



Australian Government

The Board of Taxation

REVIEW OF THE FOREIGN SOURCE INCOME ANTI-TAX-DEFERRAL REGIMES

Position Paper

the **board** of **taxation**
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Review of the Foreign Source Income Anti-Tax-Deferral Regimes

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EXECUTIVE SUMMARY

BACKGROUND (CHAPTER 1)

A review of the foreign source income anti-tax-deferral (attribution) rules, to be undertaken by the Board of Taxation, was announced on 10 October 2006. Following the announcement of the review, the Board conducted targeted consultations and, drawing from these consultations, developed a discussion paper which was released on 25 May 2007.

Drawing on further consultations and submissions in response to the discussion paper, the Board has prepared this position paper. Given the time available, and the breadth of issues associated with the review, the position paper sets out the Board's considered views on the high level principles that should apply in the future design of the foreign source income attribution rules. A complete list of the Board's positions in respect of these principles is set out in Appendix A.

To assist in settling the detail underlying these principles, the Board intends to release several issues papers on specific topics for further consultation. The Board also anticipates that further consultation will be conducted in respect of draft legislation.

AUSTRALIA'S ATTRIBUTION RULES (CHAPTER 2)

In general, Australia taxes residents on their worldwide income derived from both labour and capital. To ensure residents cannot accumulate income offshore and thereby defer, or even avoid, Australian tax, attribution rules apply to tax residents on an accruals basis on their share of income accumulating offshore. This ensures offshore investments are not favoured over domestic investments for taxation reasons.

The policy underlying Australia's attribution rules is based on a balance between two competing economic policy benchmarks – capital import neutrality (CIN) and capital export neutrality (CEN). Essentially, CIN applies to active income, effectively allowing deferral, while CEN applies to passive income, resulting in income being attributed and taxed on a current basis. The Board considers it desirable to maintain these policy settings into the future, with the main focus of the review directed at what is considered passive or active.

The attribution rules serve the dual purpose of eliminating the deferral benefit that arises in both the avoidance case and the case where the deferral benefit is merely incidental to the foreign investment. While the Board supports the continuance of this dual purpose, in seeking to better target the rules, the Board proposes that the focus of the rules shift more towards the avoidance end of the spectrum.

OPTIONS FOR REFORM (CHAPTER 3)

While harmonisation of the attribution regimes was presented as a key consideration in the Board's discussion paper, a consistent message that the Board heard during consultations was that so long as the problems in the current regimes are fixed, the means by which this is achieved should be a secondary consideration.

The Board considers that the focus of reforms should not be on harmonisation itself, but rather on outcomes based on a range of policy factors relevant to the foreign source income attribution rules. These policy factors are relevant at three different levels: the resident investor level; the resident entity level, where the foreign investment is made indirectly; and the foreign entity level.

By focusing on the policy factors to identify the appropriate policy settings, the problems with the existing attribution regimes will be addressed in a systematic and consistent manner.

POLICY FACTORS — HIGH LEVEL PRINCIPLES (CHAPTER 4)

At the resident investor level, the Board proposes that the coordination and distortionary problems that are inherent across the rules be addressed by applying the attribution rules more consistently to all interests in foreign entities. A starting point in this regard is how the rules apply to those kinds of interests that currently fall under the attribution rules (that is, interests in companies and trusts), and how the application of the rules to interests in non-common law entities (such as anstalts, foundations and stichlings) can be clarified. The Board also supports retention of, and improvements to, the de minimis and complying superannuation fund exemptions.

At the resident entity level, the Board proposes that an Australian public company exemption be introduced, subject to suitable integrity rules being developed.

At the foreign entity level, the Board proposes an active investment exemption, a distribution exemption, a listed country exemption and a foreign employer-sponsored superannuation exemption. Where applicable, these exemptions would be based on existing exemptions to ensure lower transitional costs for taxpayers. The exemptions, particularly the active investment exemption, would be better targeted to exempt the full range of investments that present little, or no, deferral risk.

The Board proposes that these exemptions would, as far as possible, be designed as high level exemptions. This would reduce compliance costs by enabling taxpayers to determine as early as possible whether they are exempt from the attribution rules, without having to collect detailed information or complete complex calculations.

By introducing high level, better targeted exemptions, complexity and compliance cost concerns for taxpayers and administrators will be addressed, ensuring that Australian residents can remain competitive in the global economy.

ATTRIBUTION METHODS — HIGH LEVEL PRINCIPLES (CHAPTER 5)

For those taxpayers who are not exempt from the attribution rules, the Board is proposing a number of improvements to the way taxpayers calculate their attributable income.

The current attribution methods are highly complex and compliance intensive and the restrictions on these methods lead to distortions and inconsistent outcomes across the attribution regimes.

The Board proposes to allow taxpayers to choose the attribution method which best suits their needs. In addition, the branch-equivalent calculations would be simplified and the deemed rate (under the deemed rate of return method) lowered so that it is no longer a penal rate.

The Board also proposes other changes to the calculation of attributable income and to the record keeping requirements to ensure that the rules are simpler and fairer for taxpayers.

CHAPTER 1: INTRODUCTION

BACKGROUND TO THE REVIEW

1.1 On 10 October 2006, the former Treasurer announced a review of Australia's foreign source income anti-tax-deferral regimes.

1.2 These regimes include the controlled foreign company (CFC) rules, the foreign investment fund (FIF) rules, the transferor trust rules and the deemed present entitlement rules.

1.3 The regimes are designed to ensure that no undue tax deferral benefit arises as a result of resident taxpayers accumulating income in offshore entities.

1.4 The review addresses a number of concerns raised by business about the attribution regimes, including that they are complex and involve substantial compliance and administration costs.

1.5 Business has also raised the concern that, in some cases, the regimes are poorly targeted, potentially impacting on offshore investment decisions that are not motivated by tax deferral reasons.

REVIEW'S TERMS OF REFERENCE

1.6 Against this background, the Board of Taxation was tasked to review the operation of these regimes. The review's terms of reference are:

- to identify ways to reduce the complexity and compliance costs associated with the foreign source income anti-tax-deferral regimes, including whether the regimes can be collapsed into a single regime; and
- to examine whether the anti-tax-deferral regimes strike an appropriate balance between effectively countering tax deferral and unnecessarily inhibiting Australians from competing in the global economy.

1.7 The Board of Taxation is an independent, non-statutory body established to advise government on various aspects of the Australian taxation system.

REVIEW PROCESS

1.8 Following the announcement of the review, the Board conducted some targeted consultations with key stakeholders. Drawing on these consultations and other information, the Board developed a discussion paper, which was released on 25 May 2007.¹ The paper canvassed issues that were brought to the attention of the Board and posed questions to be addressed as part of the consultation process.

1.9 Following the release of the discussion paper, the Board conducted further consultation forums in Sydney and Melbourne in June 2007 as an additional mechanism for obtaining views and to assist stakeholders in preparing written submissions.

1.10 The Board received over 25 submissions in respect of the issues raised in the discussion paper. A list of submissions, other than confidential submissions, is provided in Appendix B.² The Board expresses its gratitude to those that have provided the Board with submissions and participated in consultations.

POSITION PAPER

1.11 In response to submissions and consultations, the Board has prepared this position paper. The paper provides a framework for further consideration of the key issues so that they can be addressed in a systemic way. Given the time available, and the potential breadth of issues associated with the scope of the review, the position paper sets out the Board's considered views on the high level principles that should apply in the future design of the foreign source income attribution rules.

1.12 To settle the detail underlying those principles, the Board anticipates that further consultation with key stakeholders will occur. To assist in this process, the Board will prepare and circulate for comment in early 2008 issues papers to develop and identify some of the key design details. Following this consultation, the Board will inform government of its final recommendations, expected to be around the middle of 2008.

1.13 The Board also anticipates that further consultation in respect of draft legislation will occur between the Board, Treasury and stakeholders once government has announced its position in respect of these recommendations.

1 The discussion paper can be accessed from the Board's website. See: www.taxboard.gov.au.

2 Submissions are provided in full on the Board's website. See: www.taxboard.gov.au.

CHAPTER 2: POLICY UNDERLYING THE FOREIGN SOURCE INCOME ATTRIBUTION RULES

OVERVIEW

2.1 In general, under Australia's taxation rules, residents of Australia are taxable on their worldwide income, from both labour and capital.

2.2 For individuals, taxation of worldwide income is important in achieving the principles of vertical equity (individuals with a greater ability to pay should pay more tax) and horizontal equity (individuals with a similar ability to pay should pay the same amount of tax). These principles are important in minimising distortions in economic choices and thus promote an economically efficient tax system. An economically efficient tax system is one which interferes to the least possible extent with the efficient allocation of risk and promotes long-term economic growth.

2.3 To ensure residents cannot undermine these principles by accumulating foreign source income offshore and thereby defer, or even avoid, Australian tax, attribution rules apply to tax residents on an accruals basis on their share of foreign source income accumulated in an offshore entity. This means offshore investments are not favoured over domestic investments for taxation reasons.

UNDERLYING POLICY

2.4 The underlying policy that should apply to Australia's foreign source income attribution regimes distils to a question of the extent to which the taxation treatment of returns on foreign investment should mirror the taxation of returns on domestic investment. Two competing economic benchmarks – capital import neutrality (CIN) and capital export neutrality (CEN) – are commonly used in evaluating the taxation of foreign source income. Appendix C contains further details of these benchmarks.

2.5 CEN supports the proposition that capital that is exported should be treated the same as capital that is invested in Australia and that the benefit of deferral should therefore be eliminated to remove any potential bias in favour of capital exported. On the other hand, CIN supports the proposition that capital imported into a foreign jurisdiction should be treated the same as other investments in that jurisdiction and that foreign investment should therefore benefit from possible deferral.

2.6 Essentially, Australia's foreign source income attribution rules have adopted CIN as the policy setting for foreign active investment and CEN for foreign passive investment. As explained in the Board's discussion paper, this was on the basis that there are legitimate commercial reasons why residents would invest capital in foreign active operations and, therefore, deferral should be permitted. However, there are no good reasons why foreign passive investment should be favoured over domestic passive investment and, therefore, deferral should be eliminated.

2.7 The Board considers it highly desirable that CIN be retained as the policy setting for foreign active investment and CEN for foreign passive investment. The challenge going forward, however, is to ensure that the boundary that separates active and passive income is appropriately drawn.

Position 2.1

That, as a general principle, the economic principle of capital import neutrality be retained as the policy setting for foreign active investment and capital export neutrality for foreign passive investment.

That the main focus of the review be directed at determining those investments that should be classified as active and those that should be classified as passive.

2.8 The cumulative effect of the various attribution regimes also means that the rules serve the dual purpose of eliminating deferral in both the avoidance case, primarily through the application of the CFC and transferor trust rules, and the case where the deferral benefit is merely incidental to the foreign investment, primarily through the application of the FIF rules.

2.9 While some submissions suggested that the rules would be better targeted if they were to focus on avoidance cases only, for equity reasons, the Board considers the better approach is to maintain the dual purpose of eliminating deferral in both avoidance and incidental deferral cases.

2.10 While the Board supports the continued application of this dual purpose, the Board sees scope for the rules to be better targeted by shifting the focus of the rules to avoidance cases, while maintaining anti-deferral rules for incidental deferral only in circumstances where the integrity risk arising from deferral warrants attention.

2.11 To help identify how the rules should be reformed so that they are better targeted and fulfil the policy objectives outlined above, the Board applied the following criteria to assess the merits for change:

- Australian businesses with active offshore exposure are not made uncompetitive.

- Australia remains an attractive place to do business and to locate regional headquarters.
- Appropriate account is taken of market and business factors.
- The rules are simple to understand and operate with proper account made of complexity, and compliance and administrative costs.
- As far as possible, economic efficiency applies to minimise distortions in commercial choices.
- The revenue does not bear an unacceptable level of risk.

Position 2.2

That the attribution rules continue to serve dual anti-avoidance and anti-deferral roles.

CHAPTER 3: OPTIONS FOR REFORM

HARMONISATION: MULTIPLE OR SINGLE REGIMES?

3.1 The Board's discussion paper questioned whether collapsing or merging some or all of the existing attribution regimes would help reform and modernise the rules, as well as addressing the problems that exist across the current regimes. Appendix D provides a fuller account of these problems.

3.2 The discussion paper sought views on whether collapsing or merging the regimes could address the interaction problems that currently arise as a result of the concurrent application of multiple regimes, and whether this would provide greater consistency by treating equivalent taxpayers and income in a similar way. The paper also sought views on whether collapsing or merging the regimes would provide the opportunity to modernise the active/passive boundary and deliver reductions in compliance costs and complexity.

3.3 The discussion paper used the term 'harmonisation' to describe the possibility of collapsing or merging some or all of the regimes. Importantly, the paper explained that harmonisation does not necessarily imply that one set of rules would apply to all taxpayers and all income in every circumstance. Where appropriate, there may need to be differing rules for differing circumstances.

3.4 Options for achieving harmonisation canvassed in the discussion paper included:

- maintaining separate regimes but providing more consistent outcomes across those regimes (Option A in the discussion paper);
- collapsing all of the regimes into a single regime (Option B in the discussion paper);
- merging some regimes (or aspects of regimes), for example, the CFC and FIF regimes, while maintaining a separate regime for transferor trusts (Option C in the discussion paper).

3.5 While harmonisation was presented as a key consideration in the Board's discussion paper, a consistent message the Board heard during consultations was that so long as the problems in the current regimes are fixed, the means by which this is achieved, whether through harmonisation or not, should be a secondary consideration.

