client alert | explanatory memorandum

November 2017

CURRENCY:

This issue of **Client Alert** takes into account developments up to and including 25 September 2017.

Compensation for ATO systems outages

After the ATO's unplanned system outages, it provided lodgment deferrals, and remitted interest and penalties where the outages affected practitioners and their clients' lodgments. But what about compensation?

The ATO has advised that it assesses claims for compensation in two ways:

- compensation for legal liability (eg negligence)– claims that are resolved on the basis of legal liability must be settled in accordance with legal principle and practice; and
- compensation under the Compensation for Detriment caused by Defective Administration (CDDA) scheme, which allows the ATO to consider claims and pay compensation if practitioners or their clients have suffered disadvantage or loss because of defective administration.

The ATO says it considers claims in accordance with guidelines issued by the Department of Finance. Applications for compensation must address the criteria set out in the guidance material and establish that:

- the practitioner or client suffered direct financial loss;
- the loss was caused by the ATO's defective administration; and
- the practitioner or client has taken reasonable steps to mitigate that damage.

In this context, "defective administration" means:

- a specific unreasonable lapse in complying with existing administrative procedures;
- an unreasonable failure to institute appropriate administrative procedures;
- an unreasonable failure to give the proper advice within an officer's power or knowledge to give; or
- giving advice that was in all the circumstances incorrect or ambiguous.

The type of compensation the ATO says it can consider is financial loss with a direct connection to its actions that lead to a finding of legal liability or defective administration. This can be a loss such as:

- professional fees, where evidence of payment is provided and the decision-maker considers the fees to be reasonable;
- interest for delays in providing funds in cases where no statutory interest can be paid;
- bank or other administrative fees that the taxpayer incurred because of the ATO's actions.

Generally, the ATO says claims for the following types of losses cannot be considered under claims of legal liability or the CDDA scheme:

- claims for personal time spent resolving an issue;
- claims for stress, anxiety or inconvenience;
- claims for delays in receiving funds from the ATO where statutory interest was paid;
- claims for costs associated with complying with the tax system, including costs associated with audits, objections and appeals – even where it is found that taxpayers complied with their obligations;
- claims for the costs of putting in a claim or conducting a claim for compensation;
- claims for taxation or other Commonwealth liabilities with substantive review rights that can be or could have been pursued.

Claims for compensation can be made using the ATO's *Applying for compensation* form (NAT 11669).

For more information about how the ATO deals with compensation claims, send an email to compensation.application@ato.gov.au or phone 1800 005 172.

Small business restructure rollover: changes

The ATO has made a draft determination, under the Commissioner's "remedial power" in the *Taxation Administration Act 1953*, which proposes to modify how the small business restructure rollover (SBRR) operates.

When the determination is finalised, it will modify s 40-340 of the *Income Tax Assessment Act 1997* (ITAA 1997) so that where it provides balancing adjustment rollover relief for a depreciating asset under an SBRR, it "has effect as if it also provided that the disposal of the asset has no direct consequences under the income tax law".

Under Subdiv 328-G of ITAA 1997, the SBRR is available in relation to the transfer of CGT assets, trading stock and revenue assets as part of a genuine business restructure. Generally, the SBRR's effect is that no direct income tax consequences arise from the transfer of the small business's assets, and their tax costs are rolled over to the transferee. However, for a depreciating asset, the benefit of the SBRR is provided under item 8 of the table in s 40-340(1). This provides rollover relief from the balancing adjustment event that happens on the transfer of the asset.

The main concern behind the modification (as reflected in the following example) appears to be the potential for a transfer to give rise to a dividend in the transferee's hands.

Example

Fiona owns all of the shares in Orange Country Pty Ltd, which is a small business entity. Fiona decides to restructure her business to operate as a sole trader. She causes the company to transfer all of its assets, including an item of depreciable plant, to the sole trader entity for no consideration.

Under the capital allowance provisions, Orange Country Pty Ltd is taken to receive market value consideration for the transfer of plant. The company is entitled to choose the rollover and defer the tax consequences from the balancing adjustment event.

If the depreciable plant is paid out of profits derived by Orange Country Pty Ltd, Fiona's assessable income will include the market value of the plant, under s 44 of the *Income Tax Assessment Act 1936* (ITAA 1936). Alternatively, the amount would be an assessable deemed dividend under s 109C of ITAA 1936.

Tax cut closed off for passive investment companies

The Government has released exposure draft legislation to deny access to the lower corporate tax rate of 27.5% for companies with predominantly passive income. The draft legislation would amend the *Income Tax Rates Act 1986* to ensure that a "base rate entity" will qualify for the lower tax rate only if:

- its "base rate entity passive income" is less than 80% of its assessable income for the year;
- it "carries on a business" in the year of income; and
- its aggregated turnover for the income year is less than the aggregated turnover threshold for the year (ie $10 million for 2016–2017; $25 million for 2017–2018; and $50 million for 2018–2019 and later years).

Meaning of "passive income"

Each of the following will be "passive income" of a base rate entity:

- distributions (eg dividends), excluding non-portfolio dividends;
- non-share dividends;
- rent;
- interest income;
- royalties;
- gains on qualifying securities under Div 16E of the *Income Tax Assessment Act 1936*;
- capital gains; and
- amounts included in assessable partnership or trust income, to the extent that they are attributable to base rate entity passive income as listed above.

Corporate tax rate for imputation purposes

In terms of working out the maximum franking credit for a distribution by reference to the "corporate tax gross-up rate", the definition of the "corporate tax rate for imputation purposes" will be amended so that the entity can assume that its aggregated turnover, base rate passive income and assessable income are equal to the amounts for the previous income year. If the corporate tax entity did not exist in the previous income year, its corporate tax rate for imputation purposes for an income year will be deemed the lower corporate tax rate of 27.5%.

Example

Aco is carrying on a business. In the 2016–2017 income year, it has:

- aggregated turnover of $8 million;
- base rate passive income of $7.5 million; and
- assessable income of $8 million.

For the 2016–2017 income year, 92.59% of Aco's assessable income is base rate entity passive income. This means that the applicable corporate tax rate is 30%, even though the company's aggregated turnover is only $8 million (ie under the $10 million aggregated turnover threshold for 2016–2017).

Aco wants to pay a dividend to its shareholders in the 2017–2018 income year. To work out its corporate tax rate for imputation purposes for the 2017–2018 income year, it must assume that its aggregated turnover, base rate passive income and assessable income are the same as for the 2016–2017 income year.

Aco's corporate tax rate for imputation purposes is 30%.

Therefore, its corporate tax gross-up rate for that income year will be: (100% – 30%) / 30% = 2.33.

Aco makes a fully franked distribution of $100 per share in the 2017–2018 income year. The maximum franking credit that can be attached to that distribution is $42.91 (ie $100/2.33). Aco makes the dividend payment on 31 March 2018.

Amy holds 50 shares in Aco and receives a dividend of $5,000. Franking credits of $2,145 are attached to the dividend. For the 2017–2018 income year, Amy includes $7,145 (ie $5,000 plus franking credits of $2,145) in her assessable income in relation to the dividend.

Amy is entitled to a refundable tax offset equal to the amount of the franking credits. Amy's total assessable income for the 2017–2018 income year is $30,000, so her marginal tax rate is 19%. Therefore, Medicare levy aside, Amy's tax payable on the franked dividend is $1,357.55. The excess franking credits (ie $787.45) will be:

- applied to reduce Amy's other tax liabilities; or
- if she has no other tax liabilities, refunded to Amy.

Emma also holds 50 shares in Aco and receives a dividend of $5,000 (and franking credits of $2,145). For the 2017–2018 income year, Emma includes $7,145 in her assessable income in relation to the dividend.

Emma is entitled to a refundable tax offset equal to the amount of the franking credits. Emma's total assessable income for the 2017–2018 income year is $120,000, so her marginal tax rate is 37%. Therefore, Medicare levy aside, the tax payable by Emma on the franked dividend is $2,643.65. This means Emma will need to pay additional tax of $498.65 on the franked dividend.

Identification numbers for directors: an Icarus moment for phoenix activities?

The Government has announced a package of reforms to combat phoenix activities, including the introduction of a Director Identification Number (DIN).

Phoenixing involves deliberately transferring assets from a failed or insolvent company to a new company, with the intention to avoid paying the original company's creditors, tax and employee entitlements (that is, the new company illegally "rises from the ashes" of the indebted company).

The proposed DIN would identify each director with a unique number, and interface with government agencies and databases to allow regulators to map the relationships between directors and entities, and between directors and other people.

In addition to the DIN, the Government will consult on implementing a range of other measures, including:

- legislating on specific phoenixing offences, to better enable regulators to take decisive action against those who engage in this illegal activity;
- establishing a dedicated phoenix hotline, to provide the public with a single point of contact for reporting illegal phoenix activity;
- extending the penalties for promoting tax avoidance schemes to also capture advisers who assist phoenix operators;
- giving the ATO stronger powers to recover a security deposit from suspected phoenix operators;

- extending the director penalty provisions to make directors personally liable for GST liabilities;
- preventing directors from backdating their resignations to avoid personal liability or from resigning and leaving a company with no directors; and
- prohibiting entities related to phoenix operators from appointing liquidators.

Tax measures for affordable housing

The Government has released draft tax legislation to implement elements of its housing affordability plan. The following measures are contained in the draft legislation:

- enabling investors to obtain a 60% CGT discount in relation to affordable rental housing if they hold the investment for at least three years. Individual investors may invest by holding an ownership interest in affordable housing directly or through certain trusts, such as holding units within a managed investment trust (an MIT);
- allowing MITs to hold affordable housing (residential premises) primarily for the purpose of deriving long-term rent. Those MITs will also be permitted to derive other eligible investment business income from investments, including shares or commercial property. MITs will be able to construct or develop the affordable housing property within the MIT;
- precluding MITs from acquiring residential property other than affordable housing. MITs currently holding residential property will be allowed a transitional period, until 1 October 2027, for their existing property assets.

To qualify for the higher CGT discount and MIT concessional tax treatment, an affordable housing tenancy will need to be managed by a registered Community Housing Provider and provided as affordable housing for at least three years. As part of this, housing providers will determine the tenant eligibility criteria, including the rent charged, consistent with state and territory affordable housing policies.

Legislation for First Home Super Saver scheme and downsizer super contributions

A Bill has been introduced into Parliament to:

- establish the First Home Super Saver (FHSS) scheme, which will allow individuals who are saving for their first home to take advantage of the concessional taxation arrangements that apply to the superannuation system; and
- allow individuals aged 65 or over to use the proceeds from the sale of their main residence to make contributions of up to $300,000 to their superannuation provider (known as “downsizer contributions”).

FHSS scheme

Under the FHSS scheme, first home savers who make voluntary contributions into the superannuation system will be able to withdraw those contributions (up to certain limits) and an amount of associated earnings to purchase their first home. Concessional tax treatment would apply to amounts that are withdrawn under the scheme. The scheme will apply to voluntary contributions made into superannuation on or after 1 July 2017. Contributions will be able to be withdrawn from 1 July 2018;

Downsizer contributions

Under the proposed changes, downsizer contributions could be made regardless of the other contributions caps and restrictions that might apply to making voluntary contributions. However, downsizer contributions would not be tax deductible. The proceeds from contracts for the sale of a main residence entered into on or after 1 July 2018 would be eligible for use as downsizer contributions.

No GST on digital currency: Bill

The GST Act (*A New Tax System (Goods and Services Tax) Act 1999*) is being amended to ensure that supplies of digital currency receive equivalent GST treatment to supplies of money.

Under the changes, supplies of digital currency made on and after 1 July 2017 will be disregarded for GST purposes unless the supply is undertaken in exchange for a payment of money or digital currency.

To give effect to this money-equivalent treatment of digital currency, the amending Bill inserts a definition of “digital currency” into the GST Act. In arriving at this definition, the drafters have taken into account two considerations:

- the significant risk that any definition based on the current architecture of cryptographic currencies (like Bitcoin) may lose relevance if new technical approaches emerge; and
- the existence of a number of types of digital assets that bear some similarities to digital currencies, but which are not treated as currencies, generally because either they are rights to particular things rather

than having value only as a medium of exchange, or they are dealt with appropriately under the existing law.

Accordingly, the definition has been framed in terms of digital currency needing to have broadly the same features as state fiat currencies (legal tender). In particular, in the same way as state fiat currencies, the value of a digital currency must derive from the market's assessment of the value of the currency for the purposes of exchange, despite it having no intrinsic value. The units must be capable of being consideration for any type of supply, and must be generally available to the public, free of any substantial restrictions on their use as consideration.

The definition also requires that digital currency must not have a value based on the value of anything else. Hence, units will not be digital currency if they are denominated in another currency, for example with a value pegged to the Australian or United States dollars.

Units are not digital currency – even if they have independent value and are fully transferable – if they provide the holder with benefits, entitlements or privileges, such as memberships or vouchers, other than an entitlement that is incidental to holding the unit or using it as consideration.

New financial and superannuation complaints authority

Legislation has now been introduced to establish a new external dispute resolution (EDR) framework and an enhanced internal dispute resolution (IDR) framework for the Australian financial system.

The new EDR framework is designed to ensure that consumers have easy access to a single EDR scheme, known as the Australian Financial Complaints Authority (AFCA), which will resolve disputes about products and services provided by financial firms. The AFCA scheme will replace the Superannuation Complaints Tribunal (SCT) and the existing EDR schemes approved by the Australian Securities and Investments Commission (ASIC); that is, the Financial Ombudsman Service (FOS) and the Credit and Investments Ombudsman (CIO).

Certain firms that provide financial and credit services to consumers will be required to be members of AFCA. This requirement will cover Australian financial services licensees, unlicensed product issuers, unlicensed secondary sellers, Australian credit licensees and credit representatives, regulated superannuation funds (other than SMSFs), approved deposit funds, retirement savings account providers, annuity providers, and life policy funds and insurers.

AFCA will be required to provide particulars to ASIC, the Australian Prudential Regulation Authority (APRA) and/or the ATO if it becomes aware that any of the following matters may have occurred in relation to a complaint:

- a serious contravention of a law;
- a contravention of the governing rules of a regulated super fund or of an approved deposit fund;
- a breach in the terms and conditions relating to an annuity policy, a life policy or a retirement savings account; or
- a refusal or failure by a party to a complaint to give effect to an AFCA determination.

If a complaint made under the AFCA scheme is settled between the parties, AFCA may also give the particulars of the settlement to APRA, ASIC or the ATO if AFCA believes that the settlement requires further investigation by those agencies.

Key features of the SCT's complaints handling model, including the requirements for handling death benefit complaints, the decision-making test and the unlimited monetary jurisdiction, will be legislated into the new arrangements to provide certainty for stakeholders.

AFCA's monetary limit of $1 million and compensation cap of $500,000 are almost double the existing limits. These increased amounts for both small business credit facility and other non-superannuation disputes will be set out in AFCA's operating rules.

Before AFCA will consider a dispute, it will refer all complaints back to the financial firm for a final opportunity to resolve the dispute in a defined timeframe, to ensure that the IDR process has the opportunity to work.

AFCA will also have an independent assessor to investigate complaints regarding the ways disputes are handled. This measure aims to ensure procedural fairness.

Superannuation guarantee

Crackdown on employer non-compliance

The Government has announced a package of reforms to give the ATO near-real-time visibility over employers' superannuation guarantee (SG) compliance. The package includes measures to:

- require super funds to report contributions received more frequently (at least monthly) to the ATO;

- roll out Single Touch Payroll (STP), with employers that have 20 or more employees transitioning to STP from 1 July 2018, and smaller employers from 1 July 2019 – STP is designed to reduce the regulatory burden on business and transform compliance by aligning payroll functions with regular reporting of taxation and superannuation obligations;
- improve the effectiveness of the ATO's recovery powers, including strengthening director penalty notices and using security bonds for high-risk employers; and
- give the ATO the ability to seek court-ordered penalties in the most egregious cases of non-payment.

Salary sacrifice integrity: Bill introduced

Legislation has also been introduced to amend the *Superannuation Guarantee (Administration) Act 1992* (SGAA 1992) so that employers will be prevented from using an employee's salary sacrifice contributions to reduce the employer's own minimum SG contributions. This change would apply to working out employers' SG shortfalls for quarters beginning on or after 1 July 2018.

Currently, salary sacrificed superannuation amounts can count towards employer contributions that reduce an employer's charge percentage for SG purposes. This means unscrupulous employers can potentially calculate SG obligations on the (lower) post-salary-sacrifice amounts.

To avoid an SG shortfall, an employer must contribute at least 9.5% of an employee's ordinary time earnings (OTE) base to a complying superannuation fund. If an employer has a shortfall, the amount of the shortfall is calculated by reference to their employee's total salary or wages base.

For the purposes of reducing the employer's SG charge percentage, the Bill proposes to amend the definition of ordinary time earnings (OTE) so that the OTE base specifically includes any contributions that are "sacrificed ordinary time earnings amounts" of the employee for the quarter in respect of the employer. The Bill aims to ensure that contributions under a salary sacrifice arrangement will not be treated as contributions that reduce the employer's SG charge. Rather, the mandatory employer contributions that reduce the SG charge will be calculated on a pre-salary-sacrifice base.

Where sacrificed salary or wages amounts (or sacrificed OTE amounts) are never contributed but instead paid to the employee in a later quarter (eg at the employee's request), they will be disregarded to avoid double counting. The quarterly salary and wages base will also remain subject to the maximum contribution base ($52,760 per quarter for 2017–2018).

Example

Pablo has quarterly OTE of $15,000, which would ordinarily generate an entitlement to $1,425 in SG contributions ($15,000 × 9.5%). He salary sacrifices $1,000 in a quarter, expecting his superannuation contributions to rise to $2,425 for that quarter.

However, his employer uses the sacrificed amount ($1,000) to satisfy part of the employer's SG obligation, and only makes a total contribution of $1,425 (mostly consisting of the employee's $1,000 salary sacrificed amount, and only $425 of employer mandatory contribution).

As a result of the new amendments, Pablo's $1,000 sacrificed contribution would no longer reduce the employer's SG charge. Therefore, the charge percentage would only be reduced by 2.83% ($425 / $15,000 × 100). As the employer is required to contribute 9.5%, it must contribute an additional 6.67% to meet its minimum SG obligations. The total contribution of only $1,425 would mean the employer has a shortfall of approximately $1,000 (6.67% × $15,000).

With sacrificed contributions no longer reducing the charge, Pablo's employer would need to contribute $1,425 (mandatory employer contributions) in addition to the $1,000 employee sacrificed amount, for a total contribution of $2,425, to avoid a shortfall and liability for the SG charge.

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