THE TAX INSTITUTE

THE MARK OF EXPERTISE

12 November 2013

Senator the Hon Arthur Sinodinos AO
Assistant Treasurer
PO Box 6100
Senate
CANBERRA ACT 2600

By email: senator.sinodinos@aph.gov.au

Dear Minister,

Restoring Integrity in the Australian Tax System

The Tax Institute takes this opportunity to make a submission in relation to the 64 previously announced measures which are subject to further consultation to determine whether the Government should proceed with these measures.

The review of these 64 measures is focused on determining "whether there are any unintended consequences from not proceeding with the measures or whether there are compelling reasons why the measure should proceed". That is, whether there is good reason for keeping a measure other than to provide certainty and efficiency and prevent taxpayers from having to unwind transactions.

Further, we understand legislative protection will be afforded to a taxpayer who has self-assessed factoring in an announced measure that will not proceed. There is also a promise of an entitlement to a refund where a taxpayer has complied with a previously announced measure and paid tax accordingly and the announced measure does not proceed following this consultation process.

In light of the expeditious consultation process being undertaken and on reliance on the parameters of the consultation process set out above, The Tax Institute seeks to bring to the attention of the Minister only priority measures which we strongly recommend be progressed through Parliament by 1 July 2014 with solid reasons in support of their progression. In doing so, we have considered what harm may be suffered by taxpayers should certain measures not be proceeded with and whether there is an appropriate

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administrative solution to the issue the measure is intended to address. We refer to the items as numbered in the table attached to the media release[1] as relevant.

Measures to proceed by 1 July 2014

1. Capital Gains Tax – look-through treatment for earn out arrangements (#46)

Earn out arrangements are increasingly being used, particularly by the small and medium enterprise market. The Australian Taxation Office's (**ATO**) method of taxing earn out arrangements as contained in TR 2007/D10 gives rise to several adverse consequences for the buyer and seller which are inconsistent with the economics of the transaction and virtually impossible to apply in practice.

The proposed look-through method solves this issue and reduces complexity and compliance costs as it is more appropriate and practical in its effect and much less likely to give rise to as many adverse consequences as the ATO's interpretation of the current rules. The absence of look-through treatment negatively impacts on the CGT treatment of the transaction; there are significant timing issues, particularly in the case where the consequences of the earn out is taxed upfront, earn out payments are not made due to conditions of the earn out not being met (eg lack of business performance) which results in a capital loss for the taxpayer (seller) and no corresponding economic gain has been recognised. Legislating this amendment will reduce 'red tape' and compliance costs associated with earn out arrangements (eg it will no longer be necessary to obtain a valuation).

The ATO made it clear during consultation that they did not believe look-through treatment is possible for buyers and sellers. It is unlikely their views will change in the absence of an appropriate legislative amendment. Therefore, there is no appropriate administrative solution available.

2. Consolidation – operation of the rules following a demerger (#84)

The demerger provisions were introduced to ensure that tax considerations were not an impediment to the restructuring of a business, and in recognition that there should be no taxing event for a restructuring that leaves members in the same economic position as they were just before the restructuring.

The proposed amendments were designed to ensure that two current consolidation outcomes that are inconsistent with the above principle are overcome:

[1] Joint media release between the Treasurer and Assistant Treasurer entitled "Restoring Integrity in the Australian Tax System" issued 6 November 2013

- **Treatment of liabilities**: Currently, where the liabilities of a demerged entity exceed the tax cost of its assets, a capital gain may arise (CGT event L5) as a result of the demerged entity having low historical tax cost in its assets, or because the tax cost has been fully depreciated.

  Further, these liabilities are not taken into to account in resetting the tax cost of the assets of the new demerged group that forms a tax consolidated group.

  The proposed amendments would overcome both of these inappropriate outcomes.

- **Resetting of tax costs**: Where a demerger group forms a tax consolidated group, it is currently required to reset the tax cost of its assets. This will often result in existing cost base in depreciable assets (such as property, plant and equipment) being reallocated to non-depreciable assets (such as goodwill). As a fundamental principle of a demerger is that there is no change in the underlying economic ownership of an asset, this is also an inappropriate outcome that would be rectified under the proposed amendment.

  The resetting of tax costs also requires the demerger group to undertake complicated resetting calculations and incur valuation costs – both of these are an unnecessary compliance cost to business.

These outcomes arise under current law and there is no appropriate administrative solution. The provisions require amendment to ensure the appropriate treatment arises.

3. Debt/equity tax rules – limiting scope of integrity rule (#74)

The current integrity provision, section 974-80[2], is being applied much more widely by the ATO than is intended by the law, resulting in the re-characterisation of certain related-party debt as being equity. This is inconsistent with the policy intent behind section 974-80.