3.6 Blake Dawson Waldron, in its submission, expressed this view as follows:

'We do not consider that it makes a great deal of difference whether the attribution rules consist of three or more sets of rules (as at present), or a single set of rules with multiple methods.'³

3.7 Similarly, PricewaterhouseCoopers, in its submission, explained:

'We do not recommend which of the proposed high level design alternatives for the harmonised attribution regime should be followed as flexibility in the design may be required to address the issues outlined in this submission.'⁴

3.8 Nevertheless, many submissions were supportive of harmonisation and, in particular, the merger of the CFC and FIF regimes with a separate regime maintained for transferor trusts (that is, Option C in the discussion paper). Indicative comments included those from the Institute of Chartered Accountants in Australia's submission:

'Merging the CFC and FIF rules offers the possibility of bringing about positive changes such as ... having one regime applying to CFCs and FIFs so as to avoid issues such as the difficulties of moving back and forth from the FIF to CFC rules ... [and] ... dispensing with problematic aspects of the regimes, such as the control test and the definition of associate in the CFC rules at present.'⁵

3.9 Similarly, the Business Coalition for Tax Reform (BCTR) explained in its submission that:

'[It] would support collapsing the CFC and FIF rules into a single, simplified regime, with broadened exemptions and a degree of flexibility in calculating attributable amounts.'⁶

3.10 Although submissions were generally supportive of merging the CFC and FIF regimes, including the transferor trust rules with merged CFC/FIF rules was seen as adding complexity to the rules. Maintaining a separate regime for transferor trusts was preferred on the basis that the regime targeted different situations. That is, the CFC/FIF rules generally applied where fixed interests were held in the foreign entity whereas the transferor trust rules were generally applicable to cases where discretionary interests were involved.

3 Page 8.

4 Submission (2), page 1.

5 Page 50.

6 Page 2.

3.11 The BCTR cautioned against merging all the attribution regimes including the transferor trust rules into a single regime. The submission explained that:

‘... a harmonised regime incorporating all four sets of rules might be more complex than one which includes just CFCs and FIFs.’⁷

3.12 Similarly, the Australian Bankers’ Association submission explained that:

‘The ABA is opposed to the harmonisation of the CFC/FIF provisions with the transferor trust regime. In particular, the ABA considers an amendment is required to ensure the transferor trust regime does not apply to corporate taxpayers. We do not believe there is any basis for applying the transferor trust regime to corporate taxpayers (in particular, to listed public companies).’⁸

3.13 In their joint submission, Ernst & Young and the Corporate Tax Association presented their argument as follows:

‘It is generally accepted that it is very difficult to measure the interest of a discretionary beneficiary and in our view, these alternatives are likely to cause significant practical compliance problems as they would likely entail complex rules for the measurement of the relevant interests of the attributable taxpayers.’⁹

3.14 While most submissions supported the merger of the CFC and FIF regimes, some submissions were satisfied that harmonisation could include the transferor trust rules. Blake Dawson Waldron’s submission explained that:

‘... we expect that it would prove easier to maintain consistency in relation to a single set of rules, rather than across multiple sets of rules. A single set of rules should also remove a great deal of the complexity which currently arises in determining which set of rules will apply to a particular amount of income. We would therefore favour a single set of rules (but not at the expense of consistency with the CEN policy benchmark).’¹⁰

3.15 In a similar vein, the Taxation Institute of Australia’s submission explained that:

‘We support merging attribution into a single regime ... we have seldom had to distinguish between different types of residents. We see the exemptions and attribution methods as being available in all situations although sometimes they will not be of practical use. The hardest of the current regimes to fold into a single regime is the transferor trust rules ... we see the role of the transferor as being a substitute taxpayer for the taxpayers who are going to benefit from the

7 Page 2.
8 Page 3.
9 Submission (2), page 60.
10 Page 8.

income the non-resident entity has derived. Having identified a taxpayer to assess the rest of the attribution regime can apply in the same way as it would for other taxpayers.’¹¹

3.16 The Law Council’s submission stated its view as follows:

‘The [Taxation] Committee [of the Business Law Section of the Law Council of Australia] supports the creation of a single regime (Option B). The regulation of policy choices/differences should occur within that single regime. Option A (maintaining separate regimes with more consistent outcomes) and Option C (merging some regimes or aspects of regimes) are less likely to satisfy all three fundamental principles [being ‘simplicity’, ‘fairness ‘(or equity), and ‘efficiency’].’¹²

PREFERRED APPROACH: OUTCOMES FOCUS

3.17 After examining submissions and undertaking consultation, the Board considers that the focus of reforms should not be on harmonisation itself, but rather on desired outcomes based on a range of policy factors that are relevant in respect of deferral. Those factors should then be used to identify the appropriate policy settings in the redesign of the attribution rules.

Position 3.1

That changes to the attribution rules focus on outcomes and relevant policy considerations rather than harmonisation itself.

3.18 Whether this proceeds on the basis of, for example, a single regime applying to all interests, or two regimes that combine CFC and FIF rules applying to fixed interests and transferor trust-like rules applying to discretionary interests is less important. What is important is that the rules are reformed by policy considerations and not design options. Although this position leaves aside for the time being the question of whether the rules might be contained within a single regime or multiple regimes, the Board considers that there is tremendous opportunity for streamlining the signposting rules that currently complicate the attribution regimes.

3.19 A key consideration for the Board is ensuring that policy is applied consistently across the attribution regimes. Greater consistency across the regimes will ensure that, as far as possible, similar taxpayers with equivalent entitlements are treated in a consistent way. In addition, greater consistency across the regimes will reduce

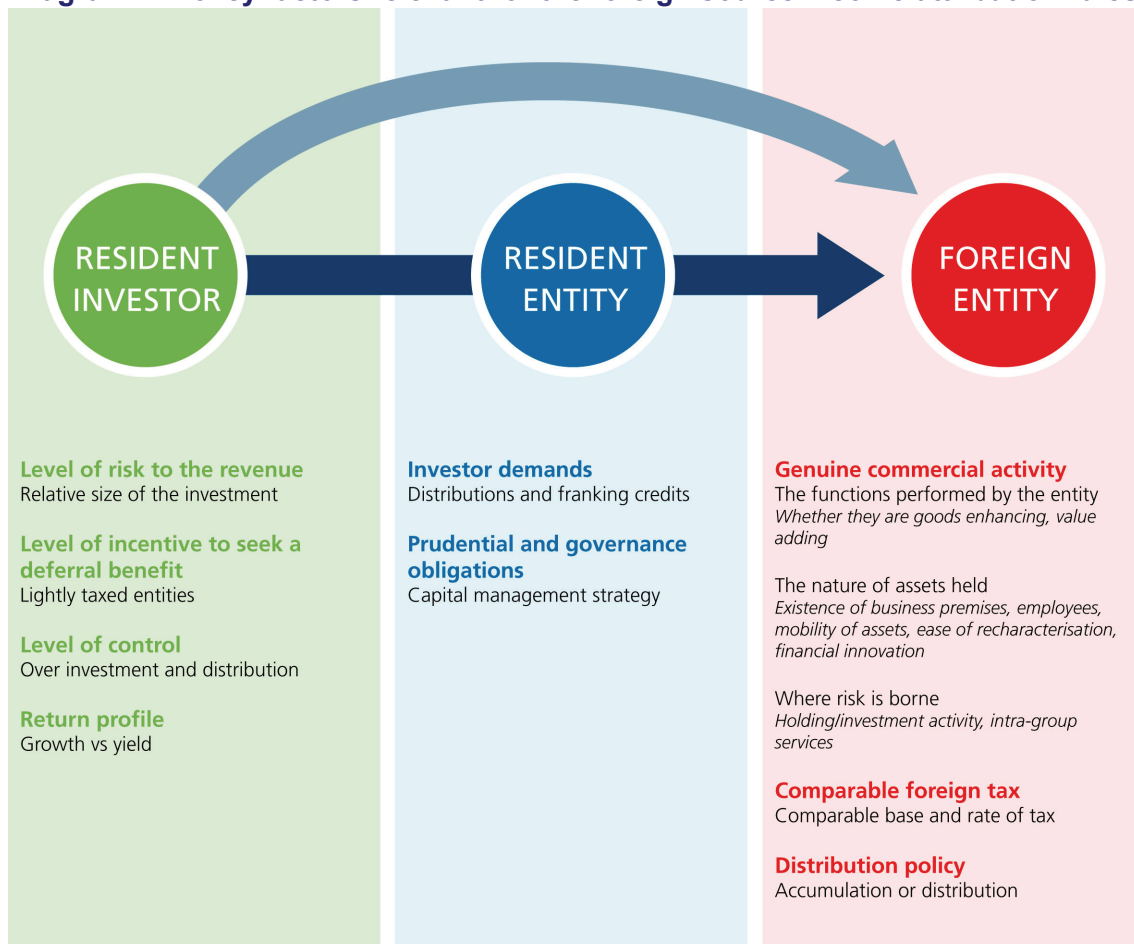
11 Submission (2), page 18.

12 Page 2.

complexity and compliance costs. To do this it is necessary to identify those rules or principles that are capable of broad application across all interests and income and those special circumstances that require differences in treatment. For example, while the Board considers that an active business exemption should, as a matter of principle, be available to all business structures and not just companies, there may be certain kinds of discretionary interests, including those traditionally associated with the transferor trust rules, where the integrity risk may prevent this from occurring.

3.20 As highlighted in the previous chapter, the design of Australia’s attribution rules is broadly shaped by CIN and CEN policy benchmarks with the operational provisions designed having regard to certain criteria or desired outcomes. However, in keeping with views expressed in submissions, the Board would like to step back from detailed design issues at this stage and focus on policy factors that are relevant in respect of deferral. There are a number of policy factors that are relevant in identifying the appropriate balance between effectively countering tax deferral and unnecessarily inhibiting Australians from competing in the global economy. These policy factors can be viewed across three different levels: the resident investor; the resident entity, where the foreign investment is made indirectly; and the foreign entity. Schematically, this can be depicted as follows:

Diagram 1: Policy factors relevant for the foreign source income attribution rules



Resident investor level policy factors

3.21 There are a number of factors at the resident investor level to consider in the design of the attribution rules. These include:

- the risk to the revenue relative to the size of the foreign investment;
 - Small amounts of foreign investment may mean that the compliance and administrative costs associated with complying with and enforcing tax obligations are disproportionate to the level of revenue at stake. In this regard, it is worth noting that the current CFC and FIF regimes apply de minimis limits to exclude small levels of income and/or investments from the scope of the rules. Although both regimes apply de minimis rules, the rules are not consistent.
- the level of incentive to seek a deferral benefit;
 - The Australian tax system creates different levels of incentive for taxpayers to seek a deferral benefit. For example, lightly taxed entities like complying superannuation funds, tax-exempts and charitable organisations have little incentive to seek a tax deferral benefit. Similarly, trustees of resident trusts acting on behalf of non-resident beneficiaries have no incentive to seek a deferral benefit as Australia does not seek to tax non-residents on the foreign source income they derive.
- the level of control that taxpayers have over their foreign investment;
 - The degree to which taxpayers can influence or exert control over their foreign investment can determine the level of deferral benefit taxpayers can obtain. This would typically involve issues associated with whether the resident taxpayer can dictate the investment and distribution policies of the foreign entity. However, even without control or influence, taxpayers can still achieve the benefits of deferral by choosing whether or not to invest in that foreign entity.
- the return profile of the resident investor.
 - Taxpayers seeking regular income flows from high yield investments are unlikely to be seeking a deferral benefit. On the other hand, taxpayers seeking growth from their foreign investment could have more incentive to extract deferral benefit outcomes.

Resident entity level policy factors

3.22 Where taxpayers invest overseas indirectly through a resident Australian entity, there are a number of factors at the resident entity level that are also relevant to consider in the design of the attribution rules. These include:

- investor demands;

- According to industry, the imputation system has created strong incentives for many entities to pursue domestic over foreign investment, reducing the incentive to accumulate income offshore. Industry also contends that the attraction of franking credits has led to shareholder demands for dividends, resulting in Australian listed companies having amongst the highest payout ratios in the world.
- corporate governance and prudential obligations.
 - There are corporate governance and prudential obligations at play, especially for publicly listed Australian companies, that, according to industry, create strong disincentives for taxpayers to seek outcomes that defer the payment of Australian tax. These include capital management strategies that return excess capital to shareholders and retire debt. Without these strategies in place businesses face the prospect of increased takeover scrutiny or higher debt financing costs.

Foreign entity level policy factors

3.23 There are a number of factors relevant at the foreign entity level that are necessary to consider in the design of the attribution rules. These include:

- genuine commercial activity;
 - As explained above, Australia’s attribution rules apply CIN as the policy setting for foreign active investment and CEN for foreign passive investment. 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. While the CFC and FIF rules deploy different approaches to effecting these outcomes, the design of the rules, in broad terms, should have regard to the following factors:
 - : The functions performed by the foreign entity (that is, whether the functions are genuinely goods-enhancing and value-adding, or mere passive investments held by a holding company).
 - : The nature of the assets held by the foreign entity (that is, the existence of premises and employees and not merely a ‘post office box’, the mobility of assets and ease of re-characterisation including financial innovation).
 - : Whether the risk of holding those assets is borne in the same location as the residence of the foreign entity.
- comparable foreign tax;
 - Currently, the attribution regimes provide an exemption where the investment is located in a comparably taxed or listed country. The exemption recognises the

fact that a deferral benefit will not generally arise where an investment has been made in a country that taxes that income or capital in a comparable way to Australia.

- distribution policy.
 - No deferral opportunities generally arise for resident taxpayers who invest into foreign entities that fully distribute their income shortly after it is derived. Investors in these situations are essentially taxed on a current basis in respect of that income.
 - Although the attribution rules use the income year as a base for determining the level of possible deferral, many investment products, particularly those relating to infrastructure, property development, private equity and alternative funds, have income harvesting profiles that are significantly longer than those on which the attribution rules are based. This has a particularly negative impact where the FIF market value method is applied to attribute income to taxpayers.

Addressing the problems in the current rules

3.24 By focusing on the policy factors behind the rules, the Board hopes to address problems with the existing regimes at their core. The Board's discussion paper identified a number of problems with the existing attribution rules. In broad terms, these problems can be classified as follows:

- Coordination and distortionary problems – primarily as a result of multiple regimes applying concurrently, together with inconsistent rules applying to equivalent entity types.
- Targeting problems – poorly targeted provisions, both in terms of distinguishing between passive and active income and identifying income that carries the greatest deferral risk.
- Compliance cost problems – compliance costs that are disproportionate to the integrity risk.
- Complexity problems – the regimes are exceedingly complex.

