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## **Chapter #**

# ***Pay as you go instalments and taxation of financial arrangements interaction issues***

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### **Outline of chapter**

1.1 Schedule # to this Bill amends the pay as you go (PAYG) instalment provisions in Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953).

1.2 The amendments address a number of issues arising out of amendments to the TAA 1953 contained in the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* (TOFA Act).

### **Context of amendments**

1.3 These amendments were announced by the Assistant Treasurer in September 2009.

1.4 The effect of the PAYG amendments in the TOFA Act is arguably to substantially change the basis on which a PAYG instalment liability is calculated. The result of this change may be to decrease PAYG instalment payments. Any decrease will result in a deferral of revenue, which will be recouped when the relevant taxpayer lodges their income tax return.

### **Summary of new law**

1.5 The amendments reverse the changes the TOFA Act made to the PAYG instalments system, thus preventing the potential decrease in the amount of PAYG instalments paid.

1.6 In addition, the amendments will ensure that where an entity has become liable to pay a decreased amount of PAYG instalments prior to the commencement of this Bill, there will be a catch-up payment of the decreased amount in the quarter that ends after the commencement of this Bill.

## Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>An entity's instalment income, including income from Division 230 financial arrangements, is generally the ordinary income the entity derived during a period, but only to the extent that the income is assessable income of the income year that is or includes that period.</p> <p>An entity's instalment income for a particular quarter that starts after the start of an income year that starts on or after 1 July 2009 may also include an additional amount worked out under these amendments. This will only be the case if the entity has chosen to apply the TOFA Act in relation to income years starting before 1 July 2010.</p>	<p>The net result of gains and losses made on a Division 230 financial arrangement is included in an entity's instalment income for PAYG instalments purposes.</p> <p>That is, the net result of the gains must exceed the losses made in an income year in respect of the financial arrangement under Division 230 to be recognised for PAYG purposes.</p>
<p>The net result of gains and losses made on a financial arrangement that is subject to Subdivision 250-E is included in an entity's instalment income for PAYG instalments purposes.</p> <p>That is, the net result of the gains must exceed the losses made in an income year in respect of financial arrangement under Subdivision 250-E to be recognised for PAYG purposes.</p>	<p>An entity's instalment income, including income from a financial arrangement subject to Subdivision 250-E, is generally the ordinary income the entity derived during a period, but only to the extent that the income is assessable income of the income year that is or includes that period.</p>

## Detailed explanation of new law

### Background of the PAYG instalments system

1.7 The PAYG instalments system facilitates the collection of income tax on business and investment income during the year in anticipation of a taxpayer's final income tax liability on assessment. The provisions are in Part 2-10 of Schedule 1 to the TAA 1953.

1.8 Typically, for large businesses, instalments are paid every quarter, and are calculated by multiplying an instalment rate notified by the Commissioner of Taxation (Commissioner) by an entity's instalment

income (which is essentially the gross ordinary income derived by the entity) during the quarter. The Commissioner calculates the instalment rate in accordance with the formula provided for in the TAA 1953. In general, the instalment rate is calculated as a proportion of an entity's tax liability for the previous year divided by the entity's instalment income for that year.

1.9 As a general rule, in calculating instalment income, losses and deductions are not offset against the gross income. That is, the instalment income, as a general rule, is calculated on a gross basis.

### **Issues caused by the changes that the TOFA Act made to PAYG instalments**

1.10 The changes made by the TOFA Act in relation to the PAYG instalments provisions (item 101 of Schedule 1 to that Act) give rise to two issues.

- First, the TOFA Act made amendments to provide that the PAYG instalments system recognises the gain or loss, or the part of the gain or loss, on a Division 230 financial arrangement that is attributable to the relevant income year.
- Second, the TOFA Act unintentionally repealed an existing provision that applied to working out the instalment income of entities that have financial arrangements subject to Subdivision 250-E of the *Income Tax Assessment Act 1997* (ITAA 1997).

1.11 These two amendments apply to entities for income years commencing on or after 1 July 2009 if the entity made or makes an election under item 103 of the TOFA Act. If the 'early adoption' of the TOFA Act is not made, the amendments apply to entities for income years commencing on or after 1 July 2010.

#### ***The first issue: Division 230 financial arrangements and the definition of instalment income for PAYG instalments purposes***

1.12 Generally, an entity's *instalment income* for a quarter is the entity's ordinary income derived during that quarter, to the extent that that income is assessable (subsection 45-120(1) of Schedule 1 to the TAA 1953).

1.13 However, where an entity has a Division 230 financial arrangement, there is a different method for calculating the entity's instalment income. Under that method, the net result of gains and losses made on arrangement is included in an entity's instalment income for

PAYG instalments purposes. This was inserted by item 101 of Schedule 1 to the TOFA Act.

