Senate Select Committee on Australia as a Technology and Financial Centre

FSC submission

July 2021

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1. About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing $3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world.

2. Introduction

The FSC welcomes the opportunity to submit to the Inquiry of the Senate Select Committee on Australia as a Technology and Financial Centre (**the Committee**).

Australia's financial services industry is highly regarded and respected globally. It is also one of the largest sectors in the economy contributing around 10 per cent of GDP and employing 450,000 people.

The FSC welcomed the Government's 2021 Budget measures aimed at furthering the growth, modernisation and flexibility in the financial services sector including addressing the vexed issue of legacy products across financial services to enable consumers to move to modern products and implementing the legislative framework for Corporate Collective Investment Vehicle (**CCIV**).

Implementing the CCIV, and removing funds management tax barriers, will help attract foreign capital and funds flow into Australian funds management businesses and support the Committee's aim of establishing Australia as a Financial Centre.

The FSC in submitting to this inquiry comments and makes recommendations specifically focussed on funds management, although many of the recommendations will improve the competitiveness of the whole financial services sector.

2.1 List of Recommendations

The FSC makes the following recommendations:

- The CCIV should be implemented with the removal of tax barriers to the uptake of the CCIV, changes to enable CCIV sub funds to be listed on an exchange and allow CCIVs to invest in another sub-fund of the same CCIV vehicle.
- Government implement a zero rate of NRWT on Passport payments, except for direct and indirect income from Australian real property.
- The Government's proposal to remove the CGT discount for collective investment vehicles (MITs, AMITs and CCIVs) not proceed, and instead be replaced with a

measure targeted at corporates and non-residents that are inappropriately accessing the CGT discount through managed funds.
- Given unfavourable changes to the OBU regime, the Government should not proceed with proposed changes to AMIT penalties and the CGT discount at fund level to offset the industry-wide adverse effects of the OBU changes.

3. Implementing a well-designed Corporate Collective Investment Vehicle

Australia has one of the largest pools of managed fund assets in the world, however our financial services exports are significantly smaller and do not reflect the relative contribution of our industry. Only a tiny proportion of funds come from offshore – foreign capital currently only contributes just over five per cent[1] of investment into Australian funds management, $126bn as a proportion of $2.2tr.

Several reviews, including the Johnson Review and the Board of Tax review have found that Australia's investment fund vehicle (the Managed Investment Trust or **MIT**) is globally uncompetitive and Australia should introduce a competitive corporate investment structure.[2]

The FSC was pleased with 2021–22 Budget measures which announced a number of reforms to attract offshore investors into Australian managed funds, including the implementation of the long-awaited **CCIV**. Finalising a well-developed and competitive CCIV regime is key to providing foreign investors with an investment vehicle they are familiar with.

A well-designed CCIV would have improved corporate governance and legal certainty compared to the existing MIT structure.

Having a well-constructed CCIV is the first step to providing the right investment vehicle to attract foreign investors. The second, and equally critical aspect, is ensuring the right tax settings for foreign investors. This would be consistent with the recommendation from the Low Report (the Australia as a Financial & Technology Centre Advisory Group Report, released in February 2021), that Australia implement an internationally competitive CCIV.

The most recent draft of legislation for the CCIV, released in late 2018, left a number of key outstanding issues to be resolved, particularly:

- addressing corporate law issues to improve the ability of CCIV sub-funds to list on exchanges, and allow a CCIV sub-fund to invest in another sub-fund of the same CCIV; and
- resolving tax problems with the CCIV, including the punitive tax treatment of funds that failed one of several tests; the tightening of the collective investment penalty regime; and the removal of the CGT discount for the CCIV and existing collective investment vehicles.

The FSC considers that the CCIV tax rules in the 2018 draft, if implemented unchanged, would harm the industry rather than making it more competitive. What is more problematic, two of the harmful changes would be imported into existing collective investment structures. These changes are the proposed tightening of the tax penalty regime for

[1] 5.4% as at March 2021, ABS Managed Funds, Australia, Table 9

[2] See Johnson Review, pages 62–64 and Board of Tax (2011) Review of Tax Arrangements Applying to Collective Investment Vehicles.

collective investments and removing the CGT discount for collective investment structures. The FSC's concerns with these tax proposals are explored in more detail in the rest of this submission.

The FSC considers implementing the CCIV without necessary changes would be inconsistent with the Government's commitments to make a CCIV regime that is similar to overseas regimes, and which increases the competitiveness of Australia's managed funds industry, as shown in the quotes from the draft explanatory materials on the latest version of the CCIV legislation, released for consultation in late 2018:

- In developing the CCIV framework, a key policy objective has been to **increase the competitiveness of Australia's managed fund industry** through the introduction of **internationally recognisable investment products** (see draft EM for regulatory framework at 1.10);
- The introduction of the CCIV is intended to support the establishment of the Passport as it will provide Australian fund managers with a vehicle that is compliant with Passport requirements and is **similar to the European-style corporate funds already popular in parts of Asia** (EM at 1.13);
- The legislation advances the more general objective of global regulatory alignment. The introduction of the CCIV advances this objective by helping to create a cohesive regional managed funds industry and facilitate more efficient participation in the global market-place (EM at 1.14);
- Aligning Australia's regulatory framework with well-developed international regimes can **lower the barriers to entry for new fund managers seeking to operate in Australia**. This can **increase competition** and **allow Australian consumers greater product choice, including exposure to new asset classes** (EM at 1.15).
- By introducing **regulatory structures that are similar to overseas regimes**, the legislation should, over time, also make substituted compliance processes simpler for Australian fund managers seeking to offer products overseas (EM at 1.16).

The FSC looks forward to working with the Government on progressing the CCIV and resolving key issues with the framework.

FSC Recommendation: The CCIV should be implemented with the removal of tax barriers to the uptake of the CCIV, changes to enable CCIV sub funds to be listed on an exchange and allow CCIVs to invest in another sub-fund of the same CCIV vehicle.

4. Removing Funds Management Tax Barriers

The FSC has for some time been arguing that more needs to be done to remove barriers to Australia as an exporter of financial services.

The Asia Region Funds Passport (**the Passport**) has lowered barriers to trade in funds management within the participating economies. From a regulatory stand point, Australian fund managers will find it easier to export funds offshore; and foreign fund managers will find it much easier to export funds into Australia. This presents both opportunities and risks for the Australian industry – while Australian funds could increase exports to Asia, conversely foreign funds could enter Australia more easily.

In the Passport, Australian fund managers should be able to compete with foreign funds on a level playing field. The concern is when the playing field is not level – if Australian fund managers face a more restrictive tax and regulatory regime, then these settings give

an inappropriate advantage to foreign managers and they can outcompete Australia purely on the basis of government policy settings.

In the case of the Passport, if Australian policy settings are not right, fund managers might prefer to service Australian investors from offshore (particularly from Singapore if they join the Passport) rather than locally.

There are currently no Australian funds registered with the Passport. Feedback from fund managers, custodians, law firms and accounting firms working in the industry have identified non-resident withholding tax, as well the lack of a well-designed CCIV, as the two barriers that limit Australian fund manager's ability to compete globally, including within the Passport.

Implementing a well-designed CCIV will assist by providing foreign investors with a more familiar corporate investment vehicle than Australia's managed investment trust structure.