3.25 Many of the existing coordination and distortionary problems arise due to the inconsistent application of the rules to different interests. By applying the policy factors more consistently across any new regime or regimes, many of these problems will be eliminated. Similarly, a proper analysis of the deferral risk posed by various investments will help to ensure that the rules are appropriately targeted and compliance costs and complexity are reduced. This will help to ensure that a better balance is struck between effectively countering deferral and unnecessarily inhibiting Australians from investing and doing business overseas.

CHAPTER 4: POLICY FACTORS — HIGH LEVEL PRINCIPLES

OVERVIEW

4.1 As explained in the previous chapter, the Board considers that changes to the attribution rules should be outcomes based and that they should be driven by consideration of the policy factors relevant at the resident investor, resident entity and foreign entity levels. The discussion in this chapter is structured on this basis.

4.2 The Board anticipates that this approach will systematically address the problems inherent across the current regimes and that the changes identified will have a lasting and beneficial impact.

4.3 In particular, the Board expects its suggested approach will:

- reduce compliance costs and better target the income at most risk of deferral by introducing higher level and more accessible exemptions; and
- address the coordination and distortionary problems by applying equivalent rules across similar entity types.

RESIDENT INVESTOR POLICY FACTORS

4.4 The first policy issue outlined in Chapter 3 relates to the factors relevant to resident investors. Factors to consider include the magnitude of the foreign investment, the level of incentive to seek a deferral benefit, the level of control taxpayers have over their foreign investment, and the return profile of the investor.

Applicable interests

4.5 As explained in the Board's discussion paper, the current attribution regimes effectively provide complete coverage for arrangements involving Australian residents holding interests in offshore companies and trusts. The rules even have potential application where amounts are transferred to foreign discretionary trusts.

4.6 The Board considers that the scope of the attribution rules in this regard should be maintained. That is, revised attribution rules should continue to apply to resident

investors holding interests in foreign companies, foreign trusts, or transferors that have transferred value to foreign trusts under a non-commercial arrangement.

4.7 Although the discussion paper put forward the option that potential beneficiaries might be taxed as an alternative to transferors where discretionary interests are involved, this would be problematic and generally had no support. For example, Shaddick & Spence’s submission explained that:

‘The point about a discretionary ‘interest’ is that it arises from a gift which has left the donor, but not yet reached the beneficiary. Thus, the gift is incomplete, and it is therefore reasonable to treat the funds as continuing to be ‘attached to’ the donor (the transferor).’¹³

4.8 The discussion paper also asked whether economic equity interests, in contrast to the legal notion of equity interest, should come within the scope of the attribution rules. While this approach received some support, most submissions supported maintaining the current legal interest based approach. For example, in its submission, the CPA explained:

‘While we acknowledge that an ‘economic interest’ test may provide for more equitable results under a new regime, we are concerned with the possible added uncertainty and compliance that could be associated with such a test ... We would recommend that legal interests be used as a base, that there be appropriate consultation on any modification for economic interests, and that these be balanced with compliance costs.’¹⁴

4.9 Similarly, in supporting the retention of the current legal interest based approach, the joint Ernst & Young and Corporate Tax Association submission explained that:

‘... there is no compelling reason to define ‘interests’ according to economic interest. Unless the need was driven by better recognising the true jurisprudential rights relevant to an interest where, for example, foreign country laws distorted how English law would view those rights (for instance where a foreign country denies voting rights on shares that may in all other respects be a non-portfolio interest in shares).’¹⁵

4.10 In its submission, the Institute of Chartered Accountants in Australia explained as follows:

‘... while we acknowledge that an economic interest test could provide for more equitable outcomes under a revised anti-tax-deferral regime, we highlight that

13 Page 2.

14 Page 9.

15 Submission (2), page 6.

such a proposal would need to be considered in light of any additional compliance issues that it may create or cause.¹⁶

4.11 On the other hand, a number of submissions supported the adoption of an economic based approach to the identification of relevant interests. PricewaterhouseCoopers's submission explained that:

'The CFC and FIF rules are uncertain in their application to certain types of entities (e.g. Liechtenstein Anstalts and companies limited by guarantee), which could be rectified by focussing on the relevant taxpayer's economic interest in the entity ... we recommend that the types of interests subject to the CFC and FIF regimes be based on the economic substance of the taxpayer's interest rather than the taxpayer's legal rights.'¹⁷

4.12 The Taxation Institute of Australia's submission contended that:

'Constructing the rules by directly referring to benefiting from the income would leave less gaps and would make the policy clearer to users of the legislation. This would be a version of the economic ownership test.'¹⁸

4.13 After considering these comments and having regard to the associated policy factors, the Board is satisfied that the current legal approach to identifying relevant interests for the purposes of the attribution regimes should be retained. The discussion paper noted that this could proceed on the basis of the term 'membership interest'¹⁹ under the current law.

4.14 However, the Board is concerned that certain kinds of interests, including interests in non-common law entities such as anstalts, foundations and stichlings, can potentially avoid the operation of the attribution regimes. Non-common law entities have no legal equivalent in Australia, having some features like a company and others like a trust. Generally, if these entities are classified as companies for Australian tax law purposes, they may avoid the operation of the attribution laws as the rules require there to be a traceable legal interest, a feature these entities often do not exhibit.

4.15 To address the integrity concerns these kinds of entities present, the Board considers that the application of the attribution rules to these entities should be clarified, possibly in a similar way that the rules currently apply to transferor trusts.²⁰ The matter will be a topic of a future issues paper that will be circulated by the Board for comment.

16 Page 11.

17 Submission (2), pages 3-4.

18 Submission (2), page 3.

19 Definition of 'membership interest', subsection 995-1(1), *Income Tax Assessment Act 1997*.

20 Paragraphs 5.41 to 5.45 discuss attribution and discretionary interests.

Position 4.1

That the attribution rules continue to apply to resident investors holding interests in foreign companies and foreign trusts, or transferors that have transferred value to foreign trusts under a non-commercial arrangement.

Position 4.2

That the attribution rules apply to resident investors holding 'interests' in non-common law entities (such as anstalts and foundations), possibly in a similar fashion to the way the rules currently apply to transferors under the transferor trust rules.

4.16 Clearly establishing who the attribution rules should target would greatly assist in reducing the overlaps and inconsistencies that are present across the current regimes. It should also reduce compliance costs by establishing with some immediacy to whom the regimes apply. This would also provide significant simplicity benefits as existing signposting rules, like the complex control rule that directs taxpayers to particular regimes, will not be needed for the purposes of the attribution rules.

4.17 Designing rules that make it easier for taxpayers to more readily understand and fulfil their tax obligations has the capacity to encourage taxpayers to engage with the tax system. Some taxpayers who were not capable of understanding, or previously ignored, their obligations should benefit from the kind of changes discussed above.

Measurement of relevant interests

4.18 Where a foreign entity, whether in the form of a company or a trust, is entirely constituted by fixed interests, the attribution rules should seek to attribute foreign income to the holders of those interests in proportion to their respective income entitlements.²¹

4.19 Where the foreign entity is entirely constituted by discretionary interests, or interests that are not discernible, the attribution rules should seek to attribute foreign income to the transferor consistent with the operation of the current transferor trust rules.

4.20 Where, however, the foreign entity is constituted by a mixture of fixed and discretionary interests (or interests that are not discernible), questions arise as to

21 The extent to which entitlements to capital amounts should be factored into this apportionment will be considered further during consultation.

whether the attribution rules should seek to attribute foreign income to the fixed interest holders only, or both the fixed interest holders and transferors. In the Board's view, the most equitable outcome would be to tax the fixed interest holders in accordance with their proportionate entitlement to the entity's income. In circumstances where the fixed interest holders do not have a cumulative entitlement to all of the entity's income, then the excess, if any, would be attributed to the transferor.²²

Position 4.3

That an attributable taxpayer be taken to be:

- to the extent that a foreign entity is constituted by fixed interests — resident taxpayers who hold those interests; and
- to the extent that a foreign entity is constituted by discretionary interests or interests that are not discernible — resident taxpayers that have transferred services or property to the foreign entity.

Non-residents

4.21 The Board heard during consultations that the current attribution rules have the potential to apply to non-residents. As the Board's discussion paper noted, this situation arises due to the operation of the FIF and the general trust provisions in the tax laws. Australian Tax Office Interpretive Decision (ATOID) 2005/200 explains that, as it is not possible for trustees to exercise a valid entitlement in favour of a beneficiary to notional FIF income, Australia may effectively be asserting a taxing right on non-residents in respect of foreign source income.

4.22 This is clearly an inappropriate outcome and one that the Board considers should be avoided under revised attribution arrangements.

Position 4.4

That the attribution rules avoid including foreign source income in the assessable income of non-residents.

Pre-resident transfers

4.23 Taxpayers emigrating to Australia are often confronted with significant compliance costs in understanding their attribution obligations. Immigrants could typically maintain interests in an array of companies and trusts that they previously

²² Paragraphs 5.41 to 5.45 discuss attribution and discretionary interests.

held in their former homeland. In most cases, these would not have been acquired for the purpose of avoiding Australian tax upon their arrival.

4.24 However, for tax equity reasons, the Board does not consider it appropriate for these taxpayers to receive, for an indefinite period, a benefit that is not available to all other Australian residents.²³ Any departure from this outcome would have to be justified on the basis of non-tax reasons, consideration of which is likely to be outside the scope of this review.²⁴

4.25 Under the current arrangements, prospective residents are allowed to transfer assets to a foreign trust immediately before becoming an Australian resident. Australian tax is thereby deferred or avoided unless it can be shown that the foreign trust is controlled by the prospective resident. On this, the Review of Business Taxation (RBT) noted that:

‘... this is not appropriate because transferors are then not taxed on income that accrues after they become resident in Australia and are enjoying the benefits of publicly provided services.’²⁵

4.26 Consistent with an earlier recommendation emanating from the RBT²⁶, the Board considers it appropriate for the current restriction relating to control be removed. Such an outcome would also be consistent with the general thrust of the Board’s desire to remove unnecessary signposting rules as explained above.

4.27 To allow new residents to Australia to reorganise their affairs, the Board also considers it appropriate for transitional relief to apply in the same manner set out in the RBT. The RBT recommended that attribution rules (specifically, the transferor trust rules) not apply for a four year period after a transferor becomes a resident of Australia, provided the transfer to the foreign trust was made more than four years prior to the transferor becoming a resident.

4.28 The Board considers that these arrangements will provide an appropriate balance between integrity, tax equity, and the compliance costs that confront new residents.

23 Amendments introduced in 2006 exempt temporary residents from paying tax on their foreign source income. The amendments are designed to attract internationally mobile skilled labour to Australia and assist in the promotion of Australia as a business location, by reducing the costs to Australian business of bringing skilled persons to work in Australia.

24 For example, the Board is aware of Government incentives that are designed to attract skilled labour and business migrants to emigrate to Australia.

25 Treasurer, *Review of Business Taxation: ‘A Tax System Redesigned’ Report*, AGPS, Canberra, July 1999, page 639.

26 RBT Recommendation 20.10. See: Treasurer, *Review of Business Taxation: ‘A Tax System Redesigned’ Report*, AGPS, Canberra, July 1999, pages 638-9.

Position 4.5

That the current restriction relating to control in respect of pre-resident transfers be removed.

That transitional rules apply so that attribution does not arise for a four year period after a transferor becomes a resident of Australia, provided the transfer to the foreign trust was made more than four years prior to the transferor becoming a resident.

Pre-commencement transfers

4.29 The RBT also explained that transfers made before the commencement of the transferor trust rules are not covered by these rules unless the transfer was made to a discretionary trust and it can be shown that the transferor or an associate is in a position to control the trust. Due to the anti-avoidance nature of the transferor trust rules and the difficulties associated with demonstrating control, the RBT recommended that the restriction relating to control should be removed.

4.30 For the same reasons, the Board also considers it appropriate for the control requirement to be removed in respect of pre-commencement transfers.

4.31 Recognising that the removal of the control condition would potentially widen the application of the transferor trust rules in relation to pre-residence and pre-commencement transfers, the RBT proposed that affected residents 'be given a final opportunity to normalise their tax affairs by providing an amnesty for winding up of those trusts'²⁷. Under the amnesty, the tax payable on trust distributions would be limited to 10 per cent of the distributed amount, and would apply to distributions of both accumulated income and contributed capital. Further details of the amnesty are set out in Appendix E.

4.32 At this stage, the Board does not want to commit to a position on whether the proposed amnesty should proceed. The Board will consult further in respect of the proposed amnesty and also consider the ramifications of wider transitional arrangements that might be necessary under revised attribution arrangements.

27 RBT Recommendation 20.11. See: Treasurer, *Review of Business Taxation: 'A Tax System Redesigned' Report*, AGPS, Canberra, July 1999, pages 641-2.

Position 4.6

That the current restriction relating to control in respect of pre-commencement transfers be removed.

That further consideration be given to the need for the proposed amnesty set out in Recommendation 20.11 of the RBT.

Better targeting resident investors

De minimis exemptions

4.33 The existence of de minimis exemptions across the tax laws reflects a desire by policy makers to exclude certain taxpayers from the operation of the tax laws based on a balanced consideration of the revenue risk, the associated compliance and administration costs, and equity.

4.34 Against this backdrop, both the CFC and FIF regimes have de minimis exemptions which, apart from the increase to the FIF balanced portfolio exemption in 2004²⁸, have remained unaltered since their inception nearly 20 years ago.

4.35 The exemption in the CFC regime applies only where the CFC is resident in a listed country. The CFC exemption applies if the sum of certain passive income of the CFC does not exceed the lesser of \$50,000 or 5 per cent of the gross turnover of the CFC for the year.²⁹

4.36 Under the FIF rules, two de minimis exemptions can apply. First, an exemption applies to natural persons whose total interests in FIFs (including the interests of associates) at the end of the year are valued at \$50,000 or less. Second, a balanced portfolio exemption applies if the value of the taxpayer's interests in non-exempt FIFs at the end of the income year is 10 per cent or less of the taxpayer's interests in all FIFs at the end of the year.

