May 2016

TaxTalk Monthly

Keeping you up to date on the latest Australian and international tax developments

Welcome to the May 2016 edition of TaxTalk Monthly

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Corporate tax update

Commissioner seeks special leave to appeal in tax consolidation litigation

The Commissioner of Taxation has lodged an application seeking special leave to appeal to the High Court of Australia against the Full Federal Court decision in *Financial Synergy Holdings Pty Ltd v Commissioner of Taxation* [2016] FCAFC 31. In this case, the Full Court agreed with the taxpayer that the time of acquisition of units in a unit trust that was subject to a capital gains tax (CGT) rollover was the date of the relevant contract for acquisition which occurred in 2007, and not a date that was apparently "just" before 20 September 1985. The importance of determining the *time of acquisition* is that the market value of the shares (given as consideration for acquiring the units) at the *time of acquisition* is the CGT cost base of the units under sub-section 110-25(2) of the *Income Tax Assessment Act* 1997 (ITAA 1997). This CGT cost base was relevant to the tax consolidation tax cost setting process (at Step 1) when the unit trust became a member of the tax consolidated group.

The Commissioner's reasoning for a date immediately before 20 September 1985 being treated as the time of acquisition, was that the effect of the CGT rollover (under sub-section 122-70(3) of the ITAA 1997) was to deem the units to have been acquired before 20 September 1985, not only for the purposes of preserving the pre-CGT status of the units, but also for the purposes of setting their cost for the purposes of sub-section 110-25(2). The Full Court rejected this reasoning, saying that there were a number of contextual reasons against extending the effect of sub-section 122-70(3) to govern the time of acquisition for the purpose of working out the cost base of the units under sub-section 110-25(2), including that (and citing *Commissioner of Taxation v Comber* (1986) 10 FCR 88 at 96 as authority) the function of the deeming provision in sub-section 122-70(3) did not need to extend beyond that purpose in the context of Division 122 of the ITAA 1997.

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Improved access to corporate losses

On 6 April 2016, the Commonwealth Treasury released draft legislation as part of the Government's National Innovation and Science Agenda, that is designed to improve access by companies to tax and capital losses by supplementing the existing 'same business test' with a new, more flexible 'similar business test'.

The current same business test discourages loss companies that have new equity investors which would cause the failure of the "continuity of ownership test", to innovate and adapt their current business activities. The purpose of the proposed similar business test measure is to encourage innovation by allowing loss-making corporates (and listed widely held trusts) to seek out new opportunities to return to profitability.

The new similar business test will be satisfied if, in general terms, the business that the company carries on in the year a loss is to be recouped is a similar business to the business it carried on immediately before the change of ownership or control that caused it to fail the continuity of ownership test.

These amendments will broadly apply to losses made by companies for income years beginning on or after 1 July 2015.

Submissions were sought on the proposed law by 22 April 2016. It was the intention of Government to have these measures introduced into Parliament in the Winter session.

Senate Report into Corporate Tax Avoidance - Part 2 - Gaming the system

The Senate Standing Committee on Economics issued its second report on its inquiry into corporate tax avoidance - Part 2: Gaming the system - on 22 April 2016.

In this report, the committee only made one recommendation and that was that the inquiry be extended until 30 September 2016 to explore the implications arising from the "Panama Papers". The Green's senators made a further recommendation that the government implements a comprehensive response to corporate tax avoidance, starting with the establishment of a public register of beneficial ownership and a public register of tax settlements.

Key points noted:

- The committee reiterates its position that greater transparency in tax affairs is important both for addressing profit shifting by multinationals and maintaining public confidence in the integrity of the tax system. While the committee notes that a government consultation process is underway to develop a

voluntary tax transparency code, it is sceptical that a voluntary code will provide the necessary incentives for multinationals with questionable tax practices to disclose their affairs, and considers that a mandatory tax reporting code should be implemented as soon as practicable.

