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Tax Laws Amendment (2010 Measures No. 3) Bill 2010

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Law and Bills Digest Section

Note: This Digest is an historical Digest, published after the Bill was read a third time in the Senate. The Bill, as passed by both Houses, contained 20 Government amendments (all relating to managed investment trusts).

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Tax Laws Amendment (2010 Measures No. 3) Bill 2010

Date introduced: 26 May 2010

House: House of Representatives

Portfolio: Treasury

Commencement: The formal provisions commence on Royal Assent (being 29 June 2010), as do **Schedules 2 to 5**. **Schedule 1** commences on 1 July 2010.

Links: The links to the Bill, its Explanatory Memorandum and second reading speech can be found on the Bills page, which is at http://www.aph.gov.au/bills/. When Bills have been passed they can be found at ComLaw, which is at http://www.comlaw.gov.au/.

Purpose

The Bill amends a number of taxation and superannuation laws for a variety of reasons.

Schedule 1 amends the *Superannuation (Government Co-contribution for Low Income Earners) Act 2003* (the *Co-contribution Act*) to maintain the Government's superannuation co-contribution matching rate at 100 per cent (up to a maximum rate of $1000). It also freezes the indexation of the co-contribution income thresholds for the 2010–11 and 2011–12 income years.

Schedule 2 amends the thin capitalisation rules in the *Income Tax Assessment Act 1997* (ITAA 1997) for approved authorised deposit-taking institutions (ADIs).[1]

Schedule 3 amends the *Taxation Administration Act 1953* (TAA 1953) to give the respective Directors-General of the Australian Security Intelligence Organisation (ASIO) and the Australian Secret Intelligence Service (ASIS) a discretionary power to declare that certain transactions involving these security agencies are exempt from the application of Commonwealth taxation laws.

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1. The thin capitalisation rules are set out in Division 820 of the ITAA 1997. They apply to Australian entities with specified overseas investments ('outwards investing entities') and to foreign entities with certain investments in Australia, regardless of whether they hold the investments directly or through Australian entities ('inward investing entities'). Specific provisions apply to authorised deposit-taking institutions (ADIs). For further details, see the discussion of **Schedule 2** in the 'Background and main provisions' section of this Digest, particularly footnote 26. See also Australian Taxation Office (ATO), 'Thin capitalisation—what you need to know', ATO website, 6 November 2009, viewed 6 August 2010, http://www.ato.gov.au/print.asp?doc=/content/19566.htm

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Schedule 4 amends the *Income Tax Assessment Act 1936* (ITAA 1936) and the ITAA 1997 to provide that unexpended income of a 'special disability trust' is taxed at a certain rate.[2]

Schedule 5 amends the definition of the term '*managed investment trust*' in the TAA 1953 and the ITAA 1997 for withholding tax purposes.

Committee consideration

On 13 May 2010, the Senate resolved to refer the provisions of 'time-critical Bills' to various legislative and general purpose standing committees for inquiry and report by 15 June 2010.[3] On 1 June 2010, the Senate Economics Legislation Committee reported that there are no substantive matters that require examination in the current Bill.[4]

Financial implications

According to the Explanatory Memorandum, the Bill has the following financial impact:

- **Schedule 1**: an expected fiscal saving of $645 million over the forward estimates period
- **Schedule 2**: unquantifiable impact
- **Schedule 3**: unquantifiable but low revenue impact
- **Schedule 4**: cost to Government of $1 million per year from 2009–10 to 2012–13 (inclusive), and

2. A '*special disability trust*' is a trust 'established solely for succession planning by parents and immediate family members for the future care and accommodation needs of a person with a severe disability'. See Centrelink, '*Special disability trusts: What is a special disability trust?*', March 2010, viewed 6 August 2010, http://www.centrelink.gov.au/internet/internet.nsf/publications/fis034.htm For further details, see the discussion of **Schedule 4** in the 'Background and main provisions' section of this Digest.

3. Here the phrase '*time-critical Bills*' refers to all Bills introduced into the House of Representatives after 13 May 2010 and before 3 June 2010 that contain provisions commencing on or before 1 July 2010. See Senator P Wong, 'References to committees', Senate, *Debates*, 13 May 2010, p. 2839, viewed 6 August 2010, http://www.aph.gov.au/hansard/senate/dailys/ds130510.pdf

4. Senate Economics Legislation Committee, 'Consideration of time critical Bills', *Report*, 1 June 2010, viewed 6 August 2010, http://www.aph.gov.au/Senate/committee/economics_ctte/timecritical_bills/report/report.pdf

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- **Schedule 5**: unquantifiable revenue implications from the 2010–11 income year.[5]

Background and main provisions

As the Bill deals with five discrete issues, this Digest will deal with the background to, and main provisions of, each Schedule in turn.

Schedule 1—Government co-contribution for low income earners

Schedule 1 maintains the Government's current superannuation co-contribution matching rate at 100 per cent (up to a maximum rate of $1000), and also freezes the indexation of the co-contribution income thresholds for the 2010–11 and 2011–12 income years. The amendments are expected to save the Government a total of $350 million in the 2012–13 and 2013–14 income years.[6]

In short, the amendments do not change the matching rate for the 2010–11 or 2011–12 income years, but they repeal existing paragraphs 9(1)(d) and (e) of the *Co-contribution Act*, which set the matching rate at 125 per cent of the sum of a person's eligible personal superannuation contributions for the 2012–13 and 2013–14 income years, and 150 per cent for the 2014–15 and later income years.[7]

Item 2 amends section 10 of the *Co-contribution Act* to set the maximum government co-contribution at $1000 per eligible person for the 2009–10 and later income years. The amendments do not change the amount for the 2009–10, 2010–11 and 2011–12 income years. However, the amendments do reduce the amount that had been legislated for the 2012–13, 2013–14, 2014–15 and later income years. Under existing subsections 10(1C) and 10(1D), which are to be repealed by **item 2** of **Schedule 1** to the Bill, the maximum amount was to have been $1250 (for 2012–13 or 2013–14) or $1500 (for 2014–15 or later income years).