1.14 As indicated above, instalment income is, as a general rule, calculated on a gross basis. The new method of calculating instalment income on a net basis could have the effect of reducing the entity's instalment income. The application of a given instalment rate to a reduced amount of instalment income would produce a reduced instalment payment.

1.15 It should be noted that any difference between the instalments the entity is liable to pay under the law prior to the insertion of subsection 45-120(2B) and the law after the insertion of that subsection would be picked up when the entity lodges its income tax return. However, the effect would be a deferral of paying of instalments on some part of the relevant entity's taxable income until it lodges its income tax return. The result would be inconsistent with the scheme of the PAYG instalments system as outlined above.

***The second issue: Financial arrangements subject to Subdivision 250-E and the definition of instalment income for PAYG instalment purposes***

1.16 In addition to inserting the new subsection 45-120(2B) of Schedule 1 to the TAA 1953 discussed above, item 101 of Schedule 1 to the TOFA Act also repealed a previous version of subsection 45-120(2B). That subsection was about the instalment income of entities that have financial arrangements subject to Subdivision 250-E of the ITAA 1997.

1.17 The previous version of subsection 45-120(2B) was introduced to ensure that only the net amount of the gains and losses on financial arrangements, that are subject to Subdivision 250-E, are attributable to an instalment period are included in the instalment income for that period. Subdivision 250-E itself was not being altered by the TOFA Act. Accordingly, there was no reason for the TOFA Act to repeal the old version of subsection 45-120(2B).

**The amendments contained in this Bill**

1.18 Schedule # makes three amendments in order to address the two issues outlined above.

- First, it repeals the version of subsection 45-120(2B) that was inserted by item 101 of Schedule 1 to the TOFA Act.
- Second, it provides for a 'catch-up' payment where a PAYG instalment has already been underpaid by an entity as a result of subsection 45-120(2B) applying to that entity.

- Third, it re-inserts the previous version of subsection 45-120(2B) that was unintentionally repealed by item 101 of Schedule 1 to the TOFA Act.

***Amendment 1: Repeal of subsection 45-120(2B)***

1.19 To clarify that the TOFA Act was not intended to significantly reduce the amount of instalments an entity is liable to pay under the PAYG instalments system, subsection 45-120(2B) of Schedule 1 to the TAA 1953 is repealed. *[Schedule #, Part 1, item 10]*

1.20 The repeal applies to entities for income years commencing on or after 1 July 2009 if the entity made or makes an election under item 103 of the TOFA Act. If no election is made, the repeal will apply to entities for income years commencing on or after 1 July 2010. *[Schedule #, Part 1, item 20]*

1.21 The timing of the repeal relies on the TOFA Act. The insertion will only take effect for income years commencing on or after 1 July 2009 if the entity made or makes an election under item 103 of the TOFA Act. If no election is made, the initial insertion of subsection 45-120(2B) will only take effect for income years commencing on or after 1 July 2010.

1.22 The effect of the repeal is that entities will rely on the other provisions of section 45-120 in order to determine their instalment income for a particular quarter. Therefore, in general, an entity's instalment income would be equal to its ordinary income to the extent that the income is assessable. This would be the case, regardless of whether the entity derives income from Division 230 financial arrangements or not.

***Amendment 2: A 'catch-up' of PAYG instalments***

1.23 For entities that do not have substituted accounting periods, their first instalment quarter for the income year starting on 1 July 2009 will end on 30 September 2009.

1.24 If this Schedule does not commence by 30 September 2009, a decreased payment of PAYG instalments could potentially occur for the first instalment quarter. If this Bill does not commence prior to 31 December 2009, a decreased payment could also arise for the second instalment quarter.

1.25 To address these possibilities, the second amendment contained in this Bill provides for a 'catch-up' of any decreased payment of PAYG instalments for instalment quarters prior to the commencement of this Schedule commencing. *[Schedule #, Part 1, item 30]*

*Who needs to consider this amendment?*

1.26 This catch-up payment provision only applies in a very specific scenario. The amendment requires *all* of the below to occur in order to apply:

- The entity must make or have made an election under item 103 of the TOFA Act to apply TOFA early (that is, from income years starting on or after 1 July 2009) *[Schedule #, Part 1, subitem 30(3)]*.
- Schedule # to this Bill commences after 30 September 2009 *[Schedule #, Part 1, subitem 30(3)]*.
- The entity must be part of the PAYG instalments system, and be a quarterly payer of instalments that pays on the basis of instalment income *[Schedule #, Part 1, sub-subitem 30(1)(a)]*.
- The entity's first instalment quarter for the income year starting on or after 1 July 2009 must end on or before the commencement of this Schedule. For example, if an entity has an income year starting on 1 October 2009 and this Schedule commences during December 2009. In that case, the amendment will not apply to the entity because its first instalment quarter ends on 31 January 2010, which is after the commencement of Schedule # in December 2009 *[Schedule #, Part 1, sub-subitem 30(1)(b)]*.

