

## Tax Brief

18 March 2008

### Board of Taxation issues Position Paper on Foreign Source Income

#### 1. Background

On 12 March 2008, the Assistant Treasurer Chris Bowen released the Board of Taxation's *Position Paper on the Review of Foreign Source Income Anti-Tax-Deferral Regimes* – that is, the reform of the controlled foreign company (CFC), foreign investment fund (FIF) and transferor trusts measures. It is significant that the Press Release places the Position Paper in the context of making Australia an Asian financial hub. The same theme runs through the recently announced review of the taxation of managed funds. This link suggests that the Labor Government is giving some priority to the Board's work in this area. We may have considerable rollback of foreign source income anti-deferral measures in the relatively near future.

Although the Position Paper, like the former Discussion Paper (May 2007), is still short on specifics, taxpayers will be encouraged by the Board's positions. The Board has recognised that most foreign investment by Australian resident ultimate investors is intermediated by resident entities and so has come up with three levels of potential exemptions from the various anti-deferral regimes. The exemptions may be quite extensive and for many Australian investors, Australian entities and foreign entities remove any issues of application of the anti-deferral regimes. Of particular interest is the proposed exemption for Australian listed companies, although it is expected that any such exemption will be covered by integrity measures.

The next stage is for the Board to issue some specific issues papers in the coming months as well as consulting more generally on the positions it has arrived at. The Board will then deliver its final recommendations to Government, reckoned to occur perhaps over-optimistically in mid 2008. Thus application from 1 July 2009 may be a possibility. The Board intends to remain engaged in the project through the later stages of consulting on the legislation to give effect to Government's decisions on the Board's recommendations.

Clients need to be vigilant in the consultation process over coming months to ensure that their situations are appropriately dealt with as the process moves forward. To this end Greenwoods & Freehills will be actively involved in the consultation with industry bodies and clients.

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## **2. Policy positions**

### ***2.1 Underlying policy position***

The Board does not see this exercise as changing the underlying current policy expressed in its 2003 report on international taxation. It is intended to maintain CIN (capital import neutrality) for active foreign income. That is, Australia will not levy current tax on active income derived through foreign entities. Similarly, it will maintain CEN (capital export neutrality) for passive foreign income derived by Australian investors through foreign entities so that the income is subject to current Australian tax usually with a foreign tax credit.

The main thrust is making the law consistent with the policy and the current international environment. Currently, in the Board's view (and in the view of many taxpayers) the anti-tax-deferral regimes for foreign source income are overly extensive and undermine Australian competitiveness in international investment.

### ***2.2 Anti-deferral or anti-avoidance?***

The Board acknowledges that the current anti-tax-deferral measures involve both prevention of deferral per se and anti-avoidance. Both purposes are proposed to be maintained but with the emphasis shifting to the anti-avoidance end of the spectrum. That is, structural deferral will be more tolerated in future and anti-tax-deferral measures more focused.

### ***2.3 Harmonisation not an end in itself***

One major theme of the Board's previous Discussion Paper was the potential for harmonisation of the anti-tax-deferral regimes. The Board has listened to submissions and indicates that harmonisation will not be an end in itself. Rather the goal is improving outcomes for taxpayers. Notwithstanding this order of priorities, the Board's positions still contain a considerable amount of harmonisation, particularly across the CFC and FIF regimes.

At a number of points the Board highlights its intention to make taxpayers better off, not worse off under the proposals. If clients consider this will not be true in their case, they should ensure that the Board is aware of their situation.

## **3. General potential scope of anti-tax-deferral regimes**

### ***3.1 Entities and interests covered***

The Board proposes to maintain the current focus covering interests in companies and trusts. FLPs (foreign life policies) are not mentioned other than in the glossary noting that they are covered by the FIF regime, but there is no express indication of change to the existing rules for FLPs.