- The parallel legislative inquiry which examined the government's multinational tax avoidance bill last year recommended that a post-implementation review of the laws be undertaken within three years. The committee noted that this recommendation should be incorporated into a broader review of Australia's progress in implementing the Base Erosion and Profit Shifting (BEPS) recommendations.
- Recommendation 3 (mandatory tax transparency code), recommendation 4 (reinstating the tax transparency laws as originally enacted), recommendations 5, 7 and 11 (Public register of settlements, annual report to Parliament and ATO resourcing) and recommendation 13 (Grandfathered proprietary companies) from the Senate Committee's interim report were reinforced.
- It is evident to the committee that recent legislative changes may not be sufficient to address the multinational profit shifting problem. There are two main areas - transfer pricing and interest deductions - where the committee considered that the present system architecture is not adequate and further reform may be warranted.

Areas for further action:

- The committee considers it is in the broader public interest for significant global entities to be required to file general purpose financial accounts. It urges the government to amend the accounting standards and make significant global entities file general purpose accounts for their Australian activities.
- The evidence presented over the course of this inquiry indicated to the committee that transfer pricing provisions do not serve Australia well. The committee appreciates that there are no easy solutions to reforming internationally accepted principles as they relate to transfer pricing. That said, the committee considers that the current transfer pricing principles need to be fully explored, and, where necessary, redrafted to ensure that transfer pricing cannot be manipulated to the detriment of Australian tax revenue.
- Throughout the course of the inquiry, more and more evidence emerged to suggest to the committee that tax avoidance is widespread among both individuals and corporations. In light of the most recent release of the "Panama Papers", the committee has resolved that it should explore the wider implications of this new information on tax avoidance and assess initiatives by the Australian Taxation Office to combat tax avoidance and aggressive minimisation by individuals as well as corporations.

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Employment tax update

Notice of data matching program for contractor payments (Cth)

The ATO has announced that it will acquire data from businesses that it visits as part of its employer obligations compliance audits during the 2017 to 2019 financial years. The data collected will include details of the payments made to the contractors. These records will be electronically matched with existing ATO data to identify non-compliance with registration, lodgement, reporting and payment obligations under taxation laws.

Cents per kilometre rate and Fringe Benefits Tax (Cth)

The ATO has announced special arrangements in relation to the calculation of cents per kilometre allowances paid during the FBT year ended 31 March 2016. While the Government had made changes to remove the tiered cents per kilometre rates based on engine size in favour of a flat rate of 66 cents per kilometre for all cars, in light of taxpayer uncertainty around the correct rate to apply for the 2016 FBT year, the ATO has confirmed it will accept 2016 FBT returns which have used the FY15 cents per kilometre rates for the entire FBT year.

For future FBT years, employers should use the rate determined by the Commissioner for the financial year ending on 30 June following the end of the FBT year. For example, for the FBT year ending 31 March 2017, employers should use the car rate determined by the Commissioner for the 2016–17 financial year.

Businesses targeted for employee and contractor obligations (Cth)

The ATO has published information on its website to help employers in the bakery, supermarket, car retailing, and computer system design industries to meet their tax and superannuation guarantee obligations. Businesses in these industries have been identified as having a higher risk of not meeting their business obligations.

The ATO has stated that from July 2016 they will be undertaking audits of employers who continue to fail to meet their obligations in respect of employees and contractors.

WA payroll tax threshold increase from 1 July 2016 reminder (WA)

From 1 July 2016, the WA payroll tax threshold will increase from $800,000 to $850,000.

The diminishing threshold will be calculated on annual wages between $850,000 and $7.5 million. The tapering value used to calculate the payroll tax threshold will change from 8/67 to 17/133. This effectively means for every $133 over the threshold, the employer will lose $17 of their payroll tax threshold.

Visa and migration

Migration Legislation Amendment (2016 Measures No. 1) Regulation 2016, registered on 15 April 2016, amends the *Migration Regulations 1994* to address inappropriate use of the Subclass 457 Visa, streamline the processing of Subclass 457 Visa applications, remove Visa criteria which require provision of evidence of English language proficiency, clarify compelling reasons for giving special consideration to granting a Subclass 202 Visa and introducing a simplified international student Visa framework.