5. Non-resident withholding tax

The FSC considers that Australia's current tax system is not competitive in the Passport. In particular, the non-resident withholding tax (**NRWT**) system is complex compared to other Passport countries, as a result of:

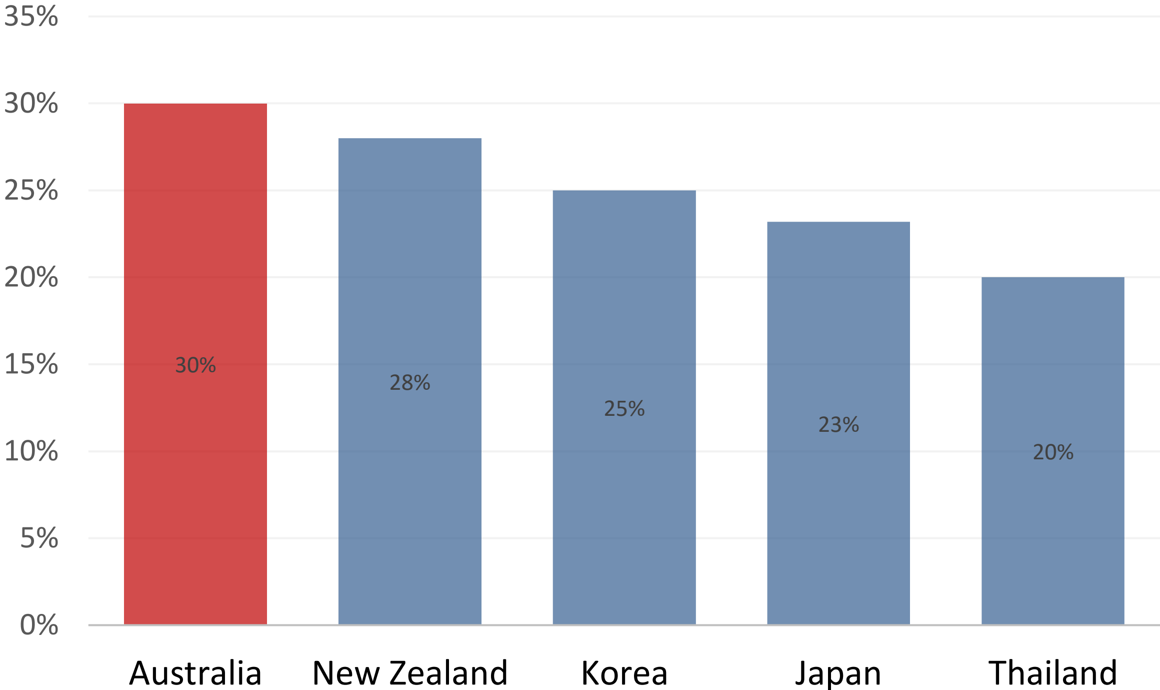
- multiple rates;
- complexity and difficulty of determining appropriate rate;
- interactions with tax treaties (including how the treaties deal with trusts);
- incorrect or inappropriate levying of tax (see discussion of forex hedging and bond profits below);
- no overarching consistent principle of application; and
- much simpler approaches in competitor jurisdictions, with Singapore in particular charging a zero withholding tax rate.

The complexity of the application of Australia's NRWT means the possible tax consequences for foreign investors cannot be explained in a simple and easy to understand manner. The Passport is specifically designed for retail investors so the inability to explain tax simply will put Australia at a substantial disadvantage.

Australia's NRWT complexity means comparisons with other jurisdictions are complicated; in general Australia's regime has high headline tax rates, but a variety of exemptions which often means the actual tax paid in Australia is low. As a result, we have a lose-lose situation – a tax system that significantly impedes investment due to its complexity while delivering little revenue (see section on potential budget impact below).

NRWT comparisons are not simple, but by contrast, comparisons of company taxes much more clearly show Australia is uncompetitive – Australia has the highest corporate tax rate in the Passport and in some cases the Australian tax disadvantage is large. This is shown in Figure 5 below.

Figure 1 – Corporate tax rate in Passport countries



Source: OECD corporate tax database: https://stats.oecd.org/Index.aspx?DataSetCode=CTS_CIT

The corporate tax comparisons are clear cut in showing Australia is uncompetitive. Our uncompetitive tax regime is inconsistent with Australia's aspirations of becoming a global financial centre and exporting fund management services, particularly to Asia.

Other countries are reducing their NRWT and corporate tax rates over time, making our system more uncompetitive as time passes. Therefore, if Australia does not set NRWT and company tax rates at a competitive rate determined in the appropriate international context, funds will not be invested in Australian vehicles and the ATO will receive 100% of nothing, while Australia will miss out on the revenue, jobs and growth of our funds management industry. The benefits are likely to include back end operations as well as higher value added operations such as investment management.

If Australia is unable to reduce its corporate tax rate, this emphasises the need for other tax settings, particularly NRWT, to be more competitive.

Investors will be choosing Passport products from a number of competing jurisdictions and Australia's current tax system will place Australian funds behind funds from other countries. If tax disadvantages are removed for Australian funds, then Australian fund managers will be able to compete. In addition, a globally competitive NRWT would address one of the larger barriers to the success of Australia's funds management export industry.

The removal of withholding tax on funds inside the Passport was a key recommendation of the Low Report which the FSC supports (recommendation 3).

FSC Recommendation: Government implement a zero rate of NRWT on Passport payments, except for direct and indirect income from Australian real property.

5.1 Potential budget impact

The Passport only allows investments into very simple ('vanilla') products such as listed equities and bonds. This means that income generated by non-resident investors will comprise dividends and interest. Analysis of these income types shows that little government revenue from NRWT (outside of property) will be received as a result of Passport funds under existing policy settings:

- Just over 90% of Australian top 100 company dividends are franked therefore dividend withholding tax collections will be small. A portion of the remaining unfranked dividend also qualifies for conduit foreign income (**CFI**) exemption. For example, the unfranked component of AMP's dividends has historically been CFI and therefore withholding tax free.
- Interest will be either overseas sourced or substantially subject to an exemption (under section128F); as a result it would not be subject to NRWT.
- Capital gains from Australian assets that are not taxable Australian real property are not subject to a withholding obligation when derived by non-residents. The permitted investment class only allows for listed equities which are all treated as non-taxable Australian real property.
    - Note the FSC is not calling for a reduction in the NRWT applying to any property income that might be received by a Passport fund (even though this income would be limited in a Passport fund).
- Some tax treaties may operate to allocate the taxation of gains to the treaty partner.
- Some of the remaining NRWT is inappropriately applied to bond profits and foreign exchange hedging transactions. The 2021–22 Budget included a commitment to reform the tax treatment of foreign exchange hedging which should reduce the incorrectly levied NRWT revenue on these transactions.

As a result of these points, a removal of NRWT on the Passport will have limited budget impact, however it will have a significant impact on the ability of Australian managers to market their funds, as it will allow confident statements to be made about the taxation impact of investing in an Australian fund.

We expect this change will reduce compliance costs for all funds without property income, as only one rate of withholding tax will apply. A fund with property income might face higher compliance costs from complying with the property-related NRWT, but this will be offset by a reduction in compliance costs from collapsing multiple non-property rates into one rate.

6. Removal of CGT discount for managed funds

The 2018–19 Budget announced the Government would remove the CGT at the fund level for MITs and Attribution Managed Investment Trusts (**AMITs**).[3] This tax treatment would also apply to the CCIV. In the rest of this section, these three vehicles (MITs, AMITs and CCIVs) are called managed funds.

The FSC has strong concerns with this proposal and has provided this feedback to Government repeatedly, including as part of the FSC's Pre-Budget submission process for the 2021–22 Budget.

Most importantly, the policy contradicts the Government's own stated policy goals. The

[3] See Budget Paper 2, page 44.

2018–19 Budget states[4] this proposal is designed to ensure that managed funds operate as genuine flow through vehicles, so that income is taxed in the hands of investors as if they had invested directly. However, the 2018–19 Budget proposal has the **opposite effect** of this policy goal.

The policy disadvantages indirect investment by individuals through managed funds compared to direct investment. It removes the current neutral treatment of individuals and replaces it with a non-neutral treatment. Using the terms from the 2018–19 Budget, under the current tax system managed funds are taxed as genuine flow through vehicles for individual investors, "so that income is taxed in the hands of investors as if they had invested directly". The proposal replaces this approach with a system that overtaxes individuals that invest through managed funds.

The specific reasons the Government's proposal overtaxes individuals that invest in managed funds are:

- In allocating deductible expenses against assessable income components, a managed fund would be required to allocate deductions against gross capital gains instead of only the assessable discount capital gains component; and
- In recouping prior year or current year revenue losses, the managed fund would be required to recognise as assessable income the gross amount of the capital gain rather than only the discount capital gain.

A briefing from Greenwoods HSF (see Attachment B) provides an example where:

- an individual would pay no tax if they invested directly; but
- the same individual would pay tax on $500 if they invested in exactly the same way, but through a MIT.

This clearly shows the Government's proposal does not meet the principle of horizontal equity which is a long-standing tax policy principle accepted by governments. Broadly, the principle should apply so that investors bear the same tax burden regardless of whether they invest directly or indirectly. The proposed measure runs counter to this principle.

The proposal will also increase the tax on superannuation funds that invest through managed funds – so the proposal will reduce super balances, make many retirees worse off, and will increase the future Government spending on the Age Pension.

