1996-97

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAXATION LAWS AMENDMENT BILL (NO. 4) 1996

SUPPLEMENTARY EXPLANATORY MEMORANDUM

Amendments to be moved on behalf of the Government

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

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Capital gains tax - majority underlying interests in assets

(Amendments 1-13)

Amends the Bill to make a number of changes to the proposed amendments to section 160ZZS of the *Income Tax Assessment Act 1936*, contained in Schedule 4 of the Bill.

The Bill is amended to:

- change the base time from 19 September 1985 to a time chosen by a public entity in the period 1 July 1985 to 30 June 1986 (inclusive);
- ensure that companies which are wholly owned indirectly by one or more public entities (eg. through a chain of wholly owned companies) will be subject to the proposed amendments;
- remove from the abnormal trading rules, the issue, redemption, transfer or other dealing of shares and units undertaken on a proportional basis;
- remove the requirement for public entities to trace through 'foreign superannuation funds'; and
- correct two typographical errors in the text of the Bill.

Date of effect: The amendments will commence on 20 January 1997.

Amendment announced: These amendments have not previously been announced.

Financial impact: These amendments will have no financial impact.

Compliance cost impact: These amendments will reduce the cost of compliance by allowing public entities to choose their base time and will also remove the requirement for public entities to trace through 'foreign superannuation funds'.

Capital gains tax - disposals of small business assets

(Amendments 14-25)

Amends proposed new Division 17A of Part IIIA of the *Income Tax Assessment Act 1936*. Division 17A allows capital gains tax roll-over relief for the disposal of some or all of the active assets of a small business, where replacement active assets are acquired. The amendments will prevent a nominated replacement asset from being precluded as an active asset where although the asset is used predominantly to derive rent, its use for that purpose is temporary. The amendments will also make minor technical changes to the Bill to ensure the provisions operate as intended.

Date of effect: The changes will apply to disposals of assets from 1 July 1997, which is also the date of effect for proposed Division 17A.

Proposal announced: Not previously announced.

Financial impact: There should be no significant impact on the revenue as the changes merely ensure the provisions operate as intended.

Compliance cost impact: There would be some compliance costs incurred by taxpayers who use their replacement assets temporarily to derive rent. These costs relate to the need to keep records evidencing the period of such use. To the extent that the technical amendments clarify the operation of proposed Division 17A, there should be a reduction in compliance costs.

Chapter

1 Capital gains tax - majority underlying interests in assets

Amendments 1-13

Purpose of the amendments

1.1 To make a number of changes to the proposed amendments contained in Schedule 4 of the Bill.

Background to the legislation

1.2 Schedule 4 of the Bill amends the *Income Tax Assessment Act 1936* (the Act) to require public entities to periodically test on prescribed dates whether there has been a change in a majority of underlying interests in assets of the entity since 19 September 1985.

1.3 The new testing rules depart from the current test under section 160ZZS of the Act by providing that testing will be periodic rather than at all times after 19 September 1985 and by providing simplified methods of tracing underlying interests.

Explanation of the amendments

1.4 The amendments:

- allow public entities to choose a base time within the period from 1 July 1985 to 30 June 1986 (inclusive) provided that such time gives a reasonable approximation of ownership as at the last moment of 19 September 1985 ***[amendment 1 and 10]***;
- provide that companies which are wholly owned indirectly by one or more public entities are subject to the new testing rules ***[amendments 2,3,4,5, 6 and 9]***;
- remove from the abnormal trading rules the issue, redemption, transfer or other dealing of shares and units undertaken on a proportional basis ***[amendments 8 and 11]***;

remove the requirement for public entities to trace through 'foreign superannuation funds' ***[amendment 13]***; and

- correct an incorrect reference in the definition of 'test time' in proposed new section 160ZZRR ***[amendment 7]*** and a typing error in proposed new section 160ZZSK ***[amendment 12]***.

New choice of base time

1.5 The Bill requires public entities to determine whether there has been a change in majority underlying interests in an asset of the entity as between the base time and test time.

1.6 The definition of 'base time' in proposed new section 160ZZRR of the Bill requires public entities to use the last moment of 19 September 1985 as their base time unless the last moment of another day is approved by the Commissioner in relation to the entity.

1.7 These amendments replace that definition with one allowing public entities to choose a base time in the period from 1 July 1985 to 30 June 1986 (inclusive).

1.8 The day chosen by the public entity must be a day that will result in a determination that gives a reasonable approximation of the natural persons who held underlying interests in the assets of the entity at the last moment of 19 September 1985. If no day is chosen, public entities must use the last moment of 19 September 1985. ***[Amendment 1]***

1.9 The Commissioner, under the Bill, has a discretion to deal with situations where a public entity can not determine the underlying interests held by individuals at the base time. This discretion is removed by these amendments. ***[Amendment 10]***

Companies which are wholly owned by other companies

1.10 The new testing rules apply to public companies. Broadly, a public company is defined by proposed section 160ZZRR to be a listed public company, or a company in which all of the shares are beneficially owned by one or more listed public companies, mutual insurance organisations, or publicly traded unit trusts.

