Review of the Foreign Source Income Anti-Tax-Deferral Regimes

Issues papers

The Board of Taxation

May 2008

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INTRODUCTION

BACKGROUND

In its January 2008 position paper, the Board set out its considered views on the high level principles that should apply in the future design of reformed foreign source income anti-tax-deferral (attribution) rules.

The Board also signalled that, to help settle the detail underlying some of the Board's proposals, several key topics would be the subject of future issues papers. The following issues papers have been assembled for this purpose and cover the following topics:

- Listed public company exemption;
- Active investment exemption;
- Distribution exemption;
- Identification of interests; and
- Branch-equivalent calculations.

These issues papers are not intended to cover all of the proposals contained in the Board's position paper, rather, they are intended to focus attention on key areas of the rules that require more detailed development and consideration. Importantly, the absence of an issues paper for a particular Board proposal (for example, the listed country exemption, the superannuation exemptions, and the de minimis and balanced portfolio exemptions) should not be taken as meaning the Board no longer supports that proposal. Rather, the issues papers should be read as complementing the Board's discussion and position papers.

The Board invites comment on any of the proposals contained in the position paper, but, in releasing these issues papers, the Board wishes to focus attention on what it considers to be the main issues requiring development. In releasing these papers, the Board also wishes to provide industry with more detailed proposals on which to comment. This will allow submissions and consultations to better consider the substantive design issues and practicalities of the proposals.

SUBMISSIONS AND CONSULTATIONS

Submissions should be sent by email to taxboard@treasury.gov.au or by facsimile to (02) 6263 4471. The closing date for submissions is 20 June 2008. Submissions should include contact details so that, if required, the Board can contact those making submissions to discuss the points raised.

Public consultation forums will be held in Sydney and Melbourne in late May. Interested parties should register their interest in attending these forums via the above email address. Further targeted consultations will be held with those who wish to discuss specific issues.

ISSUE 1: LISTED PUBLIC COMPANY EXEMPTION

BACKGROUND

1.1 The Board, in its position paper, supported the proposition that the capital import neutrality (CIN) benchmark should continue to apply in relation to the derivation of active foreign income. That is, active foreign income should be exempt from current taxation under Australia's attribution rules.

1.2 Both the discussion paper and position paper noted how the Board had received comments that there are a number of tax and commercial reasons why listed public companies should not be seen as being high risk deferral vehicles. These entities are generally seen as being vehicles constituted for the purpose of undertaking active business.

1.3 The demands of shareholders were also argued to be such that a listed public company has strong incentives to make regular distributions, thereby lessening the likelihood of offshore investments being used as vehicles for obtaining a tax deferral benefit. Similarly, it was put that the operation of the dividend imputation system creates strong incentives for domestic over foreign investment, also reducing the need for attribution rules for these entities.

1.4 Market pressures were also seen as being an influence as listed public companies are constantly under pressure to efficiently manage their capital rather than conduct passive investment for deferral advantage.

1.5 These factors were seen as the basis for a listed public company exemption to be incorporated into the attribution rules.

1.6 Against this, the Board noted that a listed public company exemption may create inappropriate incentives for listed public companies to modify their investment strategy by seeking to increase returns through exploiting tax deferral benefits through offshore investment, including by shifting profits offshore.

BOARD'S POSITION

1.7 The Board supports the implementation of a listed public company exemption provided integrity rules can be developed to address any inappropriate deferral risk.

1.8 While the Board is cognisant of the benefits that a high level exemption of this kind brings, including compliance cost savings and certainty, if numerous integrity measures are required to sustain the integrity of the exemption, the very reason to support the exemption will diminish. In this regard, the nature of the integrity rules that might be needed to accompany the exemption is set out below.

Comments sought

The Board seeks comments on the effectiveness of the proposed public company exemption including whether:

- the proposed integrity rules are sufficiently sound or whether other measures may be more appropriate, taking into account the Board's desire to minimise any impact on revenue; and
- the range of integrity rules needed, and the existence of the active investment exemption, defeats the purpose of having the exemption in the first place (that is, as a high level accessible exemption).

OUTLINE OF ISSUES

1.9 While the Board supported consideration of a listed public company exemption[1], that support was conditional on there being appropriate integrity rules. The Board noted that:

> '… a public company exemption may create inappropriate incentives for public companies to modify their investment strategy by seeking to increase returns through exploiting tax deferral benefits through offshore investment. More generally, the commercial environment may evolve such that distribution policies change and investor expectations of distributions, as opposed to growth stocks, will vary among industry sectors. There may be a case for a general exemption for listed public companies, but subject to certain integrity rules if these prove necessary.'[2]

1.10 However, the Board recognised that the need for integrity rules may affect the benefits of providing such a high level exemption. The Board noted:

> 'The benefits of a high level exemption such as a public company exemption are the compliance cost savings and certainty provided from requiring relatively lower levels of information to determine whether the attribution rules apply. However, if numerous integrity measures are required to shore up the integrity of a public company exemption, the benefits of proceeding with such an exemption will diminish.'[3]

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1 See position 4.10 of the Board of Taxation's position paper.
2 See para 4.66 of the Board of Taxation's position paper.
3 See para 4.68 of the Board of Taxation's position paper.

Going forward

1.11 The following integrity rules might form part of a package of rules necessary to support the operation of a listed public company exemption. In considering possible integrity rules, it is necessary to consider not only the efficacy of the rules but also their adequacy, having regard to the policy objectives set out in the Board's discussion and position papers.

1.12 It is also necessary to have regard to the operation of the active investment exemption that the Board is proposing, and the interaction of this exemption with a listed public company exemption. The active investment exemption would apply to interests in foreign entities where the foreign entity is principally engaged in eligible activities. As a listed public company would also have the choice to use the active investment exemption, any integrity measures for a listed public company exemption would need to be less onerous in their requirements than the active investment exemption to be of benefit.

Listed public company

1.13 The rules would need to identify those entities to which a listed public company exemption could apply. The current tax laws contain a definition of 'listed public company' in section 995 of the *Income Tax Assessment Act 1997* (ITAA97) [4]. This section provides that a listed public company means:

> a company shares in which (except shares that carry a right to a fixed rate of dividend) are listed for quotation in the official list of an approved stock exchange. However, a company is not a listed public company if:
>
> - a person (who is not a company) controls, or is able to control, or up to 20 persons (none of them companies) between them control, or are able to control, 75 per cent or more of the voting power in the company (whether directly, or indirectly through one or more interposed entities); or
> - a person (who is not a company) has, or up to 20 persons (none of them companies) have between them, the right to receive for their own benefit (whether directly, or indirectly through one or more interposed entities) 75 per cent or more of any dividends that the company may pay; or
> - a person (who is not a company) has, or up to 20 persons (none of them companies) have between them, the right to receive for their own benefit (whether directly, or indirectly through one or more interposed entities) 75 per cent or more of any distribution of capital of the company.

4 An alternative definition exists in section 103A of the ITAA 1936.

Comments sought

The Board seeks comment on the adequacy of this definition for the purposes of a listed public company exemption.

Integrity measures

1.14 While listed public companies are subject to a range of externalities that might mitigate the extent to which they can obtain inappropriate deferral benefits, integrity rules would still be necessary to protect the revenue base.

1.15 Against this backdrop, the following exclusions from a listed public company exemption have been developed. If an exclusion applies, the listed public company would still have the opportunity to use other exemptions from the attribution rules.

Limitations on certain activities

1.16 These exclusions take into account income or activities that present greater opportunities for the artificial separation of income from activities (such as highly mobile income that is prone to financial innovation or related party transactions) which create higher levels of deferral risk. In some cases, the exclusions draw on aspects of the attribution rules that apply in other countries, including France and the UK, that claw back more general exemptions from the attribution rules in specified circumstances.

1.17 Examples of how such limits might apply are as follows:

Activity-based exclusions

- No more than 20 per cent of the Australian listed public company's foreign profits are derived from nominally passive foreign activities, such as financial activities, investment business or the management of intangible assets such as intellectual property.

- The list of excluded activities could be expanded or reduced as it emerged whether the risk profile for those activities increased or diminished.

- These limits could be varied as appropriate according to the industry classification of the company.

Income-based exclusions

- No more than 50 per cent of the Australian listed public company's foreign profits are derived from nominally foreign passive income and foreign income derived from services provided to related entities, or from services provided exclusively to related entities.

- The list of excluded activities could be expanded or reduced as it emerged whether the risk profile for those activities increased or diminished.
- These limits could be varied as appropriate according to the industry classification of the company.
- A further integrity requirement would be for this income, or a substantial proportion of it, to be derived in a comparable tax country. This could be determined by reference to the current country listing approach or by an actual calculation of the level of comparable tax.