Items 4–6 amend existing section 10A of the *Co-contribution Act*, which provides for indexation of the lower income threshold for the 2007–08 and later income years, and increases the higher income threshold for the 2007–08 and later income years equal to the

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5. Explanatory Memorandum, Tax Laws Amendment (2010 Measures No. 3) Bill 2010, pp. 3–6.

6. Australian Government, *Budget measures: budget paper no. 2: 2010–11*, Commonwealth of Australia, Canberra, May 2010, p. 298, viewed 6 August 2010, http://www.budget.gov.au/2010-11/content/bp2/download/bp2_v2.pdf. Note, however, that according to the Explanatory Memorandum for the Bill, the expected savings are $645 million over the forward estimates period (which covers the period 2010–11 to 2013–14).

7. **Item 1** of **Schedule 1** to the Bill amends section 9 of the Co-contribution Act.

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indexation increase in the lower income threshold for the relevant income year.[8] The amendments exclude the 2010–11 and 2011–12 income years from the indexation. Instead the amendments set the indexation factor for these years at '1'. This amendment effectively freezes indexation of the co-contribution thresholds for the 2010–11 and 2011–12 income years at the 2009–10 income thresholds. The lower income threshold for 2009–10 is $31 920 and the higher income threshold is $61 920.[9]

The amendments in **items 4 and 5** seem unnecessary—given that **item 6** then sets the indexation factor for the 2010–11 and 2011–12 years.

The amendments were announced on 11 May 2010.[10] They apply to the 2009–10 and later income years.[11]

Schedule 2—Thin capitalisation

Schedule 2 amends the thin capitalisation rules for approved authorised deposit-taking institutions (ADIs) in the ITAA 1997. The term '*thin capitalisation*' is not defined in the ITAA 1997 but refers to the situation where an entity's assets are funded by a high level of debt rather than equity.

The thin capitalisation rules are set out in Division 820 of the ITAA 1997. They apply to Australian entities with specified overseas investments (known as 'outwards investing entities') and to foreign entities with certain investments in Australia, regardless of whether they hold the investments directly or through Australian entities (known as 'inward investing entities'). Specifically, the thin capitalisation rules in the ITAA 1997 limit the amount of debt used to fund the Australian operations of foreign entities that invest in Australia and Australian entities that invest overseas. They apply when the entity's debt-to-equity funding ratio exceeds certain limits.[12] They disallow a tax deduction for a portion of specified expenses that an entity incurs in relation to its debt finance (including interest payments or loan fees). Without the thin capitalisation rules,

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8. Currently, the lower income threshold is indexed to average weekly ordinary time earnings.

9. Explanatory Memorandum, op. cit., p. 7 and ATO, 'Super co-contribution income thresholds', ATO website, 7 June 2010, viewed 6 August 2010, http://www.ato.gov.au/individuals/content.asp?doc=/content/42616.htm&page=3&H3=&pc=001/002/064/002/003&mnu=38119&mfp=001&st=&cy=1

10. Australian Government, *Budget measures: budget paper no. 2: 2010–11*, op. cit., pp. 298–299.

11. **Item 7** of **Schedule 1** to the Bill.

12. Ordinarily, an entity cannot claim a portion of its debt deductions if its debt exceeds 75 per cent of the net value of its Australian investments—however, the threshold is higher for certain financial entities.

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such entities could inappropriately reduce their Australian profits and tax.[13] The rules were designed to ensure that Australian and foreign-owned multinational entities 'do not allocate an excessive amount of debt to their Australian operations'.[14] However, the rules do not apply if the entity's debt deductions (including those of any associated entity) are $250 000 or less for the relevant income year.

The amendments in **Schedule 2** clarify how certain assets and expenses (namely 'treasury shares';[15] an insurance/business asset previously known as 'excess market value over net assets' (or 'EMVONA');[16] and capitalised software costs) are to be recognised under the thin capitalisation provisions of the ITAA 1997. The amendments reflect the change in the accounting treatment of certain assets held by ADIs as a result of the transition from the *Australian Generally Accepted Accounting Principles* (which were used in Australia

13. Explanatory Memorandum, op. cit., p. 14.

14. Australian Government, *Budget measures: budget paper no. 2: 2009–10*, Commonwealth of Australia, Canberra, May 2009, p. 22, viewed 6 August 2010, http://www.budget.gov.au/2009-10/content/bp2/download/bp2_Consolidated.pdf

15. A 'treasury share' is an equity instrument that an entity acquires in itself: see AASB 132 Financial Instruments Presentation at http://www.aasb.com.au/admin/file/content105/c9/AASB132_07-04_COMPoct09_02-10.pdf (viewed 6 August 2010). An entity must disclose the amount of treasury shares it holds in its balance sheet or accompanying notes: see AASB 101 Presentation of Financial Statements at http://www.aasb.com.au/admin/file/content105/c9/AASB101_09-07_COMPjun09_01-10.pdf (viewed 6 August 2010). The *Corporations Act 2001* (Corporations Act) prohibits a company from acquiring shares (or units of shares) in itself (that is, 'treasury shares') except in limited circumstances: see Part 2J.2 of the Corporations Act, which deals with self-acquisition and control of shares. For example, an entity may hold parent company shares as part of a consolidated group's employee share plan arrangements.

