



TaxTalk

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What would you like to grow?

Contents

<i>Update on investment manager regime reforms</i>	<i>3</i>
<i>Tax treatment of farm-out arrangements</i>	<i>5</i>
<i>In times of market volatility who is a share trader?</i>	<i>12</i>
<i>Successful appeal demonstrates that evidence continues to be critical in Part IVA cases</i>	<i>14</i>
<i>The Commissioner responds to the Inspector General's U-turn review</i>	<i>15</i>
<i>Government to strengthen laws against phoenix companies</i>	<i>16</i>
<i>Cost price of a car: a favourable outcome</i>	<i>17</i>
<i>Corporate tax update</i>	<i>18</i>
<i>Indirect taxes update</i>	<i>19</i>
<i>International tax update</i>	<i>22</i>
<i>Personal tax update</i>	<i>24</i>
<i>Legislation update</i>	<i>26</i>
<i>Other news</i>	<i>27</i>
<i>Upcoming Events</i>	<i>30</i>
<i>Contacts</i>	<i>31</i>

Update on investment manager regime reforms

Following key recommendations in the Johnson Report, the Australian Government is developing an Investment Manager Regime (IMR), intended to remove tax impediments and uncertainty whilst providing incentives to improve Australia's prospects of becoming a financial services hub. In 2010, the Government commissioned the Board of Taxation to prepare a report with recommendations for the IMR, which is due by 30 September 2011. In the meantime, two interim measures have been announced by the Government.

The first of these (FIN 48 measure), announced on 17 December 2010, addresses concerns raised in applying the United States reporting requirements for uncertain tax liabilities (widely known as 'FIN 48') for foreign funds on profits made on Australian equities. The lack of certainty was seen as harming Australia's reputation as an investment market, thereby discouraging investment in to Australia.

The second measure (Conduit foreign income measure), announced on 19 January 2011, confirms that foreign funds having a permanent establishment (PE) in Australia, by reason of using an Australian intermediary, would not be subject to tax on past profits made on realisation of foreign assets. It is believed that this issue historically discouraged foreign funds from engaging the services of an Australian based intermediary.

On 16 August 2011, the Government released for comment exposure draft legislation on these two interim measures and the overall framework for the interim IMR measures.

Interim IMR measures – framework

The central themes of the interim IMR measures are classifying the foreign funds that are eligible for relief and the income and gains covered by the measures. Broadly speaking, an entity is an IMR foreign fund where:

- it is not an Australian tax resident
- under a foreign law it is a collective investment vehicle being broadly an entity designed to pool the funds of a number of investors and which has a common purpose of investing
- the members of the entity do not control the day-to-day operation of the foreign fund
- it does not carry on a trading business in Australia. That is, the entity only undertakes passive activities such as investing in land for the purpose of deriving rent, investing or trading in securities such as shares, bonds, loans, units in a trust, derivatives or any other similar financial arrangements
- the fund is 'widely held' at all times during the year, and
- the fund is not 'closely held' at any time during the year.

Conduit foreign income measure

The draft legislation currently deals with 'IMR income', 'IMR capital gains', 'IMR losses' and 'IMR capital losses'. IMR income, for these measures, is generally income and gains from certain 'financial arrangements' (IMR investments) that are taxable in Australia because the IMR foreign fund is taken to have a PE in Australia. The proposed legislation is not intended to cover circumstances where the income or gains are subject to withholding tax in Australia (such as interest and dividends), and does not extend to situations where the IMR foreign fund has a 'total participation interest' of ten per cent or more in the entity in which the IMR investment is held. Derivatives relating to interests in land are also not covered. Losses and deductions from or relating to IMR investments will not be deductible or available to the IMR foreign fund under the proposed measures. This measure is proposed to apply from the 2010-11 income year.

Update on investment manager regime reforms

4



FIN 48 measure

The draft legislation proposes to clarify the tax treatment adopted in prior years by IMR foreign funds in respect of realised gains and losses from certain Australian investments. Under the proposed measures, the Australian Taxation Office (ATO) will be unable to assess Australian tax in respect of certain income or gains derived by an IMR foreign fund in the 2010-11 or earlier income years from realisation of these Australian investments, provided that:

- the fund has not lodged a tax return for the relevant year or any earlier income year
- the ATO has not issued a tax assessment to the fund before 18 December 2010, and
- the IMR foreign fund had been notified by the ATO before 18 December 2010 that an audit or review was to be undertaken.

However, the Commissioner will not be prevented from issuing an assessment for those years if he is of the opinion that there has been fraud committed by the IMR foreign fund.

This concession will similarly extend to non-resident investors in transparent vehicles (being partners or beneficiaries of the IMR foreign fund or of any interposed partnership or trust), in relation to the relevant income (i.e. the income of the IMR foreign fund from realisation of the relevant Australian investments) flowing through the IMR foreign fund to the investor. However, consistent with the proposal applying to the IMR foreign fund itself, the concession will not be available to the non-resident investor where:

- the investor has before 18 December 2010 been notified by the ATO of a review or audit
- the Commissioner is of the opinion that there has been fraud by the investor, or
- the investor has lodged a tax return in respect of the relevant year or any previous income year.

For the purposes of the FIN 48 measure, the draft legislation currently proposes that the concession will apply to gains which are 'IMR income' as defined in the Conduit foreign income measure discussed above. It would seem however, that having regard to the Government's intention in enacting this measure, the definition of IMR income for this purpose will need to be extended so as to not limit the concession to situations where the IMR foreign fund is taken to have a PE in Australia. We will be seeking to clarify this issue during the consultation process.

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Tax treatment of farm-out arrangements

The Australian Tax Office (ATO) has recently released draft Miscellaneous Taxation Rulings (MTs) in relation to the income tax and goods and services tax (GST) implications of 'farm-out arrangements'. MT 2011/D1, discussing 'immediate farm-out arrangements', was released on 27 July 2011 and related MT2011/D2, regarding 'deferred farm-out arrangements' was released on 24 August 2011. Submissions on MT2011/D1 can be made until 9 September 2011 while submissions on MT2011/D2 can be made until 7 October 2011.

5 For over two decades, the Commissioner's views on the income tax treatment of farm-out arrangements have been outlined in Taxation Ruling IT 2378. In that Ruling, it was considered that the farm-out of genuine greenfields exploration tenements generally did not give rise to a capital gains tax (CGT) liability for the farmor. Since the introduction of the Uniform Capital Allowances (UCA) regime on 1 July 2001, the resources tax industry has operated without administrative guidance regarding the taxation of 'farm-out arrangements' involving post-UCA tenements, and the release of these draft Rulings is an attempt by the ATO to resolve this contentious position. It is debatable whether these rulings successfully resolve the uncertainty.

These draft Rulings provide guidance as to the ATO's view of the tax treatments of these arrangements as they apply to 'depreciating assets' (under the UCA regime). It is important to note that the draft Rulings will only apply to farm-out arrangements of the type defined in the respective Rulings.

Since most farm-out arrangements are specific to individual transactions (and may not meet the definition in the rulings), it will be important to carefully consider the terms and conditions of individual arrangements in order to determine the tax implications that may arise from them. It may well be that these Rulings will only serve as illustrative value for most taxpayers (especially because the draft Rulings explicitly state that they will not apply to arrangements having materially different features to that set out in the draft Rulings).

The application of the taxation rules to the various elements that together comprise a given farm-out transaction remains complex. In addition, the Rulings do not clarify the treatment of farm-out arrangements (and their component transactions) from the perspective the Minerals Resource Rent Tax and Petroleum Resource Rent Tax, and uncertainty remains as to whether the income tax and resource rent tax treatments are completely aligned.

What is a farm-out?

Broadly, a farm-out arrangement is an arrangement entered into for the purpose of facilitating exploration for the discovery of minerals and petroleum resources. A typical arrangement provides for the owner of an interest in a mining tenement (the 'farmor') to transfer a percentage of that interest to another party (the 'farmee') if the farmee meets specified exploration commitments (for example, the farmee may commit to carrying out exploration over a number of years, to a particular dollar value or discovery milestone).

The arrangement may also provide for monetary payments by the farmee to the farmor either directly or indirectly, and the farmor may share mining information with the farmee as a part of the transfer of the interest in the mining tenement.

MT 2011/D1 deals exclusively with immediate farm-out arrangements, that is, where the interest in the underlying tenement is transferred on entry into the arrangement. MT 2011/D2 in turn deals exclusively with deferred transfer farm-out arrangements, where the interest in the underlying tenement is transferred only after the farmee has met all expenditure commitments to earn that interest.



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Tax treatment of farm-out arrangements

Summary of key implications of MT 2011/D1

(All legislative reference are to the Income Tax Assessment Act 1997 unless otherwise stated. A reference to the GST Act is a reference to the A New Business Tax System (Goods and Services Tax) Act 1999).