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International tax update

Tax treaty with Germany

On 1 April 2016, the Commonwealth Treasury released draft legislation to give the new Australia/Germany tax treaty the force of law in Australia. The treaty was signed on 12 November 2015. The new treaty will enter into force after both countries have completed their respective domestic requirements and instruments of ratification have been exchanged.

New Zealand

The New Zealand (NZ) Government has announced a package of proposed tax changes that are intended to reduce compliance costs and make tax simpler for businesses. The package aims to make paying tax easier and more certain, reduce the burden of interest and penalties, and help smaller businesses to tailor payments to their own circumstances. A summary document available on the NZ Inland Revenue's Policy Advice website outlines all 16 proposed changes.

Taxpayer Alert on revaluation of assets for thin capitalisation purposes

On 26 April 2016, the Commissioner of Taxation issued Taxpayer Alert TA 2016/1 which covers thin capitalisation and revaluation of certain intangible assets. This Alert is just one of many issued in April that deal with various multinational tax issues.

TA 2016/1 deals predominantly with sections 820-683 and s820-684 of the Income Tax Assessment Act 1997 (ITAA 1997) which, for thin capitalisation purposes, allows departure from the 'accounting standards' in relation to recognition and valuation of certain 'internally generated intangible assets' (other than goodwill). Under s820-683, assets (other than goodwill) which fall under the definition of internally generated intangible asset in Australian Accounting Standard AASB 138 (AASB 138) can be recognised for thin capitalisation purposes, if the asset cannot be recognised under that standard as an internally generated intangible asset because AASB 138 determines that the cost of the item cannot be distinguished from the cost of developing the entity's business as a whole. Importantly however, the further condition in s820-683 is that the asset in question must otherwise meet the criteria under AASB 138 for recognition as such an asset.

In TA 2016/1, the Commissioner states his concern that some taxpayers have been applying s820-683 to assets that would not otherwise meet the criteria in AASB 138 for recognition as an internally generated intangible asset. In this respect, AASB 138, at paragraph 9 provides the criteria that must be satisfied for an item to be regarded as an intangible asset. These are:

- identifiability - this requires an intangible asset to be identifiable to distinguish it from goodwill. Under AASB 138, an asset is identifiable if it either:
  - is separable, i.e. is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so
  - arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations
- control over a resource - under AASB 138, an entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control
- existence of future economic benefits - under AASB 138, the future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the entity.

AASB 138 provides further commentary on these criteria and gives some examples.

The items that the Commissioner has identified in TA 2016/1 as not being intangible assets for the purposes of AASB 138 (and therefore are not within the scope of s820-683) are:

- market related items such as 'customer relationships' or 'customer loyalty'
- human resource items, including 'skilled staff', 'management' or 'key employees/training'

- organisational resources including 'internal policies', 'internal meeting protocols', 'procedures' and 'manuals', and
- assets not owned and controlled by the taxpayer.

In relation to customer relationships which has historically been considered by many taxpayers under the consolidation tax cost setting process, a general proposition is that this would not be an internally generated intangible asset because of the lack of control able to be exercised over customers where there is no legal right to 'compel custom'. Whether there would be control in situations where there is economic dependence of the customer on the taxpayer would need to be carefully considered on a case by case basis.

A further aspect of TA 2016/1 deals with revaluations undertaken for thin capitalisation purposes. Issues raised by the Commissioner as concerns are:

- Applying unsupportable or questionable management assumptions. For example:
  - Software valuations which assume a useful life of 25 years or more
  - Growth rates in excess of historic and probable market indicators.
- Generic material such as internal policies, internal meeting protocols and procedures being revalued.
- Double counting of asset value across multiple intangibles (e.g. recognition and revaluation of separate 'business processes' items connected to intellectual property), including failure to correspondingly impair other intangible assets where the 'revalued' intangible asset relies on the same underlying economic returns.
- Revaluing the intangible asset based on economic returns which do not accrue to the taxpayer.

The revaluations for thin capitalisation purposes need to satisfy the criteria in s820-680 of the ITAA 1997.