16. Before the adoption of the *Australian equivalents to the International Financial Reporting Standards* (IFRS) in 2005, *AASB 1038 Life Insurance Business* required all assets of a life company to be recognised at market value, with movements in market value to be recognised in profit and loss. Any 'excess of the market value of a life company's investment in a life company subsidiary over the identifiable net assets of that subsidiary was to be recognised as a separate asset and profit and loss item in the consolidated financial statements of the parent life company, as well as in the consolidated accounts of any ultimate parent company'. However, since the beginning of 2005, recognition of EMVONA has been prohibited by the Australian equivalents to the IFRS. Now, consolidated groups that have recognised EMVONA are required 'to write it off against retained earnings to the extent it represents internally generated intangible assets'. See Australian Prudential Regulation Authority (APRA), *Adoption of International Financial Reporting Standards: prudential implications*, Overview paper, 3 November 2004, viewed 6 August 2010, http://www.apra.gov.au/adi/upload/adoption-of-international-financial-reporting-standards-prudential-implications-overview-paper.pdf

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until 2005) and the adoption of the *Australian equivalents to the International Financial Reporting Standards* (IFRS) in January 2005.[17]

Although the thin capitalisation rules in the ITAA 1997 use accounting standards as the basis for identifying and valuing assets, Australian income tax law has generally evolved 'relatively independently from Australian accounting standards'.[18] However, the ATO notes that 'in recent years there has been a convergence of accounting standards and income tax law, particularly in relation to consolidation'.[19] Accordingly, in the interests of certainty, the thin capitalisation rules in the ITAA 1997 require revision so that they accord with the Australian equivalents to the IFRS.

Transition from the previous accounting standards to the Australian equivalents to the International Financial Reporting Standards (IFRS)

As part of the adoption of the Australian equivalents to the IFRS in 2005, transitional provisions were set out in section 820–45 of the *Income Tax (Transitional Provisions) Act 1997* in order to 'insulate affected entities, including ADIs, from potential adverse impacts on their capitalisation position' from the adoption of the Australian equivalents.[20] Entities could elect to apply the accounting standards as they existed immediately before 1 January 2005 instead of the Australian equivalents 'for a period of four income years from the first income year commencing on or after 1 January 2005'.[21] If an entity elected to use the earlier accounting standards, then it was also required to use the prudential standards in force under the *Banking Act 1959* immediately before 1 January 2005 for calculating amounts applicable to the ADI under Division 820.[22] The transitional provisions began expiring from 1 January 2009 (which is also the date from when the amendments in **Schedule 2** apply).

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17. Explanatory Memorandum, op. cit., p. 3. In this regard, it is noted that on 3 July 2002, the Financial Reporting Council (FRC) announced that Australia would formally adopt the International Financial Reporting Standards (IFRS) for reporting periods commencing on or after 1 January 2005. On 15 July 2004, the Australian Accounting Standards Board (AASB) issued 40 new or revised standards to harmonise Australian standards with the IFRS. Since 1 January 2005, all Australian entities that are required to prepare financial reports under the Corporations Act have been required to comply with the Australian equivalents. See Australian Taxation Office (ATO), 'International Financial Reporting Standards: overview', ATO website, 21 March 2006, viewed 6 August 2010, http://www.ato.gov.au/businesses/content.asp?doc=/content/00187382.htm

18. Ibid.

19. Ibid.

20. Explanatory Memorandum, op. cit., p. 14.

21. Ibid.

22. Ibid.

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As a result of the amendments in **item 1** of **Schedule 2**, certain treasury shares will be included in an entity's 'adjusted average equity capital'.[23] These treasury shares are 'both shares held by a group member to support liabilities to third parties (that is, policy holders) and shares that offset the accrued expense of a share-based compensation scheme'.[24] **Item 1** of **Schedule 2** is intended to retain the pre-2005 treatment of a direct investment in a particular bank's shares by that company's life insurance subsidiary.[25] Currently, where the transitional provisions no longer apply, treasury shares are deducted from equity capital under the Australian equivalents to the IFRS (with the result that the value of the treasury shares is not included in the calculation of the entity's adjusted average equity capital). However, where the transitional provisions still apply, treasury shares are included in the calculation of the entity's adjusted average equity capital.