Key income tax consequences of immediate transfer farm-out arrangements

Event	Consequences for the farmor	Consequences for the farmee	
Transfer of interest in the tenement by the farmor	<ul style="list-style-type: none">UCA balancing adjustment event broadly when the farmor ceases to be the “economic holder”.Timing of balancing adjustment event questionable – MT 2011/D1 takes a broad view of the “economic holder rule” in Item 5 of section 40-40.This broad interpretation of the “economic holder rule” in Item 5 of section 40-40 has emerged from recent ATO interpretive decisions.Whilst it may be favourable for the taxpayer in this context, it can bring forward a taxable disposal for vendor taxpayers and can also interact unfavourably with transitional provisions (i.e. transactions occurring, or involving tenements granted, around 1 July 2001).	<ul style="list-style-type: none">Arguably, the ATO’s interpretation is overly broad and other constructions of the Item 5 holder rule remain open (depending on the terms and conditions of the arrangement and any other applicable State or Federal mining statute).The tax cost of the interest disposed of is equal to a reasonable proportion of the tax cost of the whole tenement (often zero for exploration tenements due to immediate deductions claimed by the farmor).Proceeds (i.e. termination value) equals cash payments received plus the market value of exploration benefits provided by the farmee (which is approximated by the market value of the tenement interest transferred minus up-front cash receipts).	<ul style="list-style-type: none">Acquires an interest in the tenement broadly when the farmee becomes the “economic holder”.Tax cost of the tenement is broadly equal to its termination value for the farmor (i.e. market value of exploration benefits provided to the farmor plus any cash payments made).Tax cost of the interest in the tenement acquired under the arrangement may be deductible if first used for exploration (however, ATO taking restrictive view of first use which could limit these deductions).An additional issue, arising due to the ATO’s emerging interpretation of section 40-80, is that a deduction may only be allowed when the tenement is first physically used for exploration. This could create a timing mismatch for transactions near the end of an income year where the farmee is assessed on the market value of the interest in the tenement acquired (refer below) but is not able to claim an offsetting deduction under section 40-80 in the same year.
Arrangement to conduct exploration activities	<ul style="list-style-type: none">The farmor should be entitled to a deduction for that part of the market value of the interest in the tenement transferred to the farmee to the extent it represents expenditure incurred (being the interest in the mining tenement ventured by the farmor) on exploration or prospecting – that is, it is payment in kind for the farmee to conduct exploration on the farmor’s behalf (note the ATO’s strict interpretation of ‘exploration and prospecting’).	<ul style="list-style-type: none">Allowing an immediate deduction for the farmor is necessary to ensure tax neutrality. However, the ruling’s conclusion that a deduction is available under section 40-730 is novel and alternative interpretations remain open.	<ul style="list-style-type: none">The draft ruling suggests that the farmee is assessed on the market value of the interest in the tenement acquired to the extent that it is a non-cash benefit representing ordinary income received as a reward for providing the exploration services (though many commentators believe that it is arguable that the farmee is not providing a service at all).MT 2011/D1 suggests that the farmee is assessable on receipt of the interest in the tenement. However, it is arguable (depending on the terms and conditions of the farm-out arrangement) that this income should only be considered to be derived progressively as the purported services are provided (if indeed the farmee is deemed to be providing a service).

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Tax treatment of farm-out arrangements

Key income tax consequences of immediate transfer farm-out arrangements (continued)

Event	Consequences for the farmor	Consequences for the farmee
Ongoing exploration activities	<ul style="list-style-type: none"> The tenement should be operated as a joint venture with exploration deductions under section 40-730 and/or section 8-1 deductions claimable as incurred by the relevant party (subject to satisfaction of the relevant conditions). In the scenario where the farmor is free carried entirely by the farmee, then the farmor is not entitled to the ongoing exploration deductions in respect of costs for which the farmor is being “carried” by the farmee. 	<ul style="list-style-type: none"> The tenement should be operated as a joint venture with exploration deductions under section 40-730 and/or section 8-1 deductions claimable as incurred by the relevant party (subject to satisfaction of the relevant conditions). In the scenario where the farmor is free carried entirely by the farmee, then only the farmee is entitled to ongoing exploration deductions. If the expenditure committed to by the farmee is no longer of an ‘exploration’ nature as defined when the expenditure is actually incurred, then alternative deduction provisions would need to be considered in respect of the expenditure ultimately incurred by the farmee (such as for example – UCA depreciation and project pool deductions).

7

Key GST consequences of immediate transfer farm-out arrangements

Event	Consequences for the farmor	Consequences for the farmee
Supply of the interest in the mining tenement to the farmee	<ul style="list-style-type: none"> Farmor makes a ‘taxable supply’ assuming the conditions in section 9-5, GST Act are satisfied and it is not part of a supply that is a GST-free supply of a going concern (under section 38-325, GST Act) and has a GST liability. 	<ul style="list-style-type: none"> Farmee makes a creditable acquisition assuming the conditions in section 11-5, GST Act are satisfied and is entitled to input tax credits.
Supply to the farmor of the exploration benefits	<ul style="list-style-type: none"> Farmor makes a creditable acquisition of exploration benefits and is entitled to input tax credits. 	<ul style="list-style-type: none"> Farmee makes a taxable supply of exploration benefits to the farmor and has a GST liability.
Supply of mining information	<ul style="list-style-type: none"> Farmor makes a taxable supply of the information to the farmee and has a GST liability. 	<ul style="list-style-type: none"> Farmee makes a creditable acquisition of the information and is entitled to input tax credits.

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Tax treatment of farm-out arrangements

Summary of key implications of MT 2011/D2

(All legislative references are to the Income Tax Assessment Act 1997 unless otherwise stated. A reference to the GST Act is a reference to the A New Business Tax System (Goods and Services Tax) Act 1999).

Key income tax consequences of deferred transfer farm-out arrangements

Event	Consequences for the farmor	Consequences for the farmee
Grant of the option to acquire an interest in the tenement by the farmor to the farmee	<ul style="list-style-type: none">• CGT event D2 occurs.• Consideration received or entitled to be received for the grant of the option is assessable as a capital gain (the gain is reversed if the option is ultimately exercised).	<ul style="list-style-type: none">• Acquires an option on capital account.• Consideration provided to the farmor constitutes CGT cost base.• The CGT cost base generates a capital loss if the option expires unused.• The CGT cost base is transformed into a component of the depreciable tax cost of the tenement if the option is ultimately exercised.
Grant of the exclusive use and right of access by the farmor to the farmee in respect of the tenement	<ul style="list-style-type: none">• Payments made to the farmor, or for or on behalf of the farmor, in return for the grant of the right of use and access during the earn-in period are assessable on revenue account when derived.• Farmor's costs to maintain the mining tenement should be deductible when incurred under section 8-1.	<ul style="list-style-type: none">• Payments made to the farmor, or for or on behalf of the farmor, in return for the grant of the right of use and access during the earn-in period should be deductible when incurred under section 8-1 if the conditions in that section are satisfied (otherwise, a capital loss will arise when the right of use and access expires under CGT event C2).• The revenue versus capital distinction of this element of the transaction in the hands of the farmee is likely to be closely scrutinised to ascertain whether an outright revenue deduction can be validly sustained.
Exploration activities during the earn-in period	<ul style="list-style-type: none">• Exploration deductions under section 40-730 and/or section 8-1 deductions claimable as incurred by the relevant party (subject to satisfaction of the relevant conditions).• In the scenario where the farmor is free carried entirely by the farmee during the earn-in period, then the farmor is not entitled to the exploration deductions in respect of costs for which the farmor is being "carried" by the farmee.	<ul style="list-style-type: none">• Exploration deductions under section 40-730 and/or section 8-1 deductions are claimable as incurred by the relevant party (subject to satisfaction of the relevant conditions).• In the scenario where the farmor is free carried entirely by the farmee during the earn-in period, then only the farmee is entitled to exploration deductions.

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Tax treatment of farm-out arrangements

Key income tax consequences of deferred transfer farm-out arrangements (continued)