Finally, TA 2016/1 expresses the Commissioner's concern that taxpayers are not 'impairing' assets where the fair value or the cash generating unit has declined (as required by AASB 136 Impairment of Assets).

The effect of the issue of TA 2016/1 is that taxpayers who have recognised internally generated items for thin capitalisation purposes should be on notice that the Commissioner will sooner or later be reviewing the approach taken. In some instances, ATO compliance activities are underway with cases identified from data analysis including tax returns and the International Dealings Schedule.

Other Taxpayer Alerts that issued on 26 April 2016 are:

- TA 2016/2: Interim arrangements in response to the Multinational Anti Avoidance Law (MAAL)
- TA 2016/3: Arrangements involving related party foreign currency denominated finance with related party cross currency interest rate swaps
- TA 2016/4: Cross-border leasing arrangements involving mobile assets.

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Legislative update

Commonwealth revenue measures introduced into Parliament or registered as legislative instruments or regulations since our previous *TaxTalk Monthly* publication include the following:

Tax and Superannuation Laws Amendment (2016 measures No 1) Regulation 2016, registered on 15 April 2016, amends the A *New Tax System (Goods and Services Tax) Regulations 1999* and the *Superannuation Industry (Supervision) Regulations 1994* to make consequential amendments to account for changes to the tax law made by the *Tax and Superannuation Laws Amendment (2015 Measures No.6) Act 2016* and the *Tax and Superannuation Laws Amendment (2015 Measures No.1) Act 2016* (if enacted). Specifically, the Regulation:

- extends the definition of 'financial supply' in the goods and services tax (GST) Regulations so that it would include the supply of bank accounts and superannuation interests by foreign financial institutions in circumstances where an equivalent supply by an Australian entity is an 'input taxed financial supply'
- creates an exception to the superannuation contribution restrictions, allowing funds to accept a contribution of an amount of the proceeds of the sale of a business to which the small business retirement concession applies. This is provided the sale involved an 'earnout right' and the contribution would not have been affected by the contribution restrictions had it been made during the financial year in which the business was sold. This amendment applies in relation to 'look through earnout rights' (within the meaning of the *Income Tax Assessment Act 1997*) created on or after 24 April 2015.

With the proroguing of Federal Parliament on Friday 15 April 2016, there has been no further consideration of tax-related Bills that were before the House of Representatives and the Senate.

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Other News

Foreign investment review framework

On 8 April 2016, the Senate Economics References Committee released its report on its inquiry into the foreign investment review framework in Australia, making the following four recommendations:

- Treasury publish guidance about the foreign investment review assessment process including information on the steps and features of the process
- Treasury publish the Treasurer's rationale behind both positive and negative decisions

regarding foreign investment, in order to inform the public and to instill public and investor confidence in the review process

- The Australian Government establish a publicly available Agricultural Land Register for all foreign-owned agricultural land to increase public confidence in Australia's foreign investment review framework and its effectiveness in safeguarding Australia's long term economic and security interests
- The Senate extend the inquiry reporting date to 28 April 2016 to undertake an examination of the foreign investment review framework in relation to the proposed lease by the New South Wales (NSW) Government of Ausgrid, the second largest provider in the NSW electricity network.

New export loan for small business

On 6 April 2016, the Minister for Trade and Investment announced a new scheme to provide export loans to small businesses. The loans, which are to be provided by Australia's export finance agency, Export Finance and Insurance Corporation (Efic), are intended to improve convenience, increase approval speed and provide greater flexibility for Australian businesses seeking finance to export.

According to the Minister's media statement "the loan product enables businesses with annual revenue between $250,000 and $5 million to access up to $250,000 to support an export contract. The loan will be available to small exporters when their bank is unable to help".

The key features of the product include the following:

- Loan amount (unsecured): $50,000 - $250,000
- Eligibility criteria:
  - Businesses with an annual revenue of $250,000 - $5 million p.a.
  - Company established for at least two years
  - Company must have exported with the last twelve months
  - The loan must be used to finance a single specific export contract or purchase order for the export of goods and or other services from Australia.
- Borrowing limit: 80 per cent of the export contract or purchase order
- Loan term: 3, 6, 9 or 12 months

There is a $100 Initial application fee and a $1,000 Credit assessment fee and the interest rate which is fixed for the term of the loan is higher than for unsecured bank overdraft facilities.