APRA-regulated superannuation funds have about $836 billion invested into managed funds as at March 2021,[5] while SMSFs had $112 billion invested in managed funds as at March 2020.[6] So the proposal is likely to impact on over $1 trillion in superannuation assets.

6.1 Example

An example of the over taxation of individuals under this proposal is shown below.

[4] See Budget Paper 2, page 44.

[5] APRA Quarterly superannuation performance statistics, Table 1b, sum of investments into retail trusts, cash management trusts and wholesale trusts.

[6] ATO Self-managed super fund quarterly statistical report – March 2020, table 3.

Where a managed fund derives a $100 discount capital gain, but has expenses of $20 that are to be allocated against the capital gain, the difference in the trust net income would be as follows:

Trust level	Current	Proposed
Discount capital gain	100	100
50% discount	50	-
Net gain	**50**	**100**
Expenses	-20	-20
Net income	***30***	***80***

Once the net income is distributed, the impact on an individuals' investor's taxable income could be illustrated as follows (with direct investment included for comparison):

Individual level	Invest through MIT/AMIT		Direct investment
	Current	Proposed	
Distribution	30	80	100
Gross up	30	-	-
Gross gain	**60**	**80**	**100**
1/2 discount	-30	-40	-50
Individual expenses	**-**	**-**	**-20**
Taxable income	***30***	***40***	***30***

In summary, an individual pays the correct tax at the moment, but will face a tax increase under the proposed treatment; they will be subject to a tax penalty just because they have invested through a managed fund rather than investing directly.

The example above equally applies if fund-level expenses are replaced by carry forward revenue losses.

The examples above and in Attachment B show where expenses or carry-forward revenue losses are offset against these discount capital gains at the managed fund level, the proposed measure will result in members that are entitled to a CGT discount (individuals, complying superannuation funds entities and trusts taxed under Division 6) being worse off under this proposal than if they had invested in assets directly under the same scenario.

6.2 Discussion

The proposed changes to CGT treatment for managed funds will largely reduce the parity between the tax treatment of direct investment and investment through a managed fund.

The FSC submits that, across the investment life-cycle of a managed fund, many (perhaps nearly all) managed funds would allocate expenses, or current year or carry forward revenue losses, against capital gains. This means that the proposed measure will disadvantage many or all managed funds relative to direct investment by individuals and superannuation funds.

The proposal also introduces another inconsistency: all other trusts would be able to access the CGT discount, while CIVs will not. The FSC submits this is inconsistent and unfair and further underlines the concern that this proposal is clearly not meeting the policy intent of ensuring direct and indirect investment is treated similarly.

There is simply no reasonable argument to apply a tax penalty just to widely held trusts (managed funds) while excluding all other trusts, including closely held trusts.

We note the original exposure drafts of the AMIT legislation included this measure, but it was removed by Treasury during consultation. We understand this change was made because of the concerns raised above in this section: disallowing the CGT discount at the trust level reduced tax neutrality compared to direct investment.

Given the increased compliance costs from the measure and the distortion in the tax treatment of direct vs indirect investment, the proposed CGT change would likely actively discourage many investors (individuals and superannuation funds) from investing in managed funds, and would run counter to the aims of the Committee's inquiry, set out in the Interim Report of the Committee, which is to provide optimal regulatory settings which increases competition and productivity and creates jobs.[7]

The added burden on managed funds caused by higher taxation and higher compliance costs from these combined proposals means the benefit of reforming and moving out of the old Division 6 tax treatment of widely held trusts has been considerably reduced — possibly negated. It also is particularly concerning that this change has been proposed after many fund trustees have made the irrevocable election to adopt the AMIT regime.

We note that this measure is ostensibly meant to prevent beneficiaries that are not entitled to the CGT discount from getting a benefit from the CGT discount being applied at the trust level. This would be non-resident investors and corporate investors.

It is not clear why the Government has proposed a measure targeting all investors in managed funds rather than a measure specifically targeting resident corporations and non-resident beneficiaries. Instead, the Government proposes a measure that will result in individuals and superannuation funds paying an inappropriate amount of tax compared to direct investment.

Additionally, the beneficiaries of apparent concern represent a small proportion of unitholders. According to the ABS, non-government trading companies represent just 1.7% of total investment into managed funds, and foreign investors represent 5.4% of total investment as at March 2021.[8] Most investment is by individuals, superannuation funds and pension funds. In addition, capital gains are only subject to tax for non-residents when the gains relate to "taxable Australian Real Property" (TARP). Other gains are not subject to Australian tax. Hence the supposed mischief relates to a small proportion of the total gains recorded by the fund.

If the Government wishes to address concerns about corporates and non-residents accessing the CGT discount through managed funds, then we submit there would be value in exploring options that are more targeted at the issue. Some time ago, the FSC has provided a range of options to Treasury and the Government, and we are willing to discuss these options in more detail. We await further consideration of these options.

Instead of this measure, the FSC is recommending a measure targeted at corporates and non-residents that are inappropriately accessing the CGT discount through managed funds.

FSC Recommendations: The Government's proposal to remove the CGT discount for collective investment vehicles (MITs, AMITs and CCIVs) not proceed, and instead be replaced with a measure targeted at corporates and non-residents that are inappropriately accessing the CGT discount through managed funds.

[7] Page xiii, Select Committee on Financial Technology and Regulatory Technology, Interim Report.

[8] ABS Managed Funds, Table 9, March 2021.

7. Attribution penalties

The CCIV draft retains the proposal for an extension of the penalty for attribution ‘unders and overs’ that result from a lack of reasonable care. In simplified terms, the existing AMIT structures are allowed to make estimates of tax amounts and then carry forward any differences between the estimate and the actual amounts to future years. These differences are called ‘unders and overs’.

Currently, penalties apply if this estimate is made recklessly; the Government’s proposal is that the recklessness test be replaced with a much tighter test for penalties – a penalty could apply if an estimate is done with a lack of reasonable care. This is a considerably tighter test, and it is proposed that it will apply to both CCIVs and AMITs (existing investment structures).

FSC members completely oppose this change. If this penalty remains in the final legislation, it will prove to be a significant disincentive for any fund manager to elect into the CCIV (or AMIT) regime for its funds.

This proposal is revisiting a key AMIT provision only a short time after the introduction of the regime. The CCIV rules should not be an exercise in making a change of this type.

Early exposure drafts of the AMIT Regime legislation included administrative penalties relating to ‘unders and overs’ where there had been a lack of reasonable case. However, this was removed as part of the consultation process, in recognition of stakeholder concern about the application of the reasonable care concept. The absence of the reasonable care requirement in the AMIT rules was not an oversight that requires correction. It was a deliberate removal based upon Treasury consultation on that point, based upon recognition of commercial factors particular to the member reporting of the industry. Adding it into the CCIV and AMIT regime without evidence of the need for this requirement would be ignoring this consultation.

We also note the alleged mischief from attribution ‘unders and overs’ is negligible. AMITs and CCIVs are, in general, not meant to be taxpaying entities; and any unders or overs would be expected to largely cancel out over time. As a result, the amount of tax at risk over time is very small. So the change would be significantly tightening penalties for a negligible (perhaps zero) amount of tax.

Penalties in the tax system should be proportionate to the actual or potential mischief involved. However, in this case, proportionality does not apply. A potentially substantial penalty is being applied in relation to a negligible tax liability.

The risk of a reasonable care penalty will be a further discouragement from using CCIVs and AMITs compared to international vehicles and other domestic investment vehicles.

We understand the main argument in favour of the proposed change is that it will mean the same penalty regime will apply to all Australian taxpayers. This argument is without substance:

- AMITs currently operate (and CCIVs would operate) in a different commercial environment to other taxpayers. For example, other taxpayers (in general) do not use estimates to calculate taxable income in one tax period and then ‘true up’ the estimates in a later period. Other taxpayers are not permitted to use the ‘unders and overs’ approach that is central to the attribution system. If the goal is to be consistent across all taxpayers, then this would lead to the incongruous conclusion that no taxpayers should be able to use ‘unders and overs’, a conclusion that fund managers would naturally oppose.

- AMITs and CCIVs could be penalised for attributing too much assessable income to investors. It appears CCIVs and AMITs would be the only classes of taxpayer subject to reasonable care penalties where there has been no tax shortfall. Again if the goal is to be consistent, then this would lead to another incongruous

conclusion: penalties should apply to all taxpayers who pay too much tax (again, a conclusion that fund managers would oppose).