Event	Consequences for the farmor	Consequences for the farmee
Transfer of interest in the tenement by the farmor	<ul style="list-style-type: none"> Balancing adjustment event broadly when the farmor ceases to be the “economic holder”. Timing of balancing adjustment event questionable – MT 2011/D2 takes a broad view of the “economic holder rule” in Item 5 of section 40-40 (see the comments relating to this point in the table summarising the key implications of MT 2011/D1). As noted above, the ATO’s interpretation is broad and other constructions of the Item 5 holder rule remain open (depending on the terms and conditions of the arrangement and any other applicable state or federal mining statute). The tax cost of the interest disposed of is equal to a reasonable proportion of the tax cost of the whole tenement (often zero for exploration tenements due to immediate deductions claimed by the farmor). Proceeds (i.e. termination value) equals the up-front cash payments received for the grant of the option to acquire the interest plus the market value of exploration benefits provided by the farmee (which is approximated by the market value of the tenement interest at the time of entry into the arrangement minus up-front cash receipts). The initial CGT event D2 gain is reversed. 	<ul style="list-style-type: none"> Acquires an interest in the tenement broadly when the farmee becomes the “economic holder”. Tax cost of the tenement is broadly equal to its termination value for the farmor (i.e. market value of exploration benefits provided to the farmor plus any cash payments made up-front for the acquisition of the option to acquire the interest). Tax cost of the interest in the tenement acquired under the arrangement may be deductible if first used for exploration (however, the ATO is taking restrictive view of first use which could limit these deductions) . Similar timing issues as that outlined in the table summarising the key implications of MT 2011/D1 are applicable under this scenario in respect of the transfer of the interest in the underlying tenement. The risks associated with being able to claim an immediate deduction for the tenement interest acquired becomes even more pronounced if the exploration and appraisal activities funded by the farmee during the earn-in period results in the identification of proven resources that is bankable or that is sufficient to lead to the making of a Final Investment Decision which in turn subsequently triggers the exercise by the farmee of the right to acquire the tenement interest.
Arrangement to conduct exploration activities	<ul style="list-style-type: none"> The farmor should be entitled to a deduction (when the farmee exercises the option to acquire the tenement interest) for that part of the market value of the interest in the tenement transferred to the farmee to the extent it represents expenditure incurred (being the interest in the mining tenement ventured by the farmor) on exploration or prospecting – that is, it is payment in kind to secure the provision of exploration services by the farmee to the farmor (note the ATO’s strict interpretation of ‘exploration and prospecting’). Allowing an immediate deduction for the farmor is necessary to ensure tax neutrality. However, as noted in the table summarising the key implications of MT 2011/D1, the validity of the immediate deduction under section 40-730 may potentially be challenged and/or alternative treatments/interpretations may exist. 	<ul style="list-style-type: none"> The draft Ruling suggests that the farmee is assessed on the market value of the interest in the tenement acquired to the extent that it is a non-cash benefit representing ordinary income received as a reward for providing the exploration services (once again, many commentators would argue that the farmee is not providing a service at all). MT 2011/D2 suggests that the farmee is assessable on receipt of the interest in the tenement (i.e. when the option to acquire the tenement interest is exercised). In a deferred farm-out context, this would generally be the case as the obligation to provide the services must be completed before the farmee is entitled to acquire the tenement interest (if indeed the farmee is deemed to be providing a service to the farmor upon entering into the arrangement).
Farmee withdraws without exercising the option to acquire the tenement interest	<ul style="list-style-type: none"> Exploration benefits or services received represent a non-cash business benefit but no amount is assessable provided the exploration costs are otherwise deductible to the farmor. 	<ul style="list-style-type: none"> Capital loss in respect of the amount paid to the farmor for the option to acquire the tenement interest. No impact to the deductions claimed for exploration expenditure incurred during the earn-in period.

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Tax treatment of farm-out arrangements

Key GST consequences of deferred transfer farm-out arrangements

Event	Consequences for the farmor	Consequences for the farmee
Supply of the option to acquire an interest in the tenement by the farmor to the farmee	<ul style="list-style-type: none"> Farmor makes a 'taxable supply' assuming the conditions in section 9-5, GST Act are satisfied and it is not part of a supply that is a GST-free supply of a going concern (under section 38-325, GST Act) and has a GST liability. Basic attribution rules apply. 	<ul style="list-style-type: none"> Farmee makes a creditable acquisition assuming the conditions in section 11-5, GST Act are satisfied and is entitled to input tax credits. Basic attribution rules apply.
Supply of the exclusive use and right of access by the farmor to the farmee in respect of the tenement	<ul style="list-style-type: none"> Farmor makes a 'taxable supply' assuming the conditions in section 9-5, GST Act are satisfied and it is not part of a supply that is a GST-free supply of a going concern (under section 38-325, GST Act) and has a GST liability. Basic attribution rules apply unless the farmor is an accruals taxpayer and the total consideration is unknown, then the attribution rules in the legislative instrument¹ apply. 	<ul style="list-style-type: none"> Farmee makes a creditable acquisition assuming the conditions in section 11-5, GST Act are satisfied and is entitled to input tax credits. Basic attribution rules apply unless the farmee is an accruals taxpayer and the total consideration is unknown, then the attribution rules in the legislative instrument² apply.
Supply of the interest in the mining tenement to the farmee	<ul style="list-style-type: none"> Farmor makes a 'taxable supply' assuming the conditions in section 9-5, GST Act are satisfied and it is not part of a supply that is a GST-free supply of a going concern (section 38-325, GST Act) and has a GST liability. The attribution rules in the proposed legislative instrument³ apply. 	<ul style="list-style-type: none"> Farmee makes a creditable acquisition assuming the conditions in section 11-5, GST Act are satisfied and is entitled to input tax credits. The attribution rules in the proposed legislative instrument⁴ apply.
Supply to the farmor of the exploration benefits	<ul style="list-style-type: none"> Farmor makes a creditable acquisition of exploration benefits and is entitled to input tax credits. Basic attribution rules apply. 	<ul style="list-style-type: none"> Farmee makes a taxable supply of exploration benefits to the farmor and has a GST liability. Basic attribution rules apply.
Supply of mining information	<ul style="list-style-type: none"> Farmor makes a taxable supply of the information to the farmee and has a GST liability. Basic attribution rules apply. 	<ul style="list-style-type: none"> Farmee makes a creditable acquisition of the information and is entitled to input tax credits. Basic attribution rules apply.

1 See A New Tax System (Goods and Services Tax) (Particular Attribution Rules Where Total Consideration Not Known) Determination (No. 1) 2000

2 *ibid*

3 See the draft of A New Tax System (Goods and Services Tax) (Particular Attribution Rules Where Supply or Acquisition Made Under a Contract Subject to Preconditions) Determination 2011

4 *ibid*

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Tax treatment of farm-out arrangements

Income Tax Implications

In summary:

- MT 2011/D1 concludes that the transfer of an exploration tenement under an immediate farm-out arrangement should generally be tax neutral to the extent of the 'barter' or non-cash component (i.e. no net assessable income or allowable deduction for the farmor or farmee) with subsequent exploration expenditure also being an allowable deduction where the conditions of section 40-730 and section 40-80 of the *Income Tax Assessment Act 1997* (ITAA 1997) are satisfied.
- MT 2011/D2 concludes that the transfer of the interest in the underlying tenement itself under a deferred transfer farm-out arrangement should generally be tax neutral (i.e. no net assessable income or allowable deduction for the farmor or farmee). In theory, under a deferred transfer farm-out arrangement, the farmor should effectively be subject to net assessment on the consideration received (or entitled to be received) for the grant of the option to the farmee to ultimately acquire an interest in the underlying tenement and the grant to the farmee of the right to access and use the tenement during the earn-in period.

The approach taken to reach these outcomes is complicated and arguably other constructions of the relevant provisions remain open.

Furthermore, tax neutrality is only achieved where both parties are able to claim immediate deductions for exploration expenditure incurred, and assets first used,

for exploration and prospecting purposes under section 40-730 and section 40-80 of the ITAA 1997 respectively. Given the ATO's renewed focus on, and narrow interpretation of, these provisions at present many farm-out arrangements may not achieve tax neutrality.

GST Implications

It is important to recognise the Commissioner's view that in these circumstances the farmor and the farmee both make supplies for GST purposes and should issue tax invoices for the appropriate value of the supplies. This is potentially inconsistent with how a number of arrangements have been treated in the past, and may not consider how relevant GST exemptions such as the GST Joint Venture rules would otherwise operate to streamline GST accounting.

Whilst the Commissioner has emphasised that the various transactions should result in an offsetting GST position for each party (giving rise to a nil net GST outcome), this only occurs where both parties account for GST on the same basis and have a fully creditable purpose.

Further, the transaction may give rise to a temporary cash flow cost where the farm-out involves a GST-free supply of a going concern (which includes the supply of the interest in the mining tenement). Whilst the farmor would have no GST payable in respect of this supply (and no entitlement to input tax credits will arise for the farmee), under the ATO's interpretation, the farmee will need to account for GST on its supply of the exploration benefits to the farmor.



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In times of market volatility who is a share trader?

Although the current volatility of the share market may provide opportunities for taxpayers to make short term profits, it does raise the question of how those short term profits should be treated for taxation purposes.

Anyone who is not a long term passive holder of investments should seek specific advice in relation to their personal circumstances and the correct tax treatment of their transactions. In particular, taxpayers who take advantage of periods of stock market volatility in buying or selling decisions should seek further advice.

Revenue treatment will apply where taxpayers are able to demonstrate they are carrying on the business of a share trader. Typically, long term passive investors will be treated as holding their investments on capital account. Revenue treatment as a share trader may allow taxpayers to offset any resulting losses against their other assessable income, however, be wary of the potential application of the 'non commercial loss rules' in the taxation law which could quarantine losses to future years. It also means that a share trader will not qualify for the capital gains tax (CGT) 50 per cent discount on profits. The tax position of taxpayers will therefore differ significantly depending upon whether they hold their investments on revenue account as a trader or on capital account.

The issue of whether a taxpayer is a share trader has been examined in a number of cases over the years and ultimately "is a question of fact and degree, a question of impression".

This question was considered in the recent Administrative Appeals Tribunal (AAT) decision of *The Taxpayer and Commissioner of Taxation* [2011] AATA 545 where the taxpayer was found to be carrying on the business of a share trader. This decision is particularly interesting in light of recent market events as it involves a taxpayer who was trading shares at the height of the Global Financial Crisis (GFC). At the time of writing this article, the Australian Taxation Office (ATO) had not appealed against this finding.