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The Board is *not* proposing to use economic interests to define the investments caught by the regimes. Rather, they will continue to apply to legal interests (shares or interest as beneficiary in a trust). This is a welcome approach given the difficulties that would arise in applying debt and equity or similar rules to interests in foreign entities.

The Board does propose to make coverage of exotic foreign entities like anstalts and stiftungs express, probably under the transferor trust measures. Considerable care will be required, if the transferor trust rules are used, to ensure that Australian taxpayers are not unfairly taxed on the income derived by these entities. (There has been some related international activity in this area recently – such as the announcement by Liechtenstein that it proposes to reform the law governing anstalts and the current focus on tax evasion through Liechtenstein by Australia and other OECD countries – a kind of concerted action that we are likely to see more often in the future.)

### **3.2 Measurement of interests and coverage of regimes**

The Board proposes that fixed interests will be subject to attribution in accordance with the investor's interest in the income of the foreign entity (though it will consult on also using capital as a factor). Voting interests, which are used in the current CFC rules, will apparently disappear. This is a significant shift from current policy where a range of variables are tested (voting, capital and income entitlements) to determine the extent of a taxpayer's interest.

Discretionary interests will be subject to transferor trust type measures (that is, tax on persons transferring services or property on non-commercial terms). The extent of the discretionary interest in a foreign entity will in effect be determined by the value of property or services contributed by each interest holder.

The Board proposes fixing the potential technical glitch set out in ATO ID 2005/200 (in a trust setting with FIF income) to ensure that foreign income caught by anti-tax-deferral regimes and belonging to non-residents is not taxed in Australia.

It is proposed that the control rule be removed for pre-resident and pre-commencement transfers under the transferor trust measures (as already twice recommended in the past and accepted by the previous Government but never legislated).

### **3.3 Motivation test**

Thankfully, the Board has not adopted a motivation test for the regimes though further consultation will occur on whether the need for such a test can be demonstrated. In other words, the Board proposes that Australia use relatively objective tests for the application of its anti-tax-deferral regimes, and not tests based on a taxpayer's purpose.

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## 4. Resident investor issues

The current anti-tax-deferral rules do not systematically distinguish between the ultimate Australian investors and the Australian entities through which they commonly invest in making investments into foreign entities. The Position Paper draws out the distinction and proposes a range of exemptions at all levels. Some more thinking than is evident in the Position Paper will, however, be required in deciding how to deal with tiers of on-shore entities.

### 4.1 *De minimis* exemptions

The Board proposes an exemption for \$200,000 unindexed total value of interests in foreign entities for all investors whether individuals or entities. It is possible that this will be a substitute for the CFC active income test though there is to be more consultation on the active income test.

The balanced portfolio exemption is to be increased such that a taxpayer would need to have interests in foreign entities that give rise to attribution representing more than 20% of its *total* assets (not just foreign assets). This proposal will be reviewed during further consultation to address administrative issues such as timing and measurement for the exemption. If this proposal is adopted it may result in a considerable number of managed funds being exempt from attribution.

It is not spelt out in either case how the exemptions will operate through tiers of on-shore entities.

### 4.2 *Lightly taxed entities*

The complying superannuation entity exemption introduced in 2004 is to be expanded to cover control situations as well as portfolio interests. In addition, recognising that such entities often invest offshore through other resident intermediaries, it is proposed to flow the exemption through interposed entities substantially (95%) held by superannuation entities. There is some possibility of a proportionate exemption below 95% but it is not currently favoured by the Board. It may be expected that industry will not find the 95% threshold workable in many cases.

## 5. Resident interposed entity issues

The *de minimis* exemptions seem to be able to operate at the level of the ultimate investor and on-shore interposed entities though how is not entirely clear. It will be a challenge for the Board to implement this policy without creating an administrative burden for the ultimate investor and interposed entities.

In addition one very important exemption for an on-shore interposed entity is proposed.

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Potentially the most significant of all changes in the Position Paper is the proposal to exempt Australian listed companies from the anti-tax-deferral regimes. The recommendation is driven by the imputation and capital management pressures on Australian companies to regularly distribute substantial profits. Corporate governance is also mentioned in this context.

