16 July 2007

Foreign Source Income Anti-Tax Deferral Review
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
Parkes ACT 2006

Review of Foreign Source Income Anti Tax Deferral (ATD) Regimes

The Corporate Tax Association of Australia (CTA) and Ernst & Young welcome the review of Foreign Source Income Anti Tax Deferral Regimes as a continuing step in enhancing the international tax competitiveness of Australian business and building on the Government’s recent initiatives in this area since the 2003 Federal Budget.

This response builds on an earlier submission by the CTA and Ernst & Young presented in March 2007 to the Board of Taxation (the March 2007 submission).

We believe that the Government’s current initiative to harmonise the anti deferral regime provides a unique opportunity in the history of Australia’s taxation evolution to achieve fundamental and long lasting reform in the area of international tax.

It is self evident to anyone familiar with Australia’s anti tax deferral regimes that the measures need modernisation and simplification. Australian companies should have a tax regime enabling them to be internationally competitive and uncertainty and compliance should be kept to a minimum. Further, the investment of Australia’s savings offshore through managed funds must be encouraged. The current FIF regime acts as a deterrent to foreign investment in circumstances where there is no discernable risk of tax avoidance.

Australia now has a unique opportunity to fundamentally harmonise, simplify and increase the global competitiveness of its outbound taxation regime with the change in policy from a capital export neutrality mindset (under which Australia seeks to tax all foreign income) to a capital import neutrality approach (under which Australia should not impose tax where foreign income has been taxed overseas). We discussed this in our March 2007 submission.

It is also important to bear in mind that ultimately the outbound taxation regime is fundamentally one dealing with timing differences rather than permanent differences. The Government has not introduced franking credits for offshore taxed profits. As a result, all offshore income will ultimately be subject to tax in the hands of the ultimate Australian shareholder or unit holder – and in many cases, the income will be subject to double tax, having suffered first foreign tax and then Australian domestic tax in the hands of the ultimate owner.

Therefore, there is already an inherent bias against offshore income. In developing the new ATD regime, this should be borne in mind when trade offs are required involving simplification, international competitiveness and risk to the revenue.
By making substantial improvements to the CFC and FIF regimes we believe that not only can the law be significantly improved but that harmonisation of the regimes can be substantially advanced.

**Substantial improvements for modernisation and harmonisation of the CFC measures**

The CFC measures were developed in the context of the major overhaul of the Australian taxation system in the 1980s and in an economy where although trade in foreign markets was substantial, the globalisation of business was in its infancy. In its final form, the CFC regime was developed to target very specific income and gains of substantial investments in ‘controlled’ companies. On the other hand, the FIF regime was developed to target passive foreign funds and the distinction between a passive fund and an active fund was inexact.

Since then, Australian companies have been able to successfully expand and compete in foreign markets and the impact of the CFC measures has grown. The foreign investment by Australian multinationals has also been based on strategic stakes in foreign companies and joint ventures with foreign companies. In either case the limited, and in some cases ‘blunt’, exemptions under both the CFC and the FIF measures are inappropriate. This has resulted in the original demarcation between the types of anti tax deferral measures based on ‘control’ becoming out of date.

Further, 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.

Harmonisation is also advanced by modernising the existing rules to ensure that commercially driven gains, currently being attributed, are excluded.

One clear example where this applies is the case of rental income and the disposal of property. Income and gains made in connection with holdings of foreign property (including infrastructure) should be excluded from attribution. We do not believe that the exclusion should be limited to cases where the attributable taxpayer is engaged in ownership, development or management of the property. In particular, the capital necessary for many foreign infrastructure projects is currently raised through infrastructure funds and it is an unsophisticated tax regime that would subject these investors to the ATD measures. We do not see a basis for treating these investors as though they are investing for the purposes of tax deferral.

The issue is not confined only to land and buildings. Rent can also arise from the leasing, hire and letting of goods. Where these activities are connected with a genuine business conducted in the foreign country, no integrity concern should arise.

Further, royalties from the exploitation of intellectual property should not be treated adversely compared to income from services. Australia’s future prosperity will in large part turn on the provision of services and the development and exploitation of intellectual property (IP). The distinction between IP and services is becoming increasingly less clear.

We believe the rules dealing with base company income are redundant and create unnecessary compliance costs. Further, this aspect of the CFC rules discourages the use of Australia as a base for operations within the region and further abroad.
At present, there is only one basis upon which a CFC may calculate its attributable income. In order to liberalise the CFC measures and reduce compliance costs other methods should be introduced. To accommodate cases where the attributable taxpayer does not wish to incur the compliance costs of performing a full branch equivalent calculation, or does not have access to the necessary information, several other shortcut bases for the calculation of attributable income should be allowed. This should include the options found in the existing FIF measures to use profits as calculated according to modified accounting principles, the option to calculate the attributable income according to movements in market value and a deemed rate of return on funds invested.

Also from a compliance perspective, the listed country exemption from the ATDs should not only be maintained, it should be expanded. From a compliance perspective, it has proved to be the most important feature of the CFC measures. The restriction of the list of designated concessions in respect of these countries was a major compliance saving resulting from RITA. We do not accept that the administrative costs to government of monitoring a larger list of listed countries (but not as extensive as the original list of 60+ countries) outweighs the compliance saving. We believe that the administrative costs can be easily estimated and would be relatively insignificant in the overall scheme of things. Moreover, those listed countries (e.g. the US) with a robust ATD regime of their own provide the basis of a ‘push-down’ exemption without major integrity concerns.

One significant source of frustration to Australian multinationals has been the treatment of transactions between associates offshore. The income and gains from these transactions are potentially taxed under the CFC measures, notwithstanding that the amount does not represent a real accretion to the value of the group. Substantial resources are devoted to managing this issue to ensure that such uneconomic outcomes do not arise. We believe recent changes to the US subpart F regime provide a useful platform to explore solutions to dealing with this.

Because the CFC measures are concerned with the movement of mobile capital, there can be no integrity concern if there is no motive or purpose of gaining an Australian tax advantage. Moreover, a purpose or motive test can be applied to cater for unforeseen future developments which are clearly not motivated by tax deferral and which may inadvertently be caught by the revised regime. We also believe this motive test should cater for the ability to exclude an entire entity from the rules and not just a particular transaction or type of income. The criteria for this should be the subject of detailed design and development consultation.

In this context, there is a strong case for excluding many widely held public companies and collective investment vehicles altogether from the ATD rules based on certain criteria.

**Substantial improvements for modernisation and harmonisation of the FIF measures**

In the absence of a harmonised ATD regime, there is a reasonable case for repealing the FIF rules in their entirety. Their impact far exceeds the original intended scope of the measures. In their place, there should be a set of rules that are targeted at investments in passive foreign funds where the taxpayer is likely to have transferred funds or invested to gain the benefit of deferral of Australian tax. These measures would then be somewhat complementary to the mischief sought to be impugned by the transferor trust measures.

In the absence of the restriction of the FIF measures in this manner, additional exemptions need to be introduced.
The motivation of an investor with a relatively small investment in a foreign company or trust can be very different to that of a significant investor. In our experience the majority of portfolio investments by Australians are via Australian superannuation funds (which should continue to be exempt from the FIF measures) and collective investment vehicles. Further we note that Australian equity markets are no longer large enough to accommodate the investment of the savings of Australians and investment offshore is therefore unavoidable.

We also note that, all other things being equal, the benefits provided to individuals from the imputation system creates a tax bias in favour of investments in an Australian entity deriving its profits from Australia. Given this, it is reasonable to assert that the main motivation for portfolio investments in foreign entities is very likely to be an increased pre-Australian tax rate of return irrespective of the underlying foreign tax.

Some exceptions exist to this and the exceptions that create integrity risks are investments in passive offshore funds where there are comparable investment opportunities in Australia and where the investor is likely to invest in such a foreign fund to gain the benefit of Australian tax deferral – or a significant reduction in Australian tax; for example, by converting revenue distributions into a ‘roll-up fund’ and a discounted capital gain. However this does not justify the complex and commercially retarding design features of the existing FIF measures.

As discussed, the FIF measures were developed at a time when the Australian savings ratios were exceptionally low and foreign portfolio investments were comparatively unsophisticated. The blunt distinction between active and passive foreign entities had less overall impact on the return on Australian savings. These ‘blunt’ policy settings are no longer appropriate. One example is in banking. In 1992, Australian banks did not take strategic stakes in offshore banks and there was no imperative to develop an exemption for non publicly listed banks. This is no longer the case. Similar issues arise for insurance companies.

Moreover, exemptions will need to be significantly expanded to avoid taxing currently tainted investments such as property, infrastructure, rent and related investments generally including investments in publicly listed entities. Serious consideration also needs to be given to investments in the private equity sector as this asset class has evolved into a major global offering.

A CFC-like listed country exemption for FIFs would also significantly assist with compliance.

The purpose or motive test mentioned earlier in the CFC context should equally be available for collective investment vehicles.

There is currently an exemption for funds managers where the total value of investments in FIFs that are subject to the measures are greater than 10% of the total value of all FIFs (increased as a result of the previous RITA reforms from 5%). This recognises that any fund manager with a diversified portfolio will need to invest in a level of ‘passive’ investments. At this level there is still a substantial level of compliance necessary to determine whether the investments at year end are greater than the 10% threshold. The exemption provides significant compliance savings. In our view the threshold can be lifted significantly. This would reduce the compliance burden and on fund managers. Set at an appropriate level it should not create integrity risk.

To avoid expensive ‘bed and breakfast’ arrangements, taxpayers should also be given the option of ‘marking to market’ the investments that would typically be subject to these arrangements.
Harmonisation

We discuss the harmonisation options in our submission and build therein on what was said in our March 2007 submission.

We believe that coupling the removal of the control test with greater flexibility in attribution methods and more modern exclusions from the ATD rules, will significantly enhance the possibility of harmonising the CFC, FIF and Division 6 rules.

For reasons discussed in the submission, we believe the Transferor Trust rules are best left as a separate regime – although there is no reason why they could not equally be modernised, simplified and brought into the 1997 Act, using many of the new harmonised concepts.

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Our submission attached deals in detail with these issues and other matters we believe are important.

As mentioned earlier, the current Review of the anti tax deferral regimes provides a rare opportunity to achieve substantial and long-lasting reforms in Australia’s international tax regime. We should not let this opportunity pass us by without fundamental reform in this space.

If you have any questions, please do not hesitate to contact Alf Capito of Ernst & Young on (02) 8295 6473 or Frank Drenth at the CTA.

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If you have any questions, please do not hesitate to contact Alf Capito on (02) 8295 6473 or Frank Drenth on (03) 9600 4411.

Yours sincerely

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Response by Ernst & Young and Corporate Tax Association to the Board of Taxation May 2007 discussion paper

Review Of The Foreign Source Income Anti-Tax-Deferral Regimes

16 July 2007
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Overview

Ernst & Young and the Corporate Tax Association (‘the CTA’) are pleased to provide this response to the Board of Taxation Discussion Paper titled ‘Review of the Foreign Source Income Anti-Tax-Deferral Regimes’ issued on 25 May 2007 (‘the Discussion Paper’).

The major focus of this response is on the CFC and FIF rules, which are the principal anti-tax-deferral regimes relevant to business. We have, however, set out some brief comments on the transferor trust rules where they affect business activity and as they relate to the harmonising of the anti-tax-deferral regimes.

This response focuses on the strategic directions for reform of the anti-tax-deferral regimes on the basis that, once the strategic aspects have been decided, there will be further consultation to refine the detail of the new regime. As a result, this response does not provide detailed analysis of every feature.

We have set out our views on the policy basis for the development of an international tax regime in our submission of March 2007 (‘the March 2007 submission’) to the Board, a copy of which is attached, and we have therefore not repeated them here. However, we would like to make the following additional comments regarding the statements in Chapter 2 of the Discussion Paper.

General policy objectives

In addition to the issues regarding neutrality at paragraph 2.54(with which we are in broad agreement), the Discussion Paper sets out several parameters for the development of an anti-tax-deferral regime or regimes being:

- 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.
- As far as possible, economic efficiency applies to minimise distortions in commercial choices.
- The revenue does not bear an unacceptable level of risk.

We agree with these statements.

Complexity

In addition, the discussion paper states that a policy objective should be for the anti-tax-deferral regimes to be ‘simple to understand and operate with proper account made of complexity and compliance and administrative costs’. While we agree with the second part of this statement, we believe that it is unrealistic to expect that anti-tax-deferral rules will be ‘simple’ to understand, unless the policy is simple to articulate. In our experience, tax policy is rarely simple because of the other objectives of ensuring a competitive tax system and appropriate regard being given to market and business factors. Simple legislation has not been a feature of other countries’ anti-tax-deferral rules. That said, relative simplicity can be achieved by restricting the application of the rules to the cases of potential ‘worst abuse’ and greatest revenue risk as discussed in this response.

The length of legislation is often cited as an indication of its complexity. We are unconvinced that shorter law necessarily translates into simple law. We agree that the length of the current anti-tax-deferral rules can be reduced and have for some time suggested that this is possible. However, we stress that an inability to clearly articulate the policy, or to translate an appropriately articulated policy into the law, gives rise to complexity.
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Shortening the law can be achieved with little effort and no cost as part of the necessary policy modernisation of the rules. For example, it is questionable whether the complex system for maintaining attribution accounts and attributed tax accounts and the detailed record keeping requirements were necessary. Straightforward reductions in the size of the legislation could include replacing the attribution accounts with a short statement of principle and to delete the record keeping requirements. In all, we believe this minor exercise would delete approximately 15 pages of legislation. Other such deletions could occur without any change to policy.