1.11 This definition was intended to bring all wholly owned companies into the new rules, even if they are owned through a chain of wholly owned companies.

1.12 The current wording of the Bill does not ensure all wholly owned companies in a chain of companies are subject to the new rules. As a result, it is possible that some companies which are wholly owned by a public entity would not be able to take advantage of the new tracing rules etc, but would be required to test under the existing section 160ZZS.

To avoid this result the Bill is proposed to be amended so that the definition of 'public company' in section 160ZZRR is expanded to include companies which are '100% subsidiaries' of a company which is wholly owned by one or more listed public companies, mutual insurance organisations or publicly traded unit trusts. ***[Amendments 2,3,4,5 6 and 9 - new section 160ZZRRA]***

1.13 The term '100% subsidiary' is consistent with the Tax Law Improvement Project's re-write of section 80G of the Act which uses the same term.

What is a '100% subsidiary'?

1.14 A company (the company) will be a 100% subsidiary of another company (the holding company) where the company is directly or indirectly owned by the holding company. These rules, however, will not apply if a person is in a position to affect (now or in the future) rights which relate to the company, being rights of the holding company or another company which is wholly owned by the holding company.

1.15 The company will be directly owned by the holding company if all the shares in the company are beneficially owned by the holding company (eg. all the shares in the company are owned by ABC).

1.16 The company will be indirectly owned by the holding company if:

- all the shares in the company are beneficially owned by one or more 100% subsidiaries of the holding company (eg. all the shares in the company are owned by a company which is wholly owned by ABC); or
- all the shares in the company are beneficially owned by the holding company and one or more 100% subsidiaries of the holding company (eg. half of the shares in the company are owned by ABC and the other half by a company which is a 100% subsidiary of ABC).

Abnormal trading - exclusion of proportionate trading of shares and units

1.17 Public companies and publicly traded trusts will be required by the Bill to test for changes in underlying interests in assets owned by the company or trust when there is abnormal trading in the company's shares or units in the trust. See proposed sections 160ZZRR - 'test time' and proposed section 160ZZSA.

1.18 What constitutes abnormal trading is explained in new subdivision D of Division 20 of Part IIIA of the Act which will be inserted by the Bill.

1.19 Testing on each day that there is abnormal trading is required because abnormal trading can be indicative of a change in majority underlying interests in the assets of an entity. However, where shares or units are traded in a way that maintains the holdings of the underlying interests in the same proportion that they were previously held, there will be no change in the majority underlying interests in the assets of the entity. Such proportionate trading may occur as a result of dividend reinvestment plans, rights issues or bonus share plans.

1.20 To recognise this, the amendments ensure that the issue, redemption or transfer, or another dealing in, shares in the company or units in the trust which do not change the proportions in which natural persons hold underlying interests in assets of the company or trust are not subject to the abnormal trading rules will not require the company or trust to examine its records to determine whether there has been a change in underlying interest. ***[Amendments 8 and 11]***

Exclusion of foreign superannuation funds from tracing rules

1.21 Under proposed new section 160ZZSS of the Bill, public companies and publicly traded unit trusts do not have to trace through any 'complying superannuation fund' that is interposed between the company or trust and the natural persons who beneficially hold underlying interests in the assets of the company or trust.

1.22 Complying superannuation funds are funds that satisfy strict supervisory arrangements aimed at ensuring that such funds are maintained solely for superannuation purposes rather than for non-superannuation purposes.

1.23 The proposed amendments will expand the concession granted to complying superannuation funds to 'foreign superannuation funds' within the meaning of subsection 6(1) of the Act. ***[Amendment 13]***

1.24 Broadly, a 'foreign superannuation fund' is a provident, benefit, superannuation or retirement fund -

(a) that was established in a country outside Australia;

(b) that was established, and is maintained and applied, for the sole purpose of providing superannuation benefits for persons other than persons who are, or would ordinarily be or become, residents of Australia or residents of a Territory; and

(c) the central management and control of which is carried on outside Australia by persons none of whom is a resident of Australia or a resident of a Territory, not being a fund for which an amount has been set aside, or to which an amount has been paid, by a taxpayer that is an amount that has been allowed or is

allowable as a deduction, or in respect of which a rebate of tax has been allowed or is allowable, under any provision of this Act.