It is recognised, however, that such an exemption could lead to changes of behaviour (or new kinds of listed entities, though not mentioned by the Board expressly). Hence, integrity rules will almost certainly be adopted.

The Board refers as an example to the French carve-out from exemption if 20% of a company's income is from financial activities or the management of intangible assets. Finance houses will need to ensure that their circumstances are dealt with appropriately in any integrity rules.

There is no mention of listed trusts and stapled entities in this context (though see below on the proposed distribution exemption). In this regard there is an obvious overlap between the current Position Paper and the upcoming project by the Board on managed funds generally. Depending on the details of the proposed listed company exemption and the structure of any revised regime for managed funds, there may be a case for extending this exemption to (certain) managed funds or listed trusts. Alternatively, it may be the case that managed funds are better off with the appropriate definition of other exemptions for their businesses.

## 6. Foreign entity issues

The main focus of the current CFC and FIF regimes in terms of exemptions is on the foreign entities involved. Considerable reform is proposed in this context also, though along more familiar lines.

### **6.1 Active investment exemption**

The Board prefers the current FIF approach to the active income test. It proposes to continue with the existing stock exchange listing and balance sheet methods based on more than 50% of active assets. It also suggests a new test or tests drawn from France and the UK based on genuine business activity.

Oddly in this context there is reference to transfer pricing functional analysis which may make many taxpayers pale with trepidation. In the anti-tax-deferral context which is now apparently driven by easing compliance burdens, the mention of transfer pricing, a notoriously intense and costly area of compliance, seems entirely out of place. It is expected that this concept will be removed as the consultation process unfolds.

Fortunately this is an area where further consultation will occur with an issues paper and there is a promise that taxpayers who are not currently subject to attribution will not become so under the new rules.

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Property and intellectual property are two areas singled out as candidates for shifting from the passive to the active side of the line, though again integrity measures are mentioned as with the listed public company exemption. This may be a very significant change for property trusts and companies, as well as businesses involved in high cost research and development.

## **6.2 Base company income**

The Board has proposed that the tainted sales and services income rules should be eliminated and the tax treatment left to be dealt with under transfer pricing rules, subject to some possible closely defined and narrow integrity exceptions. The Board last tackled this area in 2003 and met with some resistance to its then more limited recommendations.

## **6.3 Listed country exemptions**

The Board's position is to retain the listed country exemptions. The exemption would be based on the current US type of exemption in the FIF measures (that is, without any eligible designated concession income) but extended to the seven current CFC listed countries and possibly beyond. In another way this would achieve a 2003 proposal of the Board which has not been actioned to date – relying on other countries' anti-tax-deferral regimes for other foreign entities held by resident entities of those countries into which an Australian resident has invested.

Again, integrity concerns over concessionally treated income and chains of entities routed through listed countries into tax havens may mean that it is not possible to implement such a broad exemption. If so, the current CFC approach for taxpayers using a calculation method is proposed to be retained.

## **6.4 Distribution exemption**

The Board supports a distribution exemption so that fully distributing foreign funds, especially in the funds management area, would not be covered by the anti-deferral regimes. The problem with such exemptions is applying them through successive tiers of offshore entities and once again the proposal is subject to integrity issues being resolved. Although the Board does not mention it, the UK is currently consulting on a regime for authorised distributing funds that may provide a possible model.

The current rules have in many cases a distribution exemption but not in an express way. Whether an express exemption will be better will depend on its precise details.

## **7. Attribution methods**

As the current system has developed, one major difference between the CFC and FIF regimes was the calculation method used. In 2007 there was some freedom of choice introduced (allowing FIFs to use CFC calculation methods in certain cases). Electivity is the main theme of the Board's Position Paper.