As a result of the amendments in **items 2–6** of **Schedule 2**, the '*safe harbour capital amount*' is adjusted to exclude the 'value of business in force' (or VBIF) component of the EMVONA asset.[26] However, the 'value of business in force' component is only excluded

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23. '*Adjusted average equity capital*' is the 'average value of an outward investor ADI's equity capital, other than ADI equity capital attributable to its overseas permanent establishments, less the average value of the controlled foreign entity equity other than controlled foreign entity equity attributable to overseas permanent establishments'. See ATO, 'Guide to thin capitalisation—Glossary', ATO website, viewed 6 August 2010, http://www.ato.gov.au/corporate/content.asp?doc=/content/22584.htm&page=2&H2

24. Explanatory Memorandum, op. cit. p. 17.

25. Ibid.

26. The term '*safe harbour capital amount*' is defined in section 995–1 of the ITAA 1997 by reference to section as 820–310 (for an outward investing entity (ADI)) and by reference to sections 820–405 or 820–615 (for an inward investing entity (ADI)). It is 'one of the capital amounts that can be used by an ADI as the minimum capital amount' and is 'based on the value of risk-weighted assets attributable to Australian operations'. See ATO, 'Guide to thin capitalisation—Glossary', op. cit. See also section 820–310 of the ITAA 1997 (which sets out how 'outward investing entities (ADIs)' should calculate any safe harbour capital amount) and section 820–405 (which sets out how 'outward investing entities (ADIs)' should calculate the amount). In this regard, it is important to note that the Bill does not amend section 820–405. The amendments will only apply to 'outward investing entities (ADI)'. An '*outward investing entity (ADI)*' is an entity that is (a) an Australian controller of at least one Australian controlled foreign entity (not necessarily the same Australian controlled foreign entity throughout the relevant period); (b) an Australian entity that carries on a business at or through at least one overseas permanent establishment (not necessarily the same permanent establishment throughout that period), such as a branch; and/or (c) an associate entity of either of the above. (See section 820–300 of the ITAA 1997, which sets out the thin capitalisation rule for outward investing entities (ADI), particularly subsection 820–300(2), which sets out when an entity is an 'outward investing entity (ADI)' for the relevant period.) The amendments will not apply to any entity that is a foreign bank that carries on its banking business in Australia at or through one or more of its Australian

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to the extent to which it is reflected in the goodwill or intangible assets of the ADI group. The safe harbour capital amount is also adjusted to include only 4 per cent of the value of capitalised software costs.[27]

The amendments in **Schedule 2** were announced by the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, Chris Bowen MP, on 12 May 2009.[28] They apply retrospectively to income years commencing on or after 1 January 2009. While it is a long-established presumption at common law that statutes do not operate retrospectively, the High Court of Australia has also long held the view that Parliament has the power to enact legislation that operates retrospectively, particularly where it indicates its intention to do so by using clear and express words.[29] In this case, the issue of retrospectively does not apparently operate to the detriment of people's rights, particularly when it is noted that the commencement date of 1 January 2009 is the date when the transitional provisions (following the 2005 adoption of the Australian equivalents to the IFRS) began expiring.[30]

Schedule 3—Exempting certain transactions involving security agencies

Schedule 3 amends the TAA 1953 to give the respective Directors-General of the Australian Security Intelligence Organisation (ASIO) and the Australian Secret Intelligence Service (ASIS) a discretionary power to declare that certain transactions involving these security agencies are exempt from the application of Commonwealth taxation laws.

Specifically **item 1** of **Schedule 3** inserts **proposed Part 5–100** into Chapter 5 in Schedule 1 to the TAA 1953.[31] Chapter 5 deals with the administration of taxation laws, with **proposed Part 5–100** to deal with miscellaneous matters. Currently, **proposed**

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permanent establishments (that is, any '*inward investing entity (ADI)*', as defined in subsection 820–395(2) of the ITAA 1997).

27. For details of the practical operation of these amendments, see Explanatory Memorandum, op. cit., pp. 17–23.

28. C Bowen MP (then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs), *Government acts to reduce compliance costs and improve the tax law*, media release, No. 48 of 2009, 12 May 2009, viewed 6 August 2010, http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/048.htm&pageID=003&min=ceb&Year=&DocType=0 See also Australian Government, *Budget Measures: Budget Paper No. 2: 2009–10*, op. cit., pp. 22–23.

29. *R v Kidman* (1915) 20 CLR 425.

30. **Item 9** of **Schedule 2** to the Bill.

31. Schedule 1 to the TAA 1953 deals with the collection and recovery of income tax and other liabilities.

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Part 5–100 contains only one Division—**proposed Division 850**, which is titled 'Transactions exempt from application of taxation laws'.

The object of **proposed section 850–100** in Schedule 1 to the TAA 1953 is to 'remove the possibility of a conflict arising between Australia's national security interests and Australia's taxation laws'.[32] **Proposed subsection 850–100(2)** permits the Director-General of ASIO to declare that proposed section 850–100 applies to one or more specified entities (including ASIO itself) in relation to one of more specified transactions. Similarly, **proposed subsection 850–100(3)** permits the Director-General of ASIS to declare that proposed section 850–100 applies to one of more specified entities (including ASIS itself) in relation to one or more specified transactions.

Before a declaration can be made, the relevant Director must be satisfied that the making of the declaration is necessary for the proper performance of the functions of ASIO or ASIS (whichever is the relevant agency).[33] A declaration must be in writing, signed by the relevant Director.[34] The declaration may be made even though it relates to a transaction already entered into or carried out, or relates to an entity that has 'died or ceased to exist'.[35]

Where a declaration is made, the existence or amount of a liability of the entity specified in the declaration relating to taxation under any Commonwealth law is disregarded.[36] Similarly, the existence or amount of any kind of benefit (such as a deduction, credit or offset under the ITAA 1997) relating to taxation under any Commonwealth law is also to be disregarded.[37] Further, the existence or extent of any other obligation or right of the entity relating to a liability or benefit is also to be disregarded.[38] This includes an obligation to withhold money from a payment, and an obligation to become registered under a taxation law.