4.37 Ideally, under reformed attribution arrangements more uniform de minimis rules would apply across all interests in foreign entities. This would help address the distortionary and non-neutrality effects that arise under the current arrangements.

28 An increase to the balanced portfolio threshold was recommended as part of the Board's Review of International Taxation Arrangements (see: Recommendation 4.2) and subsequently enacted by the Government (see: *New International Tax Arrangements Act 2004*, No. 73 2004).

29 A de minimis test also applies under the transferor trust rules to listed country trust estates but the threshold is \$20,000.

4.38 In identifying appropriate rules that are capable of broad application, issues like the dollar threshold, the base on which it is measured, and the continued need for the current restrictions governing investor and jurisdictional eligibility, need careful consideration.

4.39 Having regard to the competing policy factors, the Board considers that the de minimis exemptions should be designed as a uniform set of rules applying to all interests.

4.40 In the Board's view, the current monetary thresholds have become outdated and should be increased. Such an approach is consistent with submissions. Indicative of many submissions, the joint Ernst & Young and Corporate Tax Association submission explained that:

'... irrespective of whether or not the various anti tax deferral measures are retained or are harmonised, there is no basis to distinguish between the measures when applying a de minimis exemption.

Further, we submit that the absolute dollar amount should be increased to take account of the true cost of compliance and potential for deferral.'³⁰

4.41 For complexity and administration cost reasons, the Board does not favour an approach of annually increasing thresholds in line with inflation.

4.42 The Board considers that a \$200,000 threshold should be applied to the total value of interests in foreign entities (that is, modelled on the current FIF approach). Such a level will 'future proof' the threshold for a significant period since it more than accounts for the effect of inflation since 1990. This will allow taxpayers with both high and low levels of information about their foreign investment access to the exemption. Applying the threshold to the value of income along the lines of the current CFC approach would prove difficult for taxpayers with low levels of information about their foreign investment to satisfy.

4.43 The current restrictions that exist under the FIF and CFC rules should be removed. As a result, the exemption would be available to all investors, not just those that are natural persons (as is the case under the FIF rules), and would be available in respect of investments located in any foreign jurisdiction, not just those located in listed countries (as is the case under the CFC rules).

4.44 Given the increase in the monetary threshold, and the lifting of the restrictions explained below, the Board is not anticipating that taxpayers will be adversely affected by the removal of the CFC income based approach. Nevertheless, the Board is keen to

30 Submission (2), page 31.

hear from taxpayers that currently rely on the CFC de minimis exemption whether they would be adversely affected by such a change.

4.45 The Board also considers that the balanced portfolio exemption threshold should be retained and increased from 10 per cent to 20 per cent, and be applied to an entity's total asset base, not just offshore investments which is the case at present.

4.46 Applying the test to the total asset base gives a better reflection of an entity's true business operations, and the extent to which offshore investments can realistically influence the return on investments of an entity. Broadening the exemption encourages firms to seek out offshore investments while still capturing those arrangements set up purely to accumulate income offshore for a tax advantage. For managed funds, this change will reduce compliance costs considerably while maintaining appropriate levels of integrity.

4.47 The Board notes that there are existing administrative and compliance issues around the balanced portfolio exemption that will need to be addressed, such as the timing of applying the test and measurement issues.

Position 4.7

That uniform de minimis exemptions be applied to all interests in foreign entities and that:

- a \$200,000 threshold apply to the total value of interests in foreign entities;
- the balanced portfolio threshold be increased to 20 per cent and that it apply to an entity's total assets (rather than being confined to offshore investments only).

Lightly taxed entities

4.48 The Board considers that the attribution rules should not target those investments where the risk of inappropriate deferral is low. Offshore investments undertaken by residents that would be lightly taxed, or not taxed at all, in Australia provide little or no deferral advantage. The application of the attribution rules in these cases would serve no purpose other than to raise compliance costs and restrict commercial operations.

4.49 The FIF regime already provides an exemption for (trustees of) complying superannuation funds and certain fixed trusts. This recognises that the tax deferral benefit for complying superannuation funds investing in FIFs is minimal, given the lower tax rate applying to the earnings of these funds.

4.50 This exemption is, however, narrowly cast and requires updating to reflect the changes that have occurred in the superannuation and managed funds industry in

particular. The pooling of superannuation funds into managed funds with larger critical mass for on-investment is a commercially driven phenomenon occurring worldwide. Entities that would otherwise be exempt from the attribution rules should not be disadvantaged by inappropriate restrictions on accessing these pooling arrangements.

4.51 Submissions were supportive of improving the operation of this exemption. In its submission, the Investment & Financial Services Association explained that:

‘Super funds are currently exempt from the FIF regime, where they invest through an Australian unit trust that is wholly invested in by super funds. However, if they invest into an Australian managed fund that has other investors, the exemption is nullified. IFSA recommends that the current exemption for super funds should be modified to ensure that they retain their exempt status, regardless of whether the fund they are investing is: a) exempt itself or; b) has other investors that are not super funds.’³¹

4.52 The Board considers that, where superannuation funds pool their investment with other entities, there should be some level of tolerance so that the exemption is not completely lost where other investors represent only a nominal amount of, say, 5 per cent or less, of the overall funds.

4.53 While not currently predisposed to the idea, the Board will further consider whether the exemption could apply on a proportionate basis. That is, if superannuation funds have contributed, say, 70 per cent towards a pooled entity’s total funds, the pooled entity would be required to attribute 30 per cent of its attributable income to other investors. While the proposal appears attractive, the Board is concerned about the level of complexity and compliance costs that might be associated with such a rule.

4.54 The Association of Superannuation Funds of Australia’s (ASFA) submission also highlighted an anomaly that can arise for certain superannuation funds whereby what would otherwise be an exempt FIF investment is converted into a taxable CFC investment. The submission noted:

‘Section 519B of the Income Tax Assessment Act 1936 exempts trustees of complying superannuation entities and certain fixed trusts from the foreign investment fund (FIF) provisions ... However, where multiple funds take up an interest in the same investment there is a likelihood of the extended definition of a CFC being satisfied, thus requiring each of the funds to deal with the CFC provisions.

In effect, the extended definition of a CFC converts what would be an exempt FIF investment into a CFC investment.

31 Page 11.

The concern of the superannuation industry is that the reclassification as a CFC occurs not because there is any degree of control exercised by the superannuation funds (they are merely passive investors) but rather because of who else invests.³²

4.55 The Board anticipates that this problem will be automatically addressed by wider systemic changes that will ensure more consistent outcomes apply to all entities irrespective of their legal form or the magnitude of their investment holding.

Position 4.8

That the current FIF exemption for complying superannuation funds be improved by:

- extending its application to controlling interests held by complying superannuation funds; and
- allowing the exemption to flow through to entities that are largely held by complying superannuation funds (that is, other entities hold only a nominal interest).

Motivation test

4.56 The Board received mixed responses to the suggestion contained in the discussion paper of including a motivation test under revised attribution arrangements. An objective motivation test received support, primarily to act as an exclusion of last resort. However, the circumstances in which such a test would be of assistance in exempting activities that are inadvertently caught in the attribution rules are not clear at this time. Even if there were a category of activities that could be exempted by a motivation test, it is not clear why those activities could not be specifically exempted as part of the wider package of objective exemptions discussed across this chapter.

4.57 Such an exemption would also not fit well with the self assessment taxation environment and would be contrary to the previous Government's position in respect of the Review of Self Assessment (ROSA)³³.

4.58 While the Board is not categorically ruling out the need for a motivation test, the Board considers that the disadvantages of proceeding with a motivation test outweigh the advantages. Nevertheless, the Board will further consider the merits of a motivation test during consultations in respect of this position paper.

32 Pages 1-3.

33 Recommendation 6.3 of ROSA. See: Treasurer, *Report on Aspects of Income Tax Self Assessment*, AGPS, Canberra, page 63.

Position 4.9

That a motivation test not proceed unless a demonstrable need is provided during further consultations.

RESIDENT ENTITY POLICY FACTORS

4.59 The second policy issue outlined in Chapter 3 relates to the factors relevant to resident entities. Factors to consider include investor demands, corporate governance and prudential regulation.

Australian public company exemption

4.60 Industry submissions put forward a number of tax and commercial reasons why listed Australian public companies are arguably not at high risk of seeking deferral advantages.

4.61 Submissions were in general agreement that there were grounds for considering providing a public company exemption. Shaddick & Spence's submission explained that:

'There are grounds to argue that the businesses of public companies are, by definition, active. The fact that public companies now tend to return surplus funds to shareholders suggests that they would not seek to accumulate funds offshore, other than to defer the imposition of overseas withholding taxes. Also, it is well established that Australian public companies tend to favour the payment of Australian income tax, in order to increase franking credits.'³⁴

4.62 The demands of shareholders of public companies are argued to be such that a public company has strong incentives to make regular distributions. That is, there is less likelihood that a public company will invest offshore to gain a tax deferral benefit. The operation of the dividend imputation system is also viewed by many as reinforcing this behaviour, by creating strong incentives for domestic over foreign investment, reducing the need for attribution rules.

4.63 It is also argued that listed public companies are subject to higher levels of governance and prudential requirements that mitigate the extent to which such companies can obtain inappropriate deferral outcomes. The Australian Stock Exchange listing rules, for example, impose a range of obligations in this regard.

34 Page 6.

4.64 In addition, public companies are also under pressure to efficiently manage capital rather than conduct passive investment activities for deferral advantage. The management of such companies constantly face market pressures to effectively use excess capital by retiring debt, introducing share buybacks or reinvesting capital into the company's core operations.

4.65 Interests that are widely held and regularly traded are also less likely to be used as a deferral vehicle for both tax and commercial reasons. This would equally apply to listed entities other than companies.

4.66 Against this, the Board notes 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.

4.67 For example, under the French CFC rules, although a high level exemption applies for businesses that are primarily engaged in commercial or industrial activities, the exemption ceases to apply if the business derives more than 20 per cent of its income from financial activities or the management of intangible assets. The Board foresees that such integrity rules would necessarily be broadly consistent with the criteria for the active investment exemption the Board is proposing (see below).

4.68 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.

4.69 Providing an exemption for a particular class of entity inevitably also raises issues about neutrality of treatment with other resident companies and entities that might also make regular distributions, and are also less likely to invest offshore to defer income. The Institute of Chartered Accountants in Australia stated in its submission that:

'We recognise however such a public company exemption would mean that entities which are not widely held public companies would be denied the benefit of this desirable compliance improvement. This would mean that such entities would when compared to their public company counterparts:

: have higher tax compliance costs and

: potentially have higher Australian tax imposts in relation to their foreign income, causing them to be less competitive.³⁵

4.70 Balanced against this are a range of factors that are less likely to be applicable to other entities, such as public companies being widely held and subject to higher levels of governance to reinforce confidence in the share market.

Position 4.10

That a listed Australian public company exemption be introduced provided appropriate integrity rules can be developed. Such rules should be the subject of further consultation.

FOREIGN ENTITY POLICY FACTORS

4.71 The third policy issue outlined in Chapter 3 relates to the factors applicable to the foreign entity in which Australian residents have invested. Factors to consider include the nature of the activity being undertaken and whether the foreign entity is located in a comparable taxing country.

Active investment exemption

4.72 As explained in Chapter 3, Australia applies CIN as the policy setting for foreign active investment. 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.

4.73 The Board supports the continued application of the CIN benchmark to foreign active investment. The challenge going forward, however, is to ensure that the boundary that separates active and passive investments is appropriately drawn.

4.74 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'.

4.75 Under reformed attribution arrangements, the boundary that distinguishes between active and passive would, ideally, be drawn in such a way that it applies consistently across all interests in foreign entities, including interests in companies and trusts. This would help address the distortionary and non-neutrality effects that arise

35 Page 37.

under the current arrangements through the application of different regimes and different rules within those regimes.

4.76 Unlike the CFC active income exemption, the FIF active business exemption can be applied universally to all interests because it requires lower levels of information in order to demonstrate eligibility. In contrast, the CFC active income exemption requires taxpayers to collect extensive information or complete detailed calculations, something that will be beyond the capability of taxpayers holding low levels of information about their foreign investment. Telstra explained the situation as follows in its submission:

‘As far as collapsing the CFC/FIF regimes is concerned, we would support adopting the FIF style entity based (for example, the balance sheet method) approach as being simpler in practice to apply than the CFC active income test. Typically fewer adjustments are necessary in applying the FIF exemptions versus the CFC active income test.’³⁶

4.77 Consequently, the Board considers that the FIF approach would better accommodate taxpayers with lower levels of information about their foreign investment as well as benefiting those with higher levels of information through reductions in compliance costs and complexity.

4.78 The FIF active business exemption relies on two methods for establishing whether a foreign company is principally engaged in eligible activities: the stock exchange listing method and the balance sheet method.

4.79 While these should be retained under future arrangements, which will help reduce transition costs and retain a degree of familiarity, there are problems relying on these approaches alone³⁷ as the sole determinants of what constitutes an active business.

4.80 For this reason, the Board considers that it would be appropriate for additional criteria to be developed to supplement the existing FIF active business methods. These criteria could be drawn from the active business exemptions that apply under the UK and French CFC rules.

4.81 Both countries have comprehensive active business exemptions. The UK rules treat all 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. These include: the presence of a business establishment in the CFC’s territory of residence; effective management in the CFC’s territory of residence; and conduct of the CFC’s business so that the main business activities do not include

36 Page 5.

37 It has been argued that the stock exchange listing and balance sheet methods alone are too limited to properly cover the full range of activities that present a low deferral risk. Moreover, the current exemptions are overly restrictive and complex.

precluded activities. Similarly, the French rules provide an active business exemption where the foreign entity is principally engaged in industrial and commercial activities.

4.82 Additional criteria could also borrow from the functional analysis that applies under the transfer pricing rules.³⁸

4.83 These criteria, and others identified in further consultation, would then be used in conjunction with the balance sheet and stock exchange listing criteria to determine whether the business is active or not. The expansion of the active business exemptions to provide coverage of the full range of activities not driven by deferral opportunities will provide better outcomes for investors. It would also provide taxpayers with a range of high level criteria which would allow them to determine at as early a stage as possible whether they are exempt from the rules.