Proposal to allow self-assessment of effective life of certain intangibles

On 1 April 2016, the Commonwealth Treasury released draft legislation as part of the Government's National Innovation and Science Agenda to amend the tax law to allow taxpayers the choice to either self-assess the effective life of certain intangible depreciating assets or use the statutory effective life. The proposed measure will give taxpayers the opportunity to better align the tax treatment of intangible assets with the actual period of time that the assets provide economic benefits, rather than being limited to claiming depreciation deductions over a statutory based period.

The intangible assets to which this choice will apply from 1 July 2016 are:

- a standard patent
- an innovation patent
- a petty patent
- a registered design
- a copyright (except copyright in film)
- a licence (except one relating to a copyright or in-house software)
- a licence relating to a copyright (except copyright in a film)
- an in-house software
- a spectrum licence
- a datacasting transmitter licence, and
- a telecommunications site access right.

Submissions were sought on the proposed law by 22 April 2016. It was the intention of Government to have these measures introduced into Parliament in the Winter session.

Data matching programs

The Commissioner of Taxation has given formal notice of the following data matching programs and amendment to existing programs:

- Addendum to the Credit & Debit Cards 2014-15 program to specify that the Commissioner will also be collecting data from Suncorp-Metway Ltd as part of this existing program.
- Special Payment Systems 2014-17 program under which the the Commissioner will acquire data relating to electronic payments made to merchants through specialised payment systems for the 2014-15, 2015-16 and 2016-17 financial years

- Contractor Payments 2016 -19 program under which the Commissioner will acquire data from businesses that it visits as part of its employer obligations compliance program during the 2016-17; 2017-18 and 2018-19 financial years
- Commonwealth electoral roll program under which the Commissioner will acquire details of registered voters on the Commonwealth electoral view from the Australian Electoral Commissioner. This data will be collected on an ongoing basis and refreshed every three months.

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State Taxes Update

Victorian State Budget released

The Victorian State Budget for 2016-17 was released on 27 April 2016 by the Treasurer of Victoria, Tim Pallas MP.

The Victorian Government announced that the stamp duty surcharge applying to 'foreign purchasers' of residential property in Victoria will increase from 3% to 7% for contracts entered into on or after 1 July 2016, resulting in a stamp duty rate of up to 12.5% on the dutiable value of residential property acquired by foreign purchasers. Further, the land tax surcharge will increase from 0.5% to 1.5% for taxable land owned by an 'absentee owner' in respect of the 2017 land tax year onwards, resulting in annual land tax rates of up to 3.75% on the taxable value of all taxable land in Victoria held by an absentee owner.

The Government also announced that the payroll tax-free threshold will progressively increase from $550,000 to $650,000 over the next four years in $25,000 increments, starting with an increase to $575,000 from 1 July 2016. Further, a payroll tax exemption will be introduced for the wages paid or payable by an employer to a displaced apprentice or trainee from 1 July 2016.

Property developer Metricon successful in NSW Supreme Court appeal for primary production land

On 31 March 2016, the Supreme Court of NSW ruled in favour of the taxpayer (a property developer) who claimed the primary production exemption in respect of parcels of land in NSW. The land was mostly used for cattle grazing and partially for residential rent. The taxpayer also incurred over $2.2 million in consultants, planning and development application fees during the review period. No earthworks had commenced. The Court found that the dominant 'use' of the property was for primary production, and that the use of the property as a 'land bank' for future development was not to be considered for the purposes of the exemption.

The key issue of the case involve the claim by the Chief Commissioner the 'dominant use' of the land was not for the maintenance of cattle when compared with other, competing uses of the lands.

In summary, the Court found that the primary production use of the land was greater in scale and intensity than the rental use or any other alternate use of the land. The consulting fees were not incurred for the current use of the land and do not alter the dominant use of the land for primary production.