A declaration under **proposed section 850–100** is not a legislative instrument, and is therefore not subject to parliamentary scrutiny or disallowance under the *Legislative Instruments Act 2003*.[39] However, any such declaration may be reviewed by the

32. **Proposed subsection 850–100(1)** in Schedule 1 to the TAA 1953.
33. **Proposed subsection 850–100(4)** in Schedule 1 to the TAA 1953.
34. **Proposed subsection 850–100(5)** in Schedule 1 to the TAA 1953.
35. **Proposed subsection 850–100(6)** in Schedule 1 to the TAA 1953.
36. **Proposed paragraph 850–100(8)(a)** in Schedule 1 to the TAA 1953.
37. **Proposed paragraph 850–100(8)(b)** in Schedule 1 to the TAA 1953.
38. **Proposed paragraph 850–100(8)(c)** in Schedule 1 to the TAA 1953.
39. **Proposed subsection 850–100(9)** in Schedule 1 to the TAA 1953.

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Inspector-General of Intelligence and Security.[40] It may also be reviewed by the Parliamentary Joint Committee on Intelligence and Security (PJCIS) under section 29 of the *Intelligence Services Act 2001* (the *Intelligence Services Act*).[41]

However, it is not clear how the PJCIS discovers that a declaration has been made—or more importantly, how thoroughly it can perform its review function in relation to any declaration. While section 30 of the *Intelligence Services Act* states that in performing its functions, the PJCIS can request a briefing from the Director-General of one of Australia's six intelligence agencies and the Inspector-General of Intelligence and Security, the committee cannot require anyone briefing the Committee to disclose operationally sensitive information.[42] However, as noted in the Explanatory Memorandum for the Bill, declarations 'will necessarily contain sensitive operational information and personal information'.[43]

The proposed measure was not announced prior to the introduction of the Bill. However, in a statement of reasons for the introduction and passage of the Bill in the 2010 Winter Sittings, the Treasurer explained that the measure 'needs to be implemented expeditiously to avoid compromising authorised operational activities'.[44]

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40. The Inspector-General of Intelligence and Security is an independent statutory office holder 'who reviews the activities of [Australia's] six intelligence agencies'. For further details, see Inspector-General of Intelligence and Security (IGIS), 'Roles and Functions of the Inspector-General', IGIS website, no date, viewed 6 August 2010, http://www.igis.gov.au/about/index.cfm

41. The PJCIS was known as the 'Parliamentary Joint Committee on ASIO, ASIS and DSD' until December 2005. Its functions are set out in section 29 of the *Intelligence Services Act 2001*, including to review the administration and expenditure of ASIO, ASIS and other Australian intelligence organisations (including annual financial statements), and to review any matter in relation to Australia's intelligence community which is referred to it by the responsible Minister (usually the Minister for Defence) or a resolution of either House of the Parliament. It is not authorised to initiate its own inquiries but may request that the Minister refer certain matters to it. Its homepage is available at http://www.aph.gov.au/house/committee/pjcis/index.htm (viewed 6 August 2010). The latest consolidation of the *Intelligence Services Act 2001* is available electronically at http://www.austlii.edu.au/au/legis/cth/consol_act/isa2001216/ (viewed 6 August 2010).

42. See the note to section 30 of the Intelligence Services Act and clause 1 of Schedule 1 to that Act.

43. Explanatory Memorandum, op. cit., p. 30.

44. See 'Statement of reasons for introduction and passage in the 2010 Winter Sittings: Tax Laws Amendment (2010 Measures No. 3) Bill 2010, tabled by Senator Ludwig (Manager of Government Business in the Senate), Senate, *Debates*, 23 June 2010, pp. 4148–4155 at p. 4152, viewed 6 August 2010, http://www.aph.gov.au/hansard/senate/dailys/ds230610.pdf

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Schedule 4—Special disability trusts

Schedule 4 amends the *Income Tax Assessment Act 1936* (ITAA 1936) and the ITAA 1997 to provide that unexpended income of a 'special disability trust' is taxed at the principal beneficiary's personal income tax rate (instead of the top personal tax rate plus the Medicare levy).

As mentioned in footnote 2 of this Digest, a '*special disability trust*' is a trust 'established solely for succession planning by parents and immediate family members for the future care and accommodation needs of a person with a severe disability'.[45] The *Social Security Act 1991* (*Social Security Act*) sets out specific rules for such a trust, as discussed below. They were introduced in September 2006 to assist parents and immediate family members 'wishing to make private financial provision for the current or future accommodation and care of a family member with a severe disability' without reducing the recipient's entitlement to social security and related benefits.[46]

Items 1 and **2** of **Schedule 4** insert the terms '*principal beneficiary* [of a special disability trust]' and '*special disability trust*' into subsection 6(1) of the ITAA 1936. Both terms are defined to have the same meaning as they have in the ITAA 1997. However, those terms are not currently defined in the ITAA 1997. **Item 6** of **Schedule 4** to the Bill inserts the term '*principal beneficiary* [of a special disability trust]' into subsection 995–1(1) of the ITAA 1997 and defines it as having the meaning given by section 1209M of the *Social Security Act*. Section 1209M provides that:

- a special disability trust must have no more than one beneficiary ('the principal beneficiary'), not including any residuary beneficiary
- if the principal beneficiary has reached 16 years of age, the beneficiary must:
  - have an impairment that would qualify the person for disability support pension; be receiving an invalidity service pension under Part III of the *Veterans' Entitlements Act 1986,*[47] or be receiving income support supplement under that Act on the grounds of permanent incapacity, and
  - have a disability that would, if the person had a sole carer, qualify the carer for carer payment or carer allowance; or be living in an institution, hostel or group home in which care is provided for people with disabilities, and for which funding is provided (wholly or partly) under an agreement, between the Commonwealth,

45. Centrelink, 'Special disability trusts: What is a special disability trust?', op. cit.

46. For further explanation, see the Standing Committee on Community Affairs, *Building trust: supporting families through Disability Trusts*, report, October 2008, p. 2, viewed 6 August 2010, http://www.aph.gov.au/senate/committee/clac_ctte/disability_trusts/report/report.pdf

47. Part 3 of the *Veterans' Entitlements Act 1986* deals with service pensions. See http://www.austlii.edu.au/au/legis/cth/consol_act/vea1986261/ (viewed 6 August 2010).