We emphasise that the other policy objectives noted by the Board are more significant than mere word-count or page-count of the anti-tax-deferral regimes.

Policy underlying the anti-tax-deferral measures

We support harmonising the CFC and FIF regimes. Such harmonisation should remove the current distortions arising from the control rule and allow improved flexibility offered by each of the existing measures.

As noted in the Discussion Paper, the existing anti-tax-deferral regimes were developed with the following design features:

- There would be a greater possibility that Australian investors could influence the behaviour of a foreign entity as so avoid Australian tax (that is, there is a greater integrity risk) where the foreign entity is controlled by residents of Australia. As importantly, Australian investors in a foreign entity would be in a position to demand the information needed to complete branch equivalent calculations where the entity was controlled by residents. Experience has shown that this is not necessarily correct in our view, while this may be acceptable as a broad proposition.

- Conversely, the possibility that Australian investors could influence the behaviour of a non-controlled foreign entity as so avoid Australian tax was lower. Such taxpayers would also not be in a position to demand all of the information needed to complete branch equivalent calculations (irrespective of whether or not the investor was a portfolio or non-portfolio investor). Again, experience has shown that this is not necessarily correct while this may be acceptable as a broad proposition.

- The FIF measures were later developed for Australian investors having smaller interests in controlled foreign entities and any investment in a non-controlled foreign entity. These contained broader compliance approaches using different mechanisms for the measurement of attribution. The ‘blunt’ bases for the exemptions follow from the proposition that investors would not be in a position to demand the all of the information needed to complete branch equivalent calculations.  

- Trusts were already ‘look through’ vehicles and, therefore, the anti-tax-deferral regimes need not provided the same level of exemptions available to companies. Further, there may have been a perception that trusts had traditionally been used to avoid tax and were not prevalent as vehicles for conducting active business in a foreign country. (This is clearly incorrect).

Policy underlying the FIF measures

One matter where we do take some issue is the original intended purpose of the FIF measures. It has been speculated that the FIF measures were intended to be a surrogate to the CFC regime for cases where access to information was presumed not to exist. This may well be the ultimate effect of the FIF measures but there is no indication that this was their intended role. The development of the measures tends to indicate

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1 The Taxation Law Amendment (2007 Measures No. 4) Bill 2007 is a consequence of the acceptance by the Government that investors in non controlled entities may have the access to the requisite information to perform a branch equivalent calculation.
Overview

that the original intention, being to target a narrow range of passive offshore funds that could be used as roll-up vehicles to defer or reduce Australian tax, was not abandoned. However, it is clear that the legislation implementing the rules went beyond the original stated aim.

Although not fully apparent from the available policy documents, the parameters for the development of the FIF measures appear to have included the following:

- Greater risk to the revenue would arise with unlisted vehicles which could be developed and marketed specifically to Australian investors. While it was recognised that publicly listed investment vehicles could be used for deferral, it was probable that the abusive deferral would arise from non listed vehicles established for the specific purpose of deferring tax. Therefore, the wider (or ‘blunter’) exemptions for listed vehicles were acceptable.

- Trusts were seen as the greatest risk of being used as a passive investment vehicles and would provide the greatest scope for deferral, as was also evident in the development of the CFC and transferor trust measures.

- Latitude was given to identifying when a FIF would be taken to be carrying on an active business. While a minimal level of ‘active’ business was considered insufficient to exempt an investor from the FIF measures, a significant level falling short of predominant was considered acceptable. There is no evidence that there was any science to the choice of 50% of assets as the benchmark for the active/passive distinction.

It is not the case, we suggest, that the policy has always been that the FIF measures should cover all investments not subject to the CFC measures.

Therefore the harmonisation of the CFC and FIF regimes is not merely a task of simplification and removal of anomalies and overlaps. Rather, we suggest that any decision to treat truly portfolio investors in the same manner as truly active investors would be a fundamental change of policy. We therefore suggest that the harmonising of the measures take this into account.

Approach to Harmonisation

We summarise the preferred broad framework for a harmonised regime. We submit that it is possible to harmonise the CFC and FIF measures into one anti-tax-deferral regime for foreign entities provided that the following conditions are satisfied:

- Capital Import Neutrality (‘CIN’) should continue to be the tax policy underlying for the foreign investment by Australian companies. To the extent that Capital Export Neutrality (‘CEN’) is maintained as the preferred basis for neutrality, for example, for individuals, the paradigm should remain that Australian income tax should only be imposed upon the derivation of income and gains (whether by distribution of profits or upon the disposal of the investment).

- The anti-tax-deferral regime should be clearly recognised as a departure from these paradigms, and should only be imposed where:
  - there is a reasonable expectation of an integrity risk from the diversion of income and assets;
  - and then only where the underlying investment represents mobile capital.

- The anti-tax-deferral regime should provide sufficient exemptions to ensure that investors can readily apply the anti-tax-deferral regimes, and there should be no presumption as to the ability of a taxpayer to access information. Further, the exemptions should be provided on a similar basis to all investors irrespective of the activities or the business of the taxpayer. Because there can be no presumption as to

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2 In considering the role that anti-tax-deferral rules should now play, this historical development is still instructive.
the ability of a taxpayer to access information, all taxpayers should have access to all of the methods for the calculation of the amount subject to the anti-tax-deferral regime. The exception to this would be where particular categories of taxpayers might be eligible for further exemptions where they do not impose an integrity risk (for example superannuation funds).

We further note that:

- One issue in harmonising the regimes is that there is a fundamental economic difference between active and passive investors and investments. Therefore, allowance in a harmonised regime must be made for the different nature of these investors and investments. There are internationally accepted bases for distinguishing these investments based on percentage interests. However, these distinctions are arbitrary.

- The original policy of the anti-tax-deferral measures was to differentiate between taxpayers having a substantial interest or a non-substantial interest. The additional issue was one of access to information. In our view the concern with access to information is better dealt with by mechanisms that do not include a distinction between foreign entities based on control.

- As a broad generalisation, non-portfolio investments are more likely to be made for genuine business reasons than for deferral reasons. It is this distinction that was part of the design features of the CFC and FIF measures. The investor is in the best position to assess whether an investment should properly be classified as a portfolio investment or a non-portfolio investment. If a distinction is left between the regimes that deal with portfolio investment and non-portfolio investments, we submit the taxpayer should be allowed to choose between the regimes that best suit their circumstances.

The portfolio investments of the funds management industry are made to maximise total returns before Australian taxes. The existence of foreign tax on the underlying investment is not the key driver. Moreover investments are made on a diversified approach under which ‘passive’ FIFs necessarily form part of that diversified portfolio. Further, we note that the Australian equity market is no longer large enough to accommodate the investment of the savings of Australians and investment offshore is unavoidable. Connected to this is the mobility of the investment funds that allows Australian investors to benefit from gaining access to international portfolio investments. Last, all other things equal, the benefits provided to individuals from the imputation system create a tax based bias in favour of investments in an Australian entity deriving its profits from Australian investments. Thus, as mentioned above, the motivation of an investor with a relatively small investment in a foreign company or trust is in almost all cases commercial and not tax driven and this must drive the tax policy underlying harmonisation of the FIF rules with the CFC rules.

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3 We have further referred to this distinction as the distinction between a portfolio and non portfolio investment or investor. These terms do not represent the defined terms used in the ITAA 1936. A non-portfolio investment is generally considered to be the point where an investor can be considered, economically, to participate in the underlying activities of the foreign entity.

4 In Australia for the purposes of the international tax system, this distinction is set at 10% of voting shares and is relevant to the exemption for dividends derived by resident companies, the participation exemption, attribution under the CFC measures and the proposed branch equivalent basis under the FIF measures. This is consistent with OECD benchmarks and the previous threshold for the allowance of an underlying foreign tax credit. Other countries have different benchmarks.

5 For example, the funds available to superannuation funds are estimated to be over of $1 trillion, approximately the size of the entire Australian equity market.
Overview

We accept that these propositions are not universally correct and that there is a place for measures to prevent risk to the revenue. The integrity risks relate to investment in non-distributing passive offshore entities where:

- there are comparable investment opportunities in Australia;
- the diversion of the investment funds to a foreign entity has no discernible commercial basis;
- the investor is likely to invest in the foreign entity to gain the benefit of a deferral of Australian tax, or a significant reduction in Australian tax (for example, by converting revenue distributions to so-called ‘roll up funds’ to a discount capital gain); and
- while this risk might be most obvious where the foreign fund is closely held, widely held non-distributing foreign funds might still provide the same benefits.

However, none of this justifies the design features of the existing FIF measures and the general application of those measures to the funds management industry.

At a minimum, a non-portfolio investor in a controlled entity should have access to the same treatment as a non-portfolio investor in a non-controlled entity and any differential treatments that arise in a harmonised regime should not turn on this issue of access to information. The access to information becomes an issue for applying the various exemptions (in particular the active income/active business exemptions) and the proxy for the income and gains accruing to the entity that might be subject to attribution.

We submit that both types of investor/investment can be accommodated within a harmonised anti-tax-deferral regime and advantages might result. We restate that the advantages of a harmonised regime should not be determined by the length of the legislation but by its practical application. We emphasise, however, that if both types of investor/investment cannot be accommodated within one harmonised anti-tax-deferral regime (which at this stage we do not accept) the basis for any distinction between the treatments should not turn on control of the foreign entity. There would still be significant simplification advantages if full harmonisation could not be achieved.6

Finally, to the extent that perceived integrity allows, Australia’s anti-tax-deferral measures should be less onerous than international benchmarks.

The policy objectives of making Australia an attractive location for regional headquarters of global groups and global headquarters of Australian groups, requires an internationally competitive and attractive regime in Australia, and not the most costly or compliance-intensive regime in areas involving legitimate commercial activity.

As a result, all integrity measures proposed to be included need to be benchmarked against these objectives.

6 For example, the regimes could still eliminate the control rules, including the issues with associate interest; the attribution thresholds; the problems of moving between the regimes; the problems of access to information; the inconsistencies of calculation methodologies under the existing regime, etc.
Summary

We summarise our submission as follows:

- **Response to Question 3.1 – Transferor Trusts**

  There is no reason in principle why the harmonisation of the CFC and FIF measures should not extend to the trust rules of Division 6. However, the difficulty of identifying an interest where a transferor trust is concerned militates against its inclusion in a harmonised anti-tax-deferral regime and on this basis; we submit that a harmonised regime should exclude transferor trusts. Notwithstanding this, the transferor trust measures require review to ensure that they do not affect genuine business transactions and more appropriately attribute to the transferor the income and gains that might give rise to an integrity risk. We submit that there is a very strong argument that transferor trust regime should not apply to Australian corporate taxpayers.

  Otherwise, this submission does not examine issues with the application of the transferor trust measures.

  We submit that an attributable taxpayer should not be subject to attribution that is disproportionate to the taxpayer’s entitlement or potential entitlement to the profits that give rise to the attribution.

- **Response to Questions 3.2 to 3.4 – Interests in Foreign Entities**

  We submit that the issue with the classification of foreign ‘entities’ is an issue at the margin. It does not impinge on the vast majority of foreign investments. Concern that there might be some issues at the margin should not drive the development of the anti-tax-deferral regimes.

  We further submit that there is no compelling reason to define ‘interests’ according to economic interests. 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).

  We submit that an attributable taxpayer should not be subject to attribution that is disproportionate to the taxpayer’s entitlement or potential entitlement to the profits that give rise to the attribution.

  Under the current anti-tax-deferral regime the notion of control is used to distinguish between operation of the CFC and FIF regime. In a more integrated CFC and FIF regime the control test will no longer be relevant. However, various other provisions rely upon the concept of control. In particular the concept of ‘controlled foreign entity equity’ in the thin capitalisation provisions must be preserved. This concept is relevant to calculating the ‘adjusted average equity capital’ of an outward investing entity and is ultimately defined by reference to the Part X concept of control. We understand that measures outside the anti-tax-deferral regimes are not within the scope of this Review but we submit it should be put to Government that there should be no changes to policy to the thin capitalisation measures as well as other measures using the concept of control.

  The Board is aware that the operation of the foreign hybrid rules causes problems. Again this is outside the scope of this Review. Nevertheless, we submit that the Board should report these concerns to Government.
Response to Question 3.5 – Conduit Foreign Income

We submit that the legislation should be amended so that Australian trustees are not subject to tax in respect of a non-resident’s share of any CFC or FIF income included in the calculation of the net income of a trust.

Response to Questions 4.1 and 4.2 – Passive Income

Income from or in connection with real property (irrespective of the nature of the income) should be excluded from attribution, at the very least where the attributable taxpayer is engaged in ownership, development or management of property. This would include, for example, activities in respect of investments in retail, commercial and tourism properties. Consideration should be given to excluding rental income in its entirety.

Income from or in connection with intellectual property (irrespective of the nature of the income) should be excluded from attribution, at the very least where the attributable taxpayer is engaged in development, ownership and/or exploitation of that intellectual property. This would include, for example, activities in respect of the development and licensing of intellectual property such as trademarks, patents, copyrights and know-how by a CFC or an associate. We would not go so far as to advocate the complete exclusion of royalty income.

Income from leasing of goods should similarly be excluded, again, at the very least if the attributable taxpayer is engaged also in a business of leasing.

Response to Question 4.3 – Active Income Test improvements

We submit that the active income test should be retained and that the calculations necessary under the active income test must continue to be based on information that is already easily accessible.

We further submit that the current 5% threshold acts a de minimis test only. This should be lifted to more appropriately identify circumstances where a foreign company has been used predominantly for the purpose of deferral of Australian tax. That is, it should be limited to the cases of worst abuse. The appropriate threshold will need to be identified in the design phase.