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## **7.1 Choice of methods**

The Board proposes that all taxpayers be entitled to access all the attribution methods – in particular, methods based on a tax calculation would no longer be subject to control or 10% thresholds. Essentially, the control test of the current CFC rules would disappear entirely.

The choice of attribution methods would be subject to rules to prevent cherry-picking (on which there will be further consultation). The Board floats the possibility that generally taxpayers be entitled to review elections every four years.

## **7.2 Branch equivalent calculation method**

The Board would like to see a single simplified calculation method possibly based on financial accounts and/or relaxing the Australian tax rules that are applied. Whatever its form, the Board proposes that the calculation be limited to tainted income and not apply to all income of the foreign entity.

Further consultation is to occur and the Board has not ruled out the retention of more than one calculation method and the active income test.

## **7.3 Market value method**

This method would be retained along the lines of the current FIF rules. No solution has been found to the problem of taxing unrealised gains under this method but the expansion of exemptions means that it will apply less often. Because of the change next mentioned, this may become the last resort method in many cases.

## **7.4 Deemed rate of return method**

The Board proposes that the method be retained with the very significant difference that the rate of return be the statutory interest rate *with no uplift*. There is currently a 4% uplift applied. In effect, it is likely to become the second preference after the branch equivalent method, given that the deemed rate will not have the penal element that is currently present.

## **7.5 Discretionary interests**

In the case where the interests of the beneficiaries are discretionary, the transferor will continue to be taxed. Where there is more than one resident transferor, attribution will be based on the relative values of property and services transferred by them. If this is not possible the current 100% attribution rule will continue to apply.

## **7.6 Part year rules**

The Board proposes that only part of the year's income should be attributed if interests are acquired or disposed of part way through a year, based either on time apportionment or separate calculation of the income for the part year period. For an acquisition case, this is a considerable improvement compared to the current scenario where a full year's attribution can arise irrespective of the acquisition date.

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## **7.7 Capital gain interaction**

The Board does not propose to change the current treatment of capital gains under which the CGT discount is lost and domestic capital losses cannot be applied against capital gains realised by a CFC.

We further note that no changes to the CGT participation exemption have been proposed in the Board's paper. Given the stated intention for this exemption to provide a 'level playing field' in respect of offshore divestments, we expect this issue to be reviewed to ensure alignment between these provisions and the new attribution rules.

## **7.8 Record keeping**

The Board proposes that the attribution account mechanism for keeping track of previously attributed income be made less prescriptive (similar to the changes for conduit foreign income).

Further, the possibility is floated for consultation on fund managers keeping bulk attributed income accounts, rather than separate accounts for each investor. Fund managers who support this approach will need to make their position clear to the Board and explain in some detail how the method will work.

## **8. Other issues**

In its 2007 Discussion Paper the Board indicated that it was not going to deal with foreign hybrids. The Position Paper retains this stance and does not even mention hybrids. The foreign hybrid rules remain a problem for Australian funds managers in particular and it is to be hoped that the Government will give consideration to the issue, particularly for entities located in tax havens which are commonly used for pooling investment from foreign investors from various countries.

At the very least, if the CFC and FIF regimes are effectively merged, it will be necessary to decide whether the tax treatment of foreign hybrids is elective or not. Currently the foreign hybrid rules are not elective for CFC situations, but are elective for FIFs. In line with the rest of the Position Paper, the likelihood is that the Board would make the application of the rules elective.

Another issue not mentioned is a problem that may have emerged from the repeal of inoperative provisions in 2006 following another of the Board's reports. The ATO is currently considering if the reduction of capital proceeds for previously attributed income under the CFC and FIF regimes only applies to capital assets and not revenue assets. The original position was clearly that both revenue and capital assets were covered and this clearly should remain the position.

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Similarly the recently enacted foreign income tax offset rules may contain some disguised changes which adversely impact on Australian fund managers and their investors. If so, the changes are contrary to the spirit of the Position Paper and it is hoped that the Board would recommend that investors should not be worse off under the new foreign income tax offset which commences on 1 July 2008.

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