 30-270(4), paragraph 30-275(c), subsections 30-280(1), 30-280(4) and 30-285(1), paragraph 31-5(5)(c) and subsection 995-1(1) | Table 7.6 |
| Item 34, section 50-70 | Table 7.6 |
| Items 35 and 57, subsection 51-57(1) and paragraph 197-20(b) | Table 7.6 |
| Item 36, section 61-560 | Table 7.6 |

| ***Bill reference*** | ***Paragraph number*** |
|---|---|
| Items 37 and 38, subparagraph 118-12(2)(a)(i) | Table 7.6 |
| Items 39 to 56, 60, 63 and 66, paragraph 165-12(7)(b), subsections 165-12(8) and (9), paragraph 165-37(4)(b), subsections 165-37(5) and (6), paragraph 165-115C(4)(b), subsections 165-115C(5) to (7), paragraphs 165-115GB(2)(a) and 165-123(7)(b), subsections 165-123(8) to (10), paragraph 166-272(8)(b), subsections 166-272(8), (10) and (11), subsection 713-545(6), paragraph 727-95(b) and subsection 995-1(1) | Table 7.6 |
| Item 57 | Table 7.6 |
| Item 58, subsection 320-85(1) (note 1) | Table 7.6 |
| Item 59, subsection 713-545(6) | Table 7.6 |
| Item 60 | Table 7.6 |
| Item 61, subsections 820-37(2) and (3) | Table 7.6 |
| Item 62, subsection 820-946(3) | Table 7.6 |
| Item 63 | Table 7.6 |
| Item 64 | Table 7.6 |
| Item 65, subsection 995-1(1) | Table 7.6 |
| Item 66 | Table 7.6 |
| Item 67, subsection 995-1(1) | Table 7.6 |
| Item 68, subsection 995-1(1) | Table 7.6 |
| Item 69, section 3 | Table 7.7 |
| Item 70, section 4 | Table 7.7 |
| Item 71, paragraph 7(a) | Table 7.7 |
| Item 72, section 8 | Table 7.7 |
| Items 73 to 96, subsections (3)(1) and 23(1A), paragraphs 23(2)(a) to (d), subsections 23(3) to (6), section 23A, paragraphs 23A(a) and (b), sections 23B and 23C, and subparagraphs 29(2)(c)(iii) and (iv) | Table 7.8 |
| Item 97, heading to Division 136 | Table 7.9 |
| Item 98 | Table 7.9 |
| Items 99 to 101, section 14ZQ | Table 7.10 |
| Item 102, subsection 288-80(4) in Schedule 1 | Table 7.10 |
| Item 103, paragraph 9(6)(b) | Table 7.11 |
| Item 104 | Table 7.12 |
| Sections 5 and 7 | Table 7.3 |
| Section 97A | Table 7.5 |
| Sections 701C-10 and 701C-15 | Table 7.9 |

## Schedule 8: Family trusts

| ***Bill reference*** | ***Paragraph number*** |
|---|---|
| Items 1 and 9, paragraph 270-25(1)(da) and subsection 272-90(3A) | 8.44 |
| Item 2, subsection 272-80(5A) | 8.31 |
| Item 2, subsections 272-80(5C) and (5D) | 8.38 |
| Item 3, subsection 272-80(6A) | 8.15 |
| Item 3, paragraphs 272-80(6A)(a) and (b) | 8.16 |
| Item 3, paragraph 272-80(6B)(a) | 8.18 and 8.34 |
| Item 3, paragraph 272-80(6B)(b) | 8.19 and 8.35 |
| Item 4, subsection 272-80(8) | 8.20, 8.21, 8.36, 8.37 |
| Item 4, subsection 272-80(9) | 8.17 and 8.33 |
| Item 6, subsection 272-85(5A) | 8.22 and 8.23 |
| Item 6, subsection 272-85(5B) | 8.24 |
| Item 6, subsection 272-85(5C) | 8.25 and 8.26 |
| Item 6, subsection 272-85(6) | 8.27 and 8.28 |
| Item 6, subsection 272-85(6A) | 8.29 |
| Item 6, subsection 272-85(6B) | 8.30 |
| Item 8, subsection 272-90(2A) | 8.39 and 8.43 |
| Item 8, paragraph 272-90(2A)(a) | 8.40 |
| Item 8, paragraph 272-90(2A)(b) | 8.41 |
| Item 8, paragraph 272-90(2A)(c) | 8.42 |
| Item 10, section 272-95 | 8.45 |
| Item 10, subsection 272-95(2) | 8.47 |
| Item 10, subsection 272-95(3) | 8.46 |
| Items 11 to 13, section 272-140 | 8.48 |
| Item 14 | 8.49 |