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

4.85 It is worth noting in this regard that applying the FIF active business exemption to what are currently CFC interests results in a more concessional, but what the Board considers to be a more appropriate, threshold. That is, while the current CFC active income exemption requires more than 95 per cent of the CFC's income to be active, the FIF active business exemption is satisfied if the FIF is principally (that is, more than 50 per cent) engaged in active business.

4.86 The discussion paper outlined a number of areas where the active/passive divide under the attribution rules has not kept pace with business practices. In modernising the boundary between active and passive investments, the Board considers that income that represents returns from genuine commercial activity should be given active treatment. Specific examples provided to the Board include property income and returns from intellectual property where these are derived as part of an active business. Such income has 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. The Board considers that the commercial reality is that active businesses conduct substantial activities in such areas. Rules should be developed to allow active treatment of income in such cases, while ensuring appropriate levels of integrity around the redrawn active income boundary.

38 The transfer pricing rules use criteria based on factors such as:
 Function — that there is a genuine commercial enterprise being conducted in the foreign country and it is not merely a post-office box.
 Assets — that there are assets and employees commensurate with the level of foreign operations.
 Risk — that returns are derived in the same location as assets held at risk.

4.87 To elicit further comment, the Board intends to circulate an issues paper setting out the current problems with the active investment exemptions and options for reform.

Position 4.11

That the boundary that distinguishes active and passive income be universally applied to all interests in foreign entities and that it be modelled on the current FIF active business exemption.

That further criteria be identified through consultation to supplement the existing stock exchange listing and balance sheet methods contained in the FIF active business exemption.

That rules be developed to ensure appropriate integrity around the revised boundary between active and passive income. Areas where such rules are needed should be the subject of further consultation.

Base company income

4.88 As explained in the Board's discussion paper, base company income, which comprises tainted sales and services income, is attributable under the current CFC rules.

4.89 In response to the Review of International Taxation Arrangements (RITA), the Board recommended³⁹ that the tainted sales and services income rules be abandoned, subject to certain restrictions for income or gains derived through designated tax havens, and that services that are considered to raise particular integrity issues be dealt with expressly rather than all services being broadly included as is currently the case.

4.90 In arriving at this recommendation, the Board explained:

'Where the concern is transfer pricing out of Australia, the Board considers that Australia's transfer pricing regime is sufficient and reliance could be placed solely on the transfer pricing rules, not the CFC regime. Where the concern is the movement of service capacity from Australia, the issue for taxation of income from services under the CFC rules is in essence no different to that for sales income. Different treatment would disadvantage companies deriving services income internationally compared to others.'⁴⁰

39 Recommendation 3.2. See: Board of Taxation, *International Taxation: Report to the Treasurer*, vol 1, AGPS, Canberra, page 86.

40 Board of Taxation, *International Taxation: Report to the Treasurer*, vol 1, AGPS, Canberra, page 86.

4.91 As noted in the discussion paper, the effect of the current approach is that an Australian investor may be placed at a competitive disadvantage compared to another investor in the same country with the same business structure. This is because the Australian, rather than the local, level of tax is being applied. In a globalised economy where business structures cross multiple borders, base company income rules increasingly place multinational firms in Australia at a competitive disadvantage in overseas markets.

4.92 The Board continues to support the removal of the base company income rules, with express rules used if and where necessary to ensure appropriate levels of integrity. The Board's proposals to improve the operation of the active business exemption and to better target passive income will ensure that an appropriate balance between integrity and global competitiveness is maintained.

4.93 Removing the base company income rules will help to reduce compliance costs and complexity for taxpayers. It will also allow for greater consistency across the attribution rules since the FIF regime does not have base company income rules. Moreover, it would be difficult to apply base company income rules where investors have low levels of information about their foreign investment.

Position 4.12

That the base company income rules be removed.

That, where needed, express rules should be developed to ensure appropriate integrity. Areas where such rules might be needed should be the subject of further consultation.

Listed country exemption

4.94 A listed country approach is used as a proxy for a comparable tax test across the attribution regimes. The exemption is provided on the basis that, so long as income is comparably taxed, there is little or no risk of deferral.

4.95 The CFC rules provide a listed country exemption in respect of seven countries. If CFCs are resident in one of these listed countries, only certain designated concessional income is attributable.⁴¹ The transferor trust rules provide a similar exemption.

4.96 The FIF rules provide an exemption only for certain entities resident in the United States. If a FIF satisfies the exemption, none of the FIF's income is attributable.

41 This includes eligible designated concession income (EDCI), FIF and transferor trust income derived by the CFC, and low-taxed income derived through a third country.

4.97 In the discussion paper, the Board questioned whether there would be less of a need for a listed country approach going forward, given other changes proposed by the Board to more appropriately target the rules. In particular, the Board’s proposals to better target and exempt active investments should mean that a wider class of active investments in listed countries (as well as unlisted countries) are exempt from the rules.

4.98 Notwithstanding these possible changes, submissions were strongly in favour of retaining the current listed country approach, and expanding it where possible to include other comparably taxing countries. The Institute of Chartered Accountants’ submission was representative of the general views expressed across most submissions in noting that:

‘The largest savings in compliance costs for Australian taxpayers with CFCs or affected by the transferor trust rules comes about as a result of the concessional treatment of listed countries. We consider that even if income to be attributed was to be better targeted, retaining the concept of listed country is likely to remain an important compliance cost saving measure under any revised anti-tax-deferral regime.’⁴²

4.99 Similarly, the Australian Bankers’ Association’s submission explained:

‘The ABA would not support the abolition of the concept of ‘comparable listed countries’ without fully understanding how it would reduce the compliance burden for the taxpayer. The listed country concept currently provides an effective means of reducing the amount of information which is required from these countries.’⁴³

4.100 For these reasons, the Board supports the retention of a listed country exemption.

4.101 Ideally, any listed country exemption would apply universally to all interests in foreign entities. The Board believes that this would be best achieved by applying the current FIF-style listed country exemption to the CFC list of countries. This approach would accommodate taxpayers with low levels of information since, unlike the CFC exemption, taxpayers would not be required to identify particular items of eligible designated concession income (EDCI).

4.102 The Board is mindful that this approach should only proceed so long as the removal of EDCI does not result in an unmanageable level of risk. The Board would also need to be satisfied that a FIF-style exemption could not be undermined by structures involving a chain of entities (for example, where a taxpayer invests indirectly into a tax haven through a listed country).

42 Page 27.

43 Page 6.

4.103 If suitable integrity rules cannot be devised to ensure appropriate outcomes, an alternative approach may be to apply a CFC-style approach linked to the branch-equivalent calculations. The current FIF exemption could be maintained alongside this CFC-style exemption for those taxpayers who do not have sufficient information to calculate their income using branch-equivalent calculations.

4.104 Such an approach was generally advocated by submissions, with the Australian Bankers' Association commenting that:

'Given the extremely narrow prospects of any leakage to the revenue, the ABA submits that there should be a complete exemption from the CFC/FIF regimes for CFCs and FIFs (which are companies) and which are resident in a listed country ... If the above submission is not accepted, then the list of designated concession income should be re-examined.'⁴⁴

Position 4.13

That an expanded FIF-style listed country exemption apply consistently to all interests in foreign entities, subject to appropriate integrity rules being developed in consultation.

That, if suitable integrity rules cannot be developed, a CFC-style approach be available to those taxpayers who choose to use branch-equivalent calculations, with the current FIF exemption applying to other taxpayers.

Distribution exemption

4.105 The Board's discussion paper outlined the particular issues facing entities that tend to fully or substantially distribute their foreign income, such as the funds management industry. If the income from offshore investments is fully or substantially distributed to Australian investors, no or minimal deferral advantage is obtained. The practical effect of the current attribution regimes is the imposition of significant compliance costs on such arrangements where there is seemingly little or no risk of deferral.

4.106 The Board is not advocating the unfettered use of offshore accumulation entities as this would create longer term risks. Such an approach would enable resident taxpayers to increase after-tax returns by substantially reducing the Australian tax payable on their passive foreign investment income. Such an outcome would be contrary to the goal of taxing resident individuals on their worldwide income, pose a

44 Page 6.

risk to the revenue base, and favour the use of particular offshore managed funds over Australian managed funds.

4.107 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.

4.108 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.

4.109 The Board notes that managed funds and similar tiered investment structures can be complex and involve multiple layers of entities and jurisdictions. There will be a need to contain the risk of arrangements being structured to prevent the examination of the underlying investment arrangements.

4.110 The Board considers that a distribution exemption is, in principle, capable of application to all entities within the attribution rules as appropriate. However, there is a strong case for attribution rules that recognise the potentially adverse competitive impact on collective investment arrangements that are driven more by commercial factors than jurisdictional tax considerations. It is therefore important that exemptions from the attribution rules deliver measurable improvements in outcomes for managed funds and collective investments more broadly as a matter of priority.

Position 4.14

That a distribution exemption be introduced.

That appropriate integrity rules be developed in further consultations.

Foreign superannuation exemption

4.111 The current FIF regime contains an exemption for foreign employer-sponsored superannuation funds. The exemption helps to align the treatment of foreign employer-sponsored superannuation funds with other government initiatives in regards to superannuation. Such treatment recognises that domestic superannuation arrangements are subject to concessional tax treatment and, therefore, there is no significant deferral benefit that can be gained by investing in foreign employer-sponsored superannuation funds.

4.112 The Board noted in its discussion paper, however, that the current exemption is very narrowly cast and that this has led to problems with the operation of the exemption. Key among these is the situation outlined in the paper whereby an employer-sponsored superannuation fund is rolled over (and subject to lock-in arrangements) when the employee leaves their employment to move to Australia. Since the fund is no longer employer-sponsored, the FIF regime may therefore apply.

4.113 Submissions also highlighted this problem and suggested that the exemption be expanded.

4.114 While the Board's proposal to raise the de minimis threshold to \$200,000 will accommodate many taxpayers, the Board's position is that the exemption should apply to those funds that are rolled over from an employer-sponsored superannuation fund.

4.115 Some submissions suggested widening the exemption even further to include all foreign superannuation funds. However, the Board is mindful of the need to ensure the continuing integrity of the exemption.

Position 4.15

That an exemption apply to funds that have been rolled over from an employer-sponsored superannuation fund.

CHAPTER 5: ATTRIBUTION METHODS — HIGH LEVEL PRINCIPLES

BACKGROUND

5.1 This chapter is relevant for those taxpayers that are not eligible for one of the exemptions outlined in Chapter 4 and are consequently subject to attribution. This chapter explains how taxpayers would calculate their attributable income under improved attribution methodologies.

5.2 This involves a discussion of the attribution methods themselves, the notion of choice, the determination of attribution percentages and issues surrounding record keeping.

5.3 As noted in the Board’s discussion paper, the current regimes apply different methods to calculate the attributable income of a taxpayer. Different methods exist to accommodate the varying levels of information available to taxpayers in respect of their foreign investment. The intention is that taxpayers with access to higher levels of information would be required to calculate their attributable income by applying the full extent of the Australian tax laws to the income of the foreign entity (that is, using branch-equivalent calculations), while those with lower levels of information would use proxy methods such as the market value or deemed rate of return methods.

	Branch-equivalent calculations	Market value method	Deemed rate of return method
CFC rules	✓		
FIF rules	✓ ⁴⁵	✓	✓
Transferor trust rules	✓		✓
Deemed present entitlement rules	✓		

45 The FIF regime does not strictly have a branch-equivalent method. However, the FIF calculation method is essentially a simplified branch-equivalent method. Recent amendments have also allowed certain taxpayers in the FIF regime to opt into the CFC branch-equivalent calculations (See: *Taxation Laws Amendment (2007 Measures No. 4) Act 2007*).

5.4 An interest charge may also apply to distributions by a foreign trust to a resident beneficiary where the income has not previously been subject to tax. Although the interest charge was enacted as part of the transferor trust regime, it potentially applies to any foreign trust (other than a public unit trust) with resident beneficiaries. The interest charge is not an attribution method in its own right but a fall-back mechanism where income has not previously been attributed.

5.5 The Board's discussion paper, together with submissions, identified a range of problems that exist in the current regimes in respect of the methods for attributing to resident taxpayers their share of foreign source income accumulating in an offshore entity.

5.6 One of the main concerns identified in submissions was the level of complexity and compliance costs involved in calculating attributable income. For branch-equivalent calculations, in particular, the time and costs involved were seen as disproportionate to the integrity purpose the rules seek to achieve.

5.7 Another issue which featured strongly in submissions was the lack of consistent outcomes for taxpayers. Currently, similar in-substance investments may be caught under different regimes, with the result that different attribution methods apply and different amounts are attributable. Such outcomes arise due to the lack of coordination across the regimes and are exacerbated by the rules which restrict taxpayers to particular regimes and methods.

IMPROVING THE ATTRIBUTION METHODS

Choice of method

5.8 Currently, the CFC control rule and the various rules which give priority of application to one regime or attribution method over another dictate which attribution method a taxpayer must use.

5.9 The control rule, however, is somewhat arbitrary as a measure of the level of information a taxpayer might hold in respect of their foreign investment. In practice, taxpayers falling under the FIF regime may have the necessary information to perform branch-equivalent calculations but are prevented from doing so (and accessing the accompanying exemptions) by the restrictions which currently apply. In recognition of this, amendments were recently made to the attribution rules to allow certain taxpayers operating within the FIF rules to calculate their attributable income using the CFC branch-equivalent calculations.⁴⁶

46 See: *Taxation Laws Amendment (2007 Measures No. 4) Act 2007*.

5.10 In the long term, however, the Board believes it desirable to adopt a more systemic solution, and, given the inadequacy of the control rule as a measure of information levels, questions whether there is a need for such restrictions at all.

5.11 Restrictions would only be necessary if there is a class of taxpayer that should always be required to perform branch-equivalent calculations. As branch-equivalent calculations will generally produce the lowest attributable tax outcome⁴⁷, the Board does not believe that there is any risk in removing such restrictions, even in control situations. In other words, taxpayers that have the necessary information to perform branch-equivalent calculations should be permitted to do so, while those with the information but not the inclination, possibly because of the higher compliance costs, should be allowed to use one of the proxy methods.