However, we submit that the active income test should not be used as a substitute for a more precise definition of active/passive divide.

Response to Question 4.4 – Alternatives to listing passive income

We submit that the existing CFC approach to positively list categories of passive income is appropriate on the basis that the primary position should be that income should always default to active income classification.

Response to Question 4.5 and 4.6 – Intra group financing exemption

Since their inception, the CFC measures have not accommodated transactions between associates offshore. This was recognised in the previous Board of Taxation Review of International Tax
Summary

Arrangements (‘RITA’) and the Board’s recommendations to restrict the scope of tainted services income were adopted by the Government. The outstanding issue is the treatment of ‘passive’ income derived by associated CFCs. We submit that all such transactions should be ignored.

- **Response to Questions 4.7 to 4.9 – Base company income**

  The rules dealing with base company income are redundant and create compliance costs well in excess of any benefit. As such, we strongly submit that the base company income rules should be removed. In particular, tainted services income has no role to play under Australia’s anti-tax-deferral regimes. Any integrity concern is best left to transfer pricing. Further, this aspect of the CFC rules discourages foreign multinationals using Australia as their holding company for operations within the region.

- **Response to Questions 4.10 and 4.11 – Listing of countries**

  The listed country approach should not only be maintained, it should be expanded. From a compliance perspective it has proved to be the single most important feature of the CFC measures. Further, the restriction of the list of designated concessions in respect of these listed countries was one of the major compliance saving resulting from RITA. We emphasise our support for the RITA Tranche 3 proposal not yet legislated, for non-attribution of non-BELC subsidiaries of BELC CFCs. Last, we submit that estimates should be made of the administrative cost associated with monitoring this list of countries. This would allow for a reasonable basis for estimating the cost/benefit analysis of the expansion of the list of countries.

- **Response to Question 4.12 and 4.13 – De minimis exemptions**

  Irrespective of whether or not the various anti-tax-deferral measures are retained or are harmonised, we do not consider that there is a basis to distinguish between the measures when applying a de minimis exemption. The basis for the level for the exemption is a matter of judgement and it is premature to attempt to set appropriate levels until the various exemptions are settled. However, that said, it the absolute dollar amount should be increased to take account of the true cost of compliance and potential for deferral.

- **Response to Questions 4.14 to 4.15 – Other approaches to targeting income under FIF measures**

  The exemption for foreign banks and general insurances companies should be broadened.

  Further, we submit that where the shareholder of the foreign company is an AFI or AFI subsidiary, products and services falling under ‘financial intermediary services’ should not be regarded as non-eligible activities for the purposes of FIF measures.

  Finally, we submit that the listed country exemption should be extended beyond the United States. The factors that should addressed in the decision to list a country need to be addressed during the design phase.

- **Response to Question 4.16 – Other FIF processes for consideration**

  In addition to the application of the active income test as a basis for exclusion of amounts from attributable income, we submit that an assets-based exemption should be provided. This exemption could be modelled on the existing active business exemption in the FIF measures.

  In addition to the listing of countries, an exemption from the CFC measures based on the effective rate of foreign tax could be considered. This exemption should not be modelled on the similar exemption
Summary

under the UK CFC measures. Instead, the exemption should be based on measuring effective tax rates by reference to readily available accounting information.

- **Response to Question 4.17 – Purpose or motive test**

We submit that a purpose or motive exemption should apply to cater for unforeseen circumstances where taxpayers have situations which are clearly not motivated by tax deferral and which may inadvertently be caught by the revised regime. Moreover, we believe this purpose or motive exemption should cater for the ability to exclude an entire entity from the rules and not just a particular transaction or type of income.

The criteria for this should be the subject of detailed design and development consultation. It is conceivable that, as part of this review, many publicly listed companies and widely held collective investment vehicles may qualify for exemption from the anti-tax-deferral regime.

- **Response to Questions 4.18 and 4.19 - Managed Funds**

The threshold for the balanced portfolio exemption should be lifted substantially to at least 25% and the level at which the threshold is set should be the subject of consultation with the funds management industry during the design phase.

Investments that arise as a result of particular investment strategies that will not give rise to deferral concerns should be treated as active FIFs.

Funds managers should be provided with an election to deem a disposal of the interest in a FIF at the end of the taxpayer’s year of income. Effectively, this is an election to mark these FIFs to market, which is not present in the current FIF rules.

Rather than force a taxpayer to make disposals of interests at year end (either under ‘bed and breakfast’ arrangements or otherwise) the attributable taxpayer should be allowed to simply elect to treat any particular interest in a FIF as having been sold. Under the CFC measures, a taxpayer should be provided with the same option.

- **Response to Questions 4.20 and 4.21 – Australian public companies and generic accumulation tests**

We support the proposition that a complete exemption from the anti-tax-deferral rules should be provided to Australian publicly listed companies from the anti-tax-deferral rules.

We accept that this might create some non-neutrality with companies and other vehicles that are not listed that also invest offshore and have high distribution policies. However, we submit that some level of non-neutrality will inevitably occur in any anti-tax-deferral measures. Given the proportion of listed foreign multinationals to non listed multinationals, the advantages of providing an exemption far outweigh these non-neutralities.

We further submit that it might be possible to develop a comparable exemption for unlisted vehicles that are unlikely to be used as accumulation vehicles. This does not obviate the imperative for an exemption for publicly listed vehicles.

- **Response to Question 4.22 – Foreign public company exemption**
We submit that an exemption applying on a wide ranging basis across the various anti-tax-deferral regimes should apply to foreign public companies.

**Response to Question 5.1 – Attribution methods**

We submit that the policy development inherent in Taxation Law Amendment (2007 Measures No. 4) Bill 2007 provides support for a policy improvement to allow companies currently limited to using the branch equivalent method under the CFC rules to have an additional option to use the FIF methods, thus harmonising the calculation methods under the new anti-tax-deferral regimes. We further submit that the key reforms required in relation to foreign conduit entities are:

- Alignment of the compliance mechanisms, at the very least for widely held managed funds;
- Consideration of exemption of widely held managed funds as discussed below;
- If an exemption for widely held managed funds is considered not to be feasible, a focus on streamlined and harmonised compliance. We submit that consideration should be given to calculation of attributable income using:
  - Australian tax rules modified to streamline the calculations, as recommended for CFCs, or
  - Possible use of the tax rules of the foreign source country, at least for conduit entities in comparable tax countries.

**Response to Question 5.2 - Branch equivalent calculations**

We submit that the current branch-equivalent calculation approach can be improved, as detailed below.

**Response to Question 5.3 – Excluding particular Australian tax rules**

We submit that the provisions of the Australian tax laws that impose significant compliance and/or are not necessary to protect the integrity of the Australian tax base when applied in the calculation of attributable income should be excluded from branch-equivalent calculations.

**Response to Questions 5.4, 5.5 and 5.6 – FIF market value and rate of return methods**

We submit that the simplest mechanism would be to set the rate the deemed rate of return at a lower level. However, the ‘fair dividend rate’ method as used in New Zealand might be a viable option. At this stage, we have not examined each of the methodologies as this is a design consideration. We further submit that the market value method could be extended to a wider variety of non-listed foreign entities. We further submit that any minor design features that currently give rise to inappropriate outcomes are technical issues that should be considered in the design phase. We submit that the deemed rate of return method can be applied consistently across all the attribution rules.

**Response to Question 5.7 – Other attribution methods**

Presently, there is only one basis upon which a CFC may calculate its attributable income. This
Summary

transactional method should be retained (albeit some modifications are necessary). However, to accommodate cases where the attributable taxpayer does not wish to incur the compliance cost of performing a full branch equivalent calculation or does not have access to the necessary information, several other bases for the calculation of attributable income should be allowed. These should include the option to use profits as calculated according to accounting principles, the option to calculate the attributable income according to movements in the market value and a deemed rate of return on funds invested.

- **Response to Question 5.8 – Taxpayer choice of attribution rules**
  We submit that taxpayers should be permitted to choose the most appropriate attribution method so that all taxpayers can be treated consistently.

- **Response to Questions 5.9 and 5.10 – Transferor trust attribution rules**
  These questions deal with the application of the transferor trust measures. This submission does not address the operation of those measures. As such, we have not commented on these questions.

- **Response to Questions 5.11 and 5.12 – Attribution: Part year and CGT interactions**
  Attributable income should be apportioned to reflect part-year ownership of the foreign entity. We believe that the methodology for the apportionment should be considered in the design phase.
  Capital gains derived and capital losses incurred by a CFC should be included in the calculation of the net capital gain or loss of the attributable taxpayer.
  We further submit that losses derived by a CFC should be attributed to the attributable taxpayer for offset against other attributable income.

- **Response to Questions 5.13, 5.14 and 5.15 – Attribution accounting and record-keeping**
  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.
  Further, we submit that 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 different for the anti-tax-deferral measures.

- **Response to Questions 6.1, 6.2 and 6.5 – Harmonisation of the regimes**
  We endorse the harmonisation of the CFC measures, the FIF measures and Division 6. However, we submit that the transferor trusts should initially be excluded from a harmonised regime.
  To the extent that Option C (harmonisation of the FIF and CFC regimes) can be undertaken without adversely impacting taxpayers in a manner consistent with our submissions above, we prefer Option C. However, we strongly endorse maximum flexibility that will allow taxpayers to choose the most appropriate basis for attribution.

- **Responses to Questions 6.3 and 6.4 – FIF style active business exemption**
Summary

We submit that the FIF-style active business exemption and the CFC-style active income exemption could run as parallel, or alternative, exemptions.

We further submit that a FIF-style active business exemption is consistent with the principles of an anti-tax-deferral regime that seeks to target the cases of worse abuse. As such, we do not believe that it would produce an unmanageable revenue risk for the Government.

- Responses to Questions 6.6, 6.7 and 6.10 – Improvements in administration, transition issues

We submit that there are a number of the improvements that could be made to the tax administration system. Primarily these would revolve around better and more transparent interaction between taxpayers and their representative bodies and the ATO. The new ATD rules should be ‘road tested’ before legislative introduction and an appropriate lead time should be allowed. We do not think at this stage it is appropriate to make more specific recommendations and this should be dealt with in the design phase.

- Responses to Question 6.8 - Transition

We submit that provided that the transition is appropriately managed by the tax administration it should be possible to minimise any adverse unintended consequences that could arise.

- Response to Question 6.9 – Transferor Trust amnesty

This submission does not address the operation of the transferor trust measures other than in response to Question 3.1. As such, we have not commented on this question.

These matters are further considered in this Response.

The chapter headings and responses follow the sequence of the Board’s discussion paper.
Interests and Entities

Transferor Trusts

Questions 3.1

For discretionary interests, should the attribution rules focus on potential beneficiaries rather than transferors? If so, why and how?

There is no reason in principle why the harmonisation of the CFC and FIF measures should not extend to the trust rules of Division 6. However, the difficulty of identifying an interest where a transferor trust is concerned militates against its inclusion in a harmonised anti-tax-deferral regime and on this basis; we submit that a harmonised regime should exclude transferor trusts. Notwithstanding this, the transferor trust measures require review to ensure that they do not affect genuine business transactions and more appropriately attribute to the transferor the income and gains that might give rise to an integrity risk. We submit that there is a very strong argument that transferor trust regime should not apply to Australian corporate taxpayers.

Otherwise, this submission does not examine issues with the application of the transferor trust measures.

Comments

Neither Australian nor foreign multinationals were the intended target of the transferor trust measures, nor should they be, and we have not discussed them in any detail here. In any event, we do not believe that the attribution rules can focus on potential beneficiaries.

Notwithstanding the intended target of the transferor trust rules, the measures may apply to, and adversely impact upon, genuine commercial dealings. We have set out some examples in Appendix 1.

Interests in Companies and Fixed Trusts

Questions 3.2, 3.3 and 3.4

What aspects of the current rules create uncertainty in identifying relevant interests? How should those aspects be clarified?

Are economic interests that are not recognised legally for the purposes of the attribution rules a concern? If not, why not?

To what extent does the Government’s announcement to align the definition of non-portfolio dividend with economic ownership concepts affect your answer to Q3.3?

We submit that the issue with the classification of foreign ‘entities’ is an issue at the margin. It does not impinge on the vast majority of foreign investments. Concern that there might be some issues at the margin should not drive the development of the anti-tax-deferral regimes.

We further submit that there is no compelling reason to define ‘interests’ according to economic interests. 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
Interests and Entities

We submit that an attributable taxpayer should not be subject to attribution that is disproportionate to the taxpayer’s entitlement or potential entitlement to the profits that give rise to the attribution. (This issue is discussed further in our response to the Board’s Chapter 3 ‘Methods for Attributing Income’)

Under the current anti-tax-deferral regime the notion of control is used to distinguish between operation of the CFC and FIF regime. In a more integrated CFC and FIF regime the control test will no longer be relevant. However, various other provisions rely upon the concept of control. In particular the concept of ‘controlled foreign entity equity’ in the thin capitalisation provisions must be preserved. This concept is relevant to calculating the ‘adjusted average equity capital’ of an outward investing entity and is ultimately defined by reference to the Part X concept of control. We understand that measures outside the anti-tax-deferral regimes are not within the scope of this Review but we submit it should be put to Government that there should be no changes to policy to the thin capitalisation measures as well as other measures using the concept of control.

The Board is aware that the operation of the foreign hybrid rules causes problems. Again this is outside the scope of this Review. Nevertheless, we submit that the Board should report these concerns to Government.

Comments

The Discussion Paper identifies two matters that need to be dealt with under the anti-tax-deferral measures— the nature of the ‘entity’ that might be the subject of the anti-tax-deferral regimes and the identification of the ‘interest’ that gives rise to attribution.