1.27 The reason that the catch-up provision only applies in this scenario is because in all other scenarios there would be no decrease in the amount of PAYG instalments an entity is liable to pay.

*What quarter does the catch-up of the decreased PAYG instalment occur in?*

1.28 Where the provision applies to an entity, the catch-up will occur when the entity becomes liable to pay a PAYG instalment for the quarter during which the commencement of this Schedule occurs. *[Schedule #, Part 1, subitem 30(3)]*

1.29 If the entity has an income year starting on 1 July 2009, and Schedule # commences during December 2009, the Bill has commenced during the entity's second instalment quarter. In that case, the catch-up will occur when the entity becomes liable to pay a PAYG instalment in relation to its second instalment quarter. *[Schedule #, Part 1, subitem 30(3)]*

1.30 If, however, Schedule # commences during January 2010, the Bill has actually commenced during the entity's third instalment quarter.

In that case, the catch-up will occur when the entity becomes liable to pay a PAYG instalment in relation to its third instalment quarter. *[Schedule #, Part 1, subitem 30(3)]*

*What happens when an entity is required to 'catch-up' a decreased PAYG instalment?*

1.31 The catch-up of the decreased PAYG instalment amount involves the entity including an additional amount in its instalment income for the relevant instalment quarter (see above). This additional amount is over and above what the entity's actual instalment income for the relevant quarter was. *[Schedule #, Part 1, subitem 30(3)]*

1.32 The additional amount of instalment income is the difference between:

- the entity's instalment income for all the instalment quarters preceding the quarter during which this Schedule commenced which started on or after 1 July 2009, taking into account the fact that amendment 1 repealed subsection 45-120(2B) of the TAA 1953 *[Schedule #, Part 1, sub-subitem 30(2)(a)]*; and
- the entity's actual instalment income for all the instalment quarters preceding the quarter during which this Schedule commenced which started on or after 1 July 2009, assuming that subsection 45-120(2B) was not repealed *[Schedule #, Part 1, sub-subitem 30(2)(b)]*.

1.33 Essentially, the aim of this provision is to catch up any decreased PAYG instalment payment that was caused by applying the approach to new subsection 45-120(2B). It is also designed to ensure that there is no double-counting of any instalments already paid.

### **Example 1.1**

An entity has made an election under item 103 to apply the TOFA Act early, is a quarterly payer of instalments that pays on the basis of instalment income, and has an income year starting on 1 July 2009. Also, this Schedule commences during December 2009.

This is a scenario to which the catch-up provision would apply.

The catch-up would occur when the entity becomes liable to pay a PAYG instalment in relation to the second instalment quarter. This is because this Schedule commenced during the entity's second instalment quarter.

Assume that because subsection 45-120(2B) applied during the entity's first instalment quarter, the entity's instalment income was only \$10. However, if subsection 45-120(2B) did not apply during the entity's first instalment quarter assume that, its instalment income would have been \$40.

When the entity becomes liable to pay a PAYG instalment for its second instalment quarter, its instalment income for that quarter will include an additional \$30 (\$40 – \$10). This is over and above any instalment income the entity actually had during the second instalment quarter (not applying subsection 45-120(2B)).

***Amendment 3: Re-insertion of the old version of subsection 45-120(2B)***

1.34 As noted above, item 101 of Schedule 1 to the TOFA Act unintentionally repealed the old version of subsection 45-120(2B). Amendment 3 re-inserts it in identical terms to the version that was introduced by item 169 of Schedule 1 to the *Tax Laws Amendment (2007 Measures No. 5) Act 2007*. *[Schedule #, Part 2, item 110, subsection 45-120(2B) of Schedule 1 to the TAA 1953]*

1.35 The re-insertion applies for income years commencing on or after 1 July 2009 if the entity made an election under item 103 of the TOFA Act. If no election had been made, the repeal will apply to entities for income years commencing on or after 1 July 2010. *[Schedule #, Part 2, item 120]*

## **Commencement and application**

1.36 Amendments 1 and 2 will commence on Royal Assent. Amendment 1 will apply in the manner described in paragraph #.24. *[Schedule #, item # in the table in clause #]*

1.37 Amendment 3 will commence immediately after Royal Assent *[Schedule #, item # in the table in clause #]*. This ensures that there is no confusion between the version of subsection 45-120(2B) of Schedule 1 to the TAA 1953 that is being repealed by Amendment 1, and the version of subsection 45-120(2B) that is being inserted by Amendment 3. The amendment will apply in the manner described in paragraph #.35.

