

Tax Brief

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More from the Board of Taxation on Foreign Source Income Anti-Tax-Deferral Regimes

As promised in its March 2008 Position Paper (see our Tax Brief at http://www.gf.com.au/477_628.htm), the Board of Taxation has now released five Issues Papers to give more details on proposals in relation to reform of the CFC and FIF regimes. The Board has been working on this topic for sometime, having released a Discussion Paper in mid 2007 (see our Tax Brief at http://www.gf.com.au/477_556.htm) and conducted a first round of consultations and submissions then.

The Issues Papers are still relatively short on details in some cases and may be thought to be starting to hedge on some of the more promising proposals. On the other hand there are some welcome new ideas especially for the participation exemption for non-portfolio dividends. Clients need to persevere with consideration of the area and submissions as the potential payoff is significant in terms of reducing tax issues involved in offshore activities. The closing date for submissions is 20 June 2008.

The Issues Papers need to be read in the light of the Position Paper. They are more focused in scope and by no means cover all the issues, so it is necessary to view them in the context of the Position Paper.

Issue 1: Listed Public Company Exemption

The Board indicated in its Position Paper that its proposed Australian listed public company exemption from the attribution regimes would require integrity protections. The Issues Paper discusses these as well as the definition of listed public company. For the latter the Board has asked whether the current tax definition of shares listed on the stock exchange subject to a 20/75 exception is appropriate. The 20/75 exception deals with cases where 20 or fewer persons other than companies control 75% or more of voting, dividend or capital rights.

For integrity protections, the Board groups them into two areas, activity/income based exceptions and dividend based exceptions. The intention seems to be that these rules are cumulative, that is, if one applies the exemption is not available. It is suggested that generally they should work the other way around, that is, if one integrity rule is not applicable, the exemption should be available.

The Issues Paper, like the Position Paper, has no discussion why the proposed exemption is to be limited to listed *companies*.

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Activity based integrity rule

The activity based integrity exceptions would apply if 20% or more of the foreign profits of the listed company come from nominally passive activities such as financial activities, investment business or management of intangible assets. The possibility of expanding or contracting the list of activities is raised as well as variations by industry group.

On its face this rule is likely to create difficulties for the finance industry which is one of the most active in the foreign income area. While exceptions in other areas may assist the finance industry, this is an area where industry input is vital to suggest workable rules which do not unduly hamper the industry. It would be unfair if a particular industry, especially one that the Government is trying to encourage to have greater foreign engagement, is effectively eliminated from an important exemption.

Income based integrity rule

The income based integrity exception would be based on 50% or more of the listed company's foreign profits being derived from nominally foreign passive income and services provided to related entities. Nominally passive income seems to be income from the nominally passive activities referred to above though this is not specified. Again the possibility of varying the list and having different standards by industry is raised.

In addition the taxpayer would be required to show that the income in question or a substantial proportion of it had borne substantial foreign tax for the integrity rule not to apply. Two methods are suggested without making clear if they are intended to be alternatives or if rather the new law will pick one or the other as the exclusive test. The methods are that the income is derived from a country on the current list of seven "good" countries or that the level of foreign tax on the income is comparable to the Australian rate.

The reference to related party services is a transfer pricing issue and seems to be a retreat from the Board's previous position that transfer pricing should be dealt with by the transfer pricing rules. Moreover, the reference to listed countries and comparable taxation suggests that Australia will be trying to enforce the transfer pricing rules of foreign countries or requiring that listed companies hold their passive income in high tax countries, neither of which seems to be an appropriate policy for Australia to pursue.

This is part of a new trend in the Issues Papers. Frequent reference is made on the first two issues to cases where there is danger of "artificial separation of income from activities" (five times up from one in the much longer Position Paper). Little guidance is given on what this expression means, though it is claimed to be the case with nominally passive income and at one point it is identified as "highly mobile income that is prone to financial innovation or related party transactions." It is considered that this idea, whatever it means, is definitely not a useful policy guide in this area. If the reference is to Australia's transfer pricing rules, then the policy should be to rely on and if necessary fix those rules. If the reference is to the Australian rules for source of income, again the correct policy should be to fix the rules (a longstanding issue). Most importantly if the problems are in the rules of a foreign country, then that should not be Australia's concern.

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The issue that should be addressed by accruals rules is not the separation of income from activities, but rather the fact that purely passive income that is relatively risk free is easily moved by simple investment choice – instead of placing money on deposit in an Australian based financial institution, a resident can invest in shares in a foreign company which deposits the money in a foreign bank (in Australian dollars at Australian interest rates if that is what the resident is seeking). This investment choice is not a separation of income from activities but rather income that involves (virtually) no activity and little risk.

Dividend based integrity rules

The dividend proposals have to do with the levels of profit distributed and their franking. The listed company exclusion would not apply if the dividend payout ratio is less than a certain prescribed percentage. No suggestion is made on the level but it could be expected not to be minimal. The idea is that higher levels of dividend payout reduce any chance of deferral of tax on foreign income because shareholders are being currently taxed on the dividends. Similarly the exclusion would not apply if the franking of the listed company's dividends fell below a prescribed level (again without suggestion of a limit). The idea is that higher levels of franking indicate lower levels of foreign investment and thus lower levels of risk of deferral of foreign source income.

The proposed dividend rules seem to offer greater certainty and simplicity than the activity/income tests but the critical parameter of the level is not specified and until this is done, no judgment can be made. Companies need to consider what levels it would be appropriate to suggest. Presumably the Board has refrained from specifying a number to find out what industry thinks. Moreover it is considered that the dividend payout ratio could be a stand alone positive rule, even if other integrity rules are applied cumulatively. If a listed company is paying out a relatively high proportion of its profits, franked or unfranked, it should be exempt from the accruals regimes.

Issue 2: Active investment exemption

Although there is lengthy discussion of this issue, the matter is not moved much further forward from previous documents. Most of the Paper is devoted to a discussion of the existing FIF rules which the Board wishes to adopt as the model for the active investment exemption. Moreover the Board's "no-one worse off" position may be not so firm. The Position Paper stated:

In advocating this approach, the Board's intention is that taxpayers who are currently exempt, including under the CFC active income exemption, would continue to be exempt under any revised arrangements. Indeed, the Board envisages that taxpayers will receive the same results, and more likely improved results, under a new regime with a simpler, more consistent and expanded approach to determining what constitutes an active business.

The Issues Paper has a similar passage but "generally" has crept in before "continue".

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FIF based rules

Among the discussion of the current FIF approach the following issues are raised.

- Exemptions currently confined to companies could be extended to other entities.
- Common criteria in current banking, insurance and life insurance exemptions could be extended more broadly (what exactly is in mind is not clear).
- The list of bad activities could be modernised to better reflect the active/passive boundary (exactly in what sense is not clear).
- The current specific banking exemption does not fit with investment limitations that Australian banks face in some foreign countries (presumably something is to be done about it but nothing is specified apart from retaining the possibility introduced in 2007 to allow the use of the CFC calculation which makes CFC ADI exemptions available instead of the FIF calculation method).
- It is noted that the current real property exemption has been argued not to represent commercial realities but nothing new is suggested.

Rules for taxpayers with access to fuller information

In addition it is indicated that investors that have detailed information about their offshore investments will have further tests they can apply to be exempt. Generally such investors will be non-portfolio investors though this is not to be a limit on access to the exemption. It will be necessary to satisfy all criteria that are settled on, that is, the tests are not viewed as alternatives.

The Paper does not provide any real guidance on what is intended but simply describes briefly what happens in the UK and France and indicates that some synthesis of both may be appropriate. The description is very similar to the activities/income material above for the listed public company exemption. In addition it would be necessary to show that the entity has a business establishment in its territory of residence and its business affairs must be effectively managed there.

Related party transactions again enter the fray as well as transfer pricing in a significant way which is put on the basis that business is already spending so much on transfer pricing analysis anyway they may as well spend a bit more and use it in this area. The comments above on this misplaced use of transfer pricing are pertinent here also.

Issue 3: Distribution exemption

One complaint of funds managers about current rules is that while they fully distribute realised income on investments in foreign companies and other vehicles, the FIF rules under the commonly used market value method catch and attribute unrealised gains on foreign investments. This discriminates against foreign investments compared to domestic investments. Accordingly they have argued for a full distribution exemption (as used by a number of other countries). The Board has previously supported such an exemption but without any details.

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Market value based proposal

Now that the proposed details are out, fund managers may wonder what is achieved. The proposal is that full distribution be measured by market value, that is, the fund will have to distribute all or substantially all of the increase in value of its foreign investments. Substantially all is less than 98% but presumably will be still in the vicinity of 90%. Fund managers in many cases cannot distribute unrealised gains as they would have to realise the gains to make the distribution.

So the point of the exemption formulated in this way is unclear as it does not deal with the very problem for which it was intended, by industry at least. Foreign countries have sought other ways of overcoming problems posed by tiers of entities offshore (which is driving the market value approach here) but no mention has been made of them in the Board's discussions of the distribution issue.