1.25 These funds do not fall within the definition of 'complying superannuation fund' in proposed new section 160ZZRR. However, 'foreign superannuation funds' are likely to be subject to strict supervisory arrangements similar to those applying to complying superannuation funds. Accordingly, the concessional tracing rules in section 160ZZSS of the Bill will be expanded to also apply to 'foreign superannuation funds'. ***[Amendment 13]***

Correction of typographical errors

1.26 The amendments correct an incorrect reference to the word 'other' in the phrase 'other public company' in the definition of "test time" in proposed new section 160ZZRR, by replacing it with the word 'listed'. ***[amendment 7].*** The amendments also correct a typing error by inserting the words "***head company***) or a publicly traded unit trust (the ***head trust***) may" before the word "determine" in proposed new section 160ZZSK ***[amendment 12].***

Chapter

2 Capital gains tax - disposals of small business assets

Amendments 14-25

Summary of the amendments

Purpose of the amendments

2.1 The Bill introduced proposed new Division 17A of Part IIIA of the *Income Tax Assessment Act 1936* (the Act). Division 17A allows capital gains tax roll-over relief for the disposal of some or all of the active assets of a small business, where replacement active assets are acquired.

2.2 The proposed amendments will prevent a nominated replacement asset from being precluded as an active asset where, although the asset is used predominantly to derive rent, its use for that purpose is temporary. The amendments will also make minor technical changes to ensure Division 17A operates as originally intended. The changes will apply to disposals of assets from 1 July 1997, which is also the date of effect for proposed Division 17A.

Background to the legislation

2.3 The Bill introduced a new capital gains tax roll-over relief regime whereby, in certain circumstances, the disposal of active assets of a small business would not incur an immediate capital gains tax liability, if active replacement assets were acquired. To be eligible for roll-over relief, a taxpayer's total net business assets must not exceed $5 million. The capital gain on the disposal of an active asset will not be taxed in the disposal year but will instead be used to reduce the cost base of newly acquired replacement assets.

2.4 The measures sought to ensure that a lack of capital does not impede the growth and development of small business. The design details of the roll-over relief were announced in the 1996-97 Budget. The amendments aim to ensure that the provisions operate as originally

intended and to rectify minor technical problems identified in the Bill since its introduction.

Explanation of the amendments

Asset temporarily used to derive rent

2.5 New section 160ZZPL provides the meaning of the terms assets, active assets and roll-over assets for the purposes of Division 17A. Paragraph 160ZZPL(4)(c) states that an asset whose predominant use is to derive, among other things, rent is not an active asset. Section 160ZZPX provides that where a replacement asset ceases to be an active asset, a capital gain will accrue to the taxpayer equal to the amount rolled over into the replacement asset.

2.6 The interaction of these provisions could lead to a capital gain accruing to a taxpayer where a replacement asset is used predominantly to derive rental income, albeit on a temporary basis. An example would be where the owner of a taxi licence who operates a taxi business decides to lease the licence for a short period in order to take a holiday. Notwithstanding that the taxpayer resumes operating the taxi business at the end of the holiday, section 160ZZPX would deem a capital gain to accrue to the taxpayer when the licence was initially leased.

2.7 Due to the harshness of this result, proposed ***new subsection 160ZZPL(5A)*** will ensure that a replacement asset will not be precluded from being an active asset by virtue of paragraph 160ZZPL(4)(c), if it is used predominantly to derive rent on a temporary basis ***[amendment 19]***. ***Amended paragraph 160ZZPL(4)(c)*** will provide that it operates subject to new subsection 160ZZPL(5A) ***[amendment 18]***.

2.8 As a result of these amendments, an asset which is held ready for use by the taxpayer in the carrying on of a business will continue to be an active asset as long as the period in which the asset is predominantly used to derive rent is only temporary. Whether a period of rental use qualifies as temporary depends on the individual circumstances of the taxpayer. If the period of rental use turns out to be longer than expected, so that it cannot be concluded that the rental period is temporary, section 160ZZPX will deem a capital gain to accrue when the asset was first used to predominantly derive rent.

Definition of 'trust'

2.9 New section 160ZZPK provides definitions for the purposes of Division 17A. One of the defined terms in section 160ZZPK is 'trust'. It is proposed to remove the current definition and replace it with a reworded version which will promote clarity. ***[Amendments 15 and 16]***

Definition of 'asset'

2.10 New subsection 160ZZPL(1) defines 'asset' for the purposes of Division 17A. Paragraph 160ZZPL(1)(a) currently provides that, in relation to an individual who is not acting as a trustee, an asset does not include an asset for the personal use and enjoyment of the individual or an associate of the individual.

2.11 This provision could be interpreted as excluding an asset with any element of personal use. This would mean that a predominantly business asset would be excluded for the purposes of the $5 million threshold in section 160ZZPP. In addition, it would also mean that any capital gain on the disposal of the asset would not be eligible for roll-over relief.