Characteristics of listed public companies

1.18 As already noted, it is argued that listed public companies have strong incentives to make regular distributions, thereby lessening the likelihood of offshore investment being made for tax deferral benefit. The operation of the dividend imputation system is also said to create strong incentives for domestic over foreign investment, also reducing the need for attribution rules for these entities. There are two readily discernable measures that reflect the extent to which listed public companies exhibit these behaviours.

Minimum dividend payout ratio

1.19 The listed public company exemption does not apply if the dividend payout ratio is less than a certain prescribed percentage. The specified percentage may vary according to the industry classification of the company.

1.20 Dividend payout ratios measure the extent to which profits are distributed to shareholders. The higher the ratio, the lower the income retained in the company.

1.21 In most instances, a company would not tend to distribute all available profits as, while shareholders may wish to receive strong dividend payouts, this has to be balanced against retaining sufficient profits to reinvest in future profit growth. Also, companies may retain profits to enable a more stable dividend payout ratio from year to year. These competing demands are part of the market pressures on listed public companies to efficiently manage their capital and maximise returns on capital employed.

Minimum franking credit ratio

1.22 The listed public company exemption should not apply if the franking percentage ratio is less than a certain prescribed percentage. The specified percentage may vary according to the industry classification of the company.

1.23 A franking credit ratio measures the extent to which dividends are franked. Australian companies receiving exempt dividend income from foreign companies will tend to have lower levels of franking. The income is subject to tax when dividends are distributed to shareholders.[5]

1.24 The franking credit ratio may therefore provide a high level indication of the level of offshore income relative to total income, and therefore the incentive for domestic over foreign investment that the company faces. In broad terms, the higher the level of offshore business as part of the total business of a company, the lower the franking credit ratio. If a listed public company conducts a relatively high level of offshore investment over domestic investment, it is more arguable that its offshore investments should be subject to the scrutiny of the attribution rules. The participation exemption for dividends is based on offshore income being subject to the attribution rules.

5 The conduit foreign income regime may allow the payment of dividends to foreign shareholders without further Australian tax.

Issue 2: Active investment exemption

Background

2.1 As the Board of Taxation's position paper explained, Australia applies capital import neutrality (CIN) as the policy setting for foreign active investment (that is, active income is exempt from current taxation under the attribution rules). This is on the basis that there are legitimate commercial reasons why residents would invest capital in foreign active operations and, therefore, deferral should be permitted.

2.2 The current CFC and FIF regimes each provide a boundary for distinguishing between active and passive investments. The CFC active income exemption applies where less than 5 per cent of the gross turnover of the CFC is passive income. The FIF exemption applies if the foreign company is principally engaged in active business activities, referred to as 'eligible activities'.

2.3 Under both regimes, if an entity passes the relevant test, no income is generally attributed. If an entity fails the relevant test, under the FIF regime all income is attributed, while under the CFC regime generally only passive income is attributed.

Board's position

2.4 The Board supports the continued application of the CIN benchmark to foreign active investment. The challenge identified by the Board in going forward is to ensure that the boundary that separates active and passive investments is appropriately drawn.

2.5 The Board's intention in developing the active investment exemption is that taxpayers who are currently exempt, including under the CFC active income exemption, would generally continue to be exempt under any revised arrangements. Indeed, the Board envisages that by better targeting the active investment exemption, taxpayers will receive at least the same outcomes, and more likely improved results in terms of compliance cost reductions.

2.6 The Board's proposals focus on achieving appropriate and consistent outcomes under the active investment exemption, rather than on the ultimate legislative design to achieve these outcomes.

Comments sought

The Board seeks comment on the effectiveness of the active investment exemption set out below, including:

- what improvements might be necessary to the existing FIF approach, including the extent to which changes are needed to modernise the active/passive boundary for businesses that actively derive passive income;
- whether, in light of the improved existing FIF approach canvassed in this paper, additional supplementary criteria are required, given the complexity and compliance costs this might add; and
- if additional supplementary criteria are required, whether the supplementary criteria proposed would be effective, and how might they best be used or improved.

OUTLINE OF REFORM PROPOSAL

2.7 In modernising the active and passive investment boundary, the Board considers that assets held as part of genuine commercial activity should be given active (eligible) treatment under an active investment exemption.

2.8 The Board's position paper outlined a number of areas where the active/passive divide under the current attribution rules has not kept pace with business practices. Specific examples provided to the Board include property investments, intellectual property and intra-group financing where these are part of an active business and not driven by obtaining a deferral advantage. The assets and income from these activities have traditionally been treated as passive in nature due to a higher risk of obtaining inappropriate deferral benefits through the artificial separation of income from the activities giving rise to that income.

2.9 The Board recognises that the commercial reality is that active businesses may conduct substantial activities in areas where activities and income are at a higher than normal risk of artificial separation. The attribution rules should allow active treatment of such assets and income if it can be demonstrated that they are part of an active business, while ensuring appropriate levels of integrity.

2.10 The Board considers that the boundary that distinguishes between active and passive investments should be redrawn in such a way that it applies consistently across all relevant interests in foreign entities. This would better address the distortions and non-neutrality effects that arise under the current arrangements through the application of different regimes and different rules within those regimes.

2.11 The Board advocates using the FIF-style approach as the basis for the active investment exemption. Under this approach, an interest in a foreign entity would be exempt from the attribution rules if the foreign entity is principally engaged in eligible activities. The stock exchange listing and balance sheet methods are used to determine whether the foreign entity is principally engaged in eligible activities.

2.12 The Board considers that the entry point into the attribution rules should operate to allow taxpayers to determine as early as possible whether the attribution rules apply any further. Interests in entities that are exempt would not be subject to the further application of the attribution rules. This approach has the potential to significantly reduce compliance costs and complexity for all taxpayers, regardless of the level of information that they have about their foreign investments.

2.13 While the Board's preference is to apply exemptions as close to the entry point into the attribution rules as possible, this should not operate in such a way that taxpayers with access to further information that could be used to demonstrate the active nature of their business are disadvantaged. The entry level criteria will of necessity need to be specified to protect the integrity of the attribution rules. Activities and assets that are at a higher risk of artificial separation of activity and income would prima facie be treated as ineligible activities. However, taxpayers that can access further information to demonstrate the activities are in fact active should have this opportunity. Such taxpayers would generally be those in a position to be able to make an election to use branch equivalent calculations.

2.14 The Board's preference is to use objective criteria to determine whether an activity is eligible. Under a self assessment environment, this would provide the greatest level of certainty for taxpayers.

