1993-94-95

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAXATION LAWS AMENDMENT BILL (NO. 3) 1995

SUPPLEMENTARY EXPLANATORY MEMORANDUM

Amendments to be moved on behalf of the Government

(Circulated by authority of the Treasurer,
the Hon Ralph Willis, MP)

75264 Cat. No. 95 5497 1 ISBN 0644 34248X

Printed by Authority by the Commonwealth Government Printer

General outline and financial impact

Rebatable and frankable dividends

Amends the rebatable and frankable dividend measures of the Bill to better target them and provide for certain commercial transactions of life assurance companies. The amendments will prevent the measures applying to transfers of share capital and asset revaluation profits to extinguish accumulated losses or losses in the value of assets, transfers of share premiums to the statutory funds of life assurance companies, and the revaluation of statutory fund assets.

Date of effect: The amendments will apply to transfers made and dividends paid after 7:30 pm AEST on 9 May 1995.

Amendment announced: Not previously announced.

Financial impact: The amendments will prevent an unintended gain to the revenue arising over a period of years.

Compliance cost impact: None

Losses - bankruptcy and annulment of bankruptcy

Allows a capital loss to a bankrupt (or a person who has been released from debts under bankruptcy law) who pays a debt that had been taken into account in calculating a net capital loss denied under the provisions proposed by the Bill.

Date of effect: As with the amendments relating to net capital losses proposed by the Bill as it stands, these amendments will apply to taxpayers who become bankrupt or who have been released from debts after 25 February 1995.

Amendment announced: Not previously announced.

Financial impact: There is insufficient data available on which a reliable estimate of the revenue impact of these amendments can be made. However, it is considered that the revenue impact is minimal.

Compliance cost: The compliance cost is minimal because the existing law already requires taxpayers to compute and maintain records of amounts for which claims for capital losses will be made under these amendments.

Superannuation guarantee charge - notional earnings base

This amendment corrects an error in the Bill in an example explaining its operation. In error 28 August 1994 was used in the example rather than 28 June 1994 (the date of the announcement of the measure in the Treasurer's Statement). The correct date is used in the diagram itself and in the operative provisions of the Bill.

Date of effect: No change.

Amendment announced: Not previously announced.

Financial impact: None.

Compliance cost impact: No change.

Chapter *Amendments 1 to 4*

1 Rebatable and frankable dividends

Overview

1.1 The amendments better target the rebatable and frankable dividend measures of the Bill and provide for certain commercial transactions of life assurance companies.

1.2 The amendments will apply from the time the original measures take effect, i.e. to transfers made and dividends paid after 7:30 pm AEST on 9 May 1995. They will prevent the measures applying to:

- transfers of share capital and share premiums to extinguish accumulated losses;
- transfers of asset revaluation profits to reflect reductions in the value of assets;
- transfers of share premiums to the statutory funds of life assurance companies; and
- the revaluation of statutory fund assets of life assurance companies.

Background to the amendments

1.3 The Bill prevents dividends debited to share capital, share premium accounts or asset revaluation reserves being rebatable or frankable. Under the current provisions of the Bill, if a company transfers amounts from a share capital account, a share premium account or an asset revaluation reserve (disqualifying accounts) to another account (a non-disqualifying account), then proposed section 46I will cause a credit to arise in the notional disqualifying account. The effect of this would be to treat subsequent dividends, to the extent of the amount transferred, as being paid from the amount transferred. The operation of proposed section 46G and Item 26 of the Bill would then render these dividends non-rebatable and non-frankable.

1.4 This treatment prevents a company circumventing the measures of the Bill by transferring share capital and asset revaluation reserve profits to other accounts and then paying rebatable and frankable dividends from those other accounts.

1.5 There are, however, circumstances where this treatment is inappropriate. These circumstances are where:

(a) a company offsets accumulated losses against share capital, or losses in the value of an asset against an asset revaluation reserve;

(b) a life assurance company transfers share premiums from its shareholders' funds to a statutory fund (i.e. a fund containing assets included in the company's life, superannuation, roll-over or accident and disability insurance business); or

(c) a life assurance company revalues assets held in its statutory fund and subsequently transfers an amount from the statutory fund to the shareholders' fund.

(a) Transfers to offset losses

1.6 A company may reduce its share capital by writing off accumulated losses against paid-up capital or share premiums. This effectively involves a transfer from a share capital account (a disqualifying account) to another account (a non-disqualifying account).

1.7 Similarly, a company may reduce its asset revaluation reserve to offset a loss in the value of an asset to correctly reflect the recoverable value of that asset in the accounts of the company. This also results in a transfer from a disqualifying account to a non-disqualifying account.

1.8 However, in the ordinary course of events, neither of these transfers facilitate the payment of a dividend. The company therefore, has not put itself in a position by which it could circumvent the provisions of the Bill and it is unnecessary for the Bill to apply to these transactions.