These points naturally lead to the conclusion that AMITs and CCIVs are different from other taxpayers – and so therefore the consistency argument for penalties fails.

We also note the following:

- Evidence has not been presented showing the current approach, involving penalties for errors due to recklessness alone, is not working adequately.
- It has not been shown that the addition of this new penalty has a net benefit, or passes a cost benefit test, noting the substantial costs of the new penalty system, including added costs and uncertainty.
- The proposal will strongly discourage investment into assets that are more likely to produce 'unders and overs' such as property. Investment managers may just not want the risk of being confronted with a penalty for using the 'unders and overs' provisions.
- the ATO has released guidance on acceptable practice for making attribution estimates for AMITs.[9] If the threshold for AMIT penalties is lowered, then either:
  - the ATO guidance will change, in which case the law change will trap otherwise acceptable AMIT practices, highlighting the FSC concerns raised earlier; or
  - the ATO guidance will not change, in which case it is unclear why the law change was required.

We also strongly object to the retrospective nature of this proposal on MITs that have already elected into the AMIT regime and are unable now to exit this regime due to the irrevocable election made at the time. Arguably, there would not be a retrospective element to the proposal if AMITs were able to exit the regime, but the fact that there is no possibility of exit means the proposed penalty change operates to some extent retrospectively on AMITs that are now in the regime.

Furthermore, if MIT operators had the benefit of hindsight that the reasonable care test would be inserted at a later date, then it would have been significant factor impacting the decision to elect into AMIT. Changing the penalty regime after the decisions is moving the goalposts after the game has started.

Therefore, if the change in the penalty regime is retained in the final legislation, then FSC recommends that AMITs be provided with the option to leave the attribution regime to ensure the retrospective element of the proposal is removed.

8. Options to replace the Offshore Banking Unit.

The Committee has asked for options to replace the Offshore Banking Unit (OBU) regime that will maintain and enhance Australia's global position.

The OBU regime is used by a number of local fund managers and life insurers to ensure that Australia is globally competitive in these industries. The OBU regime broadly permits an Australian funds manager to pay a lower rate of tax on activities that relate to offshore managed funds (and similarly for life insurers).

[9] ATO LCR 2015/10 Attribution Managed Investment Trusts: administrative penalties for recklessness or intentional disregard of the tax law - section 288-115 See: https://www.ato.gov.au/law/view/document?DocID=COG/LCR201510/NAT/ATO/00001&PiT=99991231235958

On 12 Marcy 2021, the Government announced it will be ending the OBU regime,[10] in response to concerns by the OECD that the regime acted as an 'harmful tax practice'.

The abolition of the OBU regime will exacerbate the tax-related issues being faced by the funds management industry from the adverse policy climate facing funds managers, particularly from the proposed tightening of the AMIT penalty regime and the proposed removal of the Capital Gains Tax (CGT) discount at fund level (discussed earlier in this submission).

All of these changes put together will cause substantial cost and disruption to the industry for no clear benefit. As the Government is considering changes to other tax policies to offset the problems caused by an adverse change relating to OBUs, then we strongly suggest abandoning the proposed changes to AMIT penalties (see Section 7 above) and the CGT discount at fund level (see Section 6 above). This will ensure the Government is not placing additional burdens onto the industry, in addition to the burden occurring from the removal of the OBU regime.

FSC Recommendation: Given unfavourable changes to the OBU regime, the Government should not proceed with proposed changes to AMIT penalties and the CGT discount at fund level to offset the industry-wide adverse effects of the OBU changes.

In addition to abandoning proposals that will penalise the funds management industry, there are several changes the Government should implement to make the industry more globally competitive (more details are in Attachment A):

- Address issues with the Taxation of Financial Arrangements, particularly removing problems where incorrect taxation is imposed. While the most important issue in this context is foreign exchange hedging (discussed earlier in this submission), there are a number of other outstanding issues that would be addressed if the Government fully meets the commitments to reform TOFA that were made in 2017.[11]
- Address the outstanding issues with the Investment Manager Regime (IMR), as were highlighted in the Low Report. This is a commitment the Government made in 2017.[12]
- Prioritise double tax agreements with Luxembourg and Hong Kong.
- Expand the functional currency election to certain trusts and partnerships – a Government commitment from 2013.[13]

[10] See: https://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/media-releases/amending-australias-offshore-banking-unit-regime-0
[11] See 2016–17 Budget and: http://kmo.ministers.treasury.gov.au/media-release/126-2017/
[12] See: http://kmo.ministers.treasury.gov.au/media-release/064-2017/
[13] See 2011–12 Budget.

9. Attachment A – more details on measures in response to removal of OBU regime

The FSC requests the Government prioritise a number of existing commitments, in particular:

9.1 Address outstanding Investment Manager Regime (IMR) issues

The FSC has previously raised concerns with the ATO's interpretation of the Investment Manager Regime (**IMR**). In response to industry concerns, on 19 July 2017, the Government indicated it will "consult on whether a legislative amendment is required to ensure that the engagement of an Australian independent fund manager will not cause a fund that is legitimately established and controlled offshore to be an Australian resident. Any legislative amendment would be retrospective to apply from the start of the IMR regime in 2015".[14]

This issue remains unresolved and is an important issue for the FSC. We encourage the Government to increase the priority placed on resolving this issue. We note a change to address this issue should be classified as a technical amendment as it will ensure the IMR operates as intended.

Addressing this issue was an important recommendation of the Low Report (Australia as a Financial & Technology Centre Advisory Group Report) – Recommendation 2 – which the FSC strongly supports.

9.2 Fix outstanding issues with the Taxation of Financial Arrangements

From the 2016–17 Budget:
The Government will reform the taxation of financial arrangements (TOFA) rules to reduce the scope, decrease compliance costs and increase certainty through the redesign of the TOFA framework.

The current TOFA rules calculate the amount and timing of gains and losses on financial arrangements, and were designed for the largest taxpayers. However, in practice, these rules apply to a significant group of smaller taxpayers and TOFA has not delivered the envisaged compliance cost savings and simplification benefits to these taxpayers.
The measure contains four key components:

- A 'closer link to accounting' which will strengthen and simplify the existing link between tax and accounting in the TOFA rules.
- Simplified accruals and realisation rules, which will significantly reduce the number of taxpayers in the TOFA rules, will reduce the arrangements where spreading of gains and losses is required under TOFA and simplify the required calculations.
- A new tax hedging regime which is easier to access, encompasses more types of risk management arrangements (including risk management of a portfolio of assets) and removes the direct link to financial accounting.
- Simplified rules for the taxation of gains and losses on foreign currency to preserve the current tax outcomes but streamline the legislation.

[14] See: http://ministers.treasury.gov.au/ministers/kelly-odwyer-2016/media-releases/improving-australias-financial-services-taxation-regime

The new framework will remove the majority of taxpayers from the TOFA rules, result in lower compliance costs, provide simpler rules and more certainty and maintains the objectives of reducing costs and minimising distortions in decision making.

From a press release of 22 December 2017:
"*Simplification of the Taxation of Financial Arrangements (TOFA) rules was announced in the 2016–17 Budget…The Government will defer the commencement of changes to the TOFA regime and the changes will now commence from income years that begin after Royal Assent. Treasury will continue to engage with stakeholders in the design of the amended rules, and to identify specific aspects of TOFA reform that could be prioritised.*"[15]

A particular priority in this area for FSC members is foreign exchange hedging rules. Under the current rules hedging gains/profits are normally treated as being on revenue account and therefore potentially bear withholding tax. This has been a source of frustration to the industry for many years as such hedging is normally related to the holding of foreign assets which generate income and gains that are exempt from withholding tax. A key principle is that hedging contracts should be taxed the same as the asset they hedge – if the underlying asset is exempt from tax, then so should the hedge.

One of Korea's largest investment managers has specifically raised the issue of Australia's taxation treatment of foreign exchange hedging being a barrier to offering their Australian asset funds in Korean won. Their Korean investors would prefer to bear the foreign exchange risk themselves, by investing into an Australian dollar fund and undertaking their own hedging back to Korean won, as opposed to having the hedging undertaken in the fund. They noted that this was an Australian-specific problem that they did not have when investing in other jurisdictions.