The taxpayer had made a large number of acquisitions and few sales during the year of income which tended to suggest that he was a passive investor acquiring a portfolio of capital assets that would result in capital gains when sold. However, the taxpayer insisted in his evidence that he did not intend to operate in that way. The GFC meant that he bought more and sold less than he anticipated. Even though he may not have looked like a trader, he maintained that this was his intention.

The AAT concluded that it was "satisfied [that] the taxpayer's perception of himself as a trader (as opposed to a passive investor in capital assets) is accurate having regard to the objective facts. The fact he did not end up selling many of

the shares during the period was an accident of history that can be explained in particular by the impact of the GFC. He was an opportunist who bought and sold when opportunities arose. As it happened, the unexpected events of 2007-2008 meant there were more opportunities to buy than there were to sell."

Although the volume of trades entered into by the taxpayer was affected by the prevailing economic conditions, it is important to remember that this is only one of the factors a Court or Tribunal will look to when considering whether a taxpayer is in fact carrying on a business as a share trader. Here the AAT found that there was sufficient additional evidence to support the taxpayer's assertions that he was a share trader.

Such a finding can be contrasted with the earlier AAT decision in *Smith and Commissioner of Taxation* [2010] AATA 576. There the AAT also considered the question of whether an individual was carrying on business as a share trader during the GFC. Although the decision acknowledged that the GFC impacted the volume of trades entered into by the taxpayer, when considered together, all the surrounding facts and circumstances pointed to the conclusion that the taxpayer was not carrying on a business and was not a share trader. Resultant gains and losses were therefore treated as being on capital account.

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In times of market volatility who is a share trader?

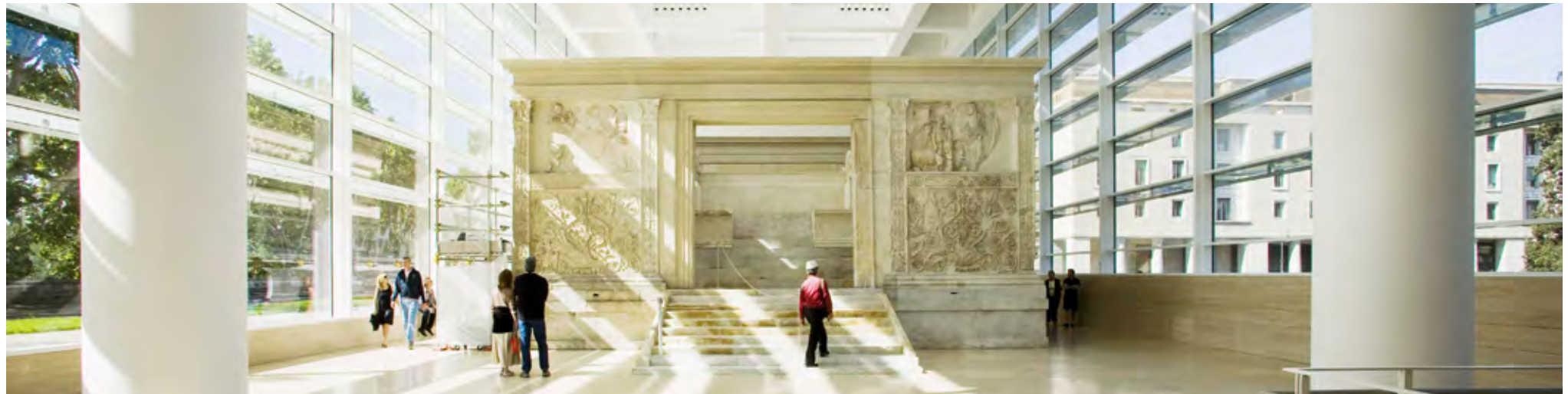
A number of important points can be gleaned from these decisions – and these become increasingly relevant with continued market volatility which may result in short term gains (and losses):

- The original intention of the taxpayer is critical in determining whether they are a share trader from the outset. If not, and there is a subsequent change, it is critical to understand what brought about this change.
- It is important to determine the trading or investment strategy and the manner in which it is implemented. In these recent cases, the Courts have considered the taxpayer's level of sophistication as a share trader when considering the issues.
- Appropriate record keeping of all transactions is essential.

- Where a taxpayer is engaged in full time employment and is also operating the business of share trading, the Courts will closely scrutinise the amount of time spent on the share trading activities.
- Where capital treatment is relevant, the volume of transactions entered into should be considered with all other factors, particularly where a number of short term gains/losses have resulted. Although only one factor, it may tend towards a conclusion that the taxpayer is a share trader as opposed to a long-term passive investor.

Even if not considered a share trader, revenue treatment may still apply to share transactions for those taxpayers who have entered into the transaction(s) with a profit-making intention. Where gains are on revenue account, the benefit of the CGT 50 per cent discount available to passive investors (subject to specific criteria being satisfied) will generally not be available.

Determining whether a profit-making intention exists requires a consideration of all the surrounding facts and circumstances including the taxpayer's investment strategy. Taxation Determination, TD 2011/21 which is featured elsewhere in this edition of *TaxTalk*, provides the Commissioner's views on the question of determining whether the realisation of investments by a trustee, not carrying on a business of share trading, may nonetheless be treated on revenue account and not on capital account. Whilst TD 2011/21 deals specifically with the position of trustees, the factors outlined in the Determination which are to be considered in determining whether a gain made by the trust is to be treated on revenue account need to be considered by all taxpayers to determine whether gains made on disposal of assets are taxable on revenue account even if the taxpayer is not a share trader.



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Successful appeal demonstrates that evidence continues to be critical in Part IVA cases

The recent decision in *RCI Pty Limited v Commissioner of Taxation* [2011] FCAFC 104 is a fact rich case which highlights that the evidence before the Court is critical in decisions concerning the application of Part IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936). On 22 August 2011, the Full Federal Court allowed RCI's appeal reversing the decision at first instance and found that the general anti-avoidance rules in Part IVA did not apply.

At issue was whether Part IVA applied to include a capital gain in respect of a dividend paid by a US company (JHH(0)) to its Australian parent company (RCI) prior to the intra-group transfer of JHH(0). The Commissioner argued that RCI had entered into a capital gains tax reduction arrangement and that the dividend reduced the market value of the shares in JHH(0) and consequently, RCI's capital gain on the subsequent transfer of the shares. The Commissioner contended that had the scheme not been entered into, James Hardie Industries Limited (JHIL) being the parent company of the James Hardie group of companies, would have proceeded with a scheme that involved the transfer of the JHH(0) shares at the full market value, resulting in an additional tax cost (and ultimately a transaction cost) of \$172 million.

Tax Benefit

The Federal Court initially determined that RCI had failed to discharge the burden of proving that the Commissioner's counterfactual was unreasonable, and accordingly, RCI had acquired a tax benefit. In allowing the appeal, the Full Court confirmed the earlier case law on 'tax benefit' and found

that the Court at first instance did not correctly apply the test required by Part IVA to objectively determine what might reasonably be expected to have occurred if the scheme had not been entered into [at 130]:

"That is because the issue is not whether the Commissioner puts forward a reasonable counterfactual or not; it is a question of the Court determining objectively, and on all of the evidence, including inferences open on the evidence, as well as the apparent logic of events, what would have or might reasonably be expected to have occurred if the scheme had not been entered into"

The Full Court considered two "very important contemporaneous documents", an Information Memorandum circulated to the shareholders of JHIL and the Chairman's address to shareholders, which emphasised the importance in limiting the transaction costs of the repatriation of funds within the JHIL group. The transactions costs were estimated at only \$35 million. The Commissioner's counterfactual would have resulted in an increase in the cost of implementation from \$35 million to \$207 million. The Full Court concluded that [150]

"...if the scheme in either of its manifestations had not been entered into or carried out, the reasonable expectation is that the relevant parties would have either abandoned the proposal, indefinitely deferred it, altered it so that it did not involve the transfer by RCI of its shares in JHH(0) to RCI Malta, or pursued one or more of the other alternatives referred to in the Information Memorandum, but they would not have proceeded to have RCI transfer its shares in JHH(0) to RCI Malta at a tax cost of \$172 million".

The finding that there was no reasonable expectation of the alternate transaction requiring RCI to pay an additional \$178 million tax was contextualised by the Full Court as a finding of fact in respect of the disposal as part of an internal reorganisation.

Dominant purpose

Having concluded that RCI did not obtain a tax benefit, the Full Court was not required to determine whether RCI entered into the scheme for the dominant purpose of obtaining a tax benefit. The Full Court nevertheless concluded that the primary judge had erred in her conclusion in respect of the dominant purpose test. In assessing the eight factors of the dominant purposes test in section 177D(b) of the ITAA 1936, only the size of the \$318 million dividend, which was larger than previous years, indicated that the parties had entered into the scheme for the dominant purpose of obtaining a tax benefit. Importantly, the Full Court determined that there was no commitment by the board of JHIL to the share transfer at the time of declaring the dividend, indicating that the dividend was not declared for the dominant purpose of obtaining the tax benefit put forward by the Commissioner.

The Commissioner will now have 28 days following the handing down of the decision (22 August 2011) to lodge a Special Leave Application to the High Court of Australia.