Limited to flow through Australian entities

The Board proposes that the exemption would be limited to fund managers (ie trusts taxed on a flow through basis) on the assumption that the exemption only makes sense in such cases. This limit is also difficult to follow. As already noted, the extent of distribution is seen as relevant to the Australian listed company exemption and such companies are not flow through vehicles. It is not clear why, for example, Australian listed investment companies which are subject to a special regime under current law could also not benefit from a distribution exemption applied to foreign entities. The same comment applies to other Australian entities as well. The concern presumably is that distributions from offshore companies to Australian companies may attract the exemption for non-portfolio dividends. If so any limitation on the distribution exemption should be so framed.

Issue 4: Identification of interests

Again there is not much of an advance in the Issues Paper on some points but equally there is considerably more information in other areas.

What interests are covered?

The Board largely repeats the Position Paper here. A distinction will be drawn between fixed and non-fixed interests. It seems that the membership interest concept is proposed to be applied rather than simply shares etc for fixed interests. That is, shares which are debt interests under the debt equity rules will not count and will be left to be taxed under the TOFA legislation. For non-fixed interests the transferor trust approach will apply including for foreign exotic entities which do not have discernible interests.

It is also clarified that foreign life policies will continue to be covered by the rules as will options, convertible notes etc to acquire fixed interests.

Measurement of interests

The Position Paper seemed to indicate that income rights would drive the measurement of interests. Measurement is necessary when calculation methods are being used to attribute income. There seems in the Issues Paper to be a complete reversion to the current CFC position of taking the

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maximum interest in voting, income and capital rights for companies and the current FIF position for trusts (based on income and capital rights).

For non-fixed interests, the rules would be more favourable to taxpayers than current law in that scale back from 100% attribution would not be in the discretion of the ATO but rather would be based on the proportion of value transferred when that can be shown by the taxpayer.

Section 404 dividends and relief of double taxation

The exemption part of the current foreign income system has not so far been the subject of detailed consideration by the Board in this Review. This Issues Paper addresses a number of questions that have been outstanding for some time. First, it proposes to make the non-portfolio dividend exemption more generous by basing the non-portfolio test not on voting power as at present but on the same tests used to measure interests just discussed, possibly utilising for this purpose the non-portfolio interest test introduced for the CGT reforms for non-residents in 2006.

The addition of capital and dividend rights to voting rights overcomes some of the current problems with the participation exemption. On the other hand nothing is said about the problems currently experienced with participation exemptions where there are interposed trusts and partnerships which may mean that there is no exemption or credit relief from international double taxation at all. The Board also does not address the surreptitious apparent removal of credits in some FIF and CFC situations in 2008 under the new foreign income tax offset rules which will impact on Australian fund managers in unexpected ways.

Fixing problems in the participation exemption means that the current section 404 exemption under which portfolio dividends can be returned indirectly to Australia tax free via a CFC can be removed and the Board so proposes. At the moment this is the way that taxpayers try to overcome problems in the voting test attached to the participation exemption.

Issue 5: Branch equivalent calculations

This Paper is dealing with the calculation of attributable income when the taxpayer does not use the market value or deemed rate of return methods but instead calculates the attributable income directly. The discussion of this issue is largely inconclusive, simply setting out the pros and cons for an accounting based calculation and an Australian tax based calculation. It is confirmed that all taxpayers who wish to do so will have access to branch equivalent calculations and that only tainted income will be attributed. The Board also indicates that it wishes to proceed with only one method, not multiple methods.

The Board points out that whichever method is chosen it will to some extent be adapted to move towards the other method. An accounting calculation is likely to be modified to reflect some of the differences between tax and accounting while a tax based calculation would likely lose some of the more compliance intensive tax rules which will make it more like an accounting calculation. The main point that the Board makes is that such modifications need to be based on tax policy principles and not just on what taxpayers do or do not like about the domestic tax calculation.

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The balance of the discussion seems to be in favour of a tax based calculation on three grounds:

- neutrality with domestic taxpayers;
- the fact that calculations should be less necessary in future (and so less onerous) because of the broader levels of exemptions;
- because an accounting based method would require suitably rigorous accounts and there is no guarantee that they would exist for all foreign entities.

Conclusion

The Board is proceeding in a very deliberative fashion in relation to the review of the foreign source income rules. While this may test the patience of clients and advisers, it is worth investing the effort to stay with the exercise as there may be significant and favourable change in rules that currently represent a considerable burden to Australian business and funds managers.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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