(b) Transfers of share premiums by life assurance companies

1.9 As part of its ordinary business, a life assurance company may transfer share premiums from its shareholders' funds to a statutory fund it maintains to eliminate a deficit in that fund or to provide capital for investment. Again, this involves a transfer from a disqualifying account to a non-disqualifying account. In terms of the Bill, the transfer would prevent the company paying frankable or rebatable dividends to the extent of the amount transferred.

1.10 This outcome is inappropriate because life assurance companies can only pay dividends from their shareholders' funds. So, provided there

is no transfer back from the statutory fund, the Bill should not apply in this situation.

(c) Revaluation of statutory fund assets

1.11 It is also an ordinary part of a life assurance company's business to revalue assets to determine the surplus held in the statutory fund that can be allocated to policyholders or shareholders. This surplus can be transferred to shareholders' funds to pay dividends. Because these dividends may in part be paid out of amounts transferred from an asset revaluation reserve (a disqualifying account), as the Bill currently stands they will be non-rebatable and non-frankable to that extent.

1.12 Notwithstanding that the value of assets is a factor in determining any surplus in the statutory fund, the surplus could also be attributable to the taxed profits of the statutory fund. The amount of the surplus attributable to the asset revaluation reserve cannot be determined. Therefore it is not appropriate to treat a surplus as being from the revaluation of assets in all cases. It would therefore be appropriate to exclude the revaluation of assets held in the statutory funds of a life assurance company from the scope of the Bill.

Explanation of the amendments

(a) Transfers to offset losses

1.13 The amendments prevent the rebatable and frankable dividend measures applying inappropriately to transfers to offset accumulated losses or to reflect a reduction in value of assets by specifying that certain transfers are 'excluded transfers'. An excluded transfer is a transfer from a disqualifying account to a non-disqualifying account that, contrary to the general rule, does not give rise to a credit in the notional disqualifying account. ***[Amendment 3; amended proposed subsection 46I(3)]***

What is an excluded transfer?

1.14 In relation to capital reductions to offset accumulated losses, an excluded transfer is a transfer from a share capital account or share premium account which gives effect to a reduction in paid-up share capital or share premiums that have been lost or ceased to be represented by assets. This would be the case, for example, in a capital reduction scheme under paragraph 195(1)(b) of the Corporations Law. An exception is provided in relation to certain dividend payment or replacement arrangements (explained below). ***[Amendment 4; new subsections 46IA(1) and (2)]***

1.15 To prevent companies obtaining the benefit of the exemption in relation to accumulated losses that are likely to be recovered, the loss or deficiency in share capital or share premiums must be permanent. In the context of capital reductions, the courts have provided guidance as to what permanent means: see for example *Re Jupiter House Investments (Cambridge) Ltd* [1985] 1 WLR 975 at 979. These judicial decisions will be relevant for the purposes of determining whether the permanency test in ***new paragraph 46IA(2)(b)*** is satisfied.

1.16 In relation to the reduction in value of an asset, an excluded transfer is a transfer from an asset revaluation reserve to reflect a decrease in value of the asset. Once again, this is subject to the exception for certain dividend payment or replacement arrangements. ***[Amendment 4; new subsections 46IA(1) and (3)]***

What is a dividend payment or replacement arrangement?

1.17 To prevent abuse of the exemptions explained above, excluded transfers do not include transfers to the extent to which they constitute dividend payment or replacement arrangements. If part of a transfer is made under a dividend payment or replacement arrangement, and the remainder is not so made, then only the remainder will be an excluded transfer. ***[Amendment 4; new subsection 46IA(5)]***

1.18 A dividend payment or replacement arrangement is defined as a transfer under an arrangement in which the company will pay a dividend directly or indirectly from the transferred amount, or will use the transferred amount to replace, directly or indirectly, an amount from which a dividend was paid. ***[Amendment 4; new subsection 46IA(6)]***

1.19 For example, a company with an accumulated loss may reduce the par value of its shares to offset that loss (thereby effectively transferring an amount from its share capital account to the accumulated loss account). If the amount of the reduction in par value equals the loss then, assuming the company had not undertaken the transfer as part of an arrangement involving the payment of a dividend, the transfer would be an excluded transfer.

1.20 However, if in the above example the reduction in par value exceeded the loss to be offset, there may be a dividend payment arrangement which would preclude the amount of the excess transferred being an excluded transfer. This would depend on whether, on the facts of the case, the transfer could be described as part of an arrangement involving the payment of a dividend. The company could show that there was no such arrangement by, for instance, demonstrating a reason for the excess transfer which did not involve the payment of a dividend, and by conclusively showing that the excess will not be distributed as a dividend. An undertaking to a court that, as part of a capital reduction scheme, the

excess will be held in a special reserve and not distributed to shareholders would be sufficient for these purposes.

1.21 A dividend payment or replacement arrangement requires a link, other than a merely temporal link, between the transfer and the payment of the dividend. This link may, for example, be a preconceived plan under which the company makes a transfer intending to subsequently pay a dividend from all or part of the amount transferred.