The Commissioner responds to the Inspector General's U-turn review

The Commissioner has recently released his Practice Statement on the matters he will consider when determining whether the Australian Tax Office's (ATO's) view of the law should be applied only prospectively (PS LA 2011/27). This Practice Statement was developed in response to recommendations from the Inspector-General of Taxation in his 'U-turn review' Report issued last year.

Taxpayers who feel that the Commissioner has made a decision which is at odds with previous information provided by the Commissioner may now have grounds to complain under relevant circumstances as provided in the Practice Statement.

The Practice Statement requires ATO officers to consider whether the ATO has contributed in any fashion to a different view of the law on a particular issue than the view the ATO now considers correct. This can be to taxpayers generally or to particular classes of taxpayers or industry groups, but not to a particular individual taxpayer. ATO officers will be required to undertake research to "form an opinion whether any ATO publications, products or conduct could have reasonably conveyed a different view on a particular issue" (at paragraph 31).

The relevant factors that ATO officers must consider are set out in paragraph 36 of the Practice Statement. These focus on the extent to which the ATO has facilitated or contributed to taxpayers adopting a different view of the law, particularly by not challenging in a timely manner a position taken by taxpayers, or by making statements that would lead taxpayers to apply the law in a certain manner.

However, in particular cases where the ATO considers there is fraud or evasion, or where it considers general anti-avoidance provisions should apply, the ATO will not be bound by the Practice Statement and will be free to apply the law retrospectively irrespective of its own contribution to the adoption of a different view of the law.

The Practice Statement sets out a number of examples of circumstances where the ATO would only apply the law prospectively (such as the existence of a general industry practice arising from ATO communications), and where it would apply the law retrospectively (where the ATO is not aware of any industry practice and has not issued a definitive view on the particular issue).

While the Practice Statement does not prevent the ATO from applying laws retrospectively, it does provide some clarity as to how that decision should be made and what obligations fall on ATO officers before making that decision. It may also provide taxpayers with an opportunity to challenge a retrospective application of the law if they can demonstrate the ATO contributed to a particular view of the law.



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Government to strengthen laws against phoenix companies

As mentioned in the August 2011 edition of *TaxTalk*, the Assistant Treasurer recently released exposure draft legislation and explanatory material relating to proposed amendments to the law to assist the Australian Taxation Office (ATO) in cracking down on 'phoenix activity'. The changes strengthen the director penalty provisions of the *Taxation Administration Act 1953*.

Under the proposed changes, a company's unpaid pay-as-you-go (PAYG) withholding amounts and superannuation guarantee debts more than three months old may become personal liabilities of the company's directors without notice from the Commissioner.

The current director penalty regime is limited to a company's PAYG withholding obligations. Under the regime, where PAYG withholding amounts are not paid to the ATO, the ATO must issue a notice to the directors of the non-compliant company and provide 21 days for them to either pay the unpaid amounts, or appoint an administrator or wind up the company. This notice period provides an opportunity for a director to place a company into voluntary liquidation which often results in the unpaid amounts never being recoverable.

The draft legislation includes provisions which will remove the requirement for the ATO to give notice once a company's debt under the PAYG withholding provisions is more than three months old, and allow the Commissioner to immediately commence proceedings to recover the applicable director penalty from the directors. The only way a director can then extinguish that personal liability is to pay the debt or penalty – appointment of an administrator or winding up the company will no longer allow the director to avoid personal responsibility.

The draft legislation also includes a provision which gives the Commissioner a discretion to reduce the entitlements of a director or an associate of a director to PAYG withholding tax credits in their personal income tax returns in circumstances where the director's company has not complied with its PAYG withholding obligations. Currently there is no linkage between the conduct of the company and the director's personal tax affairs.

In addition to the proposed amendments relating to unpaid PAYG withholding obligations, the draft legislation also proposes to extend these provisions to unpaid superannuation guarantee obligations of companies in an attempt to better protect employee entitlements to compulsory superannuation payments.

The consultation period in respect of these amendments has now ended and we will watch developments with interest.



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Cost price of a car: a favourable outcome

A newly released Ruling provides clarity on the Commissioner's views regarding the 'cost price' of a car for fringe benefit tax (FBT) purposes. In doing so, the ruling provides employers with a unique opportunity to review existing practices and amend prior year FBT returns where a conservative approach had been previously taken due to limited and less favourable guidance from the Australian Tax Office (ATO).

The 'cost price' of a car is a major element in determining the value of a car fringe benefit where the statutory formula method is used and has a direct impact on the amount of FBT paid.

The key elements resulting from the Ruling (TR 2011/3) released on 17 August 2011 include:

- where an employee provides a trade-in vehicle to a car dealer, the value of the trade-in vehicle reduces the cost price of a car acquired by the employer
- where an employee makes a cash payment to the dealer (or to the employer) to assist with the employer's purchase of the car, the value of the cash payment reduces the cost price of the car, and
- fleet discounts, sales incentives, manufacturers' rebates and other discounts applied by car dealers reduces the cost price of a car.

The release of the Ruling requires employers to immediately review their existing calculation methodology to ensure the likes of trade-ins, employee contributions, all manufacturer rebates and other discounts do not form part of the cost price of a car for FBT purposes. Our observations are that these components are commonly ignored or are conservatively factored into the cost price, therefore, increasing the FBT liability associated with the vehicle.

Further, the decision reached in the Ruling has effect both before and after its date of issue. Therefore, this presents a significant opportunity for employers to obtain a retrospective claw back of FBT paid where the cost price of cars has been overstated.

It is important to note that the Ruling only deals with the 'cost price' of a car for FBT purposes, and where an employee does make a contribution toward the cost of a car not purchased by the employee, other taxation issues may need to be considered, including:

- where the car is leased, the Commissioner has indicated that the lease may not be treated as a lease for taxation purposes. In this situation it would remain to be considered how the arrangement is to be treated for income tax and FBT purposes, and
- determining for income tax purposes whether the amount contributed by the employee is an assessable recoupment to the 'holder' of the car, noting that generally, as a matter of commercial practice, the sale price of a car is unaffected by arrangements as to how the retail price of the car is to be paid. Thus the retail price agreed upon purchase will be the amount to be used in determining 'decline in value' deductions, but subject to the depreciation 'car limit' which places a cap on the deductions that may be claimed.

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Corporate tax update

In *GE Capital Finance Australasia Pty Limited v Commissioner of Taxation* [2011] FCA 849, the Federal Court (at first instance) has found for the taxpayer (GECF Asia) in a case involving the choice for a newly incorporated 'eligible tier one company' to join a 'multiple entry consolidated' (MEC) group.

Briefly, the facts of the case were that the GECF Asia (the 'provisional head company') sent to the Commissioner an 'approved form' specifying that a MEC was formed on 1 July 2003. In the section of the form requiring disclosure of 'current members' of the group, a company (GEMIH) that was incorporated on 10 November 2003 was included as a member. This was despite the fact that by the time the form was lodged with the Commissioner, GEMIH had exited the group (assuming it was actually included in the group) through an initial public offering (IPO). The sections of the form requesting details of companies that joined the group since formation (1 July 2003) and who had exited before the form was lodged was not completed. Despite these 'deficiencies,' GECF Asia's position was that GEMIH joined the group on 10 November 2003 and then exited the group at the time of the IPO.

The parties to the dispute were in agreement that on its incorporation, GEMIH was eligible to join the MEC group as a member, and as found by the Justice Gordon, there was only one date on which GEMIH could become a member of the group (10 November 2003).

After its incorporation on 10 November 2003, certain assets were transferred to GEMIH from companies that formed the MEC group on 1 July 2003, and based on GECF Asia's position that GEMIH was a member of the MEC group at the time of the asset transfers, GECF Asia maintained that the transfers were not subject to capital gains tax (CGT). In other words, the transfers were not subject to CGT because of the 'single entity rule' that applies to consolidated and MEC groups. The Commissioner disagreed with this position, arguing that GECF Asia had not properly made the choice for GEMIH to join the group and that CGT applied to the asset transfers.

When originally introduced into the taxation law, the choice to form and also to join a MEC group needed to be made in the approved form and lodged with the Commissioner by the prescribed date. However, retrospective changes to the law (introduced in 2010) allowed GECF Asia to apply the changed law to the dispute, which simply requires that the choice be evidenced in writing made before the prescribed date. Whilst there is a requirement to send the completed approved form to the Commissioner, failure to do so does not of itself impact on whether or not the choice has been made.

After considering various internal documents prepared by personnel of GECF Asia involved in the 'tax function' and also the form lodged with the Commissioner before the prescribed date, Justice Gordon concluded that a choice in

writing had been made for GEMIH to join the MEC group, albeit there was no date specified in writing as to the date that GEMIH so joined the group. According to Justice Gordon, the fact that no date was specified did not matter since, as a matter of statutory interpretation, the choice did not need to specify the date and there was only one date that could apply, that date being 10 November 2003. Based on this view Justice Gordon concluded that CGT did not apply.