The FSC has previously suggested that Subdivision 230E of the TOFA provisions be clarified to eliminate uncertainty as to its application to passive investment portfolios. The FSC also suggests there be consideration of a reform to simplify the hedging measures by implementing a 'safe harbour' to recognise hedging gains and losses for tax purposes over say, five years; and consider the legislative changes that will be required due to the interaction between the TOFA provisions and the new accounting standard dealing with hedging (AASB 9).

9.3 Functional currency election

The 2011–12 Budget announced:
The Government will allow certain trusts and partnerships that keep their accounts solely or predominantly in a particular foreign currency to calculate their net income by reference to that currency.

The Coalition Government announced it would proceed with this Policy in its announcement of 14 December 2013.[16]

This measure would permit trusts and partnerships to use the functional currency election under Subdivision 960-D Income Tax Assessment Act 1997 (ITAA 1997) when preparing their Australian income tax returns. The current rules without the benefit of the election are very restrictive and result in a high cost of compliance.

This measure is of more importance with the introduction of the AMIT regime and the Asia Region Funds Passport (**Passport**) in order to permit Australian fund managers to attract overseas investors who may wish to invest and receive accounting and tax reports, distributions and capital returns in their own (non-Australian dollar) currency. In particular,

[15] See: http://kmo.ministers.treasury.gov.au/media-release/126-2017/

[16] See page 4 of: http://ministers.treasury.gov.au/sites/ministers.treasury.gov.au/files/2019-05/MR008-2013.pdf

this would promote the use by Australian fund managers of multi-class trusts under the AMIT regime, with the ability to offer classes in different currencies.

We note at time of writing no Australian fund has been offered under the Passport regime. Fixing the functional currency issue, the gains or losses on bond sales issue, and the foreign exchange hedging issue (noted above) would reduce the tax-related barriers to the use of Australian funds in the Passport (noting these are not the only issues that could be discouraging Australian domiciled Passport funds).

9.4 Ensure correct Australian taxation of foreign capital gains

The *Burton v Commissioner* decision of the Full Federal Court[17] reduced the taxpayer's Foreign Income Tax Offset (FITO) to the extent the taxpayer was able to use the CGT discount. This decision raises significant uncertainty about the taxation of foreign capital gains, and could easily result in excessive taxation of these gains – an Australian taxpayer could effectively pay a higher rate of CGT on a foreign asset than on a domestic asset. This runs contrary to a tax policy principle that the Australian tax on foreign income should be no higher than either the foreign tax on the income, or the Australian tax that would apply if the income was only subject to Australian tax.

If the decision is applied to all Australian taxpayers with foreign capital gains, this could substantially increase compliance burdens for Australian-based global funds. The issue would be even more problematic if it is applied to all foreign income, including income that is not from capital gains.

Therefore, the FSC recommends the Government should make a technical amendment to the law to ensure that the Australian tax on foreign source income should not be greater than the higher of (a) the foreign tax on the income; or (b) the Australian tax that would apply if the income was only subject to Australian tax.

[17] See https://www.judgments.fedcourt.gov.au/judgments/Judgments/fca/full/2019/2019fcafc0141

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TAX BRIEF

8 May 2018

Budget 2018-19

The Budget has become like Christmas – it is a season, not an event. This year's Budget Season began in mid-April with the regular and strategic placement of good news stories (and definitely no bad news stories): no increase to the Medicare levy, personal income tax cuts for low income earners, tax reductions for higher income earners but spread over a longer time frame, incentives for the film industry (and yet another attempt to tweak the R&D tax incentive), changing the excise system to benefit brewers of craft beer, a Taskforce to crack down on illegal tobacco sales, big spending on infrastructure (including more money for hospitals in WA), new drugs added to the Pharmaceutical Benefits Scheme, more spending on the aged, and so on. Budget Season will continue for a few weeks yet as the Government tries to impress upon us the messages it wants us to remember. This Tax Brief outlines the tax components of the Budget, both the good news and the bad.

1. Corporate tax

In April, the Treasurer revealed that tax receipts from July to December 2017 were $4.8bn higher than expected, and of that, almost $3bn was due to higher than expected company tax collections. Notwithstanding that surprise, the Government has announced a series of measures which will increase corporate tax revenue.

1.1 Digital economy

Towards the end of his speech the Treasurer alluded, ever so briefly, to his earlier statements to make sure companies in the digital economy pay 'their fair share of tax,' if necessary by unilateral action pending a multilateral resolution. He indicated that a Discussion Paper on options for taxing the digital economy will be released 'in a few weeks' time.'

This is likely to include the options that the EU announced in March 2018 of developing in the longer term rules to be incorporated in tax treaties for a 'virtual permanent establishment' in the countries of the users of digital platforms and attributing some of the platform owner's profits to those countries. In the interim, the EU proposed an interim digital tax of 3% on revenues of large companies involved in (i) selling online advertising space (such as Google and Facebook); (ii) digital intermediary services (which allow users to interact with other users to facilitate the sale of goods and services between them (such as Uber or Airbnb); or (iii) the sale of data generated from user-provided information (such as Palantir).

In March the OECD said its work on these issues would be completed in 2020 but more recently the OECD has shifted the date to 2019.

1.2 Valuation of assets for thin capitalisation purposes

The thin capitalisation rules will be amended to require entities to align the value of their assets for thin capitalisation purposes to the values used in their financial statements. There is currently some flexibility in the thin capitalisation rules to use asset values that are not contained in an entity's financial statements. In this regard, the ATO has been actively reviewing taxpayers who revalued their assets after the 2014 changes to the thin capitalisation rules (which reduced the safe harbour debt threshold to a 1.5 to 1 debt to equity ratio). The Government must consider that the robust review that comes with the preparation of financial statements affords additional integrity in this area. This measure will apply to income years commencing on or after 1 July 2019.

1.3 Classification of consolidated entities for thin capitalisation purposes

Foreign controlled Australian consolidated entities and multiple entry consolidated groups that control a foreign entity will now be treated as both outward and inward investment vehicles for thin capitalisation purposes. This will overcome a curiosity under the current thin capitalisation rules where these consolidated entities are deemed to be outward investment vehicles and different tests therefore apply. This change will apply for income years commencing on or after 1 July 2019.

1.4 'Significant global entity' definition

The definition of a 'significant global entity' ('**SGE**') will be broadened 'to ensure that Australia's multinational tax integrity rules operate as intended.'

SGEs are subject to the Diverted Profits Tax rules, the Multinational Anti-Avoidance Law and the Country by Country reporting obligations. While not mentioned in the Budget measures, any amendment to the SGE definition will presumably also have an impact on the increased penalty regime applicable to SGEs and the General Purpose Financial Statements lodgement obligations.

Under the current rules, an entity is regarded as a SGE for a particular income year if it satisfies one of the following:

- the entity is a 'global parent entity' ('**GPE**') with 'annual global income' of AUD$1bn or more; or
- the entity is a member of a group of entities consolidated for accounting purposes and the GPE of the consolidated group has annual global income of AUD$1bn or more.

The Government's proposal is to broaden the current definition to include members of large multinational groups headed by private companies, trusts and partnerships. It will also include members of groups headed by investment entities that may not otherwise be currently captured as they are not permitted to consolidate for accounting purposes.

For example, the new definition may have an impact on global funds including real property and private equity funds that currently may not be required to consolidate their Australian investments for accounting purposes.

The new measure will apply to income years commencing on or after 1 July 2018.

1.5 Tax consolidation

Budget Paper No 2 re-announced two changes already enacted by the *Treasury Laws Amendment (Income Tax Consolidation Integrity) Act 2018* which received Royal Assent in March this year. That is, the announcement reflects current law, not proposed changes. This is somewhat odd. The Budget will often recap announced but unenacted measures, but these measures have already been enacted.

The 'churning measure' ensures the consolidation tax cost setting rules will not apply to reset the tax cost of assets held by a non-land rich entity that joins a consolidated group or MEC group after being transferred from a non-resident entity who is not taxed on the transfer. This measure was clarified as requiring 50% common ownership within the previous 12 months based on an associate-inclusive test.

However, this clarification was amended so that it only took effect from introduction of the Bill on 15 February 2018. For the period from 14 May 2013, the test is not associate-inclusive.