(b) Transfers of share premiums by life assurance companies

1.22 To ensure that life assurance companies can transfer share premiums to their statutory funds without triggering the rebatable and frankable dividend measures, the amendments provide for a new disqualifying account, comprising shareholders' capital (as defined in the *Life Insurance Act 1995*) held in a statutory fund. ***[Amendment 1; new paragraph 46H(1)(aa)]***

1.23 A transfer from a share premium account to a shareholders' capital account will be a transfer between disqualifying accounts. Therefore the transfer will not create a credit in the notional disqualifying account. Similarly, a life assurance company will be able to transfer amounts from a shareholders' capital account held in one statutory fund to a shareholders' capital account in another statutory fund without causing a credit to the notional disqualifying account.

1.24 A transfer from a shareholders' capital account held in a statutory fund to a non-disqualifying account will generally give rise to a credit in the notional disqualifying account because of new subsection 46I(3). However, one type of transfer from a shareholders' capital account that does not facilitate the payment of a dividend is a transfer to enable a distribution to participating policy-holders pursuant to paragraph 63(3)(c) of the *Life Insurance Act 1995*. Therefore, to prevent a credit arising in the notional disqualifying account, this type of transfer is defined as an 'excluded transfer'. Excluded transfers are explained above in paragraphs 1.14 to 1.21. ***[Amendment 4; new subsection 46IA(4)]***

(c) Revaluation of statutory fund assets

1.25 The amendments also exclude profits from the revaluation of assets of a statutory fund from the definition of the asset revaluation reserve disqualifying account. This means that a transfer of profits, including from the revaluation of assets, from the statutory fund of a life assurance company to its shareholders' fund will not affect the company's ability to pay frankable and rebatable dividends. ***[Amendment 2; substituted proposed paragraph 46H(1)(c)]***

Chapter *Amendments 5 and 6*

2 Losses - bankruptcy and annulment of bankruptcy

Summary of the amendments

Purpose of the amendments

2.1 The amendments to the Bill will ensure that a capital loss is taken to have been incurred by a taxpayer who pays an amount in respect of a debt that was taken into account in determining the amount of a net capital loss that, upon bankruptcy or release from debts under bankruptcy law, is prevented from being taken into account in ascertaining future net capital gains or losses.

Background to the legislation

2.2 The Bill as it stands removes an anomaly under which bankrupts (and other taxpayers who are released from debts under bankruptcy law), although denied deductions for carried forward revenue losses incurred before bankruptcy or release from debts, remain entitled to claim carried forward net capital losses.

2.3 However, the Bill as it stands does not include provisions equivalent to subsections 79E(9) and (10) of the *Income Tax Assessment Act 1936*. Those provisions allow a tax deduction for payments made in respect of debts that have been taken into account in calculating a carried forward revenue loss denied upon bankruptcy or release from debts.

2.4 This amendment of the Bill will accord similar treatment to taxpayers for payments made in respect of debts where net capital losses have been denied upon bankruptcy or release from debts under bankruptcy law.

Explanation of the amendments

2.5 The amendment of the Bill will ensure that a taxpayer who makes a payment in respect of a debt will be taken to have incurred a capital loss in the year of income in which payment is made, where:

- the taxpayer incurred a net capital loss that is not allowed to be taken into account because of subsection 160ZC(4A) ('denied net capital loss'); and
- the Commissioner of Taxation is satisfied that the debt was taken into account in working out the amount of the denied net capital loss.

[Amendment 6 - new subsection 160ZC(4C)]

2.6 The amount of the capital loss taken to have been incurred because of the payment of a debt is to be the smallest of the following:

- the amount of the payment;
- so much of the debt as the Commissioner is satisfied was taken into account in calculating the amount of the denied net capital loss; and
- the amount of the denied net capital loss less the sum of capital losses arising from earlier payments in respect of debts taken into account in calculating that denied net capital loss.

[Amendment 6 - new subsection 160ZC(4D)]

Consequential amendment

2.7 The amendment to the proposed subsection 160ZC(4A) in the Bill as it stands is consequential upon the insertion of the proposed subsection 160ZC(4C) and (4D). It ensures that only one net capital loss, being the net capital loss incurred in respect of the year of income before bankruptcy or release from debts under bankruptcy law, will be denied. The wording of the proposed subsection 160ZC(4A) in the Bill as it stands is too broad in that where a net capital loss is incurred not only in respect of the year of income before bankruptcy but also in respect of prior years, the cumulative nature of net capital losses may mean that more than one net capital loss will be denied. A consequence of this would be that under the proposed subsection 160ZC(4C), more than one capital loss may technically be taken to have been incurred where a payment is made in respect of a relevant debt. ***[Amendment 5]***

Chapter *Amendment 7*

3 Superannuation guarantee charge - notional earnings base

Overview and explanation of the amendment

3.1 ***Amendment 7*** corrects a minor technical error in the Bill. The second dot-point of proposed ***subsection 13(1C)*** gives information for an example explaining how the diagram in the subsection applies.

3.2 In error 28 August 1994 was used in the dot-point instead of 28 June 1994 (the date of the announcement of the measure in the Treasurer's Statement). The correct date is used in the diagram itself, and in the operative provisions of the Bill.

9 780644 342483