2.12 Accordingly, ***amended paragraph 160ZZPL(1)(a)*** will provide that an asset will only be excluded if it is being used solely for the personal use and enjoyment of the taxpayer or an associate of the taxpayer ***[amendment 17]***. This amendment will also ensure that an asset intended to be used but not actually used as a personal asset is not excluded from the definition of 'asset'.

Definition of 'connected'

2.13 New section 160ZZPK provides definitions for the purposes of Division 17A. 'Connected' is currently defined by reference to 160ZZPN. To correct an oversight, it is proposed to amend the definition to insert the word 'section' before 160ZZPN. ***[Amendment 14]***

Explanatory provision - new section 160ZZPO

2.14 New section 160ZZPO contains a broad overview of how roll-over relief will be available on the disposal of an asset of a business. The first dot point in the provision states that the threshold criteria must be satisfied at the time of disposal of the relevant assets. However, paragraph 160ZZPL(7)(b) states that the threshold criteria must be satisfied at the disposal test time. Disposal test time is defined in section 160ZZPK to mean the time immediately before the disposal of an asset.

2.15 ***Amended section 160ZZPO*** will state that the threshold criteria must be satisfied at the time immediately before the disposal of the relevant assets. ***[Amendment 20]***

Net value of assets

2.16 New section 160ZZPP outlines the threshold criteria to be satisfied before Division 17A will apply to the disposal of an asset by a taxpayer. Subsection 160ZZPP(2) states that the net value of the taxpayer's assets must not exceed $5 million. Subsection 160ZZPP(5) defines 'net value' to mean the sum of the market values of the assets of

the entity less the sum of the liabilities of the entity that relate to those assets.

2.17 The intention of this provision was to include in the calculation of net value, only liabilities of the entity incurred in respect of assets that are included for the purposes of the $5 million threshold by virtue of subsection 160ZZPL(1). The provision was not intended to include, for example, a liability in respect of a personal asset of an individual taxpayer not acting as a trustee because the value of such an asset is excluded for the purposes of the threshold under paragraph 160ZZPL(1)(a). However, there is some doubt as to whether subsection 160ZZPP(5) is effective. For example, where a loan incurred by an individual taxpayer for the purpose of acquiring a personal asset is secured by an asset of the taxpayer's business, it could be argued that the liability is related to the business asset and not the personal asset.

2.18 ***Amended subsection 160ZZPP(5)*** will specifically exclude a liability that relates to an asset excluded for the purposes of the $5 million threshold by paragraphs 160ZZPL(1)(a-d). ***[Amendment 21]***

Heading change to new subsection 160ZZPX(2)

2.19 New subsection 160ZZPX(2) is currently headed 'capital gain accrues when asset disposed of'. However, this provision provides that a capital gain accrues in the year of income in which the relevant change time occurred. The change time is defined in paragraph 160ZZPX(1)(d) and includes where an asset ceases to be an active asset. The change time does not involve the disposal of an asset.

2.20 It is proposed to amend the heading to subsection 160ZZPX(2) to state that a 'capital gain accrues when change of status occurs' ***[amendment 24]***. This will reflect the operation of the subsection.

Heading change to new section 160ZZPV

2.21 New section 160ZZPV provides the method of applying net roll-over amounts if the only replacement assets are assets other than goodwill. Subsection 160ZZPV(2) applies where the total non-goodwill cost base is not less than the total net roll-over amount. Total net roll-over amount is defined in section 160ZZPK to mean the sum of the net goodwill and non-goodwill roll-over amounts.

2.22 However, the heading to subsection 160ZZPV(2) states that the provision applies where the total non-goodwill cost base is not less than the net non-goodwill roll-over amount. It is proposed to amend the heading to remove the words 'non-goodwill' ***[amendment 22]***. A corresponding amendment is also proposed for subsection 160ZZPV(3) ***[amendment 23]***. This will ensure that the headings reflect the operation of the following provisions.

Roll-over of replacement asset upon death

2.23 New section 160ZZPZ provides that in certain circumstances, where a replacement asset forms part of the estate of a deceased person and is passed on to the legal personal representative of the deceased person, the actions of the deceased person are deemed to have been the actions of the legal personal representative for the purposes of Division 17A. This provision was intended to be consistent with section 160X of the Act which ensures that no capital gains tax consequences arise when assets forming part of the estate of a deceased person are transferred. However, unlike section 160X, the new provision in its current form does not provide for the transfer of an asset to a beneficiary in the estate of the deceased person via a legal personal representative of the deceased person.

2.24 Proposed ***new subsection 160ZZPZ(2)*** will ensure that the provision applies where a replacement asset forms part of the estate of a deceased person and is passed on to a beneficiary in the estate of the deceased person. ***[Amendment 25]***

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