We do not see any alternative to classifying interests and entities according to a jurisprudential analysis and we do not consider that there is any fundamental issue in classifying interests or entities. In our experience, there is usually no difficulty in classifying a foreign ‘entity’ as a partnership, trust or a company, albeit that in marginal cases there may be some difficulty in classification. One example often cited is the treatment of Anstalts, and no doubt there are others. However, we submit that the issue is overstated.

We note that, while the problems of classification of an ‘entity’ are often illustrated under the anti-tax-deferral regimes, the issue is more fundamental and is relevant to the general operation of the Income Tax Acts, which require classification of a taxpayer as an individual, company, trust or partnership. If an ‘entity’ were to operate through a branch in Australia it would be necessary to identify the relevant person upon whom tax should be imposed. If the entity was correctly classified as a trust the beneficiary or the trustee would be the appropriate object of taxation. If the entity was correctly classified as a partnership the partners would be the appropriate objects of taxation. If the entity was a company, the entity would be the appropriate object of taxation. In each case, classification is necessary. Similar issues arise for the imposition of withholding tax. We do not believe that a Court would accept an outcome that resulted in the non-taxation of income and gains based on an argument that a company, trustee, beneficiary, partnership or

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7 Para 3.19 of the Discussion Paper
8 Problems do arise with determining the attribution by reference to juridical rights. This is discussed in our comments on Chapter 3, regarding the mechanism for attribution.
9 For example, ATO ID 2004/909 deals with the entity classification of an investment fund created and operating under the German Investment Company Act.
Interests and Entities

individual could not be identified. We suggest that the development of the anti-tax-deferral regimes should not be driven by marginal cases.\textsuperscript{10}

Turning to the classification of the ‘interest’, we submit that it is not possible to define an interest by reference to a notion of what an economist might consider to be the ‘economic’ interest. We are not aware of any provision of the income tax law that would not have regard to jurisprudence to classify rights, nor do we believe that the identifying of interests according to the ‘economic’ interest will give rise to certainty for taxpayers and the administration. There is no assurance that moving away from classification of an interest according to the jurisprudential rights of a shareholder in relation to a company will provide a superior outcome.\textsuperscript{11}

Further, the existing CFC measures use as a basis for attribution the combination of paid-up share capital; the rights to vote; the right of a shareholder to participate in decision making regarding the distribution of profits; the rights to distribution of capital or profits on winding-up and the rights to distributions of capital or profits otherwise than on winding-up. It appears to us that while this requires an analysis of the jurisprudential rights, it does so in order to determine the economic or potential economic interest that a person has in the foreign company.\textsuperscript{12} We are also concerned that the classification of interests according to whether or not the interest qualifies as a membership interest will give rise to uncertainty because it would be necessary to analyse whether the rights give rise to a debt interest. Given recent experience with the debt-equity rules the application of these rules can be uncertain. We would also be concerned if instruments that are not membership interests that qualify as equity interests give rise to attribution.

It is such uneconomic outcomes that need to be corrected.\textsuperscript{13}

To the extent that particular entities that need to be classified cannot be classified, default provisions might apply (that is, it might be classified into one measure or the other). It might also be appropriate to provide for a Regulation making power in respect of particular ‘entities’.

The Budget 2006 proposals, as we understand their impact, do not relate directly to classification of interests for CFC and other anti-tax-deferral regimes purposes. Rather, the main amendment relates to the consideration of whether portfolio dividends paid to a CFC resident in a certain unlisted country (being those that were formerly ‘non-broad-exemption listed countries’) should continue to be exempt from attribution under the CFC measures (perhaps by repealing section 404 of the \textit{Income Tax Assessment Act 1936}). The announcement stated that there would be some ‘consequential amendments’ to align interests with economic interests. Little information has been provided on the detail of the Budget announcement and the scope of the Budget announcement is uncertain. Therefore, our comments above are unaffected by the Government’s announcement to align the definition of non-portfolio dividend with economic ownership.

\textsuperscript{10} To the extent that unusual entities that would not otherwise be used for investments are used to avoid the application of the anti-tax-deferral rules, there is a residual role for Part IVA.

\textsuperscript{11} It is suggested that the deeming of a person with de facto control to have a 100\% interest in a company for the purposes of tracing to underlying interests somehow suggests that the taxpayer’s attribution interest should be 100\%. However, we can see no fundamental inconsistency. The ability to control a company does not imply that a person’s economic interest in the underlying income and gains is 100\%.

\textsuperscript{12} No doubt drafting issues might be corrected. The development of the control interests occurred at a time when Australian administrators and policy makers had little experience with foreign corporate law, there previously being no reason to examine these matters. Therefore, the rules were developed with regard to the Australian context. For example, it was assumed that the issued share capital of a company would attach to a particular share, consistent with the concept of par value. Given greater experience, one could expect that the rights could be better articulated without resort to ‘economic’ rights.

\textsuperscript{13} This issue has been further discussed in the section dealing with attribution of income.
Conduit Foreign Income

Question 3.5

*How should the attribution rules be modified to ensure that they do not disrupt conduit income arrangements for non-residents?*

We submit that the legislation should be amended so that Australian trustees are not subject to tax in respect of a non-resident’s share of any CFC or FIF income included in the assessable income of a trust.

Comments

The Board (at paragraph 3.34 of the Discussion Paper) has commented that the interaction of the FIF rules and the generals trust provisions has resulted in an outcome (Australian Taxation Office’s Interpretative Decision ATOID 2005/200) which is contrary to the intention of the conduit income rules that were introduced as part of the RITA reforms. We strongly agree with the Board’s observation in this regard.
Types of Income

The balance between compliance costs for taxpayers and integrity

The Discussion Paper recognises that the approach to passive income must strike a balance between compliance costs for taxpayers and integrity of the Australian tax system. This issue relates back to the underlying policy of the Australian anti-tax-deferral regimes as set out in Chapter 2 of the Discussion Paper. Ultimately, the ‘integrity’ issue turns on a decision on what the measures are intended to achieve. Our views on this have been fully discussed in our March 2007 Submission.14

Compliance improvements require flexibility and improved policy and drafting approaches

The tax compliance issues relating to the active/passive divide for Australian businesses under the existing anti-tax-deferral regimes flow, in our view, from a combination of:

- Unclear policy in the existing anti-tax-deferral regimes, causing overly prescriptive and complex calculations to determine if income is passive/attributable or not.

- The enforced separation of the FIF and CFC measures (until the introduction of Taxation Law Amendment (2007 Measures No. 4) Bill 2007) which meant that foreign investments which were caught by the FIF rules did not have access to a flexibility to enable compliance improvement by applying branch equivalent calculations under the CFC rules where appropriate. However, even after the introduction of Taxation Law Amendment (2007 Measures No. 4) Bill 2007, there is excessive compliance under the CFC rules due to the requirement for affected entities under the CFC rules, which do not benefit from relevant exemptions, to use a full branch equivalent calculation without reference to the proxy calculations of attributable income under the FIF rules.

- The focus on entity by entity calculations does not necessarily sit properly with the commercial practice of global group structures and some grouping recognition is needed. It is strongly arguable that transactions between foreign associates are primarily aimed at managing the commercial and tax affairs in the foreign country and do not threaten the integrity of the Australian tax base.

As Australian companies, both large companies and, increasingly, smaller entrepreneurial or ‘born global’ companies, operate internationally, Australia cannot continue with a set of anti-tax-deferral regimes which disadvantage our enterprises compared to their global competitors.

Distinction between passive and active income

Questions 4.1, 4.2, 4.4, 4.5 and 4.6 – Distinction between passive and active income

Is passive income appropriately defined, given the need to strike a balance between compliance costs and integrity?

Are there examples of income that is currently categorised as passive but should be treated as active? How should such examples be accommodated?

Are there better alternatives to the CFC approach of positively listing passive income?

Is it possible to provide an intra-group financing exemption, having regard to integrity and compliance costs?

How could an intra-group financing exemption be defined, and why is such an approach preferred?

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14 Pages 12 to 14 of the March Submission
Types of Income

We submit that passive income is not appropriately defined under the existing rules for various reasons set out below. Examples of income that are currently recognised as passive but should be treated as active include rental income from real property, rental income from the lease of chattels, royalty income derived from associates, etc.

In particular, we submit that the rental, lease, let or hire of chattels should not give rise to passive income where the use of the chattels by the customer is in connection with the active conduct of trade or business.

We further submit that the existing CFC approach to positively list categories of passive income is appropriate on the basis that the primary position should be that income should always default to active income classification.

We support the introduction of an intra-group exemption from passive income characterisation. The mechanisms by which this might be achieved include disregarding intra-group transactions or calculating the attributable income on a group basis. The precise mechanism needs to be further examined during the design phase.

Comments

As pointed out by the Board, a policy of CIN dictates that an Australian taxpayer should be allowed to compete in a foreign jurisdiction on the same terms as its competitors. However, to be effective, the policy and law must recognise that relevant competitors are no longer only residents of the source country. In a globalised economy the competitor is as likely to be resident outside the source jurisdiction. In these circumstances the Australian taxation system should, to the extent possible, allow an Australian company to compete under the same conditions as other multinationals. These might include:

- Structuring the capital base of the subsidiary with debt rather than equity.
- Licensing intangibles to a subsidiary for use by a subsidiary.
- Using legitimate means for lowering its effective foreign tax rate such as the injection of debt in preference to equity. Note that thin capitalisation is a common feature of foreign tax systems and defines for each country the acceptable debt levels.

The categories of passive income should be amended to take into account the following:

a) **Transactions between foreign associates**

The issue of the treatment of transactions between foreign associates in the same or different countries is linked to the issue of the treatment of intra-group financing, which is further discussed below.

However, as a general proposition, we note that it is increasingly common as a part of international business to see activities which, in the last century, would have been carried on by one company operating globally (through branches or single companies in various countries) to now be carried on by a series of companies which are located in individual countries, and increasingly to see multiple companies or entities in each of the more significant countries in which the business activities are undertaken. Such company chains have arisen because of ordinary business development and are driven by factors such as:

- The need to provide entities in various countries which are able to give bankers and financiers precisely-calibrated security over particular assets without commercial risks which might accrue from cross collateralisation of other business activities conducted by the same group;
- Creating opportunities for participation by residents of a particular foreign country in the activities of that country or in a particular portion of such activities (for example employee share schemes
Types of Income

in particular elements of a supply chain or company chain, or the opportunity for third party equity or special purpose hybrid equity in particular entities); and

- Isolation of particular activities and the resulting commercial risks which might accrue, from other parts of the groups, given the more litigious environment common in many countries now.

As a result company groups have a greater number of entities in each country as well as having a greater number of countries in which they operate.

In the circumstances, basing the active/passive income test on a paradigm of a single company carrying on all the integrated activities relevant for the active/passive income test is no longer appropriate.

At this stage, we do not seek an approach which sees some consolidation measure adopted in relation to foreign jurisdictions although we do not rule out the use of consolidated accounts by foreign groups and this matter is discussed further below. This issue is better left to the design stage. Experience of Australia’s consolidation rules demonstrates the complexity that could arise. However, there needs to be an ability to net off, or alternatively to disregard, transactions between associated companies for purposes of the active/passive income characterisation.

For example, an Australian resident company might fund a foreign subsidiary by equity or debt. To the extent that the funding is by way of equity no attribution would occur. In contrast, if the attributable taxpayer capitalised the foreign company that in turn funded another subsidiary foreign company by debt, interest on the debt would be subject to attribution. This is notwithstanding that the foreign group has been capitalised by equity. In our view the arbitrage between the tax treatments provided by two foreign countries should not be a concern.

We submit that Australia needs an approach like that of the US. The US introduced section 954(c)(6) of the Internal Revenue Code (Code) applicable, broadly in the 2005-2009 period.

‘In general, and subject to certain limitations, section 954(c)(6) provides that dividends, interest, rents, and royalties received or accrued by one controlled foreign corporation (CFC) from another CFC which is a related person shall not be treated as foreign personal holding company income to the extent attributable or properly allocable to income of the related person which is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States (ECI).’

These rules are subject to integrity measures. In particular:

‘sSection 954(c)(6)(A) specifically grants the Secretary the authority to prescribe regulations to prevent the abuse of the purposes of section 954(c)(6). The transactions described below are abusive of the purposes of section 954(c)(6). However, the IRS and the Treasury Department do not intend this to be an exclusive list of abusive transactions and expect to provide further anti-abuse rules in subsequent guidance.’

In addition to the need for general modification of the anti-tax-deferral regimes applicable to related party transactions, we comment below on specific issues.

b) Rental from real property and chattels

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16 Ibid.
Types of Income

We submit that the treatment of rental income as being passive should be eliminated. While one might deal with the numerous problems listed above by a series of modifications to the passive income classification of rental income, we submit that this entire category of passive income needs to be eliminated.

If the Board or Treasury consider there are integrity issues involved which required continuation of a category of passive property income, we could engage in consultation on how to distinguish legitimate substantial property management and rental activities (including income derived by foreign affiliates of widely held entities, trusts and funds management vehicles and foreign entities conducting real foreign business activities) from passive rental of the type to be targeted by the anti-tax-deferral regimes. We submit that the volume of attribution of rental income coming in from CFC and FIF interests which could properly be classed as purely passive would not be substantial, is a minor and immaterial aspect of this major issue, and should not impede substantial reform for legitimate foreign activities.

The treatment of rental income as being passive or tainted is inappropriate for CFCs which:

- own and manage substantial properties including infrastructure projects;
- derive rental income from related parties;
- derive income from the rental of chattels; or
- have split management functions.