The highly convoluted (and unworkable) transitional rule initially proposed for the removal of deferred tax liabilities ('**DTLs**') from an entity's exit tax cost setting calculation was removed. The enacted measure removed DTLs from both entry and exit amounts from the date of introduction of the Bill on 15 February 2018.

1.6 Denying deductions for costs of holding vacant land

The Government will deny deductions for expenses associated with holding vacant land, whether the land is for residential or commercial purposes. Deductions which have been denied will not be able to be carried forward for use in later income years but will be included in the CGT cost base of the asset.

The measure will not apply to expenses associated with holding land:

- that are incurred after any property constructed on the land is complete and available for rent; or
- where the land is being used by an owner to carry on a business.

The Budget Paper says somewhat cryptically, that '*the carrying on a business test will generally exclude land held for commercial development*.' It is not clear whether the Budget Paper is trying to say:

- '*the carrying on a business test will generally exclude* [from this measure] *land held for commercial development*' and sale; or
- '*the carrying on a business test will* [not extend to] *land held for commercial development*,' even if the land is being developed for sale.

On the other hand, it may be trying to say, if the land is being developed for retention and lease, then '*the carrying on a business test'* will not be met and so the measure would apply.

Further clarification will be required about the scope of the measure given its potential impact. The measure will take effect from 1 July 2019.

2. Managed investment trusts and AMITs

2.1 CGT discount

The Government proposes to prevent Managed Investment Trusts ('**MITs**') and Attribution MITs ('**AMITs**') from applying the 50% capital gains tax discount at the trust level. This measure will apply to payments made from 1 July 2019.

The measure is directed at Australian resident companies that are beneficiaries of MITs and AMITs. They can, at present, effectively access the CGT discount where deductions (such as interest) are offset against capital gains, even though companies are not meant to enjoy CGT discount. For example, if a trust has a gross, discountable capital gain of $1,000 and interest deductions of $500 it will have net income of nil:

Gross capital gain	1,000
CGT discount	(500)
Interest deductions	(500)
Net income	0

This means that an Australian resident corporate beneficiary would have no taxable income despite the fact that, if it had derived and incurred those amounts directly, it would have had taxable income of 500. Further, at least in the case of a MIT, the trust could distribute $500 as a CGT concession amount with no cost base adjustment for the corporate or non-resident beneficiary.

While the proposed measure may be considered an appropriate outcome for Australian resident corporate beneficiaries, this represents the classic 'sledgehammer to crack a nut' response. The proposed position will put all *other* Australian resident beneficiaries in a worse position than they would have been if they had made a direct investment. Using the example above, an Australian resident individual would have no taxable income if they made the relevant investment and borrowed themselves. However, if that person invests through a MIT, the position of the MIT will now be:

Gross capital gain	1,000
Interest deductions	(500)
Net income	500

The Australian resident individual will now include $500 in their assessable income. While that $500 may qualify for the CGT discount, some tax will be payable in circumstances where no tax would be payable if a direct investment would be made.

This negative outcome will also apply for complying superannuation funds. Again, using the example above a direct investment would produce the following result:

Gross capital gain	1,000
CGT discount	(333)
Interest deductions	(500)
Net income	167

Under the proposed change, the complying superannuation fund would have net income of $500, reduced to $333 after the CGT discount. In effect, the rate of taxation has been doubled on a complying superannuation fund in this example.

These examples show that the Government's statement that, '*this integrity measure will ensure that MITs and AMITs operate as genuine flow-through tax vehicles, so that income is taxed in the hands of investors, as if they had invested directly*,' is simply not correct for Australian resident beneficiaries.

In the case of non-resident beneficiaries of MITs and AMITs, the effect of the CGT discount is already reversed in calculating the amount of income to which MIT withholding tax applies. Thus, even under current law a non-resident beneficiary would be subject to withholding tax on its share of the gross $500 income in the example set out above.

Given that Australian resident corporations make up a tiny proportion of the overall investment in MITs and AMITs, it must be wondered whether Australian resident individuals and complying superannuation funds should have to pay an inappropriate amount of tax to address the perceived windfall for Australian resident corporations. It is not clear why the Government has avoided specifically targeting Australian resident corporations and instead used the blunt instrument of changing the calculation of net income at the trust level.

Aside from the substance of the proposed change, the application date of the measure is also problematic. The Government has stated that the 'measure will apply to payments made from 1 July 2019.' Just what this means is unclear since:

- beneficiaries of AMITs are subject to tax on an attribution basis, which is unrelated to whether there are any payments made by the AMIT; and
- beneficiaries of MITs are subject to tax on their share of the net income of the trust for the year as a whole, regardless of when distributions are made. It is not clear how the Government considers

that resident beneficiaries of MITs will be taxed for the year ending 30 June 2019 where some distributions are made before and some after 30 June 2019.

It is to be hoped that, at a minimum, the proposed measure will not apply to payments that relate to an income year that commences before 1 July 2019.

2.2 Expanded list of countries for reduced MIT withholding tax

A concessional rate of withholding tax (15%), currently applies to 'fund payment amounts' made to unitholders in a MIT that are resident in an 'information exchange country' listed in the regulations. There are currently 60 countries on this list but it has not been updated since 2012.

The Government announced that it will update the list of countries to include 56 additional jurisdictions that have entered into information sharing agreements since 2012. This updated list will be effective from 1 January 2019.

The announcement does not include the list of countries and it is not entirely clear what criterion the Government is using to identify the selected countries:

- if the requirement is that the other country *automatically* exchanges information with Australia, then it should extend to countries with which Australia has a comprehensive bilateral income tax treaty plus other countries which have signed the multilateral *Convention on Mutual Administrative Assistance in Tax Matters*, and in either case have signed the multilateral Competent Authority Agreement or a bilateral Competent Authority Agreement for Automatic Exchange of Information);
- if the requirement is the other country only exchanges information *on request* (which seems currently to be the case) then this would include any countries with which Australia has a comprehensive tax treaty or a Taxation Information Exchange Agreement, or that have signed the multilateral *Convention* but only exchange information on request.

Whatever the answer to that question, it is worth noting that Luxembourg will now be added to the list and Hong Kong remains a notable omission from the list.

2.3 Stapled structures

The Budget repeats the media release by the Treasurer on 27 March 2018 that the Government will introduce a package of measures to address the perceived integrity risks posed by 'stapled structures.' Broadly speaking, the following measures are being proposed:

- applying a 30% MIT withholding tax rate to distributions derived from trading income that has been converted to passive income (usually rent) using a MIT. Certain exemptions will apply for nationally significant infrastructure projects and for third party rents;
- thin capitalisation amendments to prevent double gearing structures. This will be achieved by lowering the associate entity threshold from 50% to 10%;
- limiting the foreign pension fund and sovereign immunity exemptions from withholding tax to portfolio investments only (that is, interests in the entity of less than 10%); and
- preventing agricultural MITs from accessing the 15% concessional MIT rate.

The thin capitalisation changes will apply from 1 July 2018. All other changes will apply from 1 July 2019 with a transitional period of at least seven years.

Our Tax Brief available **here** provides further details regarding these measures.

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3. Small business measures

3.1 Extending the $20,000 instant asset write-off for small business

In the 2015-16 Budget the Government introduced a small business depreciation concession for assets costing less than $20,000. The measure was due to expire on 30 June 2017 but was extended in last year's Budget to expire on 30 June 2018. This year's Budget announces that it will be extended again to expire in 30 June 2019 at a cost to revenue of $550m. Small businesses with aggregated annual turnover of less than $10m can immediately deduct the cost of assets costing less than $20,000 which are first used or installed ready for use by 30 June 2019. From 1 July 2019, the immediate deductibility threshold will revert to $1,000.

Assets costing more than $20,000 can be put into a pool and depreciated at 15% in the year first included and 30% in subsequent years. If the pool balance falls below $20,000 before 30 June 2019, the balance can be immediately deducted. From 1 July 2019, the pool balance threshold will revert to $1,000.

The rules which prevent small businesses from re-entering the simplified depreciation regime for five years if they opt out will continue to be suspended until 30 June 2019.

3.2 Amendments to Division 7A – unpaid trust entitlements

It has long been the view of the ATO that an amount to which a company that is a beneficiary of a trust is presently entitled, but which has not been paid to the company (an unpaid present entitlement or '**UPE**') should attract the application of Division 7A. The theory is that the amount represents a loan by a private company to the trustee of the trust (usually, an associate of a shareholder of the company) but a loan which is typically not appropriately documented and so not immune from challenge under Div 7A.