5.12 Removing restrictions and allowing all taxpayers to access all attribution methods brings about significant benefits:

- It allows for the removal of concepts like ‘control’ and ‘associate’ for the purposes of the attribution rules, thereby helping to address taxpayer concerns of high complexity and compliance costs.
- It reduces the distortions and inconsistencies outlined above by allowing taxpayers with similar in-substance investments to access the same attribution methods.
- It provides taxpayers with greater flexibility and allows them to choose the method which best suits their needs and access to information.
- It helps to reduce duplication by allowing similar methods to be unified.

5.13 Submissions were also supportive of allowing choice, with the Institute of Chartered Accountants’ submission commenting that:

‘It is clear that choice is desirable, as the Discussion Paper notes at 5.35, because it allows taxpayers to choose the attribution method that best suits their needs. We agree with the comments in the Discussion Paper too, that choice allows taxpayers to be treated consistently, and does not create distortions which currently arise depending upon whether or not the taxpayer invests in a company or a trust, and the extent of their interest.

The Discussion Paper raises the concern that taxpayers will ‘trial’ methods, and therefore the concept of having multiple methods of calculating attributable income available may increase compliance for investors. We would suggest that

47 Branch-equivalent calculations generally produce the lowest attributable income figures since they are calculated using a narrower base, tainted income, whereas other methods apply to all of the entity’s income. Branch-equivalent calculations also do not capture unrealised gains, unlike other methods such as the market value method.

the existence of a choice of methods of calculating attributable income will implicitly reduce complexity and compliance because the taxpayer can adopt the method that suits their circumstances. Certain safeguards may need to be put in place to ensure that no undue advantage arises from switching of attribution methods between different years of income.⁴⁸

5.14 Other submissions also mentioned the need for integrity rules to prevent ‘cherry picking’ or ‘switching from year to year’. Such concerns might be addressed by allowing taxpayers choice but requiring that choice to be made by way of an election which would apply for a set period, such as four years, unless the taxpayer’s circumstances changed such that it would be reasonable to allow a change in the election. The details of the election should be considered further in consultation, with any restrictions being commensurate with the risk to the revenue and compliance costs.

Position 5.1

That all taxpayers be able to choose, by way of election, the branch-equivalent, market value or deemed rate of return methods.

That such an election be for a specified period, unless the taxpayer’s circumstances change such that it would be reasonable and appropriate to allow a change in the election.

Branch-equivalent calculations

5.15 The CFC, transferor trust and deemed present entitlement rules apply the domestic tax rules 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 calculation referred to as the ‘calculation method’.

5.16 Both the Board’s discussion paper and submissions highlighted the complexity and high compliance costs associated with applying the full extent of the Australian tax laws to foreign entities. Qantas, in its submission, commented that:

‘... the record keeping requirements required to ascertain attributable income from CFCs [are] extremely onerous and draconian. The systematic nature of the rules and resource requirements needed, in order to capture the relevant data, ... are both cost inefficient and time consuming.’⁴⁹

48 Page 43.

49 Page 5.

5.17 The current complexity surrounding the application of the branch-equivalent calculations is a function of the extent to which the rules require the full application of the Australian taxation law to the foreign entity.

5.18 It was suggested in the Board's discussion paper that a simpler approach (which might borrow from the FIF calculation method) could be used. While submissions all supported a simpler approach to branch-equivalent calculations, there was some hesitation about adopting the FIF-style calculation method as an alternative. Shaddick & Spence's submission explained that:

'The FIF calculation method boasts some simplicity, but would also tend to reduce the equity of the outcomes.'⁵⁰

5.19 Similarly, the Institute of Chartered Accountants' submission stated:

'The focus here should not be on replacing the branch-equivalent calculation with a FIF-type calculation method, but rather making it easier...'⁵¹

5.20 The discussion paper also suggested that another option may be to use accounting standards as the basis for the attributable income calculations. Such an approach would be consistent with the recent taxation of financial arrangements (TOFA) amendments which allow taxpayers to calculate income based on financial reports.

5.21 This was widely supported in submissions, with the Taxation Institute of Australia commenting in its submission that:

'Given the move around the world [to] International Financial Reporting Standards, the calculation should just be based on accounting income.'⁵²

5.22 And the Business Coalition of Tax Reform stating in its submission that:

'Taxpayers should ... have the option of using the audited accounts of the foreign entity, subject to adjustments such as write-downs and provisions.'⁵³

5.23 Submissions also suggested that the current branch-equivalent calculations might be simplified by continuing to base the calculations on the Australian tax law but reviewing the list of modifications to the law with the aim of extending these modifications. For example, the Property Council of Australia explained in its submission that:

50 Page 7.

51 Page 39.

52 Submission (2), page 15.

53 Page 3.

‘We consider that it is inappropriate to apply section 51AD to the calculation of the attributable income or net income of foreign entities that will be included in the assessable income of their Australian owners because [amongst other reasons] ... section 51AD was not intended to apply to foreign entity leasing or similar arrangements because the assumptions behind the rationale for section 51AD do not apply in the context of foreign entities.’⁵⁴

5.24 The Board supports moving to a simpler approach either through the adoption of an accounting based approach or through maintenance of the current tax law based approach with a reviewed list of modifications. However, 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. Instead, the Board is keen that a single, consistent approach to branch-equivalent calculations be adopted under new attribution arrangements.

5.25 One of the benefits of an accounting based approach is that it would rely on existing accounts prepared by the foreign entity rather than requiring taxpayers to prepare separate accounts based on the Australian tax law simply for attribution purposes. This approach may also lend itself to using consolidated accounts, a compliance cost saving suggestion that was raised in several submissions.⁵⁵

5.26 However, the Board is keen to hear whether such an approach would better accommodate those taxpayers using the current branch-equivalent calculations and whether taxpayers could continue to isolate tainted income using such an approach.

5.27 While the Board’s discussion paper canvassed the idea that a branch-equivalent calculation could apply to attribute all of the foreign entity’s income (in much the same way as the market value and deemed rate of return approaches operate), this idea did not receive any support during consultation. The Institute of Chartered Accountants commented in its submission that:

‘... the methods of calculating attributable income should target only the passive and base company income ... derived in the foreign entity (regardless of the level of investment), unless compliance and complexity would be created.’⁵⁶

5.28 PricewaterhouseCoopers commented on the higher compliance costs of using a transactional approach by explaining in its submission that:

‘...if the taxpayer is prepared to assume that cost, the method of calculation should be open to them.’⁵⁷

54 Submission (1), page 1.

55 See for example the Taxation Institute of Australia’s submission (2) (page 19), the Ernst & Young and CPA joint submission (2) (page 53), and the Telstra submission (page 4).

56 Page 39. See also PWC submission page 8.

5.29 Although retention of the current approach, whereby only tainted income is attributed under the branch-equivalent calculations, arguably imposes higher levels of complexity and compliance costs than an all-or-nothing approach, the Board is satisfied that this is a desirable outcome. While retaining the concept of tainted income will mean some complexity will be retained in the law, it will help ensure that the measures are better targeted by focusing on income that gives the best opportunity for inappropriate deferral.

Position 5.2

That the branch-equivalent method be retained and be made available to all taxpayers with interests in foreign entities.

That the operation of the branch-equivalent method be improved by reviewing, in consultation:

- the degree to which the full extent of the Australian tax law needs to apply in determining the attributable income of a taxpayer; and
- whether calculations based on the audited accounts of the foreign entity would help to reduce compliance costs.

Market value method

5.30 As explained in the Board's discussion paper and in submissions, the main problem perceived with the current market value approach that applies under the FIF regime is that it brings forward the taxation of unrealised gains.

5.31 However, submissions and consultation comments did not disclose any practical solutions to address the problem. Some suggestions would impose significant complexity by reducing the attributable income by an amount that is referable to the amount of any embedded unrealised gain. Other suggestions advocated an arbitrary percentage reduction in the amount of the income brought to account under the attribution rules.

5.32 While the Board supports the retention of the market value method, the Board considers that it would be counterproductive to introduce complexity to the market value method in order to provide some adjustment for unrealised gains. The market value method is the most commonly used method for calculating FIF income, owing to its simplicity and the resulting low compliance costs. The Board is also mindful that, as a result of better targeting the rules, a narrower field of taxpayers will be subject to attribution.

5.33 Under revised attribution arrangements, the Board considers that the design of the market value method should follow the current design in the FIF rules. The method would only be available if there is a recognised market for the interest in the foreign entity. If there is no recognised market, taxpayers will still be able to apply either the branch-equivalent or deemed rate of return methods.

Position 5.3

That the current FIF market value method be retained and be made available to all taxpayers with interests in foreign entities.

Deemed rate of return method

5.34 A deemed rate of return method is available under the FIF and transferor trust regimes. Under both regimes, residents are taxed at a deemed rate on the value of their investment in the foreign entity.

5.35 There are two components to the deemed rate of return: first, the deemed rate, and second, the base to which it applies.

5.36 The criticism of the deemed rate of return method relates to the first component – the rate is too penal and exceeds typical passive income returns.⁵⁸ According to the Government's 1992 FIF Information Paper, this was a deliberate policy decision designed to encourage taxpayers to use alternative attribution methods where possible.

'The Government intends that [the deemed rate of return method] be used as a fall-back for those types of investments that are unable to be taxed under the other methods of taxation. Since taxpayers may be able to earn quite high pre-tax rates of return from some FIF investments in some low-tax jurisdictions, the deemed rate of return has to be quite high if it is not to encourage taxpayers to try and use the deemed rate of return as their preferred taxing method.'⁵⁹

5.37 While this original focus on ensuring the integrity of the Australian revenue remains important today, other objectives such as low compliance costs and complexity also need to be appropriately balanced in settling on a deemed rate.

5.38 To address concerns that the rate is too penal, there are essentially three options:

58 The current deemed rate is the statutory interest rate plus four percentage points for FIFs and five percentage points for transferor trusts. The statutory interest rate is based on the monthly average yield of the 90 day bank accepted bills rate (which in recent months has been around 7 per cent).

59 Treasurer, *Taxation of Interests in Foreign Investment Funds: An Information Paper*, AGPS, Canberra, 1992, page 45, paragraph 4.13.

- Introduce a fixed rate of, say, 5 per cent.
 - This can be justified as being consistent with recent FIF changes made in New Zealand. (The changes included the introduction of a 5 per cent ‘fair’ rate, considered to be sufficiently commensurate with investment returns.) On the other hand, a fixed rate can be criticised as being very arbitrary: too low in ‘good’ years and too high in ‘bad’ years. With choice of attribution methods, taxpayers would likely opt for an alternative method rather than elect the fixed rate in a ‘bad’ year.
- Set the deemed rate as the statutory interest rate with no uplift (that is, the monthly average yield of the 90 day bank accepted bills rate). This would have the advantage of better correlating with typical investment returns over time. While this approach would appear to have no overt penalty aspect, the deemed rate of return would apply to the entire value of a taxpayer’s investment including active income. This would mean taxpayers with high information levels would still have a preference for performing branch-equivalent calculations.
- As per current arrangements but with a reduced uplift factor, of say two percentage points.

5.39 Having regard to competing policy factors, the Board believes that a uniform deemed rate of return method should apply to all interests in foreign entities and that the rate should be based on the prevailing statutory interest rate with no uplift (that is, the second option above).

Position 5.4

That the current FIF deemed rate of return method be made available to all taxpayers with interests in foreign entities and that the rate be based on the prevailing statutory interest rate with no uplift.

CALCULATION ISSUES

Attribution and discretionary interests

5.40 Generally, income is attributed to resident taxpayers in proportion to the legal interest taxpayers hold in the foreign entity. While this principle is more easily applied under the CFC and FIF regimes, it is difficult to apply in the case of transferor trusts and non-common law entities. This is because potential beneficiaries do not hold fixed legal interests which are capable of being traced.

5.41 The transferor trust regime currently addresses this problem by deeming 100 per cent of the income earned on the corpus of the foreign trust to be attributable to the Australian transferor. The Commissioner has a discretion to reduce the amount attributable where two or more Australian transferors are subject to Australian tax on the same income. While this potentially provides relief from double taxation, relying on the Commissioner's discretion within a self assessment environment often does not provide an appropriate level of certainty.

5.42 One alternative proposed in the discussion paper was to tax residents on the proportionate value of property or services they transferred to the trust, with the proportion deemed to be 100 per cent where this information could not be obtained or evidenced. This provides a more equitable outcome for taxpayers while still allowing for cases where the percentage of property or services transferred cannot be obtained.

5.43 This alternative was generally supported by the submissions. A few submissions suggested, however, that the rules would be further improved by attributing income to the transferor of the property or services *that produced the income*. This would allow for cases where assets or services are transferred but do not produce attributable income or produce income at lower rates than other assets. Given the complexities involved in linking income production to assets or services transferred, this option would seem to result in high compliance costs and substantiation difficulties for taxpayers and administrators.

5.44 Despite these concerns, however, all submissions favoured the alternative proposed in the discussion paper over the current arrangements as providing more accurate and equitable results for taxpayers.

Position 5.5

That, for foreign entities with multiple resident transferors, the amount of income attributed to each transferor be based on the respective value of the property or services they transferred to the foreign entity.

That, where it is not possible to determine this value, the transferors be deemed to hold a 100 per cent interest in the foreign entity.

Part-year ownership of an interest in a foreign entity

5.45 Australian residents with an interest in a CFC are subject to attribution on their interest holding at the end of the statutory accounting period. This means that even where the CFC was acquired during the year, the full year's income is still attributable to the resident taxpayer. Under the FIF regime, by contrast, income is only attributable in proportion to the number of days that the resident held the FIF interest.