The business of property and asset management and ownership is not a passive activity. It is an integral part of funds management and asset management activities. It is conducted in many specialised companies, trusts and other investment entities and is not conducted for the purpose of reinvestment of passive pools of capital in the context of tax avoidance or tax deferral. Property development and investment activity, including investment in infrastructure projects, might yield rental, toll, licence or royalty income. These activities create the infrastructure or setting for commercial, industrial and retail activity as well as residential occupation, and the utilities which serve those activities. These activities involve substantial management including the selection and rotation of tenants, presentation of the relevant properties, marketing of the properties in the relevant environment, possible marketing of the brand name of the property chain (particularly for retail property where the name of the ownership chain is relevant to the position and presentation of the property) and other associated activities including the management of investors if the property is held for other investors.

This management and ownership of substantial properties involving multiple tenants and of infrastructure projects is not a passive activity and should not be characterised as such.

We submit that it is strongly arguable that rental income does not fit the criteria for mobile capital because an investment in foreign real estate or infrastructure is not a ready substitute for a similar investment in Australia. Further, major investment in rental property (such as commercial property developed or owned for leasing) is different to an investment by an individual in residential property.

This fundamentally inappropriate approach to the classification of rental income has led to ‘blunt’ attempts to limit the adverse effects through the definition of tainted rental income which excludes certain rental activities. However, as noted in the Board’s Example 4.2, those exclusions do not fit the needs of the asset management industry, in which the functions of asset management and ownership are split between different entities.

The inappropriate treatment of multi-company and multi-entity groups is seen also in the treatment of rental from associates being classified as passive income. This policy treatment appears to have been developed on the basis that a foreign entity owning property, and not conducting other trading activity,
is engaged in tax avoidance or deferral activities and should be subject to the CEN principles. However that treatment is inappropriate because:

- It is common for corporate groups to have property ownership and other similar functions separated from other commercial activities in other entities, for reasons which include better access to specialist property finance, lower-cost finance and better management of capital in respective activities;
- When global relationships or structures involve various unrelated parties coming together to create partly-owned entities, it is often difficult to move property ownership into the jointly owned entities because of pre-existing financial obligations and foreign indirect and other tax issues. As a result it is common for restructured businesses to involve property being retained in precursor entities and being rented to associated entities.

We submit that recognition of this commercial reality was a factor in the US modification of their Sub-Part F rules to exclude income from related entities as discussed earlier.

The rental of chattels is also adversely treated by the existing CFC measures. There would seem little or no rationale for this when the chattels are used in the context of a commercially driven business irrespective of whether the chattel is used by the company in the ordinary course of its business or is let or hired to the customer. This is particularly the case where the group to which the CFC belongs is carrying on the same, similar or complementary business to the parent company or the group as a whole. Therefore, we strongly submit that the income from the rental, lease, hiring or letting of chattels should not be attributed.

c) **Intra group financing**

The discussion on transactions between foreign associates, above, largely covers this issue. We restate that the issue is relevant to other intra group transactions, and in particular royalties.

Turning to the integrity issues, the potential for undue tax minimisation (the integrity issue) might arise where a CFC in a group is capitalised and the funds are lent to another company in the group under an interest bearing loan, which funds are then deposited with a third party. The US style intra-group concession counters this. Under that approach dividends, interest, rents, and royalties received or accrued by one CFC from another related CFC will generally not be treated as passive to the extent that they are attributable, or can be properly allocated, to active income of the related CFC.

The US rules expressly allow such income not to be treated as passive unless it is income effectively connected with the conduct of a trade or business in the United States and to the extent it is not sub-part F income. The US has developed rules for determining the application of this concession.

The tax competitiveness achieved as a result of such a measure, and the significant reduction in compliance activity which will accrue to the benefit of Australian businesses and taxpayers and the Australian Taxation Office in circumstances where the exemption is properly applicable, will cause a substantial improvement to the operation of the anti-tax-deferral regimes generally.

d) **Royalties**

The measures target passive type income derived from an associate, notwithstanding that such income if derived from an unrelated party would be active income. This includes royalty income.

With the ongoing development of Australian companies developing intellectual property in areas such as telecommunications, media activities such as TV and film production and software development, there are increasingly situations where intellectual property ownership is in a stand alone company,

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17 Refer US Notice 2007-9 (Op cit 12)
Types of Income

which does not carry on the related business activities. Ownership in this way is required for various reasons, including those mentioned earlier under the heading “Transactions between foreign associates” dealing with protecting assets from litigious or credit risk, as well as potentially to allow for securitisation of the financing required to create that intellectual property.

In such circumstances it appears inappropriate for this prudent behaviour designed to protect the assets of the global group to cause the income to be classified as passive.

It is strongly arguable that ‘tainted royalty income’ should not include payments by associates where either party has developed the intangible. That is, the fact that the intangible property is licensed to an associate should be irrelevant.

It is even more strongly arguable that the licensing of such intangible property to an unrelated party should be completely excluded from the concept of ‘tainted royalty income’, particularly where the members of that CFC group are involved in the development and/or ownership and exploitation of that intellectual property.

We recognise that there might be concerns about the use of royalties for intellectual property as representing activities which have a dominant purpose of reducing Australian taxes where the intellectual property was developed in Australia. Integrity measures can be developed in the design process and transfer pricing as an effective tool is always available.

e) Interest income of financial intermediaries

A CFC whose sole or principal business is as a financial intermediary is required to be the subsidiary of an Australian financial institution in order for interest earned by the CFC to be treated as active. This recognises that financial intermediation is a genuine business activity and an exemption for interest derived in the active conduct of such a business is warranted. However, this means that the income of a CFC is potentially given different treatment depending on the nature of the Australian investor, not objectively on the activities of the CFC itself.

We believe consideration of the activity of the CFC as an alternative to the identity of its ultimate shareholder may in itself warrant exclusion from the rules.

f) Interest income in the growth and development phases

A business may derive tainted interest income during its growth and development phases due to a timing mismatch with subsequent active business income. While the intention of the business may well be to develop an active business, the potential attribution of interest income early in the growth phase may place undesirable financial pressure on the business at this early stage. However, mature businesses might also argue that tainted income could be attributed at times over a business cycle due to similar timing mismatches.

g) Share and commodity trading activities

A key feature of many financial service entities in Australia has been the expansion of share trading, commodity trading, stockbroking, and introductory services performed in offshore jurisdictions. The reasons why Australian taxpayers have expanded offshore and not conducted these businesses from within Australia has been due to numerous factors including:

- Offshore regulations may require domestic entities to facilitate such transactions from within their jurisdiction;
- Consumers wishing to conduct trades locally; and
- Offshore share markets require staff in those jurisdictions who have knowledge of that jurisdiction.
Types of Income

Where the CFC takes a principal position in shares or other instruments as part of its active business operation, income arising from such transactions is attributable as passive income. However, this fails to recognise that these operations are not passive investments but rather part of the active operations of a full-service financial services business operating offshore. The reasons for the trade are not to derive dividend income or long term capital gains but rather akin to a trading business where the gains are treated on revenue account and the assets are frequently turned over.

h) **Intellectual property – consistency with capital gains participation exemption**

Attribution will arise where the intellectual property is not held by the company in the group that developed it.

There needs to be consistency in the meaning of passive activities under both the accruals rules and the capital gains participation exemption rules. The interests of legislative simplicity and consistency cannot be well served by having differing notions of what is ‘passive’ for these two sets of foreign income and gain provisions.\(^\text{18}\)

**Are there better alternatives to the CFC approach of positively listing passive income?**

There are two general mechanisms in CFC regimes for identifying whether or not there will be attribution under the various anti deferral regimes:

- The first is to focus on the business of the foreign company. Such focus lends itself to an entity basis for taxation. Examples of this approach include the United Kingdom’s CFC regime and Australia’s FIF measures.

- The second is to focus on the nature of the income or gain derived by the foreign entity. Examples of this transaction approach include the CFC systems of Australia, the United States, Canada and Australia’s FIF measures in the amendments proposed by *Tax Laws Amendment (2007) Measures No.4) Bill 2007*.

In order to maintain a transactional approach (and there appears to be no suggestion in the Discussion Paper that an entity approach will be mandated) it appears that it will always be necessary to identify the particular income and gains to be attributed. An approach that seeks to identify active income would mean that anything that is not so classified will be passive income and potentially subject to attribution. This would not be best practice.

We note that this issue was considered in the development of the CFC measures and the decision to list passive income was based on the belief that ‘... it is simpler, more direct and consistent with the anti-avoidance approach to define the types of income that are considered to be more open to tax avoidance being shifted to low-tax countries’.\(^\text{19}\)

We agree with this conclusion and maintain that the imperative for this approach has grown. As the businesses of Australian multinationals evolve it can be expected that the definition of active income will not accommodate these new forms of active business. It follows that this unanticipated active income will then be artificially classified as passive income. We submit that the primary position should be that income should always default to active income classification.

\(^\text{18}\) March 2007 submission discussion – pages 22-29

\(^\text{19}\) Para 4.15 of Taxation of Foreign Source Income – An Information Paper April 1989.
Active income test

Question 4.3

What other improvements could be made to the operation of the active income and business exemptions to address difficulties and reduce compliance costs?

We submit that the active income test should be retained and that the calculations necessary under the active income test must continue to be based on information that is already easily accessible.

We further submit that the current 5% threshold acts a de minimis test only. This should be lifted to more appropriately identify circumstances where a foreign company has been used predominantly for the purpose of deferral of Australian tax. That is, it should be limited to the cases of worst abuse. The appropriate threshold will need to be identified in the design phase.

However, we submit that the active income test should not be used as a substitute for a more precise definition of active/passive divide.

Comments

From the comments at paragraph 4.20, we have assumed that this question goes to the operation of the active income test under the CFC measures and to the operation of the active business test under the FIF measures. It does not go to the issue of whether or not an active business exemption should be provided under the CFC measures. We have discussed this issue under the heading of “New Exemptions”.

The active income exemption

The active income exemption was developed over the course of the development of the CFC measures. Its present form was, in the main, settled at a time when attribution under the CFC measures was to be on an entity basis. It was intended at that time to determine whether a CFC, as a whole entity, was an ‘active’ company. It is not clear whether there was any substantial reconsideration of the development of the active income exemption after the attribution under the CFC measures was changed to a transactional basis. When applied in the context of an entity basis for attribution, the exemption recognised that a certain amount of income and gains that are correctly categorised as passive income or tainted income will be derived as an incident of the active trade or business of a CFC and should not cause the CFC to be categorised as a ‘passive’ company. That is, it was recognised that active companies do derive passive income.

When applied in the context of a transactional basis for attribution, since the entity categorisation of the CFC as active or passive is not relevant, the exemption operates on one of two bases being:

- It recognises that certain passive income is not, in the context of a particular business, passive income. This implies that the definition of passive is inexact drawn. We expect that the classification of income and gains as passive income will never be able to exactly distinguish between income derived by a CFC that is truly passive and other income.

- Where only a relatively small amount of passive income is derived by the CFC, the compliance and administrative costs imposed under the CFC measures would outweigh any integrity concerns.

In practice, while this is not the stated policy set at a threshold of 5%, the active income test tends to operate as an additional de minimis test.

We submit that the calculations necessary under the active income test must continue to be based on information that is already easily accessible. However, we submit that the active income test should not be used as a substitute for a more precise definition of active/passive divide.
Types of Income

From a compliance perspective, one of the concerns with the application of the active income test under the CFC measures is that the taxpayer will not have the necessary information readily available to perform the active income test. For example, difficulties arise in the application of the active income test to a distributor can be difficult where there is a mixture of Australian suppliers and foreign suppliers, since this requires a bifurcation of the sales where this information would not be readily available from the accounts.

However, we believe that the current active income test which acts as a de minimis exemption should operate as a mechanism for identifying when a company has been used predominantly for the purpose of deferral of Australian tax. That is, the anti-tax-deferral regimes should be limited to the cases of worst abuse. This is consistent with the original purpose behind the active income test.

Although the 5% threshold is inappropriately low, the extent to which the threshold should be lifted is a matter for judgment and should be considered in the design phase.

Base company income

Questions 4.7, 4.8 and 4.9 – Base company income

Do the base company income rules need to be retained? If not, why?

Would the removal of the base company income rules create an unacceptable revenue risk? If not, why?

If necessary, in what way could the transfer pricing rules be strengthened to allow the base company income rules to be repealed, or reduced in scope?

The rules dealing with base company income are redundant and create compliance costs well in excess of any benefit. As such, we strongly submit that the base company income rules should be removed. In particular, tainted services income has no role to play under Australia’s anti-tax-deferral regimes. Any integrity concern is best left to transfer pricing. Further, this aspect of the CFC rules discourages foreign multinationals using Australia as their holding company for operations within the region.

Comments

Our position regarding the removal of the base company income rules has previously been articulated to the Board.20 Put briefly, our position is as follows:

- The development of the transfer pricing rules since 1990 obviates the need for attribution of base company income as an integrity measures. Removal of the attribution of base company income does not demand that the transfer pricing rules are strengthened. Rather, it the strength of the existing transfer pricing rules that allows for the removal of the attribution of base company income.

- Where the attribution of base company income arises from operations in a higher tax jurisdiction, there is no incentive to shift profits (and, incidentally, the revenue raised from the attribution is reduced to the extent of the tax paid in the foreign jurisdiction). To this extent the integrity risk is minimal.

- As a taxpayer must comply with the transfer pricing rules in any event, the attribution of base company income creates two compliance costs for the taxpayer - compliance with the arm’s length pricing and compliance with the CFC rules.

