client alert | explanatory memorandum

June 2015

CURRENCY:

This issue of **Client Alert** takes into account all developments up to and including 4 May 2015.

Commissioner's statutory remedial power on the way

The complexity of Australia's tax law, combined with evolving business practices, has increasingly led to unintended outcomes. Even though the Commissioner of Taxation endeavours to interpret the law to give effect to its purpose or object, there are instances where this is not possible.

To address this, the Assistant Treasurer announced on 1 May 2015 that the Government will provide the Commissioner with a statutory remedial power to allow for a more timely resolution of certain unforeseen or unintended outcomes in the taxation and superannuation law.

This will allow the Commissioner to make a disallowable legislative instrument that will have the effect of modifying the operation of the taxation and superannuation law to ensure the law can be administered to achieve its purpose or object.

There are similar powers to make legislative instruments in Commonwealth law currently granted to APRA, and also to ASIC.

The Assistant Treasurer said the power will be appropriately limited in its application and will only apply to the extent that it has a beneficial outcome for taxpayers. It will only be available where the modification is not inconsistent with the purpose or object of the law and has no more than a negligible revenue impact. The Commissioner will consult publicly prior to any exercise of the power.

Source: Assistant Treasurer's media release, 1 May 2015, http://jaf.ministers.treasury.gov.au/media-release/021-2015.

ATO ramps up face-to-face contact with wealthy individuals

The ATO has released details of its new approach to wealthy individuals and their private groups on the *ATO Building confidence* site www.ato.gov.au/General/Building-confidence/Privately-owned-and-wealthy-groups.

The ATO said it was taking a "prevention-before-correction approach and ramping up face-to-face engagement with key taxpayers". Acting Second Commissioner Michael Cranston said most wealthy individuals and their private groups do the right thing; however, some choose to avoid tax, and that is why the ATO was shifting its approach. Mr Cranston said the ATO will be visiting the largest private groups to look at their tax affairs in "real time, raise any concerns and resolve issues before companies lodge their tax returns".

According to the ATO, about 30% of wealthy individuals and their private groups are considered "high-risk". Mr Cranston said there are about 175 private groups controlling almost 6,000 entities with more than $1 billion in turnover or $500 million in net assets. He said if taxpayers are open and transparent with the ATO, they can expect better services and faster turnaround on key decisions.

Mr Cranston also noted the ATO "will sign-off on the previous year's tax returns of taxpayers who have been open and transparent" about their affairs, have good compliance records and are considered low-risk. He said this will provide certainty for about 30,000 privately owned and wealthy groups that they will not be subject to an audit for specific income years.

The ATO's approach to privately owned and wealthy groups comprises "excellent working relationships", "the right services", "transparency", and "tailored engagement". Some key points from the ATO include the following:

- **Excellent working relationships**: the ATO said it will engage with taxpayers early, providing access to ATO experts and clear escalation points from which to resolve issues. Taxpayers will be able to seek

advice from the ATO, expect "productive, professional tax assurance engagements", and engage with the ATO through consultation. To support a productive and professional working relationship, the ATO said it will be transparent in explaining what it knows of the taxpayer, why it was making contact, provide information about its risk assessment of the taxpayer, and the options available to correct a mistake. In relation to tax assurance engagements, the ATO said it will:

  - work closely with taxpayers to develop a work plan;
  - agree on the most efficient channels for exchanges of information;
  - use information already known to the ATO;
  - clarify how documents covered by legal professional privilege or the accountants' concession could be managed; and
  - discuss opportunities for voluntary disclosures or alternative dispute resolution, where relevant.

- **The right services**: the ATO said it was working to improve its digital services and was "currently developing a number of initiatives". Among other things, the ATO said taxpayers can:
  - engage early with the ATO prior to seeking advice to get certainty about a complex transaction or arrangement;
  - enter into an annual compliance arrangement to identify and resolve tax issues early;
  - request an advance pricing arrangement for dealings with international related parties; and
  - apply for a mutual agreement procedure for relief from double taxation on international transactions.
- **Transparency**: the ATO said it will be transparent about what attracts its attention. It also said it will be transparent about how it assesses risk, give lower risk groups an "income tax assurance notification" (if the ATO does not intend to take further action in a specific year), and provide an "income tax risk report" to the largest groups (and other groups where specific issues have attracted its attention). Some of the risk areas that attract the ATO's attention include:
  - individuals with unreported foreign income or assets;
  - certain types of remuneration arrangements used by members of professional firms;
  - egregious use of trusts; and
  - mixing personal and company expenditure (Div 7A).
- **Tailored engagement**: the ATO said it is improving its knowledge about business, industry and commercial realities, so that it can better understand taxpayer circumstances, and provide a tailored engagement approach. In relation to large privately owned and wealthy groups, the ATO said it may use pre-lodgment reviews in certain circumstances.