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the States and the Territories, nominated by the Secretary under subsection 1209M(3),[48] and

- have a disability as a result of which he or she is not working, and has no likelihood of working, for a wage that is at or above the relevant minimum wage[49]

- if the principal beneficiary is under 16 years of age, then:
  - the principal beneficiary must be a person 'with a severe disability or a severe medical condition'
  - another person ('the carer') must have been given a qualifying rating of intense under the Disability Care Load Assessment (Child) Determination for caring for the principal beneficiary,[50] and
  - a treating health professional has certified in writing that, because of that disability or condition the principal beneficiary will need personal care for six months or more, and that the personal care is required to be provided by a specified number of persons, and
  - the carer has certified in writing that the principal beneficiary will require the same care, or an increased level of care, to be provided to him or her in the future
- a trust stops being a special disability trust when the principal beneficiary dies, and
- a person can be a particular principal beneficiary for only one special disability trust.

Similarly, **item 7** inserts the term '*special disability trust*' into subsection 995–1(1) of the ITAA 1997 and defines it as having the meaning given by section 1209L of the *Social Security Act*. There it is defined as follows:

> A trust is a *special disability trust* if the following requirements of this Division[51] are complied with:
>
> (a) the beneficiary requirements (see section 1209M);

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48. Subsection 1209M(3) of the *Social Security Act* states that the Secretary 'may, by legislative instrument, nominate an agreement for the purpose of subparagraph (2)(b)(ii)'.

49. See subsection 23(1) of the *Social Security Act*.

50. The current Disability Care Load Assessment (Child) Determination is the 'Disability Care Load Assessment (Child) Determination 2010' (being Legislative Instrument F2010L01874), which is available electronically at http://www.comlaw.gov.au/ComLaw/Legislation/LegislativeInstrument1.nsf/0/5A567D8B113995D4CA25775100822E47?OpenDocument (viewed 6 August 2010). In order to be eligible for the relevant carer payment or allowance, a person needs to receive a rating of 'intense' in accordance with Parts 2 or 3 of the Determination.

51. Part 3.18A of the *Social Security Act* deals with private financial provision for certain people with disabilities. Division 1 of Part 3.18A deals with special disability trusts.

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(b) the trust purpose requirements (see section 1209N);

(c) the trust deed requirements (see section 1209P);

(d) the trustee requirements (see section 1209Q);

(e) the trust property requirements (see section 1209R);

(f) the reporting requirements (see section 1209S);

(g) the audit requirements (see section 1209T).

Note: The Secretary may waive one or more requirements in certain circumstances (see section 1209U).

The amendments apply retrospectively from 1 July 2008.[52] The measure was first announced by Jenny Macklin MP (Minister for Families, Housing, Community Services and Indigenous Affairs and Bill Shorten MP (Parliamentary Secretary for Disabilities and Children's Services) on 12 May 2009 in response to a report by the Senate Standing Committee on Community Affairs following its inquiry into special disability trusts in 2008.[53] On 4 August 2009, the Treasury released a discussion paper on the proposed changes to the taxation of the unexpended income of special disability trusts, and on 16 April 2010, it released draft legislation and explanatory materials.[54] In submissions on both the discussion paper and the draft legislation, stakeholders raised two main concerns:

52. **Item 8** of **Schedule 4** to the Bill. See earlier comments in this Digest about the retrospective operation of legislation.

53. J Macklin MP (Minister for Families, Housing, Community Services and Indigenous Affairs and B Shorten MP (Parliamentary Secretary for Disabilities and Children's Services), *Extra support for people with disability and their carers*, media release, 12 May 2009, viewed 6 August 2010, http://www.jennymacklin.fahcsia.gov.au/mediareleases/2009/Pages/support_disability_carers_12may2009.aspx See also the homepage for the Senate Standing Committee on Community Affairs' Inquiry into Special Disability Trusts at http://www.aph.gov.au/senate/committee/clac_ctte/disability_trusts/index.htm (viewed 6 August 2010).