20 Page 22 of the March Submission
Types of Income

- The base company rules, developed in Australia in the 1980s and modelled on US policy analysis of the 1960s, represent a policy developed in a pre-global economy. To the extent that the attribution of base company income acts as an administrative measure that reduces the administrative costs associated with transfer pricing, the disadvantages for the conduct of normal business activities in the global economy outweigh the administrative benefits.

Regarding the last point, the administrative saving asserted in not having to carefully monitor transfer pricing issues has not to our knowledge been quantified. Similarly, the effect on business can only be illustrated anecdotally.

Further, we note that the issue of the inclusion of base company income in attributable income is solely a consideration where the foreign entity is controlled. If the anti-tax-deferral regimes were to be harmonised there would be no role for base company sales income (since it acts as an adjunct to transfer pricing which affects only transactions with associates). Further, from a compliance perspective, minority investors could not be expected to be able to identify tainted services income.

Inappropriate coverage of tainted services income

Our views on the inclusion of tainted services income are set out in our March Submission. Put simply, we see no basis for the inclusion of services provided to residents of Australia as tainted services income.

The issues below have been covered in our previous submission and are summarised as follows:

a) Contract manufacturers

Where a foreign manufacturing operation is established (for example in China) which acquires raw materials from an Australian associated entity, the activities are exempt activities only if the employees of the foreign subsidiary actually add value to the goods. Unfortunately, if an unrelated contract manufacturer is used to add the value, this rule cannot be satisfied and the income will be tainted sales income. In some countries, for example China, it is very difficult if not impossible for a foreign owned entity to establish a local factory, and foreigners are encouraged to have production undertaken for them by locally owned contract manufacturers in the supply chain. As a result, the base company rules clearly operate inappropriately in this case.

b) Support services

If a foreign company which produces goods also establishes a service/warranty activity which provides services to the purchasers including Australians, this activity will not be an exempt activity. It will lead to tainted services income to the extent that the services are provided to Australians. Examples where this will arise include contract software, contract R&D activities affiliated with foreign technical centres and services from foreign back office service facilities.

c) Distributor (Australian product) or distributor to Australian associates

If a foreign CFC commences to operate as a distributor, acquiring Australian products and acting as a regional distributor to resell the products to unrelated parties, that distribution function will constitute tainted sales income.

Conversely, if that foreign company operates as a distributor of foreign sourced product to Australia then any sales to Australian related companies will constitute tainted sales income. While it might be said that this was a design feature of the base company rules, it is inconsistent with typical commercial practice often found, where a foreign CFC operating in a particular jurisdiction will identify and source attractively-priced or highly marketable product which can be resold by the group in Australia, and operates in compliance with transfer pricing rules by acting as a distributor in the supply chain. Unfortunately such activity, even if conducted in full conformity with the transfer pricing rules, creates attribution.
The exempting activities are very restrictive, and require that employees of the actual overseas entity itself ‘add value’ to goods under the substantial alteration, or substantial manufacture, or substantial production tests. Unfortunately these ‘added value’ rules do not apply to services delivered by the CFC.

International comparisons and trends

We note that the United States is reducing the scope of the base company income rules.

This substantial policy change reflects that the base company rules must be limited to clear instances of diversion of income from the US, where the CFC does little more than act as a front or intermediary for services the value of which is largely provided by a US resident. We submit that this is an attractive model for Australia’s base company rules to be modernised.

We note further that various countries other than the US do not attribute sales or services income, because of the inevitable compliance deadweight which arises from the operation of the anti-tax-deferral regimes to cross border business.

A potential driver for the base company rules may have been an element of protection for Australian business. As the Board notes at paragraph 4.36:

‘Whether the base company income rules should play a role over and above the transfer pricing rules in an increasingly globalised economy depends on competing policy objectives, some of which lie outside the tax system objectives outlined in chapter 2. The use of the tax system to achieve non-tax policy objectives can add to the complexity of the system.’

If it is submitted to the Board that the base company rules are needed to protect Australian jobs as a non-tariff protectionist device, then we suggest that this contention should be tested with Government agencies such as the Productivity Commission for consistency with Australia’s broader economic objectives and the reform of Australia’s tariff policies in the 1990s. In today’s global environment we seriously doubt that this policy can remain relevant. Moreover, with an aging population and a tight employment market these arguments can hardly be substantial.

As Treasury Secretary Dr. Ken Henry has stated:

“It is pretty well accepted these days that Australia’s economic interests have been well served by trade liberalisation and globalisation.

And yet, even in this country, the accelerating liberalisation of trade in services has attracted the pejorative label of ‘off-shoring’, with India usually identified as the winner and the industrialised world, Australia included, as the loser.

‘Off-shoring’ used to be called importing. And that is what it is: importing services. It is true that India gains from being able, because of ICT developments, to export services to the industrialised world. The ICT revolution, initiated in Silicon Valley, and considered by many to have given America ‘new economy’ status in the 1990s, turns out to be a precious gift to the people of India.

But the industrialised world, Australia included, also has much to gain from ‘off-shoring’ – most obviously through a lowering of costs to business and, ultimately, consumers.

Opposition to ‘off-shoring’ is based on the same protectionist nostrums that were once used to support the high tariff wall that a generation of Australian policy makers has been busy dismantling. It may be dressed in different garb, but it is no more respectable.”

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21 Refer to section 447 (4) – (4B)
22 Managing Prosperity: Address to the 2006 economic and social outlook conference, Melbourne 2 November 2006, Dr. Ken Henry, Secretary to the Treasury.
Types of Income

We agree.

Listing of countries

Questions 4.10 and 4.11

Are there alternative approaches that, either alone or in combination, would obviate the need for a listed country approach? If so, what are the advantages and disadvantages over a listed country approach?

Would the listed country approach need to be retained if the definition of passive income was narrowed (or active income better targeted)?

We submit that, irrespective of whether additional exemptions are introduced or passive vs active income is better defined there is no basis for the removal of the listing approach.

We further submit that there should be a longer list of listed countries, albeit this does not need to be as extensive as the original listed countries.

We emphasise our support for the RITA Tranche 3 proposal not yet legislated, for non-attribution of non-BELC subsidiaries of BELC CFCs.

Last, we submit that estimates should be made of the administrative cost associated with monitoring this list of countries. This would allow for a reasonable basis for estimating the cost/benefit analysis of the expansion of the list of countries.

Comments

There are no comparable alternative approaches that would obviate the need for a listed country approach, and the listed country approach needs to be maintained. Although not identified as a question, we see the real issue as being whether the listed country approach should be extended.

As identified in the Discussion Paper, the listed country approach acts as a proxy for an exemption based on comparable tax that requires detailed calculations of the effective tax rate. To date, our experience is that the listing approach creates the single greatest saving in compliance costs. This reduction in costs should not be underestimated.

We take issue with the statement at that ‘there is less need for a listed country approach if active income is properly excluded’. This would only be the case if the tainted income of the CFC was precise, readily identifiable and less extensive than the designated concessions of a particular country. We note that the basis for maintaining a small list of broad-exemption listed countries (as they were then known) was entirely independent of the definition of tainted income.

Irrespective of the improvement in the targeting of the anti-tax-deferral regimes, the removal of the listed country approach will increase the compliance burden in respect of companies in listed countries if those companies have any tainted income. This will often arise in circumstances where, in the absence of a specific concession in one of the high tax countries, there is little or no risk that taxpayers would divert income to those countries in order to avoid tax.

We submit that the only relevant issue is whether the existing list of countries should be extended.

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23 Para 4.49 of the Discussion Paper. The calculations necessary under a comparable tax rate exemption impose their own compliance burden (we have subsequently discussed the possibility of such an exemption for unlisted countries).

24 Para 4.51 of the Discussion Paper
It is self-evident that a longer list of listed countries will reduce compliance costs. We understand that the ATO considered it was not administratively feasible for the ATO to monitor the initial list of 60+ countries listed. However, we note that the compliance burden for taxpayers is greatest where a country is a significant destination for Australian investment. Therefore, the number of countries to be listed need not be as extensive as the number of pre-1997 listed countries to achieve significant reduction in compliance. For example, the original list of 60+ countries included Bangladesh, Brunei, Bulgaria, Iran, Kenya, Kiribati, Myanmar, Pakistan, Saudi Arabia, Solomon Island, Tokelau, Tuvalu, and Zimbabwe.

We submit that under an expanded list of listed countries it is unlikely that there would be an imperative to list these countries. The revised list would therefore some no more than (say) 20 to 30 countries.

These 20 to 30 countries will generally have a DTA with Australia which would allow for relatively straightforward access to information regarding the tax regimes of these countries. For example, it is conceivable that China could be a listed country on the basis that it has a comparable rate of tax, Australia has a DTA with China, and China is a major destination for Australian investment and there is [sentence incomplete].

We accept that a listing approach imposes a slightly higher administrative burden on the ATO. However, we would be surprised if the ATO found it difficult to monitor the current list of listed countries. Further, it is not clear to us why a longer list should not be manageable from an administrative perspective. If the countries on an extended list are initially restricted to countries with which Australia has a double tax agreement the list should be readily administrable. 25

We submit that, while these assertions regarding the administrative costs can be accepted as reasonable where the list of listed countries is extensive (as was the original list), estimates should be made of the likely administrative costs associated with a less extensive list to determine the true cost. For example, if a reasonable estimate of the cost of monitoring the list was (say) two administrators full time per annum, this cost could be readily ascertained. A cost benefit analysis could then be applied to confirm the justification for this approach.

Where appropriate, the Government has already committed to exempt from attribution under the CFC measures lower tier subsidiaries of a CFC resident in a listed country, irrespective of whether that CFC is a resident of a listed country. This is discussed below.

The Discussion Paper appears to express the concern that the extension of the list of listed countries will mean that there is little scope to exempt such lower tier subsidiaries. However, to date, no such exemption has been provided, and it is foreseeable that such exemption will not be provided for all of the countries currently treated as listed countries (the United States is the primary example where the Government’s announcement should apply). Therefore, we do not consider that this is an impediment to extending the number of listed countries. 26

As far as the development of criteria for listing is concerned, we note that the Treasurer has announced that the Government, following a recommendation by the Board of Taxation, would develop and publish criteria for declaring further countries as listed. 27 We strongly support such action.

Publishing criteria used in assessing a country’s suitability for inclusion certainly will provide transparency and certainty of the underlying policy. The 2007 Discussion Paper outlines the following parameters:

- Company tax rate, treaty country or major trading partner status are important indicators but cannot alone be used to decide if a country can be listed.

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25 Each of Australia’s treaty partners already commits to exchange of information and, we understand, provides annual updates on changes to its tax laws.

26 The elimination, maintenance or extension of the listed county exemption might have further relevance in a harmonised regime. We have commented on this matter in our submissions regarding Chapter Six of the Discussion Paper.

An up-to-date list of eligible designated concession income would need to be maintained if the current hybrid attribution approach to the CFC regime is maintained.

We accept those parameters. The Government agreed in May 2003 to develop and publish criteria for listing. In extending the list, factors to be considered might include the following:

- The country must have a headline corporate tax rate comparable to Australia’s.
- The country must have a comprehensive income tax base. However, the country need not have a tax on capital gains or have a CFC system. Further, no regard should be had to particular concessions that are commonly available in Australia (for example, R&D incentives, film incentives etc).
- It would be preferable if Australia and the country have entered a DTA. The existence of a DTA means that Australia is already reasonably comfortable that the country is not a tax haven. Further, and more importantly, the DTA ensures a level of sharing of information between the countries so that changes in the tax rules of the country can be readily assessed initially and on an on going basis.
- As far as is possible, political considerations should be avoided in the decision on whether or not to include a country on the list of listed countries.

Non-BELC subsidiaries of BELC CFCs

This discussion relates to a policy previously recommended by the Board and adopted by the Government, which is presumably being developed by Federal Treasury which is held over pending the current review by the Board. This reform is significant in the treatment of listed countries.

In its RITA review released in 2003 the Board recommended that Australia should eliminate the attribution of the income of non-BELC subsidiaries of BELC CFCs (where the BELC has a broadly comparable CFC regime to Australia’s CFC regime)

The Government accepted this measure and the Treasurer stated in the 2003 Budget materials that Tranche 3 of the RITA measures would include measures to “eliminate attribution of the income of non-BELC subsidiaries of BELC CFCs, where the BELC has a closely comparable CFC regime.”

CFCs in Non-BELCs controlled by BELC CFCs

The second stage applies to the income that may be attributable to Australian resident taxpayers because of their interest in a BELC CFC, which in turn, has a controlling interest in a non-BELC CFC (ie where indirect control of a non-BELC CFC through a BELC CFC exists).

Currently, the income of a non-BELC CFC controlled through a BELC CFC may be attributable under the CFC regimes of both the BELC and Australia. While the law currently makes allowance for the attribution by other CFC regimes, this attribution ‘duplication’ can be compliance-intensive and, where the BELC CFC regime is closely comparable to Australia’s, may result in little or no Australian tax being paid.

By removing the Australian CFC regime from applying to the extent that a closely comparable BELC CFC regime also applies (attributing the income of a non-BELC CFC), this measure aims to remove unnecessary compliance effort without a significant impact on integrity or the revenue. In effect it ‘pushes down’ responsibility to the closely comparable BELC CFC regime to ensure income is appropriately attributed and tax is not deferred.