Source: ATO media release, 16 April 2015, https://www.ato.gov.au/Media-centre/Media-releases/ATO-to-start-tax-assurance-talks-with-large-private-groups; ATO Building confidence, Privately owned and wealthy groups webpage, 14 April 2015, https://www.ato.gov.au/General/Building-confidence/Privately-owned-and-wealthy-groups.

Sale of business earn-out arrangements – tax changes on the way

The Government has released draft legislation to amend the ITAA 1997 to provide a "look-through" CGT treatment for earn-out arrangements (ie the sale and purchase of businesses involving rights to future financial benefits linked to the performance of an asset or assets after sale). The rule changes have been in the making for almost five years (or, over seven years if you count the ATO's draft ruling in December 2007).

Under the proposed amendments, capital gains and losses arising in respect of eligible earn-out rights will be disregarded. Instead, taxpayers will be required to include financial benefits provided or received under, or in relation to, such rights in determining the capital proceeds of the disposal of the underlying asset (for the seller) or the cost base and reduced cost base of the underlying asset (for the buyer).

The draft legislation also amends the rules relating to amendments to assessments, interest charges, recognition of capital losses and access to CGT (and other) concessions. This is to ensure the new treatment provides taxpayers with outcomes broadly consistent with those that would have arisen had the value of all of the financial benefits under the earn-out right been included in the capital proceeds from the disposal of the underlying asset (for the seller) and the cost base of the underlying asset (for the buyer).

Significantly, these proposed amendments will **apply to all earn-out arrangements entered into on or after 23 April 2015.**

Earn-out requirement

The draft legislation provides that to be a look-through earn-out right for these purposes, a right must be created as part of an arrangement for the disposal of the business or its assets (ie the disposal must cause CGT event A1 to happen). Similarly, what is disposed of must be an "active asset" of the business before it is sold, ie one used in the business of the taxpayer or a connected or affiliated entity.

Likewise, an interest in an Australian resident company or trust will also be an active asset if at least 80% of the value of the assets of the company, or trust, are active assets (rather than passive investments). In this regard, the amendments provide that in determining whether such an interest is an eligible "share or an interest", the following requirements must be met:

- the entity holding the share or interest must either be a CGT concession stakeholder in relation to the company or trust (if they are an individual) or otherwise own a sufficient share of the business that they would be a CGT concession stakeholder were they an individual;
- the trust or company must carry on a business and have carried on a business or businesses for at least one prior income year; and
- for the immediate preceding income year, at least 80% of the income of the trust or company must have come from carrying on a business, or businesses, and not been derived as an annuity, interest, rent, royalties or foreign exchange gains, or derived from or in relation to financial instruments.

Note that this test avoids the need to value the assets of the trust or company. Instead, it needs only to look at how the trust or company has earned its income over the past income year. Further, where the character of a share or interest held by the taxpayer depends on the character of the shares or rights held by other entities, this test can also apply when determining the characters of the shares or interests held by that other entity.

Importantly, look-through earn-out rights must be created as part of arrangements entered into on an arm's-length basis (ie be a commercial transaction).

Contingent on future economic performance of the asset

Under the proposed measures, for a right to be a look-through earn-out right, future financial benefits provided under the right must be linked to the future economic performance of the asset or a business in which the asset is used, and must provide for financial benefits the value of which reasonably relates to this performance. However, the financial benefits provided must not be able to be reasonably ascertained at the time the right is created.

Whether a particular measure identifies economic performance will depend on the context of the business or asset. Measures that can be appropriate include profit, turnover or the number of clients retained. However, any measure adopted must actually be a reasonable measure of performance in the context of the business or asset in question. Note also that rights to financial benefits that are based on finding out more information about an existing asset are not contingent on economic performance (eg certain mining rights).