While the Commissioner had applied concessional treatment in some circumstances, from 1 July 2019, a new measure will 'clarify' that a UPE to a company beneficiary will be treated as a dividend under Div 7A unless a complying loan agreement has been entered into.

3.3 Delayed Div 7A amendments

In addition, the Government announced a deferred start date of 1 July 2019 for compliance-focused amendments to Div 7A that were announced in the 2016-17 Budget. Some of the main elements of the proposal include:

- a mechanism to amend without penalty arrangements which 'inadvertently' trigger the application of Div 7A;
- amended documentation requirements for Div 7A loans; and
- new safe harbour rules aimed at preventing the application of Div 7A in circumstances where an asset is provided for use by a company to a shareholder or associate.

A single package which combines all the Div 7A amendments will be enacted.

3.4 Removing small business CGT concession for partnership assignments

Partners who alienate their income by creating, assigning or otherwise dealing in rights to the future income of a partnership (including so-called *Everett* assignments) will no longer be able to access the small business capital gains tax concessions in relation to these transactions.

The Government has become convinced that some taxpayers, including large partnerships, are able to access these concessions inappropriately in relation to the assignment to an entity of a right to the future income of a partnership, without giving that entity any role in the partnership.

In recent times the ATO has withdrawn its guidelines in relation to income splitting in professional firms (including *Everett* assignments) due to concerns regarding 'high risk' arrangements. The ATO is still formulating revised guidelines.

4. Personal income tax measures

4.1 Staggered reductions to personal income tax rates

The centrepiece of the Budget, so far as the Government is concerned, is the personal income tax cuts. While there is a modest tax cut scheduled to start on 1 July 2018, the most significant cuts are staggered over the period until 2024 – that is, after both the 2019 election and the election after that! The Treasurer promised that these measures would be legislated immediately (one can hear the faint echo of Paul Keating prior to the 1993 election declaring that his tax cuts were 'L-A-W'), but clearly these measures are subject to the vicissitudes of the election cycle.

The new rates and thresholds would be:

	Current rates 2017-18	**Stage 1 2018-19 to 2021-22**	**Stage 2 2022-23 to 2023-24**	**Stage 3 2024-25**
Tax-free amount	$18,200	$18,200	$18,200	$18,200
First rate, income between	19% $18,201 to $37,000	19% $18,201 to $37,000	19% $18,201 to $41,000	19% $18,201 to $41,000
Second rate, income between	32.5% $37,001 to $87,000	32.5% $37,001 to $90,000	32.5% $41,001 to $120,000	32.5% $41,001 to $200,000
Third rate, income between	37% $87,001 to $180,000	37% $90,001 to $180,000	37% $120,001 to $180,000	45% $200,001 and above
Fourth rate, income between	45% $180,001 and above	45% $180,001 and above	45% $180,001 and above	

These tax cuts come at a cost of over $13bn over the four year forward estimates.

Increased Medicare levy threshold. The Budget repeats the Government's decision to increase the various Medicare levy thresholds for the 2017-18 income year.

Extra ATO funding. The Budget also announces that the Government will give the ATO an extra $130m 'to increase compliance activities' focussed on individuals. The ATO is clearly concerned about the increasing cost of employee deductions and appears to have formed the view that tax agents are not an effective bulwark against incorrect claims. Part of the money will be devoted to continuing some of the ATO's income matching programs and other measures such as '*improving real time messaging to tax agents and individual taxpayers to deter over-claiming of entitlements …*'

The Budget estimates that for an outlay of $130m, the ATO will generate additional revenue of $1.1 billion.

4.2 Increase to the LITO

The Government's decision that the Budget would offer tax cuts to low income earners was leaked some time ago; over the weekend, it was revealed the mechanism for doing this would involve something similar to the Low Income Tax Offset ('**LITO**').

The Government has decided to supplement the LITO with another tax offset, the 'Low and Middle Income Tax Offset' ('**L&MITO**'), which will operate for four years, from 2018-19 to 2021-22.

LITO. The current LITO is valued at $445. It is payable in full until the taxpayer's taxable income reaches $37,000 at which point it is withdrawn at the rate of 1.5c for every extra dollar of taxable income and ceases entirely by $66,667.

From 1 July 2022, the government is proposing:

- taxpayers with taxable income up to $37,000: the LITO would increase to $645;
- taxpayers with taxable income between $37,001 and $41,000: the $645 tax offset is withdrawn at the rate of 6.5c for every extra dollar of taxable income;
- taxpayers with taxable income above $41,000: the tax offset is withdrawn at the slower rate of 1.5c for every extra dollar of taxable income and ceases entirely by $66,667.

L&MITO. This tax offset works in these stages:

- taxpayers with taxable income up to $37,000: they will receive an additional tax offset of $200;
- taxpayers with taxable income above $37,000 but less than $48,000: the $200 tax offset will *increase* at the rate of 3c per dollar of extra taxable income up to a maximum of $530. (Presumably this counters the *reduction* to the LITO occurring over part of this income range);
- taxpayers with taxable income between $48,001 and $90,000: these taxpayers will receive the maximum tax offset of $530;
- taxpayers with taxable income above $90,000: the $530 tax offset is withdrawn at the rate of 1.5c for every extra dollar of taxable income and ceases entirely by $125,333.

From the Government's point of view, there would seem to be several benefits from delivering the tax cut in this way: unlike an increase to the tax-free threshold or a reduction in the bottom rates, the benefit is delivered only to people whose taxable income is low, it does not affect PAYG collections, it can only be accessed by people who go to the trouble of filing an income tax return, and there is a lot of wastage (the LITO is not refundable, can't be transferred and can't be carried forward, and one assumes the L&MITO will follow the same pattern).

On the other hand, a tax cut delivered by the LITO and L&MITO is all but invisible to most voters. No-one will see the impact of this tax cut in their pay slip once it begins.

4.3 Increase to Medicare levy cancelled

The biggest single revenue-raising measure in the 2017-18 Budget was the announcement of an increase to the rate of the Medicare levy from 2% to 2.5% from 1 July 2019, a measure which was expected to raise more than $8bn over the forward estimates. And in a break from Treasury tradition, this revenue was actually to be ear-marked to fund the National Disability Insurance Scheme with the Government promising to credit the funds 'to the NDIS Savings Fund Special Account when it is established.'

The Labor party supported the increase to the Medicare levy rate but only for individuals with taxable income above $87,000. The Government was unwilling to compromise and so the package of 11 Bills has been stalled in the Senate for the last 6 months.

It was not surprising when the Treasurer announced in late April that this measure would be scrapped. Not only was the proposal unachievable in the current political climate, it would undermine the Government's preferred message – people should focus on the personal income tax cuts being offered in the Budget, not the tax increase planned for 2019.

5. Superannuation

The Budget announces that the Government will:

- ban exit fees, cap fees for low balance accounts under $6,000, require low balance inactive accounts to be transferred to the ATO and make insurance optional for low balance accounts, inactive accounts and accounts for members aged under 25 years (members will have to 'opt-in' to any insurance component);
- allow new retirees aged 65 to 74 with less than $300,000 in superannuation to make voluntary contributions in the year after they fail the 40 hours in 30 days 'work test';
- require superannuation funds to formulate and offer a comprehensive income in retirement product for members and provide favourable Age Pension means testing for pooled lifetime income stream products;
- allow high paid employees with more than one job that causes mandated contributions to exceed the $25,000 concessional contributions cap to partly opt out of superannuation guarantee;
- adopt compliance procedures to reduce the incidence of employees claiming tax deductions for personal contributions where they have not advised the fund by submitting a valid and acknowledged 'notice of deduction' form (so that the fund is unaware that it has to pay 15% tax on the contribution); and
- increase supervisory levies to pay for increased ATO compliance.

6. Indirect taxes

6.1 Online hotel accommodation providers

Offshore sellers of hotel accommodation such as Wotif, Expedia and Bookings.com that provide Australian hotel accommodation will be required to calculate their GST turnover in the same way as local accommodation providers from 1 July 2019.

As a result, online providers that make sales of hotel accommodation in Australia of over $75,000 per annum will be required to register for GST and charge GST on the sales, capturing GST on their mark-up on the accommodation. The additional GST should only be on the margin as they will also be entitled to claim input tax credits on GST incurred on their acquisitions.