The ATO should narrow the scope of application of the provision to bring it back into line with the original intention of the law. This would require a redraft of the ATO's 2007 Draft Discussion Paper and Taxation Ruling TR 2012/D5. However, a legislative amendment would ensure the scope of the application of the provision was narrowed appropriately and would provide the necessary certainty around the application of this provision.

[2] *Income Tax Assessment Act 1997*(Cth)

4. GST – cross-border transactions – 'connected with Australia' rules (#48)

The current rules discourage foreign residents from transacting with Australian residents and they impose significant compliance costs on foreign residents in order to comply with Australian GST rules. The proposed legislative amendment would ease the compliance burden on foreign residents who become subject to the Australian GST regime and would assist to improve Australia's international competiveness.

There is no suitable administrative response to the current compliance burden. Two rounds of consultation on this issue have already occurred and as a result, draft legislation making the amendment should be fairly close to finalisation.

5. Administration of the GST system

a) GST – Government response to Board of Taxation report: GST Administration – review multi-party transactions (#42)

There is a significant amount of litigation around multi-party transactions caught in the system that would be alleviated following a proper examination. There is asymmetry for parties to transactions where a liability arises but no corresponding credit is necessarily available. This affects many business-to-business transactions.

The ATO has been trying to produce administrative guidance in this area; however, the guidance is not producing the desired symmetrical treatment. The ATO guidance is exacerbating the problem as taxpayers have challenged (and continue to challenge) the ATO guidance on issue, further contributing to the increasing litigation in this area. Accordingly, this is a significant area where it would be beneficial for the recommended review to occur.

b) GST – Government response to Board of Taxation report: GST Administration – simplify grouping rules (#79)

The current grouping rules are complex and difficult to apply. Most holding companies register for GST – though this is consistent with the policy intent, it is inconsistent with the legislation; hence there is broad non-compliance with the current provisions. Should the measure not proceed, this would require the ATO to actively enforce the law which is inconsistent with the policy intent. Non-compliance with the law (by holding companies choosing to register for GST which has associated compliance costs to taxpayers) would also persist.

Proceeding with this measure would fix a flaw in the legislation that administrative treatment could not circumvent. This would ensure the legislation accords with the policy intent and that taxpayers are not put in a position where they do not comply with the law.

Care and Maintenance of the Australian Tax System

There are several measures in the list of 64 that have been announced for the purpose of providing improvements and necessary corrective action / care and maintenance to the taxation system which should still be addressed at a later stage when time permits so this opportunity is not forgone.

- **Loss recoupment rules** – A general review of the company and trust loss recoupment rules should be conducted through which the multiple share class amendments (#59) and other minor technical issues (#78) could be made.

- **Simplified imputation system (#75)** – It is recommended the re-write of the imputation system rules be completed at some stage.

- **CGT provisions** – Many of the proposed CGT amendments are to overcome technical glitches that cannot be overcome by an administrative solution. The proposed amendments (such as the measures affecting insurance policies, revenue assets and trading stock and deceased estates) should proceed as they will ensure consistency and equity within the CGT provisions. These measures are not complicated and involve simple drafting. Little or no further consultation is required.

- **Consolidation measures** – many of the proposed consolidation measures could be dealt with as part of the Government's consideration of recommendations made by the Board of Tax in its review of consolidation that have not been included on the list of 64 measures.

- **GST measures –** many of the proposed GST measures are drawn from recommendations made by the Board of Taxation and focus on removing anomalies and streamlining the GST provisions. Not proceeding with the measures is contributing the 'red tape' currently imposed on taxpayers in complying with the Australian GST regime.

- **Taxation of not-for-profits** - Reform in respect of taxation of not-for profits should be fully co-ordinated to avoid unnecessary duplication or inconsistency. Further reform should not occur until the Government has considered the report commissioned from the Not-For-Profit Sector Tax Concession Working Group (which is not yet publicly available) and settled its overall reform agenda in this area. However, the "Not-for-profit sector reforms - better targeting of not-for-profit tax concessions" measure (#33) should not proceed.

- **Taxation of superannuation** – consistent with the Government's pre-election policy, restoration of stability and certainty in this area is welcome.

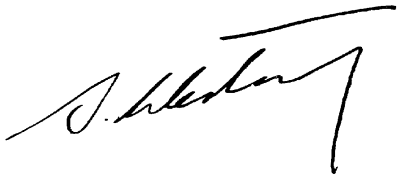
Other

In determining its tax agenda, there are other consultations on foot not listed which we strongly urge the Government to continue with, in particular the modernisation of the taxation of trust income.

The Tax Institute is keen to discuss the above measures in further detail with relevant Government stakeholders and to assist as much as possible in the consultation process.

Please contact either me or Senior Tax Counsel, Robert Jeremenko, on 02 8223 0011 to discuss further.

Yours sincerely



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