The *Metricon* decision provides some scope for questioning any denial of the primary production exemption by Chief Commissioner for land tax purposes especially in cases where there has been no change to the physical use of the land.

The *Metricon* case provides taxpayers, particularly property developers, with some certainty that the primary production land tax exemption may be claimed for land being held for future development. The mere expenditure of costs incurred on intangible planning work – such as property consultants, planning, environment reports and the like –in relation to the future use of the land which does not affect the current physical use of the land does not automatically mean that the primary production exemption will not apply. Therefore, taxpayers who have been denied the primary production exemptions on the basis that their land had alternative use or significant expenses have been incurred in relation to future use of the land should consider reviewing their position in light of this case.

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Superannuation update

US withholding tax refunds

The US Internal Revenue Service (IRS) recently began denying refunds of withholding tax for foreign investors on claims from the 2014 and 2015 US tax years. This appears to follow new IRS and US Treasury regulations and procedures to limit claims for refunds or credits to amounts verified by the IRS as actually deposited, or deny claims altogether where the withholding information disclosed on the US tax return does not match the information reported by their withholding agent.

This emphasises the need to ensure that W8-BEN E forms are completed correctly up front, as this is what withholding agents in the US use to determine the correct rates of withholding tax. Funds need to ensure W8 BEN E forms are correctly completed and should work proactively with withholding agents to avoid any issues or inconsistency which could cause the IRS to deny a refund or credit of US taxes.

OECD BEPS Consultation – Pension Fund definition

As part of its "Base Erosion and Profit Shifting" project, specifically Action Item 6 (concerning "preventing access to treaty benefits in inappropriate circumstances"), the OECD called for submissions commenting on its draft proposed changes to the OECD Model Tax Convention relating to the residence of pension/superannuation funds for the purposes of Double Tax Agreements. An important element of this was to ensure that an adequate definition of such funds was included in the Model Convention. PwC prepared two submissions that included comments on the important elements of that definition peculiar to Australian superannuation funds.

Australia's Double Tax Agreements (DTA) traditionally follow the OECD Model Tax Convention, and it is very important that Australian superannuation funds are recognised under these treaties as "pension funds" in this context, with appropriate access to DTA benefits for their international investments. We will provide further updates on the progress of this exercise.

ATO preparing Tax Governance materials to assess tax governance

The ATO is in the process of consulting on a reference document which it will use to assess the tax risk management frameworks of large taxpayers. From experience, we expect that the ATO will apply these standards to large superannuation funds. This document follows the

release on 20 July 2015 of the ATO's Tax Risk Management and Governance Review Guide.

The document is expected to rely upon Auditing Standard ASRS - 4400 (Agreed Upon Procedures) and was developed in response to feedback that the ATO's assessment of governance varied significantly.

Many funds are in the process of assessing their tax governance materials in response to the guide released by the ATO in July last year. We remain involved in the consultation process, and will provide future updates on the progress of this reference document.

Foreign Income Tax Offsets

An addendum to TR 2014/7 was published on 16 March 2016 to replace the Commissioner's views on "source" that were previously withdrawn from that ruling in June 2015. The new content on source emphasises that:

- the formation of the foreign currency hedging contract is the most important element in determining "source" of foreign currency hedging gains
- a contract is formed where the communication of the acceptance is received.

The ATO is currently updating its previously published draft guidance material on how to determine "source" in the context of foreign currency hedging transactions, based on consultation with industry participants, including PwC. It is expected that this material will provide funds with a proxy that the ATO will accept for practically determining source.

The addendum to TR 2014/7 still leaves funds with difficulty in practically determining "source" based on the ATO's views. It will therefore be important that the expected guidance materials provide a practical approach for funds to follow.

New US Tax Regulations re investing into the US

US Treasury has released new draft tax regulations directed at foreign investment into the US. These are aimed at "earnings stripping" and target transactions that increase related-party debt that does not finance new investments in the US.

The proposed regulations apply to instruments issued after 4 April 2016. Any changes to structuring arrangements or new US investments involving debt will need to consider these proposed new regulations.

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