In the event however that as a matter of law there was a requirement to specify a date in writing, Justice Gordon further considered whether the equitable remedy of 'rectification' could apply to have the 10 November 2003 date that was inadvertently omitted from the approved form included in the form. Since in her Honour's opinion, GECF Asia clearly intended that GEMIH join the MEC group on 10 November 2003, her Honour expressed the view that rectification would apply if it were necessary to overcome the deficiency in not specifying the date that GEMIH joined the group.

The Commissioner has commenced proceedings to obtain leave of the Full Federal Court to appeal the decision.

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Indirect taxes update

Draft legislation on reform of GST financial services provisions

On 18 August 2011, the Assistant Treasurer released exposure draft legislation for three of the seven proposed changes to the financial supply provisions of the goods and services tax (GST) law announced by the Government in the 2010-11 Federal Budget. The changes relate to:

- **Increase in the Financial Acquisitions Threshold**

The financial acquisitions threshold (FAT) for determining whether input tax credits must be blocked in relation to financial supplies will be increased from \$50,000 to \$150,000 with effect from 1 July 2012. The effect is to increase the amount of acquisitions that relate to making financial supplies that can be made before input tax credits must be denied from \$550,000 to \$1.65 million (inclusive of GST). The financial acquisitions threshold remains a 'two limb' test that must be considered monthly looking at both the previous 11 months and the next 11 months. While this change will not impact entities whose core business involves the making of financial supplies or taxpayers who undertake larger share transactions, it may provide relief for businesses which make minimal or irregular financial supplies.

- **Hire purchase arrangements**

A new Division 158 of the GST law will be introduced in relation to acquisitions made under hire purchase agreements entered into on or after 1 July 2012. The practical effect of the change is to allow taxpayers on a cash accounting basis to claim the full amount of any available input tax credits at the time the first payment is invoiced or paid (rather than claiming progressively in relation to each payment). This will improve cash flow, and should therefore remove the existing GST-related bias away from hire purchase arrangements for small to medium businesses. Asset financiers will also need to consider the impact of the changes on finance product decisions by these businesses.

- **Input tax credits for borrowing expenses – restrictions for ADI deposit accounts**

The exposure draft provides details of the changes announced last year to restrict the 'borrowing concession' to exclude bank deposit accounts. The borrowing concession deals with situations where taxpayers borrow funds to use in their taxable activities, and essentially removes what would otherwise be a restriction on the entitlement to claim input tax credits. The proposed legislation specifically restricts this concessional treatment to borrowings acquired other than through a deposit account which the taxpayer makes available. This change will affect acquisitions made by authorised deposit-taking institutions (ADIs) from 1 July 2012.

Interested parties have until 16 September 2011 to lodge submissions.

Revised draft legislation on self assessment for indirect taxes

On 22 August 2011, the Assistant Treasurer released revised exposure draft legislation to harmonise the self acting system for indirect taxes with the income tax system of self assessment. The proposed legislation also provides for the period of review to be refreshed when an amendment is made to a taxpayer's assessment. The revised draft follows submissions in response to the draft originally released in January 2011. Submissions are due by 20 September 2011.



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Indirect taxes update

GST Rulings update

After a period where there has been comparatively little movement in goods and services tax (GST) Rulings, the last month has seen some significant developments in relation to:

- **Multi-party transactions**

On 10 August 2011, two Draft Addenda were issued by the Australian Taxation Office (ATO) in relation to GSTR 2006/9 (the “supplies ruling”) and GSTR 2006/10 (regarding insurance settlements and entitlements to input tax credits). Among other things, the Draft Addenda, once finalised, will amend the two Rulings to reflect the reasoning of the Full Federal Court in *Commissioner of Taxation v Secretary to the Department of Transport (Victoria)* [2010] FCAFC 84. The proposed amendments result in a broader approach than that taken by the Commissioner to date to determine if a supplier makes a supply to a third party payer under a tripartite arrangement, and whether a supplier makes a supply to an insurer for a payment that an insurer makes to the insured or a third party. Comments are due by 16 September 2011.

- **Loyalty programs**

On 24 August 2011, the ATO released Draft GST Ruling GSTR 2011/D3 concerning the GST implications of certain loyalty programs. The Draft Ruling considers a range of issues including the treatment of points allocation and redemption, and arrangements between loyalty program operators and third parties. Comments on the draft ruling are due by 7 October 2011.

- **Transfer farm-out arrangements in the resources sector**

On 27 July, the Commissioner released Draft Miscellaneous Taxation Ruling MT 2011/D1 on the application of the income tax and GST laws to immediate transfer farm-out arrangements entered into by the mining and petroleum resource sectors. This Draft Ruling has clarified the GST treatment, but has instituted new GST accounting requirements. On 24 August, Draft Miscellaneous Taxation Ruling MT 2011/D2 was released in relation to deferred transfer farm-out arrangements, which are arguably more common in a mining context. These Draft Rulings are featured earlier in this *TaxTalk* edition.

GST cases update

Two decisions of the Federal Court this month will be of interest to taxpayers with potential GST refund entitlements:

- In *Central Equity Limited v Commissioner of Taxation* [2011] FCA 908, the Federal Court considered the GST treatment of a property transaction, finding that it did amount to a taxable supply of real property on or after 1 July 2000, where the enforceable contract for sale was entered into before 1 July 2000 but settlement of the contract occurred after that date. Of more ongoing interest, the Court also commented on the level of detail required to be included in a notification of entitlement to a refund, made pursuant to section 105-55 in Schedule 1 to the *Taxation Administration Act 1953*.

- In *International All Sports v Commissioner of Taxation* [2011] FCA 824, the Federal Court considered the application of the special GST rules relating to gambling supplies, in particular the treatment of monetary prizes given to non-residents. In addition, the Court rejected the Commissioner’s interpretation of section 105-65 in Schedule 1 to the *Taxation Administration Act* which provides that the Commissioner need not give a taxpayer a refund in certain circumstances.

Carbon price – GST and fuel tax implications

On Thursday 28 July 2011, the Australian Government released exposure draft legislation in relation to its recently announced climate change plan, ‘Securing a Clean Energy Future – the Australian Government’s Climate Change Plan’. Legislation is expected to be tabled in Parliament during the Spring 2011 sitting:

- GST treatment – in keeping with the VAT/GST treatment applied to similar permits overseas, Australia’s carbon units are to be treated as GST-free. Therefore, no GST will be payable on the issue, transfer, assignment or other transmission of an “eligible emissions unit” and entities trading in units will be entitled to claim full GST input tax credits on associated costs. The normal GST rules will apply to grants of financial assistance under the package and also financial derivatives of carbon units.
- Fuel tax changes – significant changes to the existing fuel tax credit and excise regimes are a core part of the carbon price proposals, and these will need to be factored into the projected costs of fuel going forward.

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Indirect taxes update

Indirect tax issues arising from the Productivity Commission Draft Report on the Retail Industry

The Productivity Commission released its draft report on the Economic Structure and Performance of the Australian Retail Industry on 4 August 2011. The draft report considers a number of indirect tax-related issues, including the appropriateness of the current \$1,000 low value threshold (LVT) for exemption from GST and duty on imports, and the efficiency of current processes for collecting taxes and duties at the border.

The Commission has outlined some options for reforming the process, based on processes that are already in place internationally, and has recommended further investigation, however the draft report makes clear that retailers should not expect immediate changes in the processing of imports which would allow the LVT to be lowered or tax neutrality being achieved in other ways. It is therefore important that retailers facing challenges arising from the growth in online channels consider their options in light of the current indirect tax regimes, given that any changes are some time away.

The final Productivity Commission report is expected to be released in November 2011.



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International tax update

United Kingdom: anti-avoidance rule to apply to tax treaty benefits

Her Majesty's Revenue & Customs (HMRC) has published draft anti-avoidance legislation which aims to prevent certain persons from benefiting from the provisions of a Double Tax Agreement (DTA), where the claim to such a benefit is part of an arrangement whose main purpose is to reduce a liability to United Kingdom (UK) taxation. The draft legislation contains separate measures dealing with tax avoidance by UK residents and non-UK residents. The effect of both measures is that a provision of a DTA will not limit the right of the UK to tax income or gains where certain conditions are met.

Broadly the legislation will deny the treaty benefit where:

- a scheme is put into place by one or more persons
- the treaty relieving provision would not apply in the absence of the scheme, and
- the main purpose, or one of the main purposes of a person putting the scheme in place is to ensure that the treaty provisions apply to the income, profits or gains.

There is no grandfathering provision such that the rules would apply to levy withholding tax on income arising post enactment from, for example, pre existing loans and licences. The proposed legislation will apply even when there is an existing treaty shopping provision in a tax treaty such that both sets of provisions are required to be considered.

United States: Foreign Account Tax Compliance Act

The United States (US) Internal Revenue Service (IRS) recently issued a Notice that will delay the effective starting date to withhold tax under the *Foreign Account Tax Compliance Act* (FATCA). As a result of this Notice, transitional relief to withhold has been provided, and it is now clear that FATCA withholding (including withholding on 'withholdable payments' made to Non-Financial Foreign Entities) will be phased in according to the following schedule:

- 1 January 2014 – FATCA withholding on US source fixed or determinable, annual or periodical (FDAP) income (for example, dividends, interest and rents) will generally begin on 1 January 2014, and
- 1 January 2015 – FATCA withholding on 'passthru payments' and gross proceeds from the disposition of securities that could produce US source interest and dividends will be effective on 1 January 2015.