Four-year payment limitation

For a right to be a look-through earn-out right, the right must not require financial benefits to be provided more than four years after CGT event A1 occurs in relation to the disposal of the relevant active asset. The purpose of this requirement is to ensure concessions for look-through earn-out rights are not available to long-term profit sharing arrangements and to place a reasonable limit on the period of deferral.

But note that this requirement is not breached simply because one party or another may be late in providing a financial benefit under the look-through right. However, it will be breached if the agreement includes an option for the parties to extend the period over which financial benefits are provided, or to enter into a new agreement providing for the continuation of a substantially similar financial benefit in relation to the asset.

Rights to receive financial benefits for ending a look-through earn-out right

The draft legislation states that a right will also be a look-through earn-out right if it is a right to receive a financial benefit for ending a right that is a look-through earn-out right under the general rules (as payments to end a look-through earn-out rights are in effect a replacement for the payments that would have been made under the right). The same treatment will apply even where the financial benefit may be provided by a third party.

CGT consequences of a right being a look-through earn-out right

Broadly, if a right is a look-through earn-out right, two consequences arise:

- the value of the right is disregarded for the purposes of CGT; and

- the value of any financial benefits made or received under the right is included in either the capital proceeds arising from the disposal (for the seller) or the cost base of the acquisition (for the buyer).

Disregarding the right

To address valuation problems of the earn-out right, the draft legislation proposes that any capital gain or loss arising in respect of the creation or cessation of a look-through earn-out right will be disregarded. Similarly, the value of a look-through earn-out right will not be taken into account in determining the capital proceeds of the disposal of the active asset for the seller nor the cost base and reduced cost base of the asset acquired by the buyer.

Adjusting capital proceeds and cost base for subsequent financial benefits

As a result of disregarding any capital gain or loss from the earn-out right, the draft legislation includes the value of any financial benefits subsequently provided or received under or in relation to such a right in the capital proceeds of the disposal of the related active asset for the seller, or the cost base and reduced cost base of the asset for the buyer.

Choices and timing

As the proposed CGT treatment of earn-outs would result in the amount of a capital gain or loss changing as a result of financial benefits provided or received for subsequent income years, a number of rules are required to ensure this does not disadvantage taxpayers.

Accordingly, the proposed amendments will extend the period of review for all of a taxpayer's tax-related liabilities that can be affected by the character of the look-through earn-out right. For these tax-related liabilities, the period of review is the later of the period of review that would normally apply and four years after the final date when financial benefits could be provided under the look-through earn-out right. This extension applies to all tax-related liabilities that can be affected by the change to a capital gain or loss as a result of financial benefits provided under a look-through earn-out right (such as those under the small business CGT retirement concession).

The extension also applies to a taxpayer's right to object where they are dissatisfied with an assessment. Where the Commissioner amends a taxpayer's assessment because of a financial benefit provided or received under an earn-out right or a right that is taken to never have been an earn-out right, the taxpayer may object in the same way the taxpayer may object to any other amendments to an assessment. Where a taxpayer is dissatisfied with a related assessment, the proposed amendments will allow the taxpayer to object within 60 days of receiving notice of the Commissioner's decision not to amend the assessment.

In relation to "choices" made by taxpayers where the amount of a gain or loss may vary from the amount of the gain or loss identified in the year in a way that is uncertain, the proposed amendments will permit taxpayers to amend a choice made previously where the choice relates to a capital gain or loss that can be affected by financial benefits provided under a look-through earn-out right. However, the decision to vary a choice must be made by the time the taxpayer is required to lodge a tax return for the period in which the financial benefits under the look-through earn-out right is received.

In relation to the shortfall interest on the underpayment of tax, under the proposed amendments taxpayers will not be subject to interest on any shortfall that arises as a consequence of financial benefits provided or received under a look-through earn-out right, as long as the taxpayer requests an amendment to their relevant income tax assessment within the period they must lodge their income return for the relevant income year. Likewise, the Commissioner will not be liable for interest on any overpayment of tax in the same circumstances.

In relation to the availability of capital losses to taxpayers and its interaction with the four-year amendment period, the proposed amendments provide that capital losses arising from disposals of assets to which look-through earn-out rights relate will be temporarily disregarded until and to the extent that they become reasonably certain. This amendment will also prevent a taxpayer from receiving an excessive tax benefit by being able to make use of the "loss" they have incurred on the disposal until subsequent financial benefits are received under the earn-out right.