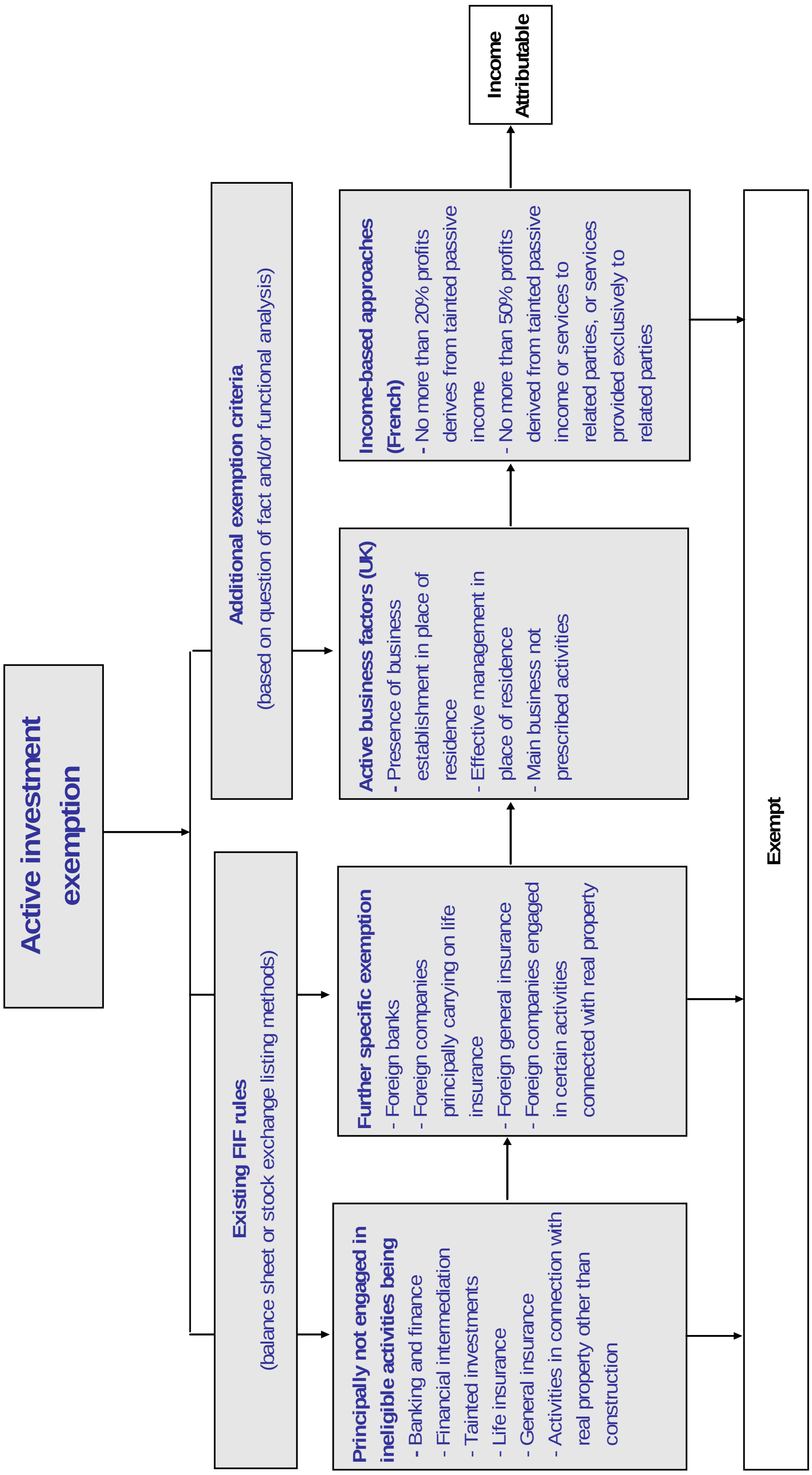
DESIGN/IMPLEMENTATION PROPOSAL

2.15 To settle the detail surrounding the Board's position in respect of the design of an active investment exemption, the Board proposes the following structure:

- Under reformed attribution arrangements, an active investment exemption would be available universally to resident taxpayers in respect of an interest that they hold in any kind of foreign entity.
  - The active investment exemption could be drafted so that exemptions apply more consistently than under the current FIF active business exemption. For example, the current FIF active business exemption only applies to companies. Likewise, many of the specific exemptions for banks, general insurance companies and so on apply similar criteria which could be applied more broadly to all foreign entities.
- To be eligible for the active investment exemption, a taxpayer must establish that the foreign entity is not principally engaged in ineligible activities. Ineligible activities will be based on the existing FIF approach, with suitable modernisation.

- A taxpayer with access to higher levels of information will have the opportunity to undertake further investigation to establish that prima facie ineligible activities should be treated as eligible.

2.16 The following diagram illustrates the general structure of the Board's proposal.



FIF exemption criteria

2.17 The Board proposes using the existing FIF methods for determining whether a foreign entity is principally engaged in eligible activities as the building blocks of an active investment exemption. The benefits of this approach are that the rules are well developed and known, and would provide many taxpayers that do not fall within the de minimis exemptions with the benefit of as early an exemption from the attribution rules as possible.

2.18 The Board's preference is to build on the existing balance sheet and stock exchange listing methods in the FIF rules as a core part of an active business exemption. These existing methods are capable of providing more certain and simpler methods of determining whether a foreign entity is principally engaged in eligible activities as a basic safe harbour. Additional criteria can be developed such that those with access to further information can choose to demonstrate that prima facie ineligible activities meet more detailed conditions for eligible activity treatment. This approach is consistent with the way the current FIF rules operate to provide eligible treatment for otherwise ineligible activities.[6]

2.19 The balance sheet method has the advantage of focusing on the level of assets rather than the level of passive income, and therefore does not result in attribution because of related party dealings, such as intra-group financing and leasing arrangements. The Board is aware that these issues represent a problem for business under the current CFC rules.

2.20 The activities that are ineligible activities under the FIF rules will be modernised to better reflect an updated active/passive boundary.

Ineligible activities

2.21 Currently, the FIF rules list business activities that are ineligible activities for the purpose of exempting interests in foreign companies designated as engaging in, or whose assets are principally for use, in certain activities.[7] These are:

- banking and the provision of finance;
- financial intermediation services;
- investment in tainted assets, or tainted commodity investments;
- life insurance business;

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6 The FIF rules are already based on this approach. Banking and financial activities, and activities in connection with real property are treated as ineligible activities, with more specific exemptions available for interests in foreign companies undertaking these activities.

7 See Schedule 4 of Part XI of the *Income Tax Assessment Act 1936*.

- general insurance business;
- activities in connection with real property, other than in connection with construction.

Specific exemptions

2.22 References to these activities as being ineligible does not, however, affect the specific exemptions provided for interests in:

- foreign banks or the holding company of foreign banks;
- foreign companies whose assets are principally used in carrying on life insurance business;
- foreign general insurance companies;
- foreign companies engaged in certain activities connected with real property.

Exemption for interests in foreign banks

2.23 The current FIF exemption applies to certain interests in eligible foreign banks or interests in the holding company of a foreign bank. Under these rules, certain criteria are imposed including that:

- the shares are held on an approved stock exchange;
- the shares are traded widely and actively;
- the bank is authorised to carry on a banking business; and
- the entity is principally engaged in active banking business.

2.24 The Board is aware that these criteria are inhibiting Australian banks from entering new markets in certain countries. This arises due to restrictions in some countries, including restrictions on the level of interest holding that foreign residents may acquire. In these cases, the shareholding may not meet the stock exchange listing and share trading requirements.

2.25 Amendments were made in 2007 that allowed banks to calculate their attributable income under the CFC rules, and have their active income and incidental amounts of passive income exempt from attribution. The Board proposes that this outcome be preserved.

Exemption for interest in foreign company carrying on life insurance business

2.26 The current FIF rules exempt a taxpayer if the criteria for a foreign company principally engaging in life insurance business are met.

Exemption for interest in foreign general insurance company

2.27 The current FIF rules exempt a taxpayer if the criteria for a foreign company that carries on general insurance business are met.

Exemption for interest in foreign company engaged in certain activities in connection with real property

2.28 The current FIF exemption applies to certain interests in a foreign company engaged in certain activities connected with real property or interests in a holding company undertaking such activity. Eligible real property activities include:

- construction;
- development of real property through capital improvement;
- receipt of rental income from commercial real property owned by the foreign company where the management, maintenance and security services for the commercial property are principally provided by directors or employees of the foreign company or by a wholly owned subsidiary that is principally engaged in providing those services through its directors and employees;
- provision of management services in respect of real property through directors or employees of the foreign company;
- acting as agent for the sale or purchase of commercial real property.

2.29 The conditions for this exemption have been argued not to represent the commercial realities of business structures used to invest in foreign real property. While businesses conduct substantial activities in this area, the returns from real property are at risk of recharacterisation to separate the returns from property from the underlying commercial activity.

Additional exemption criteria

2.30 The current FIF rules are designed more for those investors with less access to information than the CFC rules. As such, the ineligible activities and their criteria are not designed for investors with access to further detailed information on the activities of foreign entities.

2.31 As the Board has noted, taxpayers that can access further information to demonstrate that the activities are in fact active should have this opportunity. If taxpayers cannot qualify for a higher level exemption from the attribution rules, they should have the opportunity to demonstrate that the activities of a foreign entity that are prima facie treated as ineligible under higher level exemptions are, in fact, eligible under specified conditions, and should count towards meeting the active business exemption. Conversely, taxpayers without the necessary information to identify the main activities of the foreign entity would not be expected to be eligible for the exemption.

2.32 The additional criteria for examining what are ineligible activities could be drawn from the active business exemptions that apply under the UK and French CFC rules, with suitable modifications. Both countries have comprehensive active business exemptions. Under revised arrangements, taxpayers would only be eligible for exemption from the attribution rules under the additional exemption criteria if they satisfied all additional exemption criteria (for example, the relevant aspects of both the UK and French CFC criteria).

2.33 The transfer pricing rules also contain principles that could be used to demonstrate the substance of a business.

2.34 To ensure appropriate integrity, it may be necessary to consider allowing access to the additional criteria only where the foreign entity is located in a country with which Australia has a taxation information exchange agreement (TIEA) or effective exchange of information.

2.35 As stated previously, taxpayers who satisfy the existing FIF criteria would remain exempt from the attribution rules without needing to satisfy the additional exemption criteria.

UK CFC exemptions

2.36 The UK rules treat all foreign businesses as active unless they are principally engaged in certain disqualifying activities. The rules use a range of criteria to determine whether the business is active. To satisfy the exempt activities test a company must satisfy three main conditions throughout the test period, namely:

- it must have a business establishment in its territory of residence;

  This requirement is to ensure that a company has a reasonable permanent presence in its territory of residence. Whether a business establishment is occupied and used with a reasonable degree of permanence depends on the particular facts.

- its business affairs must be 'effectively managed' in its territory of residence;

  Effective management turns on the number of employees employed by the company in its territory of residence being adequate to deal with the volume of the company's business, and any services provided by the company for persons not resident in that country being not in fact performed in the UK.

- its main business must at no time consist of certain 'defined activities'.