5.46 As stated in the discussion paper, the Board believes that income should be attributed to residents in a consistent manner for all interests in foreign entities and that apportionment should only apply if residents have no claim to income earned before the interest in the foreign entity was acquired. Submissions such as the Taxation Institute of Australia submission explained that:

‘In practice ... more often than not an outgoing vendor will extract the accrued income, for example as a dividend, and it may not be possible to adjust the purchase price to take account of Australian CFC concerns, even if a vendor was willing to do so.’⁶⁰

5.47 All submissions that commented on the issue strongly argued that residents should not face attribution on the full year’s income of the foreign entity where they acquired the interest part way through the year. Submissions also suggested that rather than simply apportioning the income, residents should have the option to calculate the income of the foreign entity based on the actual period of ownership.

5.48 Submissions also strongly argued that allowing apportionment should not result in taxpayers who disposed of their interest part way through the year being subject to attribution. Shaddick & Spence commented in its submission that:

‘Apportionment should apply, at least to protect purchasers in respect of transactions occurring prior to their involvement. But this begs the question of whether anything needs to be attributed in respect of the income year of disposal. At present, it does not (unless the CFC is liquidated), and that would appear to be reasonable, because nothing, after disposal, can be said to have been “deferred”.’⁶¹

Position 5.6

That a taxpayer only be attributable on a portion of the full year’s income of a foreign entity where the entity was acquired part way through the year. Taxpayers should be able to calculate this portion based on the actual period of ownership or by apportioning the full year’s income.

Interaction of capital gains tax provisions and attributable income provisions

5.49 The discussion paper outlined a concern that had been raised with the Board that the attribution provisions can have the effect of recharacterising what might ordinarily be considered to be capital gains into statutory income. Submissions highlighted that

60 Submission (2), page 16.

61 Page 9.

the CGT discount would be lost where tainted capital gains are included in the assessable income of an attributable taxpayer.

5.50 Some submissions supported the contention that this was an inappropriate outcome and should be addressed under revised attribution arrangements. For example, the Taxation Institute of Australia stated in its submission that:

‘... attributable capital gains derived by a CFC should be included in the calculation of the net capital gain of the relevant attributable taxpayer, rather than in assessable income.’⁶²

5.51 Although submissions that commented on this matter were universal in their support for change, it was not clear whether the outcome would be consistent with the equivalent domestic capital gains tax treatment and how the change might be achieved without adding significant complexity. For these reasons, the Board does not consider it necessary to change the capital gains tax outcomes that currently arise under the attribution regimes.

5.52 For similar reasons, the Board does not consider it appropriate for changes to be made that, in respect of the sale of an interest in a foreign entity, would provide an ordinary loss (in contrast to a capital loss) which could be offset against amounts previously attributed (and treated as income) but not yet distributed.

Position 5.7

That the current arrangements in respect of the treatment of capital gains continue to apply.

RECORD KEEPING

General account keeping

5.53 Currently, Australian residents with an interest in a foreign entity use attribution accounts to trace attributable income and reconcile it with distributions. This process prevents double taxation by ensuring that distributions from previously attributed income are not subject to tax.

5.54 The process is highly complex and compliance intensive, particularly where there are multiple tiers of entities. Moreover, the legislation is extremely prescriptive as to how these accounts must be kept.

62 Submission (2), page 17.

5.55 The Board suggested in its discussion paper that this prescriptivism was unnecessary and restricted taxpayers from adopting other account keeping methods which might better suit their needs. This sentiment was reflected in submissions, with comments similar to those by Ernst & Young and the Corporate Tax Association (below), expressed in almost all submissions:

‘... the complexity and compliance costs associated with the prescriptive bases upon which attribution accounts and attributed tax accounts can be avoided by the use of simple statements of principle ... The current record keeping requirements are wholly unnecessary. Record keeping requirements are sufficiently dealt with in the general provision of the income tax legislation and should not [be] different for the anti-tax-deferral measures.’⁶³

Position 5.8

That the legislation be less prescriptive on how attribution accounts should be maintained.

Fund-level accounts

5.56 Several of the submissions highlighted the particular compliance difficulties faced by managed funds and other investment trusts. The Investment and Financial Services Association (IFSA) explained in its submission:

‘[The managed fund industry] has been most affected by the compliance costs and disruption to business because of the practical necessity of ‘bed and breakfasting’ thousands of investments annually. This ‘bed and breakfast’ practice has arisen not to avoid tax but simply because of the inability of managed funds to keep FIF attribution accounts for thousands of retail clients. In fact, ‘bed and breakfasting’ generally results in the payment of tax equal to that payable under the FIF provisions.’⁶⁴

5.57 The submissions recommended that one way to alleviate the compliance issues for the managed fund industry is to allow accounts to be kept at the trust/fund level rather than the investor level. IFSA explained in its submission that:

‘The fund can then distribute any attributable income to investors and when the non-exempt FIFs are sold, the fund can offset the tax paid against the capital gain and make a tax deferred payment.’⁶⁵

63 Submission (2), page 57.

64 Page 7.

65 Page 14.

5.58 Although the Board is receptive to ideas that will reduce compliance costs for managed funds, submissions were not entirely clear on how fund-level accounts might apply in practice. The Board intends that such issues, as well as issues surrounding taxpayer equity, be further explored in consultation with industry.

Position 5.9

That the feasibility of fund-level accounts be explored in further consultation.

GLOSSARY

Active income

Active income is income derived from genuine business activities such as mining or manufacturing operations and the provision of commercial services. The location of such business activities tends to be based primarily on non-tax considerations like access to product markets and the supply of labour and other inputs.

Attribution rules

Anti-tax-deferral rules that seek to remove the inappropriate deferral benefit gained by residents from accumulating income offshore.

Balanced portfolio exemption

The balanced portfolio exemption provides an exemption for otherwise non-exempt FIF interests where the amount of non-exempt FIF interests is relatively small (10 per cent or less).

Base company income

Base company income includes tainted sales and services income. Generally, base company income is active income derived from a related-party transaction or from certain transactions in connection with the domestic jurisdiction. Base company income is often given the same treatment as passive income, that is, accruals taxation.

Branch-equivalent calculations

This method applies the Australian tax law, subject to certain modifications, to calculate the taxable income of the foreign entity as if it were an Australian resident.

Capital export neutrality (CEN)

An efficiency benchmark advocating residence-based taxation. That is, all capital owned by Australians should be taxed at Australian rates of tax whether it is invested in Australia or overseas. This promotes efficient capital allocation worldwide.

Capital import neutrality (CIN)

An efficiency benchmark advocating source-based taxation. That is, income earned by Australians overseas should not be subject to further tax in Australia regardless of the tax rate in the foreign country. This promotes neutrality in savings decisions and efficient savings.

Comparable tax (jurisdictional) approach

In its pure form, this approach exempts income derived from investments located in particular countries. In a modified form, this approach may only exempt certain income that is comparably taxed or subject to a certain level of foreign taxation.

Controlled foreign company (CFC) rules

Rules that subject controlling interests in foreign companies to accruals taxation.

A foreign company is a CFC if any of the following three tests are satisfied:

- five or fewer Australian entities have together, directly or indirectly, a 50 per cent or more interest in the foreign company;
- a single Australian entity has, directly or indirectly, a 40 per cent or more interest in the company, and the company is not controlled by anyone else; or
- five or fewer Australian entities effectively control the company.

Deemed present entitlement

Rules in the general trust provisions that apply to interests in controlled foreign trusts and other interests in foreign trusts that are exempt from the FIF rules. The rules deem beneficiaries to be presently entitled to a share of profits accumulated in a foreign trust, based on their rights to receive distributions from the trust in the future

(Eligible) Designated concession income (EDCI)

Certain income, being income that has been concessionally taxed in a listed country, that may be attributable to Australian taxpayers under the CFC rules.

Foreign investment fund (FIF) rules

Rules that subject certain interests to accruals taxation. These interests include non-control interests in foreign companies, interests in foreign trusts and beneficial interests in foreign life insurance policies.

Listed country

Countries listed for Australian tax purposes are Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States. Income from listed countries is subject to more concessional accruals taxation treatment.

Non-portfolio / portfolio

In general terms, a shareholder with an interest in a company (for example, in respect of voting power) that is equal to 10 per cent or more has a non-portfolio interest. A non-portfolio dividend is a dividend received in respect of such an interest. Other interests, and dividends in respect of such interests, are portfolio.

Passive income

Passive income is generally highly mobile income which can easily be shifted to a tax haven and includes dividends, interest, royalties, rents, annuities and capital gains.

Tainted income

Tainted income includes passive and base company income.

Tainted sales income

Sales income of a CFC where the goods sold were purchased from, or sold to:

- an associate who is an Australian resident; or
- an associate who is not an Australian resident but carried on business in Australia through a permanent establishment.

Tainted services income

Tainted services income is broadly income from the provision of services by a CFC to an Australian resident.

Transfer pricing rules

Rules that seek to set prices in relation to related-party transactions as if the transactions were conducted at arm's length.

Transferor trust rules

Rules that subject resident transferors to accruals taxation in respect of certain transfers made to foreign trusts.

Unlisted country

A foreign country that is not a listed country.

APPENDIX A: SUMMARY OF POSITIONS

CHAPTER 2: POLICY UNDERLYING THE FOREIGN SOURCE INCOME ATTRIBUTION RULES

Position 2.1

That, as a general principle, the economic principle of capital import neutrality be retained as the policy setting for foreign active investment and capital export neutrality for foreign passive investment.

That the main focus of the review be directed at determining those investments that should be classified as active and those that should be classified as passive.

Position 2.2

That the attribution rules continue to serve dual anti-avoidance and anti-deferral roles.

CHAPTER 3: OPTIONS FOR REFORM

Position 3.1

That changes to the attribution rules focus on outcomes and relevant policy considerations rather than harmonisation itself.

CHAPTER 4: POLICY FACTORS — HIGH LEVEL PRINCIPLES

Position 4.1

That the attribution rules continue to apply to resident investors holding interests in foreign companies and foreign trusts, or transferors that have transferred value to foreign trusts under a non-commercial arrangement.

Position 4.2

That the attribution rules apply to resident investors holding ‘interests’ in non-common law entities (such as anstalts and foundations), possibly in a similar fashion to the way the rules currently apply to transferors under the transferor trust rules.

Position 4.3

That an attributable taxpayer be taken to be:

- to the extent that a foreign entity is constituted by fixed interests – resident taxpayers who hold those interests; and
- to the extent that a foreign entity is constituted by discretionary interests or interests that are not discernible – resident taxpayers that have transferred services or property to the foreign entity.

Position 4.4

That the attribution rules avoid including foreign source income in the assessable income of non-residents.

Position 4.5

That the current restriction relating to control in respect of pre-resident transfers be removed.

That transitional rules apply so that attribution does not arise for a four year period after a transferor becomes a resident of Australia, provided the transfer to the foreign trust was made more than four years prior to the transferor becoming a resident.

Position 4.6

That the current restriction relating to control in respect of pre-commencement transfers be removed.

That further consideration be given to the need for the proposed amnesty set out in Recommendation 20.11 of the RBT.

Position 4.7

That uniform de minimis exemptions be applied to all interests in foreign entities and that:

- a \$200,000 threshold apply to the total value of interests in foreign entities;
- the balanced portfolio threshold be increased to 20 per cent and that it apply to an entity's total assets (rather than being confined to offshore investments only).

Position 4.8

That the current FIF exemption for complying superannuation funds be improved by:

- extending its application to controlling interests held by complying superannuation funds; and
- allowing the exemption to flow through to entities that are largely held by complying superannuation funds (that is, other entities hold only a nominal interest).

Position 4.9

That a motivation test not proceed unless a demonstrable need is provided during further consultations.

Position 4.10

That a listed Australian public company exemption be introduced provided appropriate integrity rules can be developed. Such rules should be the subject of further consultation.

Position 4.11

That the boundary that distinguishes active and passive income be universally applied to all interests in foreign entities and that it be modelled on the current FIF active business exemption.

That further criteria be identified through consultation to supplement the existing stock exchange listing and balance sheet methods contained in the FIF active business exemption.

That rules be developed to ensure appropriate integrity around the revised boundary between active and passive income. Areas where such rules are needed should be the subject of further consultation.

Position 4.12

That the base company income rules be removed.

That, where needed, express rules should be developed to ensure appropriate integrity. Areas where such rules might be needed should be the subject of further consultation.

Position 4.13

That an expanded FIF-style listed country exemption apply consistently to all interests in foreign entities, subject to appropriate integrity rules being developed in consultation.

That, if suitable integrity rules cannot be developed, a CFC-style approach be available to those taxpayers who choose to use branch-equivalent calculations, with the current FIF exemption applying to other taxpayers.

Position 4.14

That a distribution exemption be introduced.

That appropriate integrity rules be developed in further consultations.

Position 4.15

That an exemption apply to funds that have been rolled over from an employer-sponsored superannuation fund.

CHAPTER 5: ATTRIBUTION METHODS — HIGH LEVEL PRINCIPLES

Position 5.1

That all taxpayers be able to choose, by way of election, the branch-equivalent, market value or deemed rate of return methods.

That such an election be for a specified period, unless the taxpayer's circumstances change such that it would be reasonable and appropriate to allow a change in the election.

Position 5.2

That the branch-equivalent method be retained and be made available to all taxpayers with interests in foreign entities.

That the operation of the branch-equivalent calculation method be improved by reviewing, in consultation:

- the degree to which the full extent of the Australian tax law needs to apply in determining the attributable income of a taxpayer; and

- whether calculations based on the audited accounts of the foreign entity would help reduce compliance costs.

Position 5.3

That the current FIF market value method be retained and be made available to all taxpayers with interests in foreign entities.

Position 5.4

That the current FIF deemed rate of return method be made available to all taxpayers with interests in foreign entities and that the rate be based on the prevailing statutory interest rate with no uplift.

Position 5.5

That, for foreign entities with multiple resident transferors, the amount of income attributed to each transferor be based on the respective value of the property or services they transferred to the foreign entity.

That, where it is not possible to determine this value, the transferors be deemed to hold a 100 per cent interest in the foreign entity.

Position 5.6

That a taxpayer only be attributable on a portion of the full year's income of a foreign entity where the entity was acquired part way through the year. Taxpayers should be able to calculate this portion based on the actual period of ownership or by apportioning the full year's income.