Access to CGT concessions

The draft legislation provides that the proposed amendments are not intended to affect a taxpayer's entitlement to CGT concessions except to the extent this may occur as a result of the value of the underlying disposal now including all of the amounts provided for and under the earn-out right. Accordingly, in general, there will be no need for additional special rules. Instead, taxpayers may reconsider any choices and their entitlement to concessions in light of subsequent payments ensures that the resulting gain, loss or cost base reflects any concessions that are available and only those concessions that are available.

Likewise, in some cases, a taxpayer may not initially be in a position to elect for a concession to apply to a CGT event or may be concerned that anticipated future financial benefits in respect of a look-through earn-out right may mean that they cease to be eligible for a concession to apply after they have taken irrevocable actions based on this concession (such as making contributions to superannuation). In these cases, the taxpayer can wait until it is clear whether or not they will be finally eligible for the concession before making any choice.

In relation to the CGT small business concessions that require things to be done or decisions to be made within a fixed period of time (eg under the retirement exemption), the period for accessing such concessions is extended. For example, for the 15-year exemption, and the related concession in relation to non-concessional contributions, the two-year period is extended to last until two years after the final potential financial benefit under the look-through earn-out right is concluded. Likewise, in relation to the small business rollover, the replacement asset period will be extended until two years after the potential final financial benefit under the look-through earn-out right is concluded.

Implications of changes to capital proceeds

Because the availability of some CGT concessions is linked to the capital proceeds of the CGT event or the income or turnover of a taxpayer in the relevant income year, these characteristics in the past income year can change based on financial benefits that the taxpayer provides or receives in relation to a look-through earn-out right and that, as a result, a taxpayer may become eligible or cease to be eligible for a CGT concession.

In these circumstances, the draft legislation provides that a taxpayer will not be subject to the shortfall interest charge (SIC) on additional tax that they must pay as a result of providing or receiving financial benefits under a look-through earn-out right. However, to the extent a taxpayer has accessed a concession for which they are ultimately not eligible due to these financial benefits, any additional tax that arises falls outside the scope of that exception and the taxpayer will be subject to SIC.

Additionally, while the receipt of financial benefits under a look-through earn-out right may allow the taxpayer to remake choices and often extends the period in which a choice can be made, it does not entitle the taxpayer to undo the actions they have taken in that period. For example, if a taxpayer has made contributions to superannuation in order to access a concession, they cannot withdraw these contributions now they are no longer available.

Consequential amendments

The draft legislation also makes consequential amendments to the consolidation regime. Broadly, these require consolidated groups to revise the allocated cost amount of an entity that joins the group to take account of subsequent money or property provided in respect of the acquisition of a membership interest in the entity, where the subsequent money or property was not taken into account in working out the allocable cost amount when the entity joined the group.

Consequential amendments will also be made to remove the existing definition of “contingent on economic performance” so that the term will bear its ordinary meaning. Existing references to “contingent on economic performance” will be replaced by the new defined term “contingent on aspects of economic performance”, which will be defined in exactly the same way as “contingent on economic performance” was previously.

Date of effect

The proposed amendments will apply to all earn-out arrangements entered into on or after 23 April 2015 (the day when the draft legislation was made public).

Transitional rules

Taxpayers that have reasonably, and in good faith, anticipated changes to the tax law in this area as a result of the announcement by the previous Government will have their current tax income preserved. This approach protects taxpayers that have reasonably anticipated changes, without requiring complex retrospective changes. This will operate by placing a statutory bar on the Commissioner amending an income tax assessment in relation to a particular contained in a statement, to the extent that the particular represents the taxpayer’s reasonable anticipation of the announced changes to the law and satisfies the timing conditions.

But note that the timing conditions will apply differently based on whether events happened before or after 23 April 2015. Broadly, this means that the conditions will be satisfied if either:

(a) the statement is made between the date of the announcement and 23 April 2015 and if the statement was made in a return, the return was not be required to be lodged before 23 April 2015; or

(b) the statement is made in a return lodged on or after 23 April 2015, the return was not required to be lodged before that date, no prior return had been lodged or assessment made for that income year, and the

statement relates to the application of the taxation law to events prior to 23 April 2015 or to which the taxpayer was committed prior to 23 April 2015.