  Defined activities include investment business or dealing in goods for delivery to and from the UK or to and from connected or associated persons. For companies mainly engaged in wholesale, distributive, financial or service business, there is a 50 per cent limit on the gross trading receipts of the company that can be derived from connected and associated persons. (There is a lot of commonality between this test, the FIF ineligible activities, and prohibited income under the French CFC rules (see below) which may be capable of being synthesized in the future).

2.37 Additionally, holding companies which satisfy the first two criteria and meet certain other criteria, regarding the sources of their income, may satisfy the test.

French CFC exemptions

2.38 The French rules provide a comprehensive active business exemption. A French entity automatically falls out of the rules if the foreign entities in which it holds participation interests are principally engaged in commercial or industrial activities. However, this exemption may be lost where:

- more than 20 per cent of the foreign entity's profits are derived from 'tainted passive income', which is income from:
  - financial activities; and/or
  - management of intangible assets;
- more than 50 per cent of the foreign entity's profits are derived from:
  - tainted passive income and income derived from services provided to related entities; or
  - services provided exclusively to related entities.

Transfer pricing approach

2.39 The Board raised the possibility in its position paper that additional criteria could also borrow from the functional analysis that applies under the transfer pricing rules. This would recognise that international businesses must already comply with transfer pricing regimes throughout the world, and may already have sufficient information available to demonstrate the substance of a business, and that income is not being artificially separated from activities.

2.40 The UK CFC rules provide one practical approach to applying criteria that analyse whether the business of an entity has substance, which is consistent with the principles underlying transfer pricing.

2.41 The Board is concerned to ensure that any criteria provide sufficient certainty and simplicity for taxpayers under self assessment. As the transfer pricing rules are not self executing, any criteria drawn from the transfer pricing rules would need to provide sufficient certainty to taxpayers under self assessment, and be broadly consistent with the transfer pricing requirements so as to not provide an extra layer of complexity and cost for taxpayers.

2.42 Where taxpayers have insufficient information to determine whether the foreign entity does not have as its main business ineligible activities, the assumption must be that the foreign entity is not eligible for the exemption. In some cases, it may be necessary to look at more than one year where the matter is marginal, such as in situations where a business is in the start-up phase or is exiting a market.

ISSUE 3: DISTRIBUTION EXEMPTION

BACKGROUND

3.1 The Board's discussion and position papers highlighted the issues faced under the current rules, particularly by the managed funds industry, where interests in foreign entities are potentially subject to attribution despite the foreign entity fully or substantially distributing its income each year. To solve this problem, the Board advocated the introduction of a distribution exemption.

BOARD'S POSITION

3.2 The underlying policy rationale behind the attribution rules is to prevent the accumulation of income offshore in non-resident entities. Where the income from offshore investments is fully or substantially distributed to Australian investors, no or minimal tax advantage is obtained. Consequently, the practical effect of applying the attribution rules to such interests is to impose potentially significant compliance costs on arrangements where there is seemingly little or no risk of deferral.

3.3 This is a particular issue for the Australian managed funds industry since investments made by managed funds are typically passive in nature and therefore are unlikely to satisfy an active business exemption. Consequently, these interests are potentially caught within the attribution rules, regardless of whether they fully or substantially distribute their income annually. As explained above, this imposes significant complexity and compliance costs on the Australian managed funds industry, notwithstanding that the deferral risk is low.

3.4 One of the objectives the Board has sought as part of the review process is to ensure that revised attribution arrangements have more universal and consistent application. This will help address the current distortionary problems in the rules that allow materially different attribution outcomes to arise in respect of substantially similar investments.

3.5 In respect of a distribution exemption, however, it is difficult to understand how the exemption would be relevant for any entities other than those that are flow-through vehicles (like managed funds and other collective investment vehicles). Companies, by definition, are intended to maximise the wealth of their shareholders and grow the business, which necessarily requires the retention of profits and their subsequent reinvestment. The Board is also concerned about the integrity issues that may potentially arise if the exemption applied more broadly as, in conjunction with the section 23AJ exemption, distributions would, in some cases, be exempt from Australian tax even if they were passive in nature. For these reasons, the Board advocates that the distribution exemption be confined to managed funds and other like collective investment vehicles.

3.6 While some submissions advocated a broader exemption for managed funds, the Board considers the unfettered use of offshore accumulation entities would create longer term risks. Such an approach would enable resident taxpayers to structure their affairs to increase after-tax returns by substantially reducing the Australian tax payable on their passive foreign investment income. The global availability of investment opportunities in offshore accumulation entities located in tax havens and low-tax countries is substantial for highly mobile forms of capital. Offshore accumulation entities can also be established in non-tax haven countries to take advantage of favourable taxation arrangements designed to attract such investment.

3.7 Such an outcome would be contrary to the goal of taxing resident individuals on their worldwide income, pose a risk to the revenue base, and favour the use of particular offshore managed funds over Australian managed funds. Instead, the Board advocates the introduction of a distribution exemption as a balanced approach to resolving the issues currently faced by Australian managed funds in dealing with the attribution rules.

3.8 The challenge in developing revised arrangements that deliver positive results for fully or substantially distributing entities is to find the balance that appropriately addresses the needs of government, industry and investors themselves. Among other things, this means a system that:

- strikes a balance between the conflicting objectives of preventing tax deferral and allowing legitimate foreign investment;
- minimises the compliance costs for taxpayers and administrative costs for the Australian Taxation Office; and
- ensures investors in offshore entities do not have an unfair advantage over those investing in Australian funds and other investment products.

Comments sought

The Board seeks comments on the effectiveness of the proposed distribution exemption and, in particular:

- the extent to which it can be applied having regard to industry practice;
- the nature of any modification that might be needed to make it more effective;
- the extent to which it is open to exploitation; and
- whether the proposal is superfluous in light of the other proposals the Board is advocating.

OUTLINE OF REFORM PROPOSAL

General outline

3.9 While there are potentially a number of approaches that could be adopted to determine the extent to which a managed fund fully, or substantially, distributes its profits, the Board is attracted to the idea that it be based on market value. That is, if the value of distributions received by a managed fund from a foreign entity during a year is equal, or substantially equal[8], to the accretion in the market value of that foreign entity over that year, then by definition the foreign entity has fully distributed.

3.10 Special avoidance rules may be needed to ensure, for example, that the exemption was not circumvented by the mere transfer of profits by the foreign entity to another foreign entity that a resident investor held an interest in.

3.11 An alternative approach based on tracing and looking through tiers of entities to determine whether the foreign entity is fully distributing would impose significant compliance costs and complexity.

8 The Review of Business Taxation proposals for collective investment vehicles advocated a percentage of 98 per cent. However, the Board believes that this figure is too high to be applied for the purposes of the distribution exemption and is not sufficiently flexible.

Detailed explanation of calculations

3.12 The Board proposes that the distribution exemption apply where an Australian managed fund[9] receives distributions of income from a foreign entity equal to or greater than a significant specified percentage of the market value increase[10] in the Australian managed fund's interest in the foreign entity over the year[11]. Allowance will be made for changes in the market value that result from acquisitions, disposals and distributions made during the year.

3.13 To be included in the calculation, distributions must be received by the Australian managed fund during the year or within, say, two to three months of the end of that period. This allows a reasonable time for income to be distributed and is consistent with arrangements that apply under the general trust provisions, as well as other measures such as withholding arrangements for managed fund distributions to foreign residents.

3.14 In determining eligibility for the distribution exemption, the change in market value over the year will be calculated as per the FIF market value method.[12]

3.15 Hence, the change in market value will be calculated as follows:

(i) Determine the closing market value of the taxpayer's interest(s) in the foreign entity.

(ii) Add the value of distributions made to the taxpayer in respect of that interest (those interests) during the year.

(iii) Deduct the opening market value of that interest (those interests).

(iv) Deduct the value of any interests acquired during the year, with acquisitions measured by reference to the consideration paid or given by the taxpayer in respect of those interests.

(v) Add the value of interests in the foreign entity disposed of during the year.

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9 A managed fund might be defined for this purpose consistent with the definition of a managed investment trust under the new withholding arrangements for managed fund distributions to foreign residents (see *Tax Laws Amendment (2007 Measures No. 3) Act 2007*).

10 If market value decreases during the year, no income would be attributable and therefore the distribution exemption is not applicable in this circumstance. However, the loss would be deductible against the taxpayer's assessable income up to the amount of the attribution surplus, as occurs currently under the market value method (see section 532 of ITAA36).

11 The current FIF concept of a notional accounting period (see section 486 of ITAA36) will be used as the period over which market value and the value of distributions are measured. Currently, the notional accounting period of the foreign entity is assumed to be the income year of the taxpayer unless the foreign entity's accounts are made out for another period not exceeding 12 months and the taxpayer elects to adopt this period as the notional accounting period.