However, foreign financial institutions will need to enter into a 'FFI agreement' with the US Treasury by 30 June 2013 in order to ensure there is no 30 per cent withholding for the calendar year 2014 on FDAP income.

"This document contains US tax advice and US law requires that we include the following statement: This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding US federal, state or local tax penalties."

This document has been prepared for information purposes only and is not to be relied upon by readers of this publication or any other person for US tax purposes".

New Zealand: Inland Revenue 2011-12 Compliance Focus Report

The New Zealand Inland Revenue Department (Inland Revenue) has recently released 2011-12 Compliance Focus Report which sets out the tax compliance risks of most concern to the Department, together with proposed strategies to address those risks.

As in prior years, transfer pricing is highlighted in the 2011-12 Compliance Focus Report as a key risk over the next 12 months. Accordingly, it is important that New Zealand members of multinational groups have sound transfer pricing policies and maintain appropriate documentation to support their transfer pricing filing positions.

The key aspects of Inland Revenue's 2011-12 Compliance Focus Report that are of relevance to transfer pricing are:

- **Large enterprises**

Inland Revenue will continue to assess transfer pricing issues annually across the Large Enterprises group (broadly, taxpayers with annual turnover exceeding NZ\$300 million) and will investigate any high-risk entities or issues identified.

International tax update

• Losses

In 2011-12, an important focus of Inland Revenue's review program will be on losses, to ensure that they are not driven by non-arm's length pricing and thin capitalisation. Inland Revenue will be specifically looking at:

- New Zealand-owned multinationals for possible importation of losses from overseas subsidiaries through non-arm's length subsidies and support payments, and
- groups with above average debt that may have been exposed to losses and asset write-downs.

• Controlled foreign corporations (CFCs)

Changes to New Zealand's CFC rules mean that active income of CFCs is generally no longer subject to tax in New Zealand. Transfer pricing rules will now therefore have more significance in relation to CFCs and Inland Revenue intends to monitor associated risks through its transfer pricing review program.

In addition, a number of questions have been added to the CFC form and Inland Revenue will investigate any unusual trends identified in taxpayers' disclosures. Transfer pricing aspects of the structures and tax returns of major taxpayers with significant CFCs will also be reviewed.

• Advance pricing agreements (APAs)

To reinforce its commitment to the APA program, Inland Revenue has now redirected its resources to allow more requests for APAs to be managed. This is a positive development, as Inland Revenue's APA process is efficient, timely and cost effective.

Inland Revenue's 2011-12 Compliance Focus Report, and recent discussions with Inland Revenue personnel, indicate that Inland Revenue's transfer pricing review activity will continue in 2011-12. Accordingly, New Zealand taxpayers with cross-border associated party transactions should ensure that their transfer pricing policies and filing positions are defensible, and that they are ready to support those positions in the event of future Inland Revenue scrutiny.

23



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Personal tax update

Tax Office view on when a superannuation income stream commences and ceases

On 13 July 2011, the Commissioner of Taxation issued Draft Taxation Ruling TR 2011/D3 dealing with superannuation income streams. The key elements to the Draft Ruling centre around what is an income stream (pension), when does it commence and when will it cease.

What is an income stream?

There is legislation that defines what is an income stream, but the fundamental requirements are:

- that a payment is made at least annually
- the minimum amount must be paid each year
- the pension can be transferable to another upon death, and
- the capital value of the pension cannot be used as security.

When does an income stream commence?

The commencement date of an income stream is determined through the Fund's trust deed provisions and as agreed by the Trustee(s) and Members. It cannot be started until all capital to support the income stream has been added. The Deed of the Fund may state various differing conditions. It could be that the pension is commenced the first day after the application is received, the first day of the month after the application has been received, or even after a cooling-off period.

It is essential that the trust deed of the Fund is reviewed to determine the situation if it is proposed that an income stream commences payment.

When does an income stream cease?

This section of the Draft Ruling has caused the most concern to industry, in particular the death of a Member, and whether this triggers the income stream to cease on the date of death.

The Ruling outlines that an income stream is considered to cease where there is no longer a Member who is entitled (or reversionary beneficiary) to be paid a benefit. Some common scenarios in which an income stream will be taken to have ceased are as follows:

- *Failure to comply with the minimum pension drawing for a given income year.* If the beneficiary fails to take the minimum pension drawing during an income year, the Fund is taken to not have been paying a pension at any time of the year. This also means that the Fund loses the ability to claim the exempt pension deduction for that entire year (making the Fund taxable for that entire period). If the requirements of a pension are subsequently met in the next income year, it is taken that the income stream has recommenced.
- *Exhaustion of capital.* When the capital supporting the pension has reduced to nil, the pension is considered to have ceased.

- *Commutation.* A full commutation will occur where a Member requests that they withdraw their future entitlement to an income stream benefit for an entitlement to a lump sum amount. This will only be the case where there is a commutation of their entire benefit. If a Member requests only a partial commutation, then the income stream will not cease.
- *Death.* In the case that the Member in receipt of the income stream dies, if the income stream cannot continue then the income stream is no longer considered to be paid, and the pension is deemed to cease on the date of death (including tax exemptions that apply in pension phase). This is commonly the case where there are no dependent beneficiaries to receive benefits (e.g. no spouse and the deceased's children are financially independent). If the member, however, has set up a reversionary dependent beneficiary or a valid binding death nomination for the dependent beneficiary to receive a pension, the pension can continue along with the tax free exemptions on earnings. If the benefit is being paid to a non-dependant, only lump sums are able to be paid. Thus, it is important to understand who is a dependent beneficiary and who is not. If there are no dependent beneficiaries, this means that any capital gains made on having to sell down assets to fund the death benefit payment will be taxable, along with any earnings during the time between death and payment. There is no time allowance for the estate to be administered, which is the objection the industry has with this draft Ruling.

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Personal tax update

The issues raised in the Draft Ruling will need to be carefully considered by fund trustee and individuals with superannuation interests. In particular, fund trustees should review the rules of the Fund to ensure that the fund rules and legislation are complied with, and that payments made from the Fund are correctly classified as either superannuation income stream payments or lump sum benefit payments. Depending on the classification there will be different tax outcomes for the Fund and the superannuation beneficiary.

The Commissioner's view on tax treatment of gains and losses on trustee investments

On 17 August 2011, the Commissioner of Taxation issued Taxation Determination TD 2011/21, which outlines the Commissioner's final view in relation to the tax treatment of a gain or loss from an investment made by an entity in its capacity as trustee of a trust. Specifically, the Determination outlines the basis on which a gain or loss will be treated on capital account or on revenue account.

Key points made by the ATO in the Determination include:

- It is the Commissioner's view that the mere fact that a gain or loss from an investment is made by an entity in its capacity as trustee is not conclusive as to whether the gain or loss is on revenue or capital account for tax purposes.
- A gain or loss is on revenue account for tax purposes if no provision of the income tax law specifically treats it as being on capital account (e.g. section 275-100 of the *Income Tax Assessment Act 1997* which applies in respect of certain assets owned by the trustee of a 'managed

investment trust') and, after a wide survey and exact scrutiny of all of the relevant factors, it is determined that the gain or loss was from:

- a normal operation in the course of carrying on a business of investment
- an extraordinary operation by reference to the ordinary course of that business but one entered into with the intention of making a profit or gain, or
- a one-off or isolated transaction where the investment was acquired in a business operation or commercial transaction for the purpose of profit-making.

The ATO notes that while the nature of the trust and the terms and content of the trustee's duties are important considerations in the characterisation process, they are not necessarily determinative in any particular case. They must be carefully weighed together with other factors such as:

- the nature and scale of the trustee's investment and other activities
- the investment style employed in respect of the trust assets
- the nature of the trust assets
- the length of time individual investments are held
- the regularity in sale activity involving the trust assets
- the average annual turnover of the trust assets
- the percentage of total income which the gains represent, and
- the nature of any connection between the trustee and other parties to the dealings.

If after considering these facts, it is concluded that the disposal of the investment amounts to no more than a mere realisation or change of investment, the Determination states that the gain or loss will be on capital account.

Notably the Determination makes it clear that merely because an entity acquires and holds assets as a trustee and thus has trust law duties to administer the trust estate in the interests of beneficiaries, the trustee may nonetheless be treated as holding the assets and/or dealing with the assets on revenue account.

Affected trustees will need to review their activities in the light of the views expressed by the Commissioner in the Determination (including the examples provided), and assess whether gains and losses on realisation of investments are on capital account or on revenue account.



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Legislation update

Following Winter recess, Federal Parliament passed the *Tax Laws Amendment (Research and Development) Bill 2010* and the *Income Tax Rates Amendment (Research and Development) Bill 2010* on 24 August 2011. Broadly, the new research and development (R&D) tax incentive program takes a two-tiered approach:

- 45 per cent refundable R&D tax offset will be available for companies with a grouped turnover of less than \$20 million, and
- a 40 per cent non-refundable R&D tax offset will be available for companies with a grouped turnover of more than \$20 million.