To ensure sufficient integrity, a BELC CFC regime will need to be considered closely comparable in certain key respects, including:

- mechanisms used to determine what countries receive jurisdictional exemptions from attribution;
Types of Income

This is an important reform, with significant impact on reducing significant compliance costs undertaken by Australian outbound investors. This is best illustrated as follows:

Under Australia’s current policy settings, if an Australian company establishes a US CFC, which conducts business globally – irrespective of the industry – then the Australian CFC measures cause a substantial compliance activity onto the lower-tier subsidiaries unless they themselves in listed countries. Given the commercial development of Australian companies and globalised activities, it is unrealistic to expect that Australian companies with listed country CFCs will confine their activities only to other currently-listed countries.

Delivery of this reform will make a significant difference to the compliance costs of Australian businesses investing into CFCs in comparable-tax countries, where those CFCs in turn invest into other countries.

We submit that Australian companies should not be required to carry out CFC calculations in relation to subsidiaries which are owned by comparable tax foreign countries.

We note from the Treasurer’s press release that further work would be required to determine which foreign BELC jurisdictions were sufficiently closely comparable for purposes of this reform.

We further submit that, if it is considered that there was some revenue risk from allowing this compliance improvement in relation to lower tier subsidiaries below all 7 currently-listed countries, this concession should be allowed at minimum for lower tier subsidiaries owned by a US CFC.

Selecting the US, at minimum, for early implementation of this already-announced reform is appropriate because the US has a very strong and fully developed system for the management of foreign controlled companies through its sub-part F and related rules. [Under those rules, the income of subsidiaries of US companies is either attributable to the US companies on a direct basis or, when the foreign subsidiaries’ income is paid to the US company by way of dividends or other distributions, US taxation is imposed.]

De minimis exemptions

Questions 4.12 and 4.13

Should the de minimis exemptions operate on a more consistent basis across the regimes? If so, how could this be achieved?

Should the current thresholds for the de minimis tests be adjusted, having regard to the potential tax deferral that could arise by increasing the thresholds? What other improvements should be considered?

We submit 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.

- the control test, which determines what companies are regarded as CFCs;
- the parameters of any active income test used; and
- the income items that are subject to attribution.

The impact of a BELC’s conduit arrangements on attribution will also need to be considered.”
Comments

As noted in the Discussion Paper the de minimis exemptions vary between the various anti-tax-deferral regimes. We suspect that the decisions on the quantum of each of the de minimis exemptions were arbitrary. Further, the form of the exemptions may have been determined having regard to different considerations, and that some of these considerations may no longer be relevant.

There are two bases for a de minimis exemption. The first is that, in an anti avoidance measure, it recognises that at a certain level of investment, tax deferral or tax reduction, tax avoidance is unlikely to be a motivating factor. Second, a de minimis exemption can be struck at a point where the tax raised would not outweigh the administrative and compliance associated with the measures.

We do not consider that the balanced portfolio exemption is truly a de minimis exemption as the considerations are different, contrary to the comment in the Discussion Paper. We view this exemption as a recognition that a particular category of taxpayers must as a commercial imperative hold investments that might otherwise give rise to attributable income. Further, we are not solely concerned with the inconsistencies between the de minimis levels between each of the measures but also with the efficacy of the exemption within the measures.

Some of the issues with the current de minimis exemptions are as follows.

- Under the CFC measures, a de minimis exemption applies only for CFCs in listed countries. However, when the CFC measures were introduced, there were 60+ listed countries. The change in the basis for listing of countries has reduced the potential for the application of the de minimis exemption to only 7 countries. It does not appear that detailed consideration was given to the effect that the changes to the listing would have on the de minimis exemption.
- As a practical matter, because the de minimis exemption under the CFC measures operates on the basis of the lesser of 5% and A$50,000, in our experience the exemption applies to few investments. Also, the exemption level was set when the cost of compliance was unknown.
- As a compliance saving, in our experience the efficacy of the de minimis exemption under the CFC measures is questionable. In order to obtain the benefit of the de minimis exemption it is necessary to in any event go through a significant part of the compliance imposed under the CFC measures (for example, one still needs to identify the active/passive income and whether the amount will be notional assessable income). Further, a CFC may fail the active income test because its tainted income is greater than 5% of turnover but the subsequent CFC calculation may produce an immaterial attributable income.
- The de minimis exemption under the transferor trust measures of $20,000 or 10% of the net income from all trusts does not appear to have any basis.
- The $50,000 market value exemption under the FIF measures appears entirely arbitrary.

Given the above, and that the basis for the distinctions between the de minimis exemptions is not readily ascertainable, we consider that it is feasible to disregard the existing de minimis exemptions and start anew. Establishing these thresholds is a matter of judgement and is beyond the scope of this submission. However, we have set out below general comments on some of the issues involved. The amounts used below are merely for illustrative purposes.

One issue is whether there should be an absolute dollar amount below which there would be no attribution. This requires an estimate of the potential tax that might be raised and the compliance cost, also taking into account horizontal equity. The cost/benefit will change depending on the type of taxpayer as follows:

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32 Para 4.56 of the Discussion Paper
Types of Income

- For a corporate taxpayer with significant offshore activities, compliance costs of upwards of $250,000 are not uncommon. This would imply that for these taxpayers the balance would be attributable income in the order $1,000,000. If it were assumed that there are no expenses which reduce notional assessable income, a tainted turnover of $1,000,000 would approximate this compliance cost. This response focuses on policy improvement geared to reducing compliance costs. The balance of this proposal with integrity concerns could be discussed in the detailed design phase.

- For an individual taxpayer, even in the SME market, full compliance with the CFC measures is unlikely to reach $250,000. However, a cost for full compliance in the region of $50,000 would not be unreasonable. Again assuming there are no expenses which reduce notional assessable income, this implies that a de minimis test with a threshold is $100,000 of tainted turnover. Again, this does not take into account an increase in the threshold to take account of integrity risks.

- For an individual taxpayer with an investment in a FIF deriving wholly passive income, it is unreasonable to expect a compliance cost in the region of $50,000. However, the present asset based test is already $50,000 which (at the deemed rate of return) implies a threshold of approximately $4,000 of income ($50,000 x 10.198% x 46.5%). Increasing the threshold to $100,000 would not be unreasonable. Looked at another way, it is unreasonable to expect that a person would invest in FIFs to gain a tax advantage of only $4,000. Therefore, an appropriate threshold for individuals and small business might be (say) $100,000 of tainted turnover or $100,000 value of investment.

We also note that, given the cost of establishing and maintaining a foreign entity is significant, we doubt that abuse (such as splitting the income between different foreign entities to gain the benefit of several thresholds) would be an issue. In any event, if this is considered an issue simple integrity measures could be included.

Another issue is a percentage de minimis exemption. At present, the 5% threshold under the de minimis exemption under the CFC measures acts as a cap (that is, it denies or restricts the benefit of the $50,000 de minimis exemption). If the quantum of the de minimis is appropriately set, there would be no need for a percentage based cap. If a percentage cap was considered necessary, despite these comments, it should be far higher than 25%, in our view.

Further, it is not clear why an alternative percentage based de minimis threshold cannot be incorporated. That is, the de minimis should be the greater of the dollar amount or a percentage of (say) tainted turnover to turnover. To some extent, as noted, the active income test already acts as a percentage based de minimis test, at least in relation to tainted income. It may be that a redesigned active income test will obviate the need for a separate percentage based de minimis test.

Purpose or motive test

Question 4.17 – Purpose or motive test

Would a purpose or motivation test meet the policy objectives outlined in Chapter 2? If so, how could such a test apply to provide reasonable certainty in a self assessment environment?

We submit that a purpose or motive test is consistent with an anti-tax-deferral regime that is concerned with the avoidance of tax. However, a purpose or motive test must not be a substitute for any other exemption.

We further submit that a purpose or motive test will allow for the reduction of the administration of the anti-tax-deferral measures by reducing the necessity to continually amend the regime as taxpayers’ means of conducting business offshore change.
Last, we submit that the administrative difficulty of reviewing the purpose or motive test is overstated. An exemption under the purpose test would need to be asserted by the taxpayer and could be notified to the Commissioner in the taxpayer’s income tax return. This process would facilitate ready identification of positions taken by taxpayers.

Comments

This question explores the potential application of a purpose or motive test in the design of the new anti-tax-deferral regimes measures. The Discussion Paper notes, that ‘such a test may be appropriate if the purpose of the attribution regimes is the prevention of actions undertaken predominantly to gain the advantage of tax deferral’.

We agree that, the key challenges with a purpose or motive test are that in a self assessment environment taxpayers must be able to apply the test are a reasonable degree of certainty; and that the Commissioner must be able to administer the test without extensive administrative costs.

In the context of an international tax regime that is primarily based on capital import neutrality, as we understand it, there are two bases upon which the CFC measures may be developed. The Board has stated that on balance, it believes a CIN paradigm should be maintained. We agree with the Board’s view. In this context, it has been, and remains, our position that the proper justification for attribution measures is to prevent the deliberate minimisation of Australian tax in circumstances where there is an integrity risk.

The Board has also stated what it considers are the more elementary policy objectives. Of these, we submit a purpose or motive test is conducive to achieving four of these objectives, being that

- Australian businesses with active offshore exposure are not made uncompetitive;
- That Australia remains an attractive place to do business and to locate regional headquarters;
- Appropriate account is taken of market and business factors and that economic efficiency applies to minimise distortions in commercial choices.

Therefore, apart from any perceived administrative complexity, we believe that the CFC measures dictate that a purpose or motive test should be included.

However, we would be concerned if the potential inclusion of a purpose test was seen as a justification for less precision in the development of other exemptions from and modifications to the CFC measures.

a) Australia remains an attractive place to do business and to locate regional headquarters

Aside from its impact on Australian investment, one of the aims of the RITA reforms was to make Australia an attractive place for a foreign company to locate its regional headquarters. A second aim was to allow Australian companies the opportunity to raise foreign capital to invest offshore without an imposition of Australian taxes on the foreign investor. The dividend exemption, the participation exemption and the conduit foreign income measures addressed both of these concerns. The CGT non-resident exemption addressed the latter.

However, while the RITA reforms were beneficial with respect to attracting companies to locate to Australia the CFC measures continue to act as an impediment to establishing Australia as a regional holding company location.

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33 Notwithstanding the difference between a purpose and a motive test, we have referred to the test as a purpose test.
34 Para 4.72 of the discussion paper
35 We note that any purpose test would have limited relevance where tainted sales and tainted services are concerned, since we submit that the transactions generating such income are seldom entered for the purpose of minimising Australian tax or, to the extent that they are, the transfer pricing provisions are sufficient to deal with the matter.
Complexity is only partially responsible for this. Far more significantly, it is difficult to explain to potential investors why they have a risk of attribution of tainted services and tainted sales income to Australian headquarters entities or the reason why categories of income and gains are ‘passive’. While reforms may make the CFC measures more consistent and therefore less complex, international experience shows that the rules are still, in general, not simple and need modernisation.

Further, it is self evident that a foreign resident would not establish a regional holding company in Australia to avoid Australian tax. Therefore, these investors would find great comfort in a purpose or motive test.

**b) Australian businesses with active offshore exposure are not made uncompetitive and appropriate account is taken of market and business factors, and that economic efficiency applies to minimise distortions in commercial choices**

In regards to the consideration of a purpose test, we believe that these factors can be considered as one.

One lesson from the current experience with the CFC measures is that, in a globalised economy, Australian business must be responsive to be competitive. Despite the best of intentions, we suggest that the Government’s priorities combined with finite resources will inevitably mean that amendments to the CFC measures will significantly lag changes to the global economy.

Because it will operate on a ‘real time’ basis, a purpose or motive test assists in ensuring that the CFC measures do not impinge on the ability for Australian companies to operate in a global economy as that economy changes.

**c) The rules are simple to understand and operate with proper account made of complexity; and compliance and administrative costs and the revenue does not bear an unacceptable level of risk**

Again, we believe that these factors can be considered as one.

We submit that a purpose or motive test, of itself, does not create a risk to the revenue. Rather, any risk to the revenue arises only if, in a self assessment environment, insufficient resources are allocated to reviewing claims for exemption under the purpose test. It would appear that the primary issue raised in the Discussion Paper is with the administrative issues of certainty in a self assessment environment. Often the comparison of the experience with a purpose test is based on the experience with Part IVA.

If the CFC measures were more appropriately targeted, the purpose test with only residual operation might not occupy significant resources (of either the taxpayer or the ATO), provided that the factors were suitably drawn.

We submit that a purpose or motive test under the CFC measures would not be as administratively complex as the purpose or motive tests under Part IVA. In particular, Part IVA operates at large and must be considered in all cases where (amongst other things) there is a claim for a deduction or reduction of assessable income. This makes its potentially applicable to a large number of cases.

Since the CFC measures apply to a relatively small number of taxpayers and within that only to limited categories of income, we submit that it is reasonable to assume that there are only a small number of cases where the purpose or motive test would be relevant. Therefore, much less administrative resources would be allocated to reviewing the taxpayer’s purpose or motive than is the case the case under Part IVA.

As far as the impact on the taxpayer in a self assessment environment, some risk is always borne by the taxpayer for any claim made without a private or public binding ruling on the matter. We do not consider that a purpose or motive test as a ‘sweep up’ provision will create difficulties, in contrast to
the circumstances where the purpose or motive test was the primary test for whether or not the CFC measures applied. It is also reasonable to assume that the purpose or motive test would not need to be reviewed each year. Provided the activities of a particular CFC did not change from year to year, there would be no need for the ATO to revisit the matter.

As far as the integrity issue is concerned, in contrast to anti avoidance provisions such as Part IVA where the relevant transaction must be identified by the ATO, a purpose or motive test under the CFC measures would need to be asserted by the taxpayer. It would be a simple matter for this assertion to be reported to the ATO by way of the taxpayer’s income tax return.