This measure comes after extensive ATO audit activity in the sector which recognised the 'uneven playing field' and also aligns with the move to tax digital supplies from offshore.

The Government estimates that this will raise $15m over the forward estimates period. It will only apply to sales made after 1 July 2019 and so should exclude a hotel stay after 1 July 2019 that was paid for prior to that date. Initially this cost falls on the offshore sellers but will likely be passed on to consumers or back to hotel operators.

6.2 Other online accommodation providers

In addition, the Government has noted a recommendation in the *Black Economy Taskforce Final Report* which suggested it examine how GST should apply to accommodation provided through Airbnb

and similar platforms. The Government response was merely to note that such providers may need to account for GST on those sales where they reach the turnover of $75,000 per annum.

6.3 GST and ABN aspects of phoenix activity

The Government has announced measures directed to combating illegal phoenix activity including extending the Director Penalty Regime to GST, luxury car tax and wine equalisation tax. This measure will make directors personally liable for the company's debts for these taxes.

The Director Penalty Regime currently makes directors personally responsible for PAYG and superannuation guarantee charge, which only has an impact on companies with employees. Extending this regime to GST will affect thousands more companies, and thus many thousand more directors than the current regime. The Australian Institute of Company Directors raised multiple concerns in its response to the Treasury Consultation, noting 'to impose personal liability for corporate breaches occurring at a time when the new director had no actual or legal ability to influence the conduct of the corporation offends a fundamental tenet of the rule of law.'

No details of how these measures will apply has yet been provided but presumably all company directors will now take a keener interest in the GST compliance of all entities for which they have a fiduciary responsibility. This regime will put pressure on in-house tax teams to reassure the Boards of every company in the group that GST has been correctly paid.

The Government also indicates its intention to overhaul the ABN system (including possible renewal of ABNs), a review of the business register and verifying ABNs in electronic payment processing.

7. Tax administration – the Black Economy

The final report of the *Black Economy Taskforce* and the Government's response to 'tackle the black economy' were released together with the Budget papers. The *Black Economy Package* in the Budget contains a number of announcements, mainly directed at tax administration and compliance to assist in revenue recovery, and which follow on from the *Tax Integrity Package* in last year's Budget. The *Black Economy Package* includes the following measures.

7.1 Taxable payments reporting system

The taxable payments reporting system ('**TPRS**') is a transparency measure that requires businesses to report to the ATO all payments they make to certain contractors. From 1 July 2019, the TPRS will be further extended to cover the following industries:

- security providers and investigation services;
- road freight transport; and
- computer system design and related services.

7.2 Cash payment limit

In order to tackle tax evasion and money laundering, a limit of $10,000 for cash payments made to businesses for supplies of goods and services will be introduced from 1 July 2019. An electronic payment method or cheque will be required instead.

Carve outs from this measure are anticipated for consumer to consumer (non-business) transactions, and for transactions with financial institutions (which would still be subject to existing anti-money laundering and counter-terrorism financing reporting requirements).

7.3 Removal of tax deductibility for non-compliant payments

A business that has not withheld PAYG from a payment of employee remuneration, or to a contractor that has not quoted an ABN when required, will not be entitled to claim an income tax deduction for the payment. This measure will apply from 1 July 2019.

This appears intended as a financial deterrent in addition to the existing regime, that already imposes an administrative penalty for failure to withhold when required under the PAYG system. However, as acknowledged by the *Black Economy Taskforce Report*, it requires the non-withholding to be detected, and also for phoenix type activity to be thwarted in order to recover tax shortfalls.

7.4 Government enforcement

Additional funding of approximately $300m over four years will be provided to the ATO 'to implement new strategies to combat the black economy' and 'to support the new multi-agency Black Economy Standing Taskforce', in order to ensure a more coordinated approach to combatting the black economy. This will include increased ATO audit activity, use of improved data analytics and information sharing between Government agencies.

A significant return is forecast to be delivered from this new funding (a gain to revenue of $3bn, and to cash receipts of $2.5bn, over the four year forward estimate period).

7.5 Further action to combat phoenix companies

In December 2015, the Productivity Commission released the *Final Report* from its inquiry into *Business Set-up, Transfer and Closure*.

The first measure announced following the *Report* was the proposed introduction of Director Identification Numbers. This was the subject of a Press Release from the Minister for Revenue and Financial Services on 12 September 2017. In that Press Release, the Minister also referred to 11 other measures to 'deter and disrupt the core behaviours of phoenix operators, including non-directors such as facilitators and advisors' upon which consultation would be sought.

The Budget announcement seeks to implement 6 of those measures (albeit with tweaks). Measures specifically referred to in the Budget Papers are:

1 the introduction of new phoenix offences to target those who conduct or facilitate illegal phoenix activity;

2 prohibiting entities related to the phoenix operator from appointing a liquidator – the Budget announcement differs in that related creditors will be restricted in their ability to vote on the appointment, removal or replacement of an external administrator;

3 preventing directors from backdating their resignations to avoid liability or prosecution;

4 limiting the ability of directors from resigning and leaving a company with no directors; and

5 expanding the ATO's power to retain tax refunds where there are outstanding tax lodgements.

There is still some unfinished business from the 12 September 2017 Press Release and we wait to learn the fate of the remaining measures:

1 the establishment of a dedicated phoenix hotline – the Government refers to a 'new hotline' to report illegal activity in the black economy in its response to the *Black Economy Taskforce Final Report* (both the *Report* and the response were released along with the Budget papers);

2 the extension of the promoter penalty regime to capture advisers who assist phoenix operators – the Government agreed with this measure in principle, and refers to implementing 'a comprehensive package of reforms which focus on deterring, disrupting and penalising those who

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engage in illegal phoenixing activity.' This is likely to be part of the new phoenix offences to be introduced as noted above;

3 stronger powers for the ATO to recover security deposits from suspected phoenix operators – perhaps the GST withholding regime on property developers is seen as a 'toe in the water' for this measure;

4 a 'next-cab-off-the-rank' system for appointing liquidators; and

5 allowing the ATO to commence immediate recovery action following the issuance of a Director Penalty Notice.

8. Other measures

TOFA. The Budget confirms the Government's decision, announced in December last year, to defer the start date of measure arising from the project to reform various aspects of the TOFA regime. The project will apparently try to improve the design and functioning of the basic accruals and realisation system, the forex regime in TOFA and the hedging regime in TOFA.

R&D. The Government is trying yet another design for the R&D tax incentive 'to better target the program and improve its integrity and fiscal affordability.' The proposed changes will implement recommendations made in the 2016 *Review of the R&D Tax Incentive*. The changes will apply for income years starting on or after 1 July 2018.

Treatment of concessional loans in entities that become taxable. When a tax exempt entity becomes a taxable entity (eg, a privatisation occurs), the rules in Division 57 operate to deem liabilities held by the entity to have been assumed for a payment equal to the 'adjusted market value' of the corresponding asset in the hands of the person to whom the liability was owed. In the case of a concessional loan, this would likely lead to a market value below the face value of the loan. When the loan is repaid, Division 230 treats the difference between the face value repaid and the market value at the time the entity became taxable as a loss and therefore the entity obtains a deduction for a portion of the principal.

For entities that become taxable after 8 May 2018, a tax deduction will not be allowed for that principal amount by requiring the liability to be valued as if it were on commercial terms.

Revolving trust distributions. The Budget announces that the Government will apply 'a specific anti-avoidance rule that applies to … closely held trusts that engage in circular trust distributions' to family trusts. Just which particular provision the drafters have in mind is not spelt out but the most likely candidate is Div 6D ITAA 1936 – a regime which requires the disclosure of the ultimate beneficiaries of a trust which has as one of its beneficiaries the trustee of another trust. The measure does not start until 1 July 2019 so there is clearly no great urgency to the measure.

Income of minors from testamentary trusts. The Government has announced it will change the taxation of the unearned income of minors received from testamentary trusts. Income from testamentary trusts is currently subject to tax at ordinary rates; that is, the income is not subject to the punitive rates that apply to other types of unearned income of minors. From 1 July 2019, marginal rates will only apply to 'income … from assets that are transferred from the deceased estate or the proceeds of the disposal or investment of those assets …'

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G&HSF document ID 510965425

These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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