This law includes the following amendments:

- The program has a retrospective start date of 1 July 2011, and applies for full income years commencing on or after 1 July 2011.
- From 1 January 2014, quarterly instalment payments will be available to companies eligible for 'cash back' under the 45 per cent refundable tax offset.

The new legislation also provides the following:

- greater ability to claim where R&D is undertaken in Australia but the intellectual property is held offshore, or where some R&D activities are undertaken overseas, and
- the opportunity to apply for a Private Binding Ruling on R&D activities.

Other Federal revenue measures introduced during August 2011 include the following:

Social Security (International Agreements) Act 1999 Amendment Regulations 2011 (No 1), registered on 4 August 2011, and *Social Security (International Agreements) Act 1999 Amendment Regulations 2011 (No 2)* registered on 17 August 2011, amend the *Social Security (International Agreements) Act 1999* to insert the agreements which coordinate the social security schemes (pensions) of Australia and the Republic of Austria and the Slovak Republic respectively to give better retirement income protection for people who move between the two countries and to address the issue of double superannuation coverage for employers. Both agreements are yet to enter into force.



Other news

Film Tax Offset Changes

On 29 July 2011, the Assistant Treasurer and Minister for Financial Services and Superannuation released exposure draft legislation designed to support Australia's film industry.

According to the draft explanatory material released by the Assistant Treasurer with the draft legislation, the proposed amendments will amend Division 376 of the *Income Tax Assessment Act 1997* with the changes affecting the *producer offset* including:

- amending the qualifying expenditure threshold for feature films, single episode dramas and documentary programs to \$500,000
- disallowing eligibility for those companies which receive financial assistance under the Producer Equity Program
- allowing additional screen production costs to be claimed as qualifying expenditure
- allowing television series to benefit for their first 65 broadcast hours
- allowing films with qualifying expenditure of less than \$15 million to use actual exchange rates rather than existing averaging rules
- removing the 20 per cent cap on development expenditure or remuneration provided to the principal director, producers and principal cast associated with the documentary

- allowing certain distribution and marketing costs to be included in qualifying expenditure
- allowing short-form animated documentaries access to the offset, and
- excluding goods and services tax from an amount of expenditure for the purpose of applying the offset.

The changes affecting the *location and post, digital and visual effects offsets* include;

- increasing the rate of the location offset from 15 per cent to 16.5 per cent
- increasing the post, digital and visual effects offset from 15 per cent to 30 per cent
- permitting some additional screen production costs to be claimed as qualifying expenditure, and
- excluding goods and services tax from an amount of expenditure for the purpose of applying these offsets.

For further information, please contact Eddy Moussa on (02) 8266 9156.

Enhancing tax concessions for special disability trusts

On 31 July 2011, the Assistant Treasurer and Minister for Financial Services and Superannuation, and the Parliamentary Secretary for Disabilities and Carers issued a media statement upon the release of the exposure draft legislation and draft explanatory material relating to

changes to be made to the tax treatment of 'special disability trusts' (SDT).

A SDT is a trust that meets the requirements of section 1209L of the Commonwealth's *Social Security Act 1991*. SDTs were introduced in 2006 to assist families and carers to make private financial provision for the current and future care and accommodation needs of a family member with severe disability — referred to as the principal beneficiary.



Other news

According to the explanatory material to the exposure draft legislation, there are two key benefits of establishing an SDT:

- Immediate family members making gifts to an SDT may access a concession of up to a combined total of \$500,000 from the social security or veterans' entitlements gifting rules.
- Assets of an SDT up to \$578,500 (current as at 1 July 2011 and indexed annually) plus the principal beneficiary's principal place of residence do not impact upon the principal beneficiary's ability to access income support payments.

The proposed amendments are designed to make SDTs more beneficial for families by:

- providing a capital gains tax (CGT) exemption for assets transferred into an SDT for no consideration
- extending the CGT 'main residence' exemption to SDTs
- providing a CGT exemption for the recipient of the principal beneficiary's 'main residence', if their ownership interest ends within two years of the principal beneficiary's death, and
- ensuring equivalent taxation treatment amongst SDTs established under different Acts.

It is intended that the changes will apply from the 2006-07 income year, to align with when SDTs were first able to be established.

Clean Energy Future Draft Legislation Released

As reported in our special publication – *Carbon Price Mechanism: Tax implications for businesses impacted by the carbon price and its complementary measures*, on 28 July 2011 the Government released of exposure draft legislation forming part of the Government's Clean Energy Legislative Package.

The Clean Energy Legislative Package includes four main bills:

- the *Clean Energy Bill 2011* (which sets up the carbon price mechanism)
- the *Clean Energy Regulator Bill 2011* (which establishes a regulatory body to administer the mechanism)
- the *Climate Change Authority Bill 2011* (which establishes a new Authority to advise the government on the future design of the carbon price mechanism), and
- the *Clean Energy (Consequential Amendments) Bill 2011*.

In addition there are several further Bills dealing with other consequential and procedural matters and Bills dealing with fuel tax arrangements.

The Government will consider submissions on the drafting of the Bills before they are introduced into the Parliament.

Taxation of alternative fuels

On 2 August 2011, the Assistant Treasurer and Minister for Financial Services and Superannuation announced the release for public consultation of exposure draft Regulations, and an exposure draft explanatory statement covering changes necessitated by the Taxation of Alternative Fuels legislation package which received Royal Assent on 29 June 2011 (see August 2011 edition of *TaxTalk*). The closing date for submissions was 15 August 2011.

Deductions for the cost of disability Insurance through superannuation

On 3 August 2011, the Department of Treasury released for public consultation draft Regulations specifying the deductible percentages and associated insurance policy descriptions necessary to give effect to the amendments to the tax law made by *Tax Laws Amendment (2011 Measures No. 4) Act 2011*, relating to the cost of total and permanent disability (TPD) insurance provided through superannuation. Those amendments provide for the percentage of certain TPD insurance premiums (or the cost of self insurance) that is deductible to superannuation funds to be specified in Regulations (see July 2011 edition of *TaxTalk*). The closing date for submissions was 12 August 2011.

Other news

Farm management deposits

On 8 August 2011, the Assistant Treasurer and Minister for Financial Services and Superannuation released for public consultation a package of exposure draft legislation, Regulations and associated explanatory materials to amend aspects of the tax laws related to farm management deposits (FMDs), and section 69 in the *Banking Act 1959*.

Proposed legislative changes include:

- amendments to the *Income Tax Assessment Act 1997* (ITAA 1997) to allow a FMD owner affected by an applicable natural disaster to access their FMDs within 12 months of making a deposit while retaining concessional tax treatment, and to allow FMD owners to hold FMDs simultaneously with more than one FMD provider
- amendments to the *Taxation Administration Act 1953* to require FMD providers to report certain information about FMDs to the Agriculture Secretary on a monthly basis before the 11th day after the end of a month calendar month, and
- amendments to the *Banking Act 1959* so that an FMD becomes unclaimed moneys only if the FMD has not been operated on for a period of at least seven years and the authorised deposit-taking institution (which is the FMD provider) is unable to contact the FMD owner after making reasonable efforts.

The amendments relating to holding FMDs with more than one FMD provider, reporting requirements and the unclaimed moneys provision are proposed to apply from 1 July 2012. The amendment to allow FMD owners affected by applicable natural disasters to access their FMDs within 12 months of making a deposit applies from 1 July 2010. This retrospectivity is beneficial for FMD owners who were affected by natural disasters in the 2010-11 income year.

The proposed changes to the Regulations are designed to align the *Income Tax (Farm Management Deposits) Regulations 1998* with the above mentioned legislative changes.



Upcoming Events

Included below are some of our upcoming events.

City	Date	Contacts
Brisbane		
<i>R&DSchool – Manufacturing and Processing, including Food & Food Processing</i>	Friday, 9 September	Kate Crossan 07 3257 8516 or kate.crossan@au.pwc.com
<i>R&DSchool – General workshop</i>	Friday, 9 September	Kate Crossan 07 3257 8516 or kate.crossan@au.pwc.com
<i>R&DSchool – Gold Coast general workshop</i>	Thursday, 15 September	Kate Crossan 07 3257 8516 or kate.crossan@au.pwc.com
Canberra		
<i>The New R&D Tax Incentive</i>	Monday, 26 September	Sonya Domanski 03 8603 4219 or sonya.domanski@au.pwc.com
Melbourne		
<i>Understanding and managing tax risks for short term business visitors</i>	Tuesday, 13 September	Joanne Hermans 03 8603 4017 or joanne.hermans@au.pwc.com
<i>BASchool</i>	Tuesday, 13 September	Daniel Royce 03 8603 4027 or daniel.royce@au.pwc.com
<i>The New R&D Tax Incentive</i>	Thursday, 15 September	Sonya Domanski 03 8603 4219 or sonya.domanski@au.pwc.com
Sydney		
<i>Understanding and managing tax risks for short term business visitors</i>	Wednesday, 21 September	India Jolly 02 8266 2003 or india.jolly@au.pwc.com

For further information, please phone the event contact provided. For a full list of our upcoming Tax and Legal events, please contact Sonya Domanski on +61 (3) 8603 4219.

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