12 See section 538 of ITAA36.

3.16 The Board intends for a market value to be defined in accordance with current practice under the FIF rules.[13] If the market value of the Australian managed fund's interests in the foreign entity (at the beginning or end of the period) cannot be ascertained, the exemption cannot be claimed in respect of that foreign entity for that year.

3.17 However, the Australian managed fund would not be prevented from claiming the exemption in respect of that foreign entity in subsequent years if it can ascertain (opening and closing) market value and make the required level of distributions. The Australian managed fund would also not be prevented from applying the exemption to another foreign entity which satisfies the appropriate requirements.

3.18 While the Australian managed fund will complete the calculations to determine eligibility for the exemption, if the exemption is failed and income is attributable, tax will be paid in line with the current arrangements - that is, either by the investors in the Australian managed fund or by the trustee of the fund.

3.19 Where the Australian managed fund claims the distribution exemption in respect of its interest in a foreign entity, no attribution accounts need to be kept for that foreign entity for that year since no income would be attributable and therefore no attribution credit recorded. However, appropriate records would need to be kept to demonstrate eligibility for the exemption.

Example

Assume that an Australian managed fund holds shares in a foreign entity. The opening market value of the Australian managed fund's interests in the foreign entity was $200,000. Distributions of $11,000 were made to the Australian managed fund over the year. The closing market value of those interests was $200,000. No acquisitions or disposals were made during the period.

The change in market value of the Australian fund's interests in the foreign entity is $11,000 (that is 200,000 + 11,000 – 200,000).

Since distributions of $11,000 equal the accretion in market value over the year (also $11,000), the distribution exemption applies and no income would be attributable in respect of that foreign entity for that income year.

There is no requirement for the Australian managed fund to distribute to Australian individual investors in the fund in order to pass the distribution exemption. However, if the fund does not distribute, the trustee of the managed fund will face tax on the income under section 99A of the *Income Tax Assessment Act 1936* (ITAA36) as is currently the case.

13 See section 539 of ITAA36.

In line with current arrangements, the managed fund would inform investors of income and tax payable, if any, via the investor's distribution statement.

ISSUE 4: IDENTIFICATION OF INTERESTS

BACKGROUND

4.1 An underlying principle of Australia's tax system is that resident taxpayers are taxable in Australia on their worldwide income.

4.2 To provide integrity to Australia's residence based taxation system, anti-tax-deferral (attribution) rules operate to tax residents on an accruals basis on their share of certain foreign source income accumulating in offshore entities.

4.3 A critical aspect to the effective functioning of these rules is that interests held by resident taxpayers in foreign entities are appropriately identified.

4.4 Under the current arrangements, the attribution rules apply to certain interests that taxpayers hold in foreign companies, foreign trusts, and foreign life insurance policies (FLPs). The rules can also have application in circumstances where residents have transferred value (property or services) to foreign trusts for inadequate consideration.

4.5 The cumulative effect of the attribution rules is that they effectively cover all interests[14] held in separate foreign legal entities (within the common law meaning of that term).

BOARD'S POSITION[15]

4.6 The Board in its position paper advocated the retention of the existing approach to identifying relevant interests for the purposes of reformed attribution rules.[16] These rules, which are largely built around the legal notion of an interest, include shares in a company and units in a unit trust.

4.7 As part of the retention of the existing approach, rules that include an option, convertible note or other instruments that confer an entitlement to acquire a relevant interest would also need to be retained.[17] The Board is concerned that any

14 Essentially interests other than debt interests.
15 Unless otherwise stated, all section references are to the *Income Tax Assessment Act 1936*.
16 Refer to para 4.6 of 'Review of the foreign source income anti-tax-deferral regimes: Position Paper'.
17 For example, see section 483 in the FIF rules and section 356 in the CFC rules.

diminishment in the scope of this approach would undermine the rules and present an unacceptable threat to the revenue base.

4.8 In its position paper, the Board was also concerned about arrangements that could circumvent the operation of the foreign source income attribution rules including through the use of non-common law entities. The Board advocated the wider application of the transferor trust rules to address this concern.

Comments sought

The Board seeks comments on the effectiveness of the approach set out below to, first, identify relevant interests for the purposes of the foreign source income attribution rules, and, second, measure the magnitude of those interests.

Identification of interests

Current arrangements

4.9 As mentioned, the current attribution rules use a legal-form approach to identify those interests that are subject to attribution taxation.

4.10 In summary, Australian residents are subject to:

- the controlled foreign company (CFC) rules, where their shareholding gives rise to a controlling interest in a foreign company (indirect tracing rules allow the interest to be traced through trusts);[18]
- the foreign investment fund (FIF) rules, where their shareholding is a non-controlling interest in a foreign company or where they have an interest in a foreign widely-held fixed trust; [19]
- the deemed present entitlement (DPE) rules, if they hold an interest in a foreign closely-held fixed trust;[20]
- the transferor trust rules, if they transfer value (property or services) to a foreign trust for inadequate consideration.[21]

4.11 Within the FIF rules, certain investments in FLPs will also be subject to the attribution rules.[22]

18 Section 361.
19 Subsections 483(1) and (2).
20 Section 96B.
21 Section 102AAT.
22 Subsection 485(4).

Proposed approach

4.12 In recent times, the concept of 'membership interest' has been used in Australia's tax laws to identify legal interests in companies and trusts.[23] To further improve consistency within the tax law, the concept of 'membership interest' could also be used as the basis for identifying those interests that should be subject to the attribution rules.

4.13 Specifically, in relation to fixed interests in companies and trusts, taxpayers would be considered to be members of an entity and hold membership interests[24] if they are either:

- a member of the company or a stockholder in the company;[25] or
- a beneficiary or unitholder of the trust.[26]

4.14 The definition of 'membership interest' specifically excludes debt interests which includes finance shares. Holders of these interests would not be expected to come within the scope of the foreign source income attribution rules although they may have accruals taxation issues to consider under proposed Taxation of Financial Arrangements (TOFA) reforms.

4.15 Where the foreign entity has no legal equivalent, or where the holder of the foreign interest is not discernible, no fixed membership interests would typically be expected to arise.

4.16 In these cases, it is proposed to use rules based on the current transferor trust provisions to identify the attributable taxpayer. Essentially, the transferor trust conditions would be expanded to apply to all foreign entities, not just trusts, with the resident taxpayer considered to have an interest in the entity, and therefore be the attributable taxpayer, if they have transferred value (either property or services), for insufficient or no consideration, to the entity.

4.17 That is, to the extent that no fixed interest entitlement is able to be determined, a resident taxpayer would be assumed to be the attributable taxpayer (or transferor) if, subject to certain conditions, they had transferred property or services to the foreign entity for insufficient or no consideration.

4.18 This approach will help address an arrangement that was the subject of a recent Taxpayer Alert issued by the Australian Taxation Office (TA 2008/2). The Taxpayer

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23 Membership interests also include partners in a partnership.

24 Sections 960-130 and 960-135 of *Income Tax Assessment Act 1997* (ITAA 1997).

25 This should also cover the situation referred to at paragraph 3.27 of 'Review of the foreign source income anti-tax-deferral regimes: Discussion Paper' concerning holders of interests in a foreign company limited by guarantee.

26 Objects of trusts are considered members of that entity (subsection 960-130(1)); however, it is intended that the rules applicable to transferors would apply in cases where there are no fixed membership interests (see paras 1.15 to 1.17).

Alert explained that structures established under the laws of Liechtenstein (or like jurisdictions) were being used in an attempt to avoid or evade Australian tax obligations.

4.19 Further, interests in certain FLPs should continue to be subject to the attribution rules in the same manner that applies under the current rules. The rules currently apply to those residents with interests in FLPs which have an investment component attached. A person has an interest in these FLPs where they have a legal title to the FLP.

4.20 In summary, a resident taxpayer will have an interest for the purpose of the foreign source income attribution rules if they:

(i) are a member of a foreign company or stockholder in the foreign company;

(ii) are a beneficiary or unitholder of the foreign trust;

(iii) hold legal title to a FLP; or

(iv) have transferred value to a foreign entity for insufficient or no consideration; or

(v) hold an option, convertible note, or other instrument, that confers a right to acquire an interest of the kind referred to in paragraphs (i) or (ii) above (that is, an interest in a company or a trust).

4.21 In advocating this approach the Board is confident that traditional interests that confer ownership rights will come within the scope of the reformed foreign source income attribution rules. However, the Board would be concerned if there were interests of a kind that conferred equivalent ownership rights but because they took a different legal form are able to avoid the operation of these rules. In such circumstances it may be necessary for rules to be developed to deal with this concern.

Comments sought

The Board seeks comment on whether, in addition to the interests identified in paragraph 4.20, interests that confer equivalent ownership rights but take a different legal form should be included within the scope of the foreign source income attribution rules.

Assuming the Board forms the view that it is necessary to include such rules, the Board seeks comment on how such rules should be designed.