Factors that might be considered

While not attempting to be definitive on the matter, such factors might include the following:

- Whether the relevant income of the entity was generated in the conduct of business activities, including:
  - Whether the passive income was generated from funds injected in a start-up phase (this would only be relevant where a specific exemption was not granted for reasons other than the potential inclusion of a purpose or motive test).
  - Whether the passive income was generated from funds remaining in the wind-down phase of a business (this would only be relevant where a specific exemption was not granted for reasons other than the potential inclusion of a purpose or motive test).

- Whether the foreign entity’s headline rate of tax was a given percentage (say 75%) of the Australian tax rate. This factor would be either positive or neutral, and it could not be adverse to the taxpayer.

- Whether the CFC is generating significant foreign losses and whether the passive income is unconnected with the ordinary business. This might also include a case where the CFC had foreign losses prior to the injection of the funds generating the passive income.

- In the case of liquid assets, whether there are commercial reasons why the funds generating the passive income have been retained by the CFC (e.g. exchange controls, financing/security requirements).

- Whether the foreign company is listed on a foreign stock exchange and/or widely held (this would only be relevant where a specific exemption was not granted for reasons other than the potential inclusion of a purpose or motive test).

Other approaches to targeting under the FIF measures

Questions 4.14, 4.15 and 4.16

Could the exemptions for entities or investment arrangements that pose little or no tax deferral risk be improved? If so, how?

How could the exemptions be modified to ensure greater investment neutrality?

Are there other exemptions or approaches that could be considered? If so, why?

We submit that:

- Where the shareholder of the foreign company is an AFI or AFI subsidiary, products and services falling under ‘financial intermediary services’ should not be regarded as non-eligible activities.

- The exemption for foreign banks and general insurance companies should be broadened.
The listed country exemption should be extended beyond the United States. The factors that should addressed in the decision to list a country need to be addressed during the design phase.

Comments
Some of the issues that have arisen under the FIF measures are discussed below.

Financial Intermediary Services
Whether or not an interest in a FIF is exempt under the general active business exemption provided for companies turns on whether the company is principally engaged in non-eligible activities. Financial intermediary services are listed as non-eligible activities.\(^{36}\)

We submit that where the shareholder of the foreign company is an AFI or AFI subsidiary, products and services falling under ‘financial intermediary services’ should not be regarded as non-eligible activities.

Treatment of Foreign Banks
Under the existing exemption for interests in foreign banks, the requirements which must be met for the exemption to apply include stock exchange listing and trading requirements.\(^{37}\)

This exemption is gaining importance as Australian banks are increasingly considering holding non-controlling interests in foreign banks as the size of the investment may be limited by regulatory requirements in the foreign country. China for example limits the investment of foreign ownership in local banks to 20%. Otherwise a non-controlling stake may simply be taken to enter a new market.

The current exemption requirements are inhibiting Australian banks striving to conquer new markets. Removing these restrictions will lift the competitive disadvantage. In particular, Australian banks currently take a strategic investment in foreign banks which may be a few years away from stock exchange listing or are in a country without a developed stock exchange, such as Vietnam. Further, even if the foreign bank is listed, the trading requirement that mandates that the class of shares in the foreign bank must be widely held and actively traded on regular basis in the period for which the exemption is sought should be removed. Whilst the term ‘widely held’ is not defined, the requirement is generally difficult to meet in relation to strategic investments typically in countries where the banking industry is still developing.

Exemption for Certain Entities in Listed Countries
We submit that total exemption under the FIF measures for interests in certain US entities is overly restrictive. While we accept that at the time the exemption was introduced there may have been a perception that one could safely list the US but not do so for other countries, we submit that there is no basis in policy for the restriction of the list in this manner and that a wider list of countries is appropriate.

Treatment of General Insurance Companies
We submit that the current exemption in the FIF rules for non-controlling investments in foreign general insurance companies\(^{38}\) should be expanded:

- The current exemptions have not been updated for over 14 years and are inconsistent with modern business practices;
- The current exemptions are inconsistent with the policy behind the CFC provisions (as recently amended);

\(^{36}\) Refer to Schedule 4 of Part XI  
\(^{37}\) Refer to Division 4 of Part XI  
\(^{38}\) Division 6 of Part XI
Types of Income

- Some investments are restricted to a certain threshold (e.g. 20%) because of foreign Government regulations;
- Some investments cannot be in listed entities (e.g. where the foreign insurer is currently or formerly Government owned).

Consistent with our comments regarding the restrictions on the exemption for interests in foreign banks, the widely held and actively traded requirements impose restrictions that are not justified by any integrity concern.

If there was a residual integrity concern, an expanded exemption would only apply to appropriately regulated Australian insurance companies that are themselves investing in non-controlling interests in appropriately regulated foreign insurance companies. This would remove the need for the shares to be listed, widely held and actively traded.

Managed Funds

Questions 4.18 and 4.19

For managed funds, how could the rules better target offshore income accumulation?

Could any changes for managed funds apply more broadly to cover, for example, companies? If so, why and how?

We submit that:

- The threshold for the balanced portfolio exemption should be lifted substantially and that the level at which the threshold is set should be the subject of consultation with the funds management industry during the design phase.
- Investments that arise as a result of particular investment strategies that will not give rise to deferral concerns should be treated as active FIFs.
- Funds managers should be provided with an election to deem a disposal of the interest in a FIF at the end of the taxpayer’s year of income. Effectively, this is an election to mark these FIFs to market, which is not present in the current FIF rules.

Comments

A strategic area of growth for Australia is its funds management industry involving world class skills in property management including infrastructure projects. The industry generates substantial employment and income for Australia. In our view the characterisation of property investment in tangible, substantial properties and related projects as passive, save for certain limited concessions, represents a misalignment of Australia’s tax policy with the policy settings for growth of the Australian economy.

As previously discussed in the Overview, we do not dispute the role that an anti-tax-deferral regime has in preventing the unfettered use of foreign passive funds to minimise Australian tax. However, we suggest that the current FIF measures do not fulfil this role. Certainly, the funds management industry was still developing at the time the FIF rules were introduced. We suggest that the following exemptions should be considered:
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a) **Balanced Portfolio Exemption**

The threshold for the balanced portfolio exemption should be substantially lifted. We envisage that this would be the simplest method of reducing the adverse impact of the FIF measures on the funds management industry.\(^{39}\)

While it would still require the same compliance process, the compliance costs are likely to be significantly reduced. This will occur because a greater number of investments that cannot easily be classified can be treated as passive investments with a reduced risk that these investments will cause a breach of the balanced portfolio exemption.

Further, we would be concerned if this was the only initiative. This concern arises because there is no guarantee that the extension will be significant or that it will be permanent. We therefore suggest that this must not be viewed in isolation. If it was considered that a balanced portfolio exemption operating at this level for all taxpayers would give rise to inappropriate opportunities for tax deferral in relation to privately managed wealth, we suggest that such a balanced portfolio exemption would be appropriate for Australian investors which were widely held, and conformed to market practice including distributing their income appropriately (as distinct from operating as ‘roll up funds’ offering capital management with no distribution back to Australia).

b) **Listed countries**

Obviously, increasing the list of ‘listed counties’ under the FIF measures would substantially assist the funds management industry for substantially the same reasons it assists companies in the CFC regime.

c) **Index funds and specific strategies**

Treatment of investments that are based on particular investment strategies that will not give rise to deferral concerns should be treated as active FIFs. For example, any investment strategy that tracked a particular index could be excluded. We accept that there would be an increased administrative cost associated with this approach. However, this must be balanced against the cost of compliance. If suitable criteria could be established that identified the particular investment strategies the administrative cost would be reduced.

Generally, we are not predisposed to a policy that requires for its operation extensive approval by administrators and consequent monitoring of the approved investment. However, in this case the administrative and monitoring process would be confined to one industry only. Given the potential benefits to a sector that is managing the savings of Australians, we consider that this approach deserves closer consideration of the criteria that might be established and the administrative cost.

d) **Distribution requirements**

We agree with a distribution requirement being used as one of the mechanisms to further target the rules dealing with investment funds, in order to provide additional assurance that legitimate investments by Australian managed funds in foreign collector funds was not being inappropriately exposed to the anti-tax-deferral regimes.

A distribution requirement should not be the sole exclusion method and can not be appropriate for every circumstance. In particular, there are funds that invest in foreign funds engaged in particular projects such as infrastructure projects or property development projects with a substantial lead time. In such cases the foreign investment vehicles might report accounting profits but will not have liquid cash available for distribution, especially during construction or establishment periods in relation to major property development activities or major infrastructure projects. That said, an exemption or

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\(^{39}\) At para 4.87 of the Discussion Paper 25% is suggested for the new level for the balanced portfolio exemption. The appropriate level would be a matter for discussion with the funds management industry.
Types of Income

exclusion from Australian anti-tax-deferral regimes for foreign funds which undertake distributions of their income would represent a supplementary mechanism to further narrow the focus of the anti-tax-deferral regimes applicable to managed funds and investment funds.

We submit it is flawed policy to deny an exemption that is justifiable, on the basis that the exemption would create administrative and compliance difficulties for some funds where it would not do so for others. 40

Many funds will distribute income, profits and gains as they are derived and other funds will not. Our experience with the FIF measures shows that many funds managers will take action to ensure that the administrative burden of the FIF measures does not arise. Therefore, it is reasonable to expect that many funds’ current operations would benefit from the distribution and other funds will change their behaviour and distribute sufficient funds to avoid the detailed application of the FIF measures. Therefore, the inclusion of the distribution exemption would cater for distributing funds and might also provide to other funds a simple mechanism for removing the compliance associated with the FIF measures and without risk to the revenue.

In any of the funds described above and below, it will be evident from the terms of the fund deed that the fund will distribute all cash.

e) Infrastructure funds and private equity funds

Regarding infrastructure and private equity funds, given the importance of the funds management industry not only to the returns available for Australian savings but also for the growth of the funds management industry, it is an imperative that the anti-tax-deferral measures (primarily at the moment the FIF measures) does not affect the investment decisions made where there is no realistic integrity risk.

Example 1 – Foreign funds managers

Assume that a foreign funds manager identifies an investment in a company carrying on an infrastructure project. It wishes to take up 100 of the shares in the infrastructure company. Potential investors include investors resident in Europe, North America and Australia. The investors from the United States have different tax profiles to the investors from other countries and are used to funds being structured in a particular way. To accommodate these investors a fund is established solely for those investors. The European investors also have different tax profiles as do the Australian investors. Not all investors can be accommodated within the same fund. Therefore a series of companies or limited partnerships are established as follows.

The first fund would be one for the Australian investors, although it might not be limited to them. The funds will then be invested in a second fund established for the investors from Europe, although again it might not be limited to them. The combined funds will then be invested into another fund for the investors from the United States. All of these entities are likely to be established in a country that imposes no tax. The combined funds may then be used to purchase the company carrying on the infrastructure project. Alternatively, for foreign tax reasons usually related to withholding taxes, the combined funds may be invested in a further foreign entity for investment into the company carrying on the infrastructure project. This is not an uncommon structure.

40 In the development of the FIF measures, the Government accepted that a distribution exemption was appropriate but doubted whether it could be applied in practice – Taxation of Interests in Foreign Investment Funds - An Information Paper 2 April 1992, pp9-11.
Further assume that the terms of the investment deed are that any excess cash is distributed to the investors (arising for example from dividends paid by the infrastructure company) as soon as is practicable. Further, the profits derived from the disposal of the infrastructure company are distributed as soon as is practicable. This is common feature of such funds, since the investors have invested because they wanted exposure to that particular infrastructure project.

The result is that a series of entities are established and interposed between the ultimate investment and the investor. In this case there could be up to four foreign entities interposed between the Australian investor and the company carrying on the infrastructure project. Under the FIF rules, the investor would not obtain the benefit of an exemption. Further, and investor would generally be subject to attribution under the calculated profits method or the deemed rate of return method. The outcome is that Australian investors are precluded from investing in such funds on the same basis as other investors and, solely because the anti-tax-deferral regime is applying inappropriately, their investment choice is limited.

A similar issue can arise for Australian funds managers.

**Example 2 - Australian funds manager**

Assume the same structure, investment and distribution commitment as above, except that now it is an Australian funds manager rather than a foreign funds manager. Further assume that it would be typical in establishing such a fund that the Australian funds manager would first look to the Australian market for the funds, since this is not only the market it is closest to, but also because it is likely to be easier to raise funds from the foreign market when it can already display a level of commitment of Australian funds.

Therefore, given the additional difficulty in raising the commitments from Australian funds (again except for superannuation funds) marketing the funds to foreign investors becomes more difficult. In this case, not only are the investment choices of the Australian investor constrained. The funds manager is at a competitive disadvantage compared to a similar foreign funds manager seeking to raise funds from foreign investors for the same investment.

Private equity funds can be similarly affected.

**Example 3 – Private equity funds**

The same issue as above arises for private equity funds investing in a range of underlying investments, none of which invest in ineligible activities.

Assume the same facts as in Example 2 except that investment mandate is to invest in a range of investments. A typical arrangement would be that the fund would commit to identify investments up to (say 5) over a period of time (say 5 years). It is planned that the investments will be significant stakes (generally more than 50% of the shares in the target, but not necessarily so). The investors would commit to provide funds as and when the investments are identified. Therefore, there is no excess cash held for a significant time prior to the investment. Under the terms of the fund deed the fund manager is required to distribute excess cash as soon as is practicable.

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41 If the investor is a complying superannuation fund it might gain the benefit of the exemption from the FIF measures. In practice, this has sometimes restricted such funds to direct investment by complying superannