client alert | explanatory memorandum

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CURRENCY:

This issue of **Client Alert** takes into account developments up to and including 14 February 2018.

Bill to implement housing affordability CGT changes

As part of the 2017–2018 Budget, the Federal Government announced a range of reforms intended to reduce pressure on housing affordability. Legislation – the *Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures No. 2) Bill 2018* – has now been introduced into Parliament. It proposes to:

- remove the entitlement to the capital gains tax (CGT) main residence exemption for foreign residents; and
- modify the foreign resident CGT regime to clarify that, for the purpose of determining whether an entity's underlying value is principally derived from taxable Australian real property (TARP), the principal asset test is applied on an "associate inclusive" basis.

When the Bill has passed, both of these measures will apply from 9 May 2017. At the time of writing, the Bill is before the House of Representatives.

Main residence exemption

The main residence exemption disregards a capital gain or loss for CGT purposes if the taxpayer is an individual and the gain or loss came from selling or disposing of a dwelling that was their main residence throughout the ownership period. A partial exemption is available if the dwelling was their main residence for only part of the period or was also used in part to produce assessable income.

For this exemption, a dwelling includes:

- a building (eg a house) or part of a building (eg an apartment or townhouse) that consists wholly or mainly of accommodation;
- a caravan, houseboat or other mobile home; and
- any land immediately under the unit of accommodation; and
- adjacent land that, together with the land under the dwelling, does not exceed two hectares, and adjacent structures (eg a storeroom, shed or garage) used mainly for domestic or private purposes.

The main residence exemption may also apply to:

- an individual beneficiary in, or entity that is a trustee of, the deceased estate of a person who used the dwelling as a main residence; and
- the trustee of a special disability trust where the dwelling was the main residence of the individual principal beneficiary of the trust, or the main residence of another beneficiary who inherited the dwelling upon the principal beneficiary's death.

Principal asset test

Under the foreign resident CGT regime, a capital gain or capital loss that a foreign resident makes in respect of a membership interest is disregarded unless both the non-portfolio interest test and the principal asset test are satisfied for the interest.

The principal asset test's purpose is to determine when an entity's underlying value is principally derived from TARP. A membership interest that a foreign resident holds in another entity will pass the principal asset test if the total market value of the entity's TARP assets is greater than the total market value of its non-TARP assets.

Capital gains discount for affordable housing

The Bill also proposes to amend the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Taxation Administration Act 1953* (TAA 1953) to provide an additional discount on CGT for affordable housing. The discount of up to 10% will apply if a CGT event happens to an ownership interest in residential premises that has been used to provide affordable housing.

This measure will apply to capital gains that investors realise from CGT events that occur on or after 1 January 2018, for affordable housing tenancies that start before, on or after 1 January 2018.

Changes to small business CGT concessions

Treasury has released draft legislation aimed at ensuring that taxpayers will only be able to access the small business capital gains tax (CGT) concessions for assets that are used (or held ready for use) in the course of a small business or are an interest in a small business.

This measure was announced in the 2017–2018 Federal Budget. The amendments include additional conditions that must be satisfied from 1 July 2017 to apply the small business CGT concession for capital gains that arise in relation to a share in a company or an interest in a trust (the “object entity”).

Broadly, these conditions require that:

- if the taxpayer does not satisfy the maximum net asset value (MNAV) test, the relevant CGT small business entity must have carried on a business just before the CGT event;
- the object entity must have carried on a business just before the CGT event;
- the object entity must either be a CGT small business entity or satisfy the MNAV test (applying a modified rule about when entities are “connected with” other entities); and
- the share or interest must satisfy a modified active asset test that looks through shares and interests in trusts to the activities and assets of the underlying entities.

The consultation period for the exposure draft ends on 28 February 2018.

Maximum net asset value test

To satisfy the MNAV test, the total net value of CGT assets owned must not exceed $6 million just before the relevant CGT event. The limit is not indexed for inflation.

When calculating the total, you must include the net value of CGT assets owned by the taxpayer, any connected entities, any of the taxpayer’s affiliates and entities connected with the affiliates.

Asset values contribute to the total only if the assets are used (or held ready for use) in a business carried on by the taxpayer or a connected entity. An asset doesn’t count towards the total if it is used in the business of an entity that is connected with the taxpayer only because of the taxpayer’s affiliate.

Bill to change residential property GST arrangements

A Bill has been introduced to amend the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act) and related legislation, requiring purchasers of new residential premises and new subdivisions of potential residential land to remit the GST on the purchase price directly to the ATO as part of the settlement process. Under the current law, the supplier of the property (eg the developer) is responsible for remitting the GST to the ATO upon lodging a business activity statement (BAS) up to three months after settlement.

The new measure was announced in the 2017–2018 Federal Budget to deal with developers dissolving their business and setting up a new entity to avoid paying GST to the ATO. In late 2017, the ATO reported that it had identified more than 3,700 people using this type of “phoenixing” activity to avoid their tax obligations over the previous five years.

When the Bill is passed, GST withholding by purchasers will commence on 1 July 2018. There is a two-year transition window for contracts that were executed before that date and will settle before 1 July 2020. After that date, GST withholding will apply to all residential sales.

The withholding amount is 1/11th of the contract price for fully taxable sales (reduced to 7% for margin scheme sales). Settlement adjustments are ignored and the withholding is based on the stated contract price only.

Purchasers will have two options in relation to the withheld GST:

- remit it to the ATO on or before settlement; or
- give the vendor a bank cheque on settlement (made out to the ATO).

All vendors of residential premises/residential land (including developers, investors and private home owners) will need to provide a notice to the purchaser *before settlement* advising whether GST withholding applies. Failure to do so will be a strict liability offence, attracting a fine of $21,000 for individuals and $105,000 for companies.

At the time of writing, the *Treasury Laws Amendment (2018 Measures No. 1) Bill 2018* is before the House of Representatives.

Moving to combat the black economy

The black economy includes people who don't correctly report and meet their tax obligations, and people who operate entirely outside the tax and regulatory system. The Government and the ATO consider the black economy a significant economic and social problem. The Australian Bureau of Statistics estimated in 2012 that the black economy could be as large as 1.5% of Australia's gross domestic product, or around $25 billion.

The Black Economy Taskforce

The Federal Government established the Black Economy Taskforce in 2017 "to develop an innovative, forward-looking whole-of-government policy response to combat the black economy in Australia, recognising that these issues cannot be tackled by traditional tax enforcement measures alone". In its Interim Report (released May 2017) the taskforce noted that a range of trends, vulnerabilities and other considerations suggest that the black economy could be larger today, and made a number of initial recommendations based on the experience of foreign jurisdictions, extensive consultation with stakeholders and the anecdotal evidence that the taskforce received.

The Government has now introduced the *Treasury Laws Amendment (Black Economy Taskforce Measures No. 1) Bill 2018* into Parliament. It proposes to combat the black economy by:

- prohibiting the production, distribution and possession of sales suppression tools;
- prohibiting the use of electronic sales suppression tools to incorrectly keep tax records; and
- requiring entities that have an ABN and that provide courier or cleaning services to report to the ATO (from 1 July 2018) information about transactions that involve engaging other entities to undertake those services for them.

At the time of writing, the Bill is before the House of Representatives.

Sales suppression tools

One of the taskforce's recommendations for immediate action was to prohibit sales suppression technology and software. The Government announced its acceptance of this move in the 2017–2018 Federal Budget''.

Transaction data recorded by point-of-sale (POS) systems is a key component of sales and accounting systems for modern business. This data provides a clear record of transactions against which accounts and tax returns can be audited. The importance of POS systems data for tax auditing has led to some people developing and using tools – known as 'electronic sales suppression tools –' that facilitate tax evasion by suppressing or falsifying POS records of transactions.

Currently, Australia's tax law (namely the *Taxation Administration Act 1953* [TAA 1953]) contains a variety of offences and penalties related to tax evasion and incorrect recordkeeping. These include penalties for providing false or misleading information to the ATO and for incorrectly keeping records with the intent of misleading the ATO.

Although these offences may apply to businesses that use electronic sales suppression software to incorrectly keep their records, the Government believes the TAA 1953 penalties aren't high enough to reflect the seriousness of using tools to intentionally misrepresent a business's tax position.

The Criminal Code in Sch 1 to the *Criminal Code Act 1995* (CCA 1995) also contains offences related to forgery and providing false documents. Manufacturing electronic sales suppression tools may come under the offence for possessing, making or adapting a device for making forgeries, which can be punishable by imprisonment for up to 10 years. However, for the CCA 1995 provisions to apply, the device must be possessed, made or adapted specifically with the intention to commit forgery. The provisions also only apply to Commonwealth documents; this means, broadly, a document purporting to be made by a Commonwealth entity or official.

These requirements can be difficult to satisfy in the case of electronic sales suppression tools. Electronic POS records generally aren't Commonwealth documents. And even where an electronic sales suppression tool that was developed overseas is used to falsify records kept for Australian tax purposes, it's likely to be difficult to demonstrate that the tool was made or supplied with the intention of defrauding the Commonwealth specifically.

Third-party reporting

Another of the taskforce's recommendations for immediate action was to extend the taxable payments reporting system (TPRS) to apply to contractors in the courier and cleaning industries. The Government also announced its acceptance of this move in the 2017–2018 Federal Budget.

The TPRS is a transparency measure that currently applies to the building and construction industry. It requires businesses in that industry to report to the ATO all payments that they make to contractors for building and construction services. The TPRS appears to have improved tax compliance in this area, and has the potential to do the same for the courier and cleaning industries, which are similarly high-risk sectors where tax evasion is concerned.

Corporate tax avoidance: latest ATO targets

The ATO has provided a comprehensive update on its latest compliance projects and focus areas aimed at mitigating corporate tax avoidance.

Manipulation of thin cap rules

The ATO is investigating the possible manipulation of the thin capitalisation rules by 27 taxpayers in relation to asset revaluations totalling $78 billion.

The ATO had anticipated the amount of debt deductions disallowed would increase as a result of the safe harbour debt test thresholds reducing from 75% to 60% in 2014. However, it suspects that some taxpayers have responded by undertaking revaluations of certain assets to increase the value of their total assets. This has limited the impacts of the safe harbour thresholds reductions.

Intellectual property offshore

The ATO is investigating arrangements that result in the migration or artificial allocation of intangible assets, and rights in those assets, to offshore related parties by multinationals. These arrangements present a risk as multinationals implement non-arm’s length arrangements that:

- migrate or artificially allocate Australian generated intangibles to offshore related parties;
- involve the use of intangible rights or assets, where the value of these rights and assets is derived from, or maintained by, the activities and operations of Australian entities – particularly research and development (R&D) activities; and/or
- dispose of or allocate Australian generated intangible assets to offshore related parties and subsequently grant rights in these assets back to Australian entities.

Oil and gas industry

The ATO’s main focus in the oil and gas industry is on the treatment of labour costs (revenue versus capital) associated with the construction of high-value assets. The ATO is seeing taxpayers challenge the capital treatment of these costs. It is also concerned about the treatment of other “general” indirect costs associated with the construction of assets.

Pharmaceutical industry

The ATO will examine arrangements to determine whether Australian subsidiaries and their offshore related parties are operating under arm’s length conditions, such that the income declared reflects the economic contribution of the Australian operation to the Australian and global value chain. The ATO has refined its tax risk concerns to reflect the intricacies of the Australian pharmaceuticals industry and its subdivisions; for example, patented pharmaceuticals, generic pharmaceuticals, medical devices and over-the-counter vitamins and supplements.

Tax professionals and promoters

The ATO is also working to identify tax professionals and advisers who are promoting unacceptable tax planning. It is taking steps to deal with some advisers, including those who seek to cloak the promotion of unacceptable tax planning via inappropriate claims for legal professional privilege.

E-commerce

In the e-commerce industry, the ATO finalised 11 cases in 2017, issued amended assessments worth over $1 billion, collected tax of over $800 million and estimated future company tax revenue effects of over $500 million. It is still looking at another 20 major e-commerce players.

Social security means testing of lifetime retirement income streams

The Department of Social Services (DSS) has released its proposed means testing rules for pooled lifetime retirement income streams.

The pension standards in the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regs) were amended from 1 July 2017 to allow for a broader range of tax-exempt lifetime superannuation income stream products that enable the pooling of risk to manage longevity risk. Lifetime pensions and annuities that meet these new standards qualify for concessional tax treatment.

It is proposed that such pooled lifetime income streams would be assessed for social security means test purposes as follows:

- income test: 70% of all income paid from such products; and

- assets test: 70% of the nominal purchase price of the product until life expectancy at purchase, and 35% from then on.

The DSS says this approach should still provide a sufficient incentive to support take-up of lifetime products. It is expected that pensioners who allocate a proportion of their superannuation (eg up to 30%) to a pooled lifetime product will experience a similar outcome under the income test in the early years of retirement, compared to holding an account-based income stream and drawing the minimum payments.

Compared to the current means test rules for lifetime products, the DSS believes that assessing 70% of the nominal purchase price until life expectancy balances the up-front concessionality with a more consistent asset test assessment over time. It is also considered that maintaining this asset value until life expectancy will help mitigate the risk of lifetime products being used to shield assets from assessment. Once a person reaches life expectancy (as measured at the time they purchased the product), the assessable asset value will be reduced to 35%. DSS says this will help to address the risk of punitive asset test outcomes later in life, while still recognising an asset value for the product.

Deferred income streams

The new rules propose that deferred superannuation income stream products will receive the same asset test assessment as products that commence payments immediately. However, the proposed income test rules will only assess deferred products once payments commence.

Death and surrender values

Where new products offer surrender values or death benefits above the limits imposed by the “capital access schedule” in the SIS Regs, the assets test will assess the maximum value of:

- the amount determined under the proposed new rules (70% of the purchase price until life expectancy age, and then 35%);
- the value of the lump sum amount that is payable if a person withdraws from the product; or
- the highest death benefit payable under the product.

ATO now issuing excess transfer balance determinations

The ATO has advised that is now sending out excess transfer balance (ETB) determinations to individuals who have exceeded their superannuation transfer balance cap and not rectified the excess.

Transfer balance cap

The transfer balance cap, which has applied from 1 July 2017, is a new limit on the total amount of superannuation that can be transferred into the retirement phase. An individual can continue to make multiple transfers into the retirement phase as long as the total amount transferred remains below the cap.

The transfer balance cap has initially been set at $1.6 million, and will be indexed periodically in $100,000 increments in line with the consumer price index (CPI). The amount of indexation an individual is entitled to will be calculated proportionally based on the difference between their transfer balance total and the cap amount. If an individual’s transfer balance meets or exceeds the cap, they will not be entitled to indexation.

Excess transfer balance tax

Self managed superannuation fund (SMSF) members that had exceeded their transfer balance cap by $100,000 or less on 1 July 2017 had until 31 December 2017 to commute the excess capital. If they didn’t do so by that date, they will have to commute the excess capital and excess transfer balance earnings, and also pay excess transfer balance tax.

If an SMSF member receives an ETB determination from the ATO and the trustee has not already reported information to the ATO for that member, they must do so promptly so the ATO has all the required information about the member’s circumstances. The member can request an extension of time if needed, but should do this as soon as possible. The sooner the member removes the amount set out in the ETB determination from retirement phase, the lower the amount of excess transfer balance tax they will pay.

Windfarm grant was an assessable recoupment

The Full Federal Court has dismissed a taxpayer’s appeal and held that a Commonwealth grant of almost $2.5 million for the establishment of a windfarm was an assessable recoupment: *Denmark Community Windfarm Ltd v FCT* [2018] FCAFC 11.

Background

In May 2011, the taxpayer was given a renewable energy grant in respect of 50% of the project costs it had incurred in constructing two wind turbines. The grant was payable in instalments on the completion of identified project milestones.

The ATO issued a private ruling stating that the grant would be assessable income under s 20-20(2) of the *Income Tax Assessment Act 1997* (ITAA 1997). In response, the taxpayer argued that the grant was:

- not assessable under s 20-20(2) because it was not received by way of an “indemnity”; and
- not an assessable recoupment within the meaning of subs 20-20(2) or s 20-20(3) because those provisions required the relevant deduction to have been claimed for a “loss or outgoing”, which, it said, was not the case for deductions claimed for depreciation.

At first instance the Federal Court held that the grant was an assessable recoupment under subs 20-20(2) and 20-20(3). The primary judge found that the grant was received as compensation for an “expense” the taxpayer had incurred, which fell within the meaning of “indemnity”.

Decision

The Full Federal Court dismissed the taxpayer’s appeal and held that the amounts received under the grant were assessable recoupments under s 20-20(2) of ITAA 1997. The Full Court rejected the taxpayer’s argument that the depreciation deductions it claimed were not “for the loss or outgoing” under s 20-20(2)(b). Rather, the Full Court considered that the phrase “for the loss or outgoing” was sufficiently broad to pick up a depreciation deduction under Div 40 or Subdiv 328-D where the relevant outgoing was the cost of the depreciating asset. In such circumstances, the depreciation deduction may properly be regarded as a deduction “for the loss or outgoing”.

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