However, any protection under the measure will be lost if the taxpayer makes a statement for a later year of income that is not consistent with the anticipated amendments reflected in the taxpayers original statement in a way that is to the taxpayer's benefit. Assessments may be amended at any time to give effect to the loss of protection.

Comments

Submissions are due by 21 May 2015.

Source: Treasury, "Providing 'look-through' CGT treatment to earnout arrangements", 23 April 2015, http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2015/Providing-look-through-CGT-treatment-to-earnout-arrangements.

ATO data-matching eBay sellers

The ATO has gazetted a notice advising that it will request and collect online-selling data relating to registrants that sold goods and services of a total value of $10,000 or more for the period from 1 July 2013 to 30 June 2014. This acquired data will be electronically matched with certain sections of ATO data holdings to identify possible non-compliance with registration, reporting, lodgment and payment obligations under taxation law.

The ATO said data will be sought from eBay Australia & New Zealand Pty Ltd, a subsidiary of eBay International AG which owns and operates www.ebay.com.au. It is expected that records relating to between 15,000 and 25,000 individuals will be matched.

The ATO said the program will enable it to address the compliance behaviour of individuals and businesses selling goods and services via the online selling site, and who may not be correctly meeting their taxation obligations, particularly those with undeclared income and incorrect lodgment and reporting for GST.

Key data elements that will be requested by the ATO include: account name; business name; contact details; date of birth; number and value of annual sales; number and value of monthly sales; seller status; and business/store status.

Further details on the data-matching program are available on the ATO website at https://www.ato.gov.au/General/Gen/Data-matching-program-protocol.

Source: Treasury, Notice of a Data Matching Program – Online Selling, Gazette – C2015G00559, 21 April 2015, www.comlaw.gov.au/Details/C2015G00559.

Aggressive R&D claims under scrutiny

The ATO says it is working closely with AusIndustry to identify taxpayers, tax agents and consultants who may be involved in aggressive research and development (R&D) arrangements. The agencies say they will be taking a coordinated approach to address these behaviours.

According to the ATO, these arrangements are inconsistent with the requirements of the R&D regime, may have features of tax avoidance arrangements, and may be fraudulent. In some cases, the activities of these consultants may attract the operation of the promoter penalty laws.

The ATO says tax practitioners should verify with their clients that their claims are attributed to activities consistent with their AusIndustry Registrations, and expenses (eg labour costs) were actually incurred on R&D activities.

The ATO also asks tax practitioners to tell the ATO if they are approached by an R&D consultant to lodge R&D schedules on behalf of taxpayers who are not their clients, and the consultant isn't prepared to reconcile or substantiate the information in the R&D schedule. It says tax practitioners should also tell the ATO if they come across claims that appear to be disproportionate when comparing them to a taxpayer's normal business activity.

Source: ATO website "Getting R&D claims right", 14 April 2015, https://www.ato.gov.au/Tax-professionals/Newsroom/Lodgment-and-payment/Getting-R-D-claims-right.

No jab, no pay for child benefits – Government immunisation requirement

The Government will end the conscientious objector exemption on children's vaccination for access to taxpayer funded Child Care Benefits, the Child Care Rebate and the Family Tax Benefit Part A end-of-year supplement from 1 January 2016.

Immunisation requirements for the payment of the FTB Part A end-of-year supplement will also be extended to include children of all ages. Currently, vaccination status is only checked at 1, 2 and 5 years of age. The Government will also end the exemption on religious grounds, leaving only the existing exemption on medical grounds.

Minister for Social Services Scott Morrison said "the Government has had discussions with the only religious organisation with an approved vaccination exemption, the Church of Christ, Scientist and has formed the view that this exemption, in place since 1998, is no longer current or necessary and will therefore be removed". Mr Morrison said the Government will no longer receive or authorise any further vaccination exemption applications from religious organisations.

Source: Prime Minister's media release, 12 April 2015, www.pm.gov.au/media/2015-04-12/no-jab-no-play-and-no-pay-child-care-0; Minister for Social Services media release, 19 April 2015, http://scottmorrison.dss.gov.au/media-releases/government-ends-religious-no-jab-no-pay-of-benefits-exemption.

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