MAGNITUDE OF INTEREST HELD

Current arrangements

4.22 Identifying the existence of an interest for foreign source income attribution purposes establishes a relationship between the resident taxpayer and the foreign entity.

4.23 However, it is necessary to determine the magnitude of that interest holding (as a percentage of the total holdings) to establish a taxpayer's share of the income accumulating in the foreign entity.[27] This is only relevant when using the branch-equivalent or calculation method to determine a taxpayer's share of attributable income.[28] For proxy attribution methods (that is, the market value or deemed rate of return methods) it is necessary to only determine the value of the investment or the amount being transferred in order to calculate the amount of attributable income to include in assessable income.

4.24 When using the branch-equivalent or calculation methods, the magnitude of the interest is determined by calculating a taxpayer's attribution percentage. How this currently occurs under each regime is briefly outlined below.

4.25 Under the CFC rules, a taxpayer's attribution percentage[29] is determined by the sum of their 'direct' and 'indirect attribution interest' in the company.[30]

4.26 Essentially, a taxpayer's 'attribution interest'[31] is determined by the greatest benefit receivable from one of several entitlements, being the taxpayer's percentage of total paid-up shares in the CFC; rights to vote or participate in decision-making of the CFC; total rights to distributions (capital or income) on winding-up; or otherwise than on winding-up of the CFC; with an additional calculation required to take account of indirect interests where tiers of CFCs are involved.

4.27 Under the FIF rules, where the interest relates to a foreign company, only direct holdings are taken into account in determining a taxpayer's attribution percentage.[32] Similar to the CFC rules, the attribution percentage is determined by the greatest benefit receivable from their percentage of the total paid-up shares in the company; rights to vote or participate in decision-making of the company; total rights to distributions (capital or income) on winding-up; or otherwise than on winding-up of the company.

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27 This approach, however, does not apply to the transferor trust rules. Under these rules, the whole of the net income of the trust is attributable to the transferor (see para 1.29).

28 Note: The Board's position is that only one branch-equivalent/calculation method should be available under revised attribution rules (see branch-equivalent calculations issues paper).

29 Subsection 362(1).

30 Sections 356 and 357 define 'direct' and 'indirect attribution interest'.

31 See sections 356 and 357.

32 Section 581.

4.28 Where the FIF interest relates to a foreign trust, then the attribution percentage is either:

(i) the percentage of the total income, profits or gains derived by the trust to which the taxpayer is presently entitled or if not presently entitled was distributed to the taxpayer during, or within two months after the end of, the notional accounting period; or

(ii) if the income, profits or gains of a foreign trust are not fully distributed or allocated to beneficiaries, it is the percentage equal to the greater of the percentages of the taxpayer's interest in or entitlement to acquire the income or capital of the trust.[33]

4.29 Under the transferor trust provisions, it is the whole of the net income of the foreign trust estate that is attributable to the transferor (although reductions are provided for certain specified amounts).[34] That is, the transferor is effectively treated as having an attribution percentage of 100 per cent.

4.30 Where the DPE rules apply, the attribution percentage of a taxpayer is determined on the same basis as the FIF rules (see paragraph 4.28).[35]

4.31 Within each of the regimes, there is recognition of the possibility that the total attribution percentage may exceed 100 per cent. As a consequence, provisions in the CFC, FIF and DPE rules[36] operate to proportionally reduce the attribution percentage of each taxpayer concerned. In the transferor trust rules, in recognition that double counting of income may occur where more than one transferor is involved, the Commissioner is able to exercise a discretion[37] to reduce the amount included in a taxpayer's assessable income. [38]

Proposed approach

4.32 While the four regimes currently use similar rules to determine a taxpayer's attribution percentage, the Board seeks comment on the following approach to determine the appropriate allocation of the foreign entity's income when using the branch-equivalent calculation method.

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33 Section 582.
34 Section 102AAU.
35 Section 96C.
36 Subsections 362(2), 581(4) and 96C(6) respectively.
37 Subsection 102AAZD(3).
38 Other provisions also apply to remove double counting between regimes, for example, section 493 and subpara 102(1)(c)(ix). Note, there is an issue where a different taxpayer is assessed.

Fixed interest entities

4.33 Consistent with the Board's position paper[39], if the foreign entity is constituted entirely by fixed interests, income should be attributed in proportion to each taxpayer's (member) entitlements in the same manner that applies under the current rules.

4.34 Having established that a resident taxpayer has a relevant interest in a foreign entity for attribution purposes, the magnitude of that interest would be determined by using conditions that currently apply to calculate attribution percentages (see paragraphs 4.26 to 4.28). That is, it would be determined by the greatest benefit receivable as a result of holding that interest.

4.35 Where the total attribution percentage exceeds 100 percent, then consistent with the current approach, each taxpayer's interest in the entity would be proportionally reduced to ensure that there is no double counting of income.[40]

4.36 Adopting a uniform approach provides further consistency within the taxation laws. It also reduces compliance costs and complexity by mitigating the need for multiple provisions to alleviate double counting as well as avoiding the need to replicate several similarly worded provisions across the taxation laws.

Discretionary interest entities

4.37 Where the foreign entity is constituted entirely by interests that are discretionary, are not discernible, or do not have a common law equivalent, the attribution rules would treat a resident taxpayer who transferred value to the foreign entity for insufficient or no consideration as being the attributable taxpayer and assess them accordingly.

4.38 Similar to current arrangements, rules would be needed to ensure that double counting is removed where appropriate. The Board in its position paper felt that this could be better achieved by, in effect, applying the rules in the reverse order to that which occurs under current arrangements. [41]

4.39 Presently, the rules provide a Commissioner's discretion[42] to reduce the amount of attributable income included in a taxpayer's assessable income from 100 per cent having regard to the extent to which the attributable income of the trust estate is attributable to the property or service transferred into the trust by the taxpayer (where other taxpayers have also transferred value).[43] Relying on the Commissioner's

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39 See position 4.3 of position paper.
40 Subsections 362(2) and 581(4) provide examples of how this is currently achieved.
41 See position 5.5 of position paper.
42 See subsection 102AAZD(3).
43 Adjustments to the non-resident trust's attributable income can also be made for several other factors including where beneficiaries have been identified and included an amount in their assessable income (paragraph 102AAU(1)(c)).

discretion within a self assessment environment often does not provide an appropriate level of certainty for taxpayers.[44]

4.40 What the Board is instead proposing is that where there are multiple transferors, the amount of income attributed to each transferor would, in the first instance, be in proportion to the value of the property or service that they have transferred into the entity. Where it is not possible to determine the value transferred, taxpayers would be assessed on 100 per cent of the attributable income, consistent with the current rules.

Entities comprised of both fixed and discretionary interests

4.41 Resident taxpayers may also have interests in foreign entities that are constituted by a combination of fixed and discretionary entitlements. Trusts are a vehicle commonly used for this purpose.

4.42 The obligations upon trustees, together with the entitlements of beneficiaries, depend on the wording of the relevant trust deed. For example, deeds could be structured so that certain taxpayers may have a fixed entitlement to a proportion of the income, say 90 per cent, with the balance being subject to the discretion of the trustee.

4.43 In those cases where both fixed and discretionary entitlements to the income are involved, the rules should first apply to treat those taxpayers holding fixed interest entitlements in the entity as being the attributable taxpayers. The sum of these taxpayers' attribution percentages would account for the total amount of the fixed interest entitlements of the entity.[45] For the balance of the entity's income, being subject to the discretion of the trustee, the attributable taxpayer would be the transferor(s) where value had been transferred to the entity for insufficient or no consideration.

Example

A foreign entity is constituted with the requirement that 70 per cent of distributable income is to be distributed according to the proportion of units held, the remaining 30 per cent of income is subject to the discretion of the trustee for the remaining objects of the entity.

If the entity's attributable income for the year was $100, then $70 would be proportionally attributable to unitholders.[46] The remaining $30 may be included in the transferor's assessable income, if they had transferred value to the foreign trust for insufficient consideration, in the same manner that applies under the current rules.

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44 Refer to paragraph 5.41 of 'Review of the foreign source income anti-tax-deferral regimes: Position Paper'.

45 Note: a taxpayer's attribution percentage can include their entitlement to the capital or corpus of the relevant foreign entity (refer paras 1.26 to 1.28).

46 Ibid.

OTHER ISSUES – SECTION 404

4.44 Applying more universal arrangements to the attribution rules will address a related issue canvassed in both the Board's discussion and position papers.[47] That is, certain interests are confined to the FIF regime notwithstanding that the relevant interests are, in-substance, controlling interests and the taxpayers holding these interests have the necessary information to apply the CFC rules.

4.45 Providing access to all of the attribution methods and exemptions provides the opportunity for these investments to receive similar tax outcomes under the attribution rules.