Position 5.7

That the current arrangements in respect of the treatment of capital gains continue to apply.

Position 5.8

That the legislation be less prescriptive on how attribution accounts should be maintained.

Position 5.9

That the feasibility of fund-level accounts be explored in further consultation.

APPENDIX B: LIST OF SUBMISSIONS

The following is a list of submissions, excluding confidential submissions, made to the Board as part of the Review of the Anti-Tax-Deferral Rules. Submissions can be viewed in full on the Board's website at www.taxboard.gov.au.

Table 1: List of organisations providing submissions

Organisation
Australian Bankers' Association Inc.
Association of Superannuation Funds of Australia
Blake Dawson Waldron Lawyers
Brambles Limited
Business Coalition for Tax Reform
Corporate Tax Association and Ernst & Young (1)
Corporate Tax Association and Ernst & Young (2)
CPA Australia Ltd
Cullum, J D
Deloitte Touche Tohmatsu
Institute of Chartered Accountants in Australia
Investment & Financial Services Association Ltd
KPMG (1)
KPMG (2)
Law Council of Australia
Pitcher Partners
PricewaterhouseCoopers (1)
PricewaterhouseCoopers (2)
Property Council of Australia (1)
Property Council of Australia (2)
Qantas
Shaddick & Spence

Table 1: List of organisations providing submissions (continued)

Organisation (continued)
Taxation Institute of Australia (1)
Taxation Institute of Australia (2)
Telstra
Thomas, P

APPENDIX C: CAPITAL EXPORT AND CAPITAL IMPORT NEUTRALITY BENCHMARKS

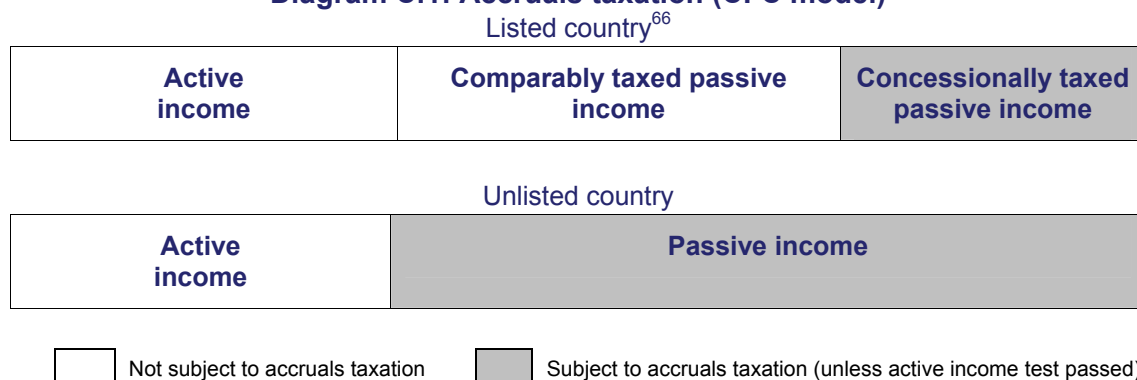
POLICY BENCHMARKS

C.1 The economic impact of systems of taxation of foreign source income is commonly assessed in terms of two competing benchmarks: capital export neutrality (CEN) and capital import neutrality (CIN). CEN would require all capital owned by Australians to be taxed at Australian rates of tax whether it was invested in Australia or overseas. It is argued that this leads to an efficient allocation of capital and labour. CIN, on the other hand, would require that foreign source income be subject to the rate of tax prevailing in the country in which it is earned. According to this benchmark, income earned by Australians overseas should not be subject to further tax in Australia regardless of the tax rate in the foreign country. It is argued that this makes Australian businesses more competitive in foreign markets.

C.2 Most countries, including Australia, that have implemented attribution regimes have adopted a blend of these two benchmarks: CIN applies for active income (that is, deferral is permitted), but CEN applies for passive and base company income (that is, accruals taxation).

C.3 The appropriate benchmark to apply in relation to the taxation of active business income derived overseas has been subject to much discussion. OECD countries, for example, do not approach the issue entirely consistently. However, there seems to be much more consensus that passive income is very mobile and will therefore seek out low-tax environments unless it is effectively taxed at domestic rates as it accrues. Diagram C. 1 outlines the current Australian position.

Diagram C.1: Accruals taxation (CFC model)



66 The CFC and transferor trust rules provide an exemption for investments held in listed countries unless the income is eligible designated concession income (EDCI). The FIF rules also have a limited exemption for certain investments held in the United States.

C.4 The Australian system for taxation of foreign source income applying up to 1987-88 reflected a CIN benchmark although, in respect of portfolio investment, prevailing foreign exchange controls restricted investment levels. Subsequent changes to the system of taxing foreign source income effectively shifted the system closer to the CEN benchmark, particularly in respect of passive income. In more recent times, the extension in 2004 of the dividend participation exemption saw a shift towards the CIN benchmark for non-portfolio investments.

C.5 While the Government has not made any definitive statement in respect of where the balance currently lies between these competing policy benchmarks, it is possible to make the following inferences about the current state of Australia's international tax settings:

- Where a corporate taxpayer derives foreign income, the underlying economic policy benchmark is:
 - CIN for non-portfolio dividends, gains on the disposal of non-portfolio assets, and the derivation of active and comparably taxed passive income in respect of the attribution rules.
 - CEN for portfolio dividends, gains on the disposal of portfolio assets, and the derivation of passive income (other than comparably taxed passive income) in respect of the attribution rules.
- Where a non-corporate taxpayer derives foreign income, the underlying economic policy benchmark is CEN.

C.6 While discussion of these efficiency benchmarks is usually limited to the company context, the benchmarks are equally relevant for other offshore investment vehicles. This is especially so within the global economy where commercial reasons increasingly drive taxpayers to use a variety of investment vehicles.

APPENDIX D: ISSUES WITH THE CURRENT REGIMES

OVERVIEW

D.1 The Board's discussion paper, and the submissions the Board received in respect of it, outlined a number of problems inherent across the current attribution regimes. In broad terms, they can be classified as follows:

- coordination and distortionary problems;
- targeting issues;
- disproportionate compliance costs; and
- significant complexity.

COORDINATION AND DISTORTIONARY PROBLEMS

D.2 One of the key problems with the current regimes is that the cumulative enactment of the attribution regimes over time has resulted in the regimes not being fully coordinated.

D.3 This lack of coordination has meant that more than one regime may potentially apply to a particular taxpayer in respect of the same income. This can result in double taxation or an exemption applying under one regime potentially being clawed back by the operation of another. In other cases, the lack of coordination across the regimes can have the effect that certain entities are not captured under any of the regimes and therefore escape attribution.

D.4 The regimes also suffer from a lack of consistency, with none universally applying across all entity types. As a result, taxpayers with similar in-substance investments made through different entities may be caught under different regimes and receive different tax treatment. This creates inappropriate investment distortions.

D.5 These coordination and distortionary problems are exacerbated by the rules which currently restrict access to the particular attribution regimes. Foremost amongst these is the notion of control. However, other restrictions also apply to confine certain entities to particular regimes. Even within the regimes, restrictions apply to limit access to particular exemptions or attribution methods. These all create distortions by subjecting what may be similar in-substance investments to different tax treatment.

D.6 The joint Ernst & Young and Corporate Tax Association submission expressed the problem in the following terms:

'... the manner in which the current rules are formulated can force a taxpayer with a significant stake in a foreign entity from one regime to the other based on the actions of the other investors in the foreign entity. Again, the treatment of a taxpayer under the different regimes on the basis of 'control' is inappropriate. This problem can be resolved in a harmonised regime where there is no distinction between the tax treatment of investors based on whether or not the entity is controlled.'⁶⁷

D.7 In a similar vein, the Association of Superannuation Funds of Australia submission provided the following example which highlights how the problem can manifest itself:

'Typically a large Australian superannuation fund will take up an interest of between 1 per cent and 30 per cent of the investment, which prima facie would be an exempt FIF interest. However, where multiple funds take up an interest in the same investment there is a likelihood of the extended definition of a CFC being satisfied, thus requiring each of the funds to deal with the CFC provisions. In effect, the extended definition of a CFC converts what would be an exempt FIF investment into a CFC investment. The concern of the superannuation industry is that the reclassification as a CFC occurs not because there is any degree of control exercised by the superannuation funds (they are merely passive investors) but rather because of who else invests.'⁶⁸

TARGETING ISSUES

D.8 Given that the attribution rules were developed nearly 20 years ago and the nature of Australia's trade profile and business practices has evolved significantly since that time, there is strong argument that the rules are no longer appropriately targeted.

D.9 Most submissions were united in the call for the rules to be better targeted. In particular, the boundary that distinguishes active and passive income needs to be modernised to better reflect current business structures and practices. As the Board's discussion paper explained, this boundary plays a significant role in the attribution rules by separating the kinds of income and investment that should receive the benefit of deferral from the kinds of income and investment that should be attributed and taxed on a current basis.

D.10 The Taxation Institute of Australia, in its submission, described the current approach in the following manner:

67 Submission (2), page 2.

68 Pages 2-3.

'The active versus passive distinction is a proxy for [the] mobility of the source of income. There is some correlation between carrying on a business versus merely investing and immobile income versus mobile income. The current approach to defining passive income is very unsophisticated and does not take into account such distinctions. It is heavily based on the type of income with little regard to the circumstances in which the income is derived, whether there has been any benefit derived from the mobility of the income or whether the taxpayer has engaged in any inappropriate behaviour.'⁶⁹

D.11 The Business Coalition for Tax Reform, in its submission, also put forward a similar line:

'Income currently treated as passive should not be attributable where it is an integral part of an active business being conducted either by the relevant entity or its associates. This includes rental and leasing income, royalties, licence fees and tolling income.'⁷⁰

D.12 Increasing overseas investment, a greater focus on trade in services and intangibles as well as trade in goods, and increasingly complex global business structures have meant that the scope and reach of the rules have inadvertently become broader. This has meant that what was once considered passive needs reviewing to ensure that it continues to be appropriately defined.

COMPLIANCE COSTS

D.13 As noted in the discussion paper, the current attribution rules can give rise to significant compliance costs for business.

D.14 The Board heard during consultations that the costs can be so significant that strong disincentives exist for taxpayers to fully comply with their tax obligations. This is particularly so for small businesses and individuals. Pitcher Partners, in its submission, explained:

'For our client base, complying with the CFC regime presents enormous communication difficulties. Often, the staff of the CFC have poor English language skills and are unfamiliar with international tax issues. In addition, it is not unusual for the CFC to have a single in-house accountant responsible for all local corporate and tax filings.'

D.15 Even where taxpayers are ultimately exempt from the rules, they still face significant compliance costs. This is largely due to the complex nature of the current

69 Submission (2), page 4.

70 Page 3.

exemptions which require taxpayers to complete a detailed analysis of their income or investments to determine whether they have any obligations under the rules. The record and account keeping requirements also impose significant compliance costs on business, particularly the managed funds industry.

D.16 In respect of the managed fund industry, the Investment and Financial Services Association explained in its submission that:

[the managed funds industry] has been most affected by the compliance costs and disruption to business because of the practical necessity of 'bed and breakfasting' thousands of investments annually. This 'bed and breakfast' practice has arisen not to avoid tax but simply because of the inability of managed funds to keep FIF attribution accounts for thousands of retail clients.⁷¹

COMPLEXITY

D.17 In terms of complexity, the rules were drafted at a time when a prescriptive black letter law approach to the general design of the tax laws applied. As a result, they occupy around 400 pages of legislation and more than 1,000 subsections (or nearly 25 per cent of the *Income Tax Assessment Act 1936*). The volume of law, and the accompanying level of complexity, is disproportionate to the common policy outcome that the regimes all set out to achieve – to identify and attribute to resident taxpayers their share of certain foreign income accumulated in a foreign entity in which they hold an interest.

D.18 In their joint submission, Ernst & Young and the Corporate Tax Association explained:

It is self evident to anyone familiar with Australia's anti tax deferral regimes that the measures need modernisation and simplification.⁷²

D.19 While submissions conceded that the rules were complex, many submissions stated that simplification of the rules should not be the overwhelming policy driver and that the focus should be on modernising the active/passive divide and reducing compliance costs.

71 Page 7.

72 Submission (2), page 1.

APPENDIX E: REVIEW OF BUSINESS TAXATION PROPOSED AMNESTY

Excerpt from Recommendation 20.11 of the Review of Business Taxation⁷³:

Provision of amnesty

- (a) That an amnesty be provided to allow foreign trusts to be wound up where they are affected by the wider application of the transferor trust measures (Recommendation 20.10), with:
 - (i) trust distributions to Australian residents made under the amnesty to be taxed at 10 per cent; and
 - (ii) an indemnity to ensure trust distributions made under the amnesty do not lead to an investigation by the ATO of a taxpayer's domestic affairs, or international dealings, relating to a foreign trust wound up under the amnesty.

Qualifying conditions for amnesty

- (b) That the amnesty only be available where a taxpayer satisfies the Commissioner that:
 - (i) a foreign trust has been wound up;
 - (ii) a full distribution has been made of all property of the trust;
 - (iii) that property includes the balance remaining:
 - (1) of all amounts transferred to the trust prior to the commencement of the transferor trust measures or prior to a transferor becoming a resident;
or
 - (2) of all income derived by the trust from those transferred amounts or from the reinvestment of such income; and
 - (iv) if the full distribution was not made to Australian residents, no Australian resident has any direct or indirect interest in that part of the property distributed to non-Australian residents.

73 Treasurer, *Review of Business Taxation: 'A Tax System Redesigned' Report*, AGPS, Canberra, July 1999, page 641-2.

Exclusion from amnesty

- (c) That the amnesty not be available if after the commencement of the transferor trust measures:
 - (i) a resident made a transfer, or caused a transfer to be made, to a foreign trust;
 - (ii) a foreign trust has been identified by the ATO as having been controlled by a resident transferor (for instance, where the transferor trust measures have previously been applied to a foreign trust because the trust was controlled);
or
 - (iii) there has been a notification that the ATO is undertaking, or will undertake, an investigation of a transferor's taxation affairs.