54. Treasury, *Greater fairness and equity in the taxation of Special Disability Trusts*, discussion paper, 4 August 2009, viewed 6 August 2010, http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1567

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- that the scope of the changes to the concessional treatment of unexpended income were not sufficiently concessional, and special disability trusts should be assessed in accordance with section 99 of the ITAA 1936,[55] and
- that the proposed changes would result in the inclusion of the entire net income of the special disability trust in the beneficiary's taxable income, which could result in a 'tax shortfall'.[56]

However, the Government's response was that while it was aware of these concerns, 'it considers that the proposed changes are fair and reasonable and that the tax treatment afforded to [special disability trusts] should be consistent with tax treatment broadly applying to other beneficiaries of trusts'.[57] Specifically in relation to the inclusion of the entire net income of the special disability trust in the assessable income of the beneficiary, it said:

> In order to implement the recommendation made by the Senate Standing Committee on Community Affairs, that unexpended special disability trust income is taxed at the beneficiary's personal income tax rate, it is necessary to include the entire net income of the SDT in the beneficiary's personal income with a corresponding offset for any tax paid by the trustee.
>
> SDT beneficiaries will be substantially better off overall because of the changes as any increase in tax payable on their personal income will be substantially less than the corresponding decrease in tax payable on that income by the trustee.[58]

Schedule 5—Managed investment trusts

Schedule 5 amends the definition of the term '*managed investment trust*' (MIT) in the TAA 1953 and the ITAA 1997 for withholding tax purposes.[59] The purpose of the amendments is to align the definition more closely with the definition of the same term

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55. Section 99 of the ITAA 1936 provides that certain trust income is to be taxed as income of an individual. See http://www.austlii.edu.au/au/legis/cth/consol_act/itaa1936240/s99.html (viewed 6 August 2010).

56. See the document titled 'Consultation Summary' at Treasury, *Exposure Draft—Changes to the taxation of the unexpended income of Special Disability Trusts*, Treasury website, 16 April 2010, viewed 27 July 2010, http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1786

57. Ibid.

58. Ibid.

59. Particularly, most of **Schedule 5** amends Subdivision 12-H in Schedule 1 to the TAA 1953, which deals with the distributions of managed investment trust income. Subdivision 12-H is found in Division 12, which deals more generally with payments from which amounts must be withheld. (Division 12 is found in Part 2-5 of the TAA 1953, which deals with pay as you go (PAYG) withholding.)

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that is used for capital account treatment purposes.[60] Specifically, as a result of the amendments, the MIT withholding tax rules will apply to wholesale managed investment schemes and government-owned managed investment schemes.[61]

As noted at the commencement of this Digest, **Schedule 5** was the subject of 20 Government amendments before being passed by both Houses.[62] In summary, **Schedule 5**:

- expands the definition of the term '*managed investment trust*' to include wholesale managed investment schemes[63] and government-owned managed investment schemes[64]

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60. See *Tax Laws Amendments (2010 Measures No. 1) Act 2010* (Act No. 56 of 2010) at http://www.austlii.edu.au/au/legis/cth/num_act/tla2010mn1a2010314/ (viewed 6 August 2010), particularly Schedule 3, which inserted *Division 275—Australian managed investment trusts* into Part 3–25 of the ITAA 1997 (which deals with particular kinds of trusts). MITs can now make an irrevocable election to treat gains and losses on eligible investments on capital account for taxation purposes.

61. Essentially a '*managed investment scheme*' is a collective investment vehicle (often in the guise of a public unit trust, such as a cash management or property trust). Investors purchase units in the scheme, which is managed by a professional on behalf of the members of the scheme, who do not have day-to-day control of the trust. For more specific details, see footnote 66. Some managed investment schemes meet the definition of '*managed investment trusts*' but others do not.

62. For the text of the Bill as passed and to which Royal Assent was given on 29 June 2010 (being Act No. 90 of 2010), see http://www.austlii.edu.au/au/legis/cth/num_act/tla2010mn3a2010314/ (viewed 6 August 2010).

63. **Proposed section 12-401** in Schedule 1 to the TAA 1953.

64. **Proposed section 12–400** in Schedule 1 to the TAA 1953, particularly **proposed subsection 12–400(3)**, which deals with 'Crown entities'. See also **proposed paragraph 12–402(3)(h)**, which provides that an entity established and wholly-owned by an Australian government agency is an entity (among other specified entities) that is required to meet the ordinary 'widely-held requirements' for MITs, including the requirement that the trust have at least 25 members at the time of the first fund payment of the relevant income year. Note that entities covered by **proposed subsection 12–402(3)** must also meet the widely-held requirements for registered MITs in **proposed section 12–402A**, including the requirement that the entity in question must have a total MIT participation interest in the trust of more than 25 per cent at the time the payment is made, and at no time in that income year does an entity other than an entity covered by proposed subsection 12–402(3) have a MIT participation interest in the trust of more than 60 per cent. Also note that previously under section 12–400 (as it existed prior to the passage of the current Bill), the term '*managed investment trust*' was defined as any trust where the trustee was an Australian resident (or the central management and control of the trust was in Australia) at the time the first fund payment was made for the relevant income year. At the time of the payment, the

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- provides that trading unit trusts and other trusts that carry on a trading business (or control the affairs or operations of another person who carries on such a business) do not qualify as MITs[65]
- provides that in order to be a MIT, the trust must either be covered by **proposed section 12–401** (which applies to any trust with wholesale membership) or be registered by the Australian Securities and Investments Commission (ASIC) as a '*managed investment scheme*' under section 601EB of the *Corporations Act 2001* (*Corporations Act*)[66]
- clarifies that the management of the trust must be maintained onshore[67]

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trust also needed to be a '*managed investment scheme*' (as defined in section 9 of the *Corporations Act*—see footnote 66 below) and be operated by a financial services licensee (as defined by section 761A of that Act) whose licence covers operating such a managed investment scheme. Finally, the trust was required to have either its units listed for quotation on the official list of an approved stock exchange in Australia; or have at least 50 members; or have a specified entity as a member of the trust (including a life insurance company or complying superannuation fund).

65. **Proposed paragraph 12-400(1)(b) and subsection 12-400(2)** in Schedule 1 to the TAA 1953. See also **proposed section 275-5** of the ITAA 1997 (which is to be inserted by **item 1** of **Schedule 5** to the Bill), and Division 6C in Part III of the ITAA 1936 (which deals with the income of certain public trading trusts).

66. **Proposed paragraph 12-400(1)(e)** in Schedule 1 to the TAA 1953. The term '*managed investment scheme*' is defined in detail in section 9 of the Corporations Act and generally means a scheme whereby people contribute money (or similar) as consideration to acquire rights (or interests) to benefits produced by the scheme but do not have day-to-day control of the scheme, or a time-sharing scheme. It does not include any partnership that has more than 20 members but does not need to be incorporated or formed under an Australian law because of regulations made for the purposes of subsection 115(2) of the Corporations Act. It does not include any body corporate (other than a body corporate that operates as a time sharing scheme), nor any scheme in which all the members are bodies corporate that are related to each other and to the body corporate that promotes the scheme, or a franchise. Further, it does not include any statutory fund maintained under the *Life Insurance Act 1995*, nor any regulated superannuation fund, approved deposit fund, pooled superannuation trust, or a public sector superannuation scheme, within the meaning of the *Superannuation Industry (Supervision) Act 1993*. It does not include any first home saver accounts trust within the meaning of the *First Home Saver Accounts Act 2008* or any scheme operated by an Australian authorised deposit-taking institution (ADI) in the ordinary course of its banking business; nor the issue of debentures or convertible notes by a body corporate; any barter scheme under which each participant may obtain goods or services from another participant for consideration that is wholly or substantially in kind rather than in cash; nor certain retirement village schemes. Finally, it does not include any scheme of a kind declared by the Corporations Regulations 2001 not to be a managed investment scheme.

67. **Proposed paragraph 12-400(1)(a)** in Schedule 1 to the TAA 1953 states that a trust is a MIT in relation to an income year if at the time the trustee makes the first fund payment in

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- requires that in order for a trust to meet the requirements in the definition of a MIT, it must meet the widely-held requirements in **proposed subsections 12–402(1) and/or 12–402A(1)**[68] or (if the trust is not registered under section 601EB of the Corporations Act) it must meet the widely-held restrictions in **proposed subsection 12–402(1)**, and
- requires that in order for a trust to meet the requirements in the definition of a MIT, it must also satisfy the closely-held restrictions in **proposed subsection 12–402B(1)** and satisfy the licensing requirements in **proposed section 12–403** (if the trust is covered by section 12–401, which applies to trusts with wholesale memberships, at the time the first payment is made).[69]

Particularly, **proposed section 12–403**, which sets out the licensing requirements for unregistered managed investment schemes, provides that a trust satisfies the licensing requirements of that section if the trust is:

- operated *or* managed by a financial services licensee (or an authorised representative of the licensee)
- is operated *or* managed by an entity that, but for subsection 5A(4) of the *Corporations Act* (which exempts the Crown from being bound by Chapters 6CA or 7 of that Act) would be required to be a financial services licensee, or
- is operated *or* managed by an entity that is a wholly operated subsidiary of an entity mentioned in the preceding dot-point, or is an entity that would, but for any relevant instrument issued by ASIC under the *Corporations Act*, be required to be a financial services licensee.

The proposed amendments were announced by the Assistant Treasurer, Senator Nick Sherry, on 10 February 2010.[70] On 16 April 2010, the Treasury released exposure draft legislation for public comment.[71] It received 15 submissions in the one week allowed for

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relation to that income year, the trustee was an Australian resident or the central management and control of the trust was in Australia.

68. The requirements vary depending on whether the trust is registered under section 601EB of the *Corporations Act* and is (or is not) covered by **proposed section 12–402**.

69. Essentially the amendments are aimed at widely-held trusts. The Government's intention is to exclude closely-held trusts from the definition of '*managed investment trust*' (and thus from the withholding tax rules). Certain widely-held pooled superannuation trusts have been added to the list of specified widely-held entities to which Subdivision 12-H in Schedule 1 to the TAA 1953 applies.

70. Senator N Sherry, *Key amendment to the withholding tax definition of a managed investment trust*, media release, no. 20, 10 February 2010, viewed 6 August 2010, http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/020.htm&pageID=003&min=njsa&Year=&DocType=0

71. Treasury, *Exposure draft—Tax Laws Amendment (2010 Measures No. 3) Bill 2010: Managed Investment Trust (MIT)*, Treasury website, 16 April 2010, viewed 6 August 2010, http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1773

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submissions.[72] Most of the 11 submissions that were subsequently released to the public supported the general philosophy behind the amendments, particularly those aimed at promoting Australia as an international financial hub.[73] However, some expressed concern that the proposed new requirement for a registered fund to be operated by *and* managed by a holder of an Australian Financial Services Licence (AFSL) may restrict the eligibility of some funds to access the MIT withholding tax rules, particularly given that the current law only requires that a fund to be either operated by *or* managed by an AFSL holder.[74] In the event, the 'either ... or' requirement was retained for both registered and unregistered trusts.

72. Ibid.

73. Treasury, *Submissions: Exposure draft - Tax Laws Amendment (2010 Measures No. 3) Bill 2010: Managed Investment Trust (MIT)*, Treasury website, 23 July 2010, viewed 6 August 2010, http://www.treasury.gov.au/contentitem.asp?ContentID=1862&NavID=037

74. Ibid.

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