4.46 The discussion paper also noted a related issue concerning the taxation treatment of portfolio dividends. This involves the proposal to amend the law to ensure consistent tax treatment of foreign dividends received by Australian companies, whether the dividends are received directly, or indirectly through a CFC.[48] This proposal resulted from a review of the current operation of section 404 in light of previous changes to section 23AJ.[49]

4.47 Presently, the operation of section 23AJ, and its interaction with section 404, can result in Australian taxpayers paying no Australian tax on dividends derived from their (in-substance) foreign portfolio share holdings when received through an interposed CFC, while dividends received directly from foreign portfolio holdings are taxable in Australia.[50]

4.48 This occurs where a CFC receives portfolio dividends from its offshore investments that when repatriated back to Australia are exempt non-portfolio dividends because of section 23AJ. This result arises because all dividends (both portfolio and non-portfolio)[51] paid to a CFC resident in a listed or section 404 country are treated as being exempt if the paying entity is also a resident of a listed or section 404 country.

4.49 To provide consistent treatment for portfolio dividends section 404 should be removed. However, the Board recognises that in removing section 404 there would be a need to ensure that dividends received as a result of in-substance substantial (that is, non-portfolio) investments also continue to receive consistent taxation treatment.

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47 Refer to para 3.30 of 'Review of the foreign source income anti-tax-deferral regimes: Discussion Paper'.

48 This proposal was a 2006-07 Budget announcement following a review of section 404. See p 33, footnote 43 of 'Review of the foreign source income anti-tax-deferral regimes: Discussion Paper.

49 *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004*.

50 See Diagram A.

51 Generally, portfolio dividends are those paid to shareholders who have a voting interest of less than 10 per cent in the foreign company, with non-portfolio dividends being those paid to shareholders who have a voting interest of 10 per cent or greater.

4.50 If section 404 was repealed without any other changes, certain in-substance non-portfolio investments would remain taxable, as the definitional requirements as to what constitutes a non-portfolio dividend for the purposes of the section 23AJ exemption would not be met. Failing the definitional requirement can occur simply because the regulatory requirements in the foreign jurisdiction where the entity is located may limit the voting interests able to be held by foreigner investors. To avoid this result, holding companies are set up in countries without voting interest restrictions, thereby ensuring dividends from their in-substance non-portfolio investments remain exempt from further taxation in Australia.

4.51 To address this situation, the Board considers that eligibility for the section 23AJ dividend exemption should be modelled on the proposed rules set out earlier in this paper for identifying relevant interests and the magnitude of those interests for the purposes of the foreign source income attribution rules. That is, factors other than voting rights are able to be used to determine whether an in-substance substantial investment is being held by a company. In this regard the Board notes that the existing definition of 'non-portfolio interest' in the tax laws could be used for this purpose.[52]

4.52 While this approach will broaden the range of equity interests that qualify for the section 23AJ exemption, interests that confer voting rights but are debt may cease to be eligible for the exemption. [53]

4.53 This outcome is also consistent with the 2006-07 Budget announcement concerning the tax treatment for foreign dividends where it was proposed to align the definition of non-portfolio dividend with economic ownership concepts.[54]

4.54 Having the same underlying basis for determining the exemption of dividends received from foreign companies and whether the attribution rules apply, ensures all non-portfolio foreign dividends are exempt provided they were sourced from the profits of active business activity or from attributed (passive) income. To that end, the Board notes that the Explanatory Memorandum that accompanied the expansion of non-portfolio dividend exemption stated:[55]

> 'The changes to the current exemptions remove an impediment to the distribution of foreign profits to Australia. This removes a deterrent to Australian companies expanding their active business offshore. Any passive or highly mobile income shifted to those offshore investments will continue to be taxed in Australia under controlled foreign company rules.'

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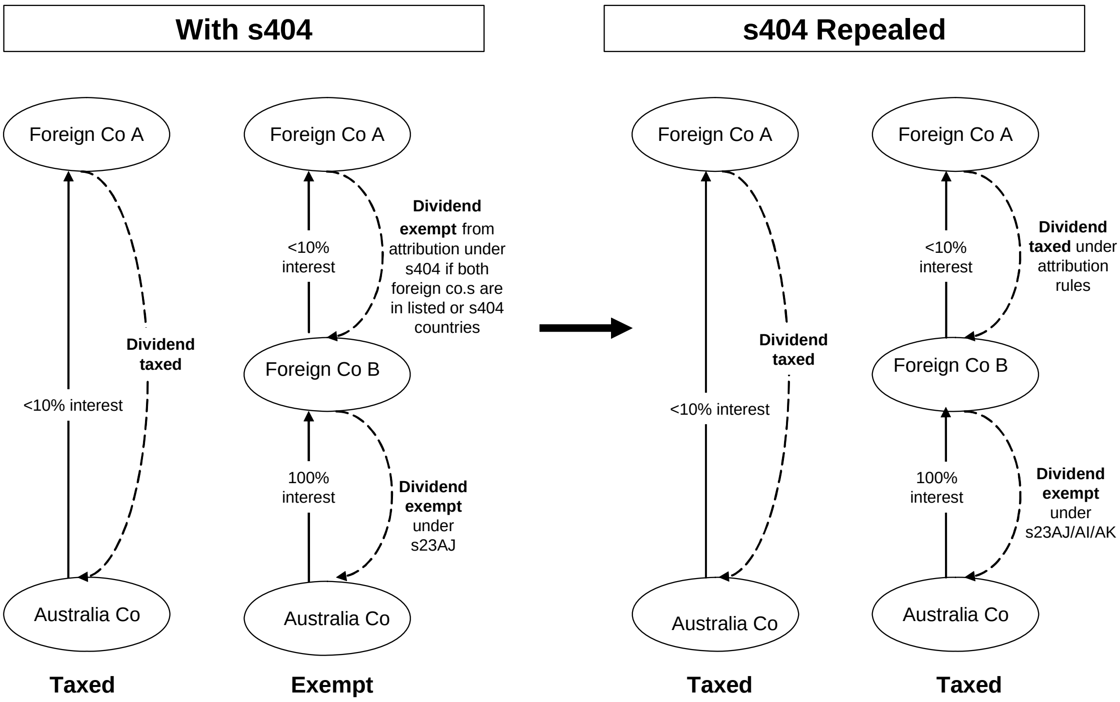
52 See section 960-195 of ITAA 1997.
53 For example, redeemable preference shares.
54 Refer to footnote 48.
55 Para 2.4 of *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004.*

Comments sought

The Board seeks comments on the proposal set out above to provide for more consistent taxation treatment of foreign dividends.

Diagram A: Portfolio interests - interaction of s404 and s23AJ



ISSUE 5: BRANCH-EQUIVALENT CALCULATIONS

BACKGROUND

5.1 The CFC, transferor trust and deemed present entitlement rules currently apply the domestic tax rules, with certain modifications, to calculate the income of the foreign entity as though it were an Australian resident, that is, on a branch-equivalent basis. The FIF regime also contains a simplified branch-equivalent method, referred to as the 'calculation method'.

5.2 Due to the high level of information required (in order to apply the domestic tax laws to calculate the income of the foreign entity), the branch-equivalent calculations can be highly complex and compliance intensive. On the other hand, the targeted nature of the calculations means that they generally provide the lowest attributable income figure when compared to other less compliance intensive methods.[56]

BOARD'S POSITION

5.3 While the Board believes it desirable to simplify the branch-equivalent calculations, the need for change has been mitigated by the Board's proposals to better target the rules and to allow taxpayers to elect the attribution method which best suits their needs. Given these changes, taxpayers may have reduced exposure to the rules or will have the option of reducing compliance costs by electing to use the market value or deemed rate of return methods. The removal of the base company income rules will also simplify the calculations.

5.4 Nevertheless, the Board still wishes to consider further ways to simplify the current branch-equivalent calculations. As discussed in the Board's position paper, this could be achieved either through the adoption of an accounting based approach or through the maintenance of the current tax law based approach but with a reviewed list of modifications or applicable provisions.

5.5 Both approaches have the potential to help alleviate the compliance costs that are currently faced by taxpayers using the branch-equivalent methods across the various regimes.

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56 Branch-equivalent calculations are essentially concerned with passive income only, whereas other methods attribute all of the income of the foreign entity.

5.6 The Board sees the two approaches as providing similar outcomes, albeit from different starting points, with certain Australian tax law provisions modified 'in' or 'out' as appropriate under the two approaches.

5.7 The Board does not wish to convey the view that it supports implementing multiple branch-equivalent calculations with the option of using either accounting or tax based information as the basis for the calculations. A single, consistent approach to branch-equivalent calculations should be adopted under new attribution arrangements. Taxpayers could elect to use the branch-equivalent method in respect of any interest they hold in a foreign entity that is subject to the attribution arrangements.

5.8 The Board therefore wishes to further explore the various issues surrounding the two approaches and to consult industry on its views.

Comments sought

The Board seeks comments on how the branch-equivalent calculations should be designed going forward with particular focus on:

- whether the calculations should rely on information prepared in accordance with accounting standards and, if so, provide details on how such an approach would apply; or
- whether the Australian tax law approach should be retained as the basis for the calculations and, if so, explain what modifications to those rules should be made having regard to the policy framework set out below.

Outline of the two reform approaches

Accounting based approach

5.9 An accounting based approach would allow taxpayers to calculate their attributable income by reference to accounts prepared in accordance with accounting standards. Taxpayers could use the financial statements as well as more detailed accounting information to identify and calculate their attributable income.

5.10 To ensure appropriate integrity, taxpayers would only be permitted to use the accounts of the foreign entity as the basis for the branch-equivalent calculations if they were audited and prepared using prescribed accounting standards. Prescribed accounting standards might include the International Financial Reporting Standards (IFRS) and the United States Generally Accepted Accounting Principles (GAAP).

5.11 Other integrity measures may also be considered, such as requiring an unqualified auditor's report in respect of the accounts. This would be consistent with other instances where the use of financial reports to calculate Australian income tax is proposed, for example in the taxation of financial arrangements.

5.12 Those submissions that commented on the accounting based option set out in the Board's discussion paper highlighted the benefits that such an approach could bring, including reduced complexity and compliance costs.

5.13 Nevertheless, if an accounting approach were to be adopted, there may be a need to add back in certain Australian tax law provisions. An example might be the non-portfolio dividend exemption[57] which, amongst other things, exempts non-portfolio dividends paid between CFCs. Other provisions which provide benefits to taxpayers, prevent tax avoidance or ensure revenue integrity may also need to be added back in.

5.14 The extent to which modifications to an accounting based approach are needed to deliver certain tax outcomes is unclear. If the range of modifications necessary were considerable, it would defeat the purpose of pursuing this approach on the basis of complexity and compliance cost reductions.

Tax law based approach with reviewed modifications

5.15 Both the CFC branch-equivalent calculations and the FIF calculation method rely on the Australian tax law to calculate the taxpayer's share of foreign income accumulating in a foreign entity in which they hold an interest. However, the FIF calculation method sets out how notional income and deductions should be calculated while the CFC branch-equivalent method relies on the domestic tax law provisions and then modifies these provisions where needed. Since the FIF method only applies the FIF provisions as stated to calculate attributable income, rather than applying the full extent of the domestic tax laws, the method is in some ways closer to an accounting based approach.

5.16 Regardless of the method used, the Board sees scope for the applicable provisions (whether stated directly as under the FIF rules or achieved indirectly under the CFC rules through modifying the general tax law provisions) to be examined as part of the attribution review process to ensure that they remain appropriate.

5.17 The current CFC branch-equivalent method contains a number of modifications in terms of the extent to which the full ambit of the Australian tax laws applies.[58] Many of the modifications are purely technical and ensure that the Australian tax laws work in a foreign context while others 'modify out' certain provisions, for example, the imputation[59], thin capitalisation[60] and debt/equity[61] rules.[62]

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57 Section 23AJ ITAA36.
58 Modifications to the Australian tax law for the purposes of the CFC branch-equivalent calculations are currently provided for in sections 388 to 431A of ITAA36.
59 Part 3-6 ITAA36.
60 Division 820 ITAA97.
61 Division 974 ITAA97.

5.18 In some cases, the modifications have been made to achieve deliberate policy outcomes or in recognition that the compliance costs incurred in performing the calculations are disproportionate to the revenue risk. In other cases, it is not readily apparent what the prevailing policy framework is to justify the modification.

5.19 In terms of the branch-equivalent calculations, going forward, submissions to the Board listed the following additional provisions as ones that should be disregarded for the purposes of calculating the income of the foreign entity.

- Tax exempt asset financing rules[63]
- Division 16E[64]
- Debt forgiveness rules[65]
- Value shifting[66]
- Foreign exchange conversion rules[67]
- Capital allowance provisions[68]
- Transfer pricing[69] (except where transactions have an Australian leg)
- Specific non-deductibility provisions (for example, non-deductible entertainment expenses)
- Tax adjustments related to provisions such as long service leave and annual leave

5.20 While the rationale behind most of the current modifications is apparent (see paragraph 5.18), submissions to the Board did not explain how additional modifications could be justified against a policy framework (see paragraphs 5.21-5.23).

5.21 If the calculation of attributable income is to deviate from the calculation of domestic taxable income, the Board needs to be satisfied that the provisions are inappropriate or irrelevant in a foreign context.

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62 Certain other provisions, such as the Australian tax consolidation and TOFA provisions, do not apply in an attribution context (that is, they 'modify out' foreign interests or attribution interests) rather than such provisions applying and then being 'modified out' for the purposes of the branch-equivalent calculations.

63 Section 51AD and Division 16D of ITAA36 (new Division 250).

64 ITAA36.

65 Schedule 2C Division 245 of ITAA36.

66 Divisions 723, 725, 727 of ITAA97.

67 Subdivisions 960-C and 960-D of ITAA97.

68 Division 40 ITAA97.

69 Division 13 of Part III of ITAA36.

5.22 Given the changes proposed in the Board's position paper to better target the rules, there is arguably less need to 'modify out' provisions simply on the basis that they are complex to apply. This would give an unfair advantage to those taxpayers who invest overseas as opposed to those who invest domestically.

5.23 However, if certain provisions are so complex that deriving the information in a foreign context is virtually impossible, the compliance costs are high and the revenue risk in a foreign context is small, there may be justification in excluding such provisions.

5.24 Any further modifications made to the domestic tax law would need to be justified against the policy framework outlined above. It is important that any modifications to the domestic law be balanced and not merely a 'cherry picking' exercise.

ADVANTAGES AND DISADVANTAGES OF THE TWO APPROACHES

Accounting based approach

5.25 An accounting based approach brings with it a number of advantages. These include:

- reduced compliance costs as taxpayers could base their calculation of attributable income on existing accounts prepared by the foreign entity;
- where foreign consolidated accounts are available, these could be used to avoid problems with accounting for intra-group transactions, further alleviating compliance costs for taxpayers.

5.26 Conversely, an accounting based approach also brings with it a number of potential disadvantages. These include that:

- outcomes that are captive to the application of accounting principles may not always be consistent with those sought from a tax policy perspective;
- the use of accounting based information as a basis for the calculation of attributable income would differ from the treatment of domestic investments and foreign branches, where taxable income is calculated using the Australian tax law;
- to the extent that modifications are needed to the accounting based approach to achieve certain tax outcomes, this will reduce the complexity or compliance costs benefits that such an approach would provide;
- not all foreign entities prepare accounts using prescribed accounting standards. This may exclude some taxpayers from electing to use the branch-equivalent calculations

in respect of that entity despite having the information to complete a tax law based calculation.

Tax law based approach

5.27 A tax law based approach also brings with it a number of advantages. These include that:

- taxpayers exposed to the current rules are familiar with the current tax law based approach and may have developed systems and expertise in connection with the current method. Retaining a tax law based method will therefore reduce transitional costs;

- the tax law has been developed over many years to achieve certain outcomes (for example, to ensure appropriate levels of integrity, avoid double taxation and provide concessions in specific circumstances). Retaining a tax law approach will ensure that these outcomes are maintained;

- the tax law has as its sole objective the calculation of taxable income and is therefore less likely to be captive to other objectives, such as financial reporting objectives. Similarly, the tax law can be adjusted in response to emerging needs or government policy while accounting standards are externally set;

- foreign investments receive more consistent treatment to that applied to most domestic investments and foreign branches.

5.28 Conversely, a tax law based approach also brings with it a number of potential disadvantages. These include:

- high compliance costs as taxpayers must prepare separate accounts based on the Australian tax law rather than being able to utilise existing accounts prepared by the foreign entity;

- taxpayers may have difficulty obtaining the necessary information to complete calculations in accordance with the Australian tax law as the foreign entity may not ordinarily prepare its accounts with Australian tax law in mind.

General workings of the branch-equivalent calculations

5.29 As proposed in the Board's position paper, regardless of the approach chosen for the branch-equivalent calculations, a taxpayer with insufficient information to use this method would have the option of electing the market value or deemed rate of return methods. Taxpayers with the information but not the inclination, possibly because of higher compliance costs, would also be permitted to elect the market value or deemed rate of return methods.

5.30 The Board envisages that taxpayers could elect to apply the branch-equivalent calculations to (calculate the attributable income of) any foreign entity in which they hold an interest, whether directly or indirectly. Calculations would only cease to be applied to calculate the income of lower-tier entities once the market value or deemed rate of return method was used, since these methods automatically capture the income of lower-tier entities.

5.31 As foreshadowed in the Board's position paper, the Board, in line with views expressed in submissions, has proposed that the branch-equivalent calculations only apply to attribute the tainted income of the foreign entity. Tainted income would be based on the current definition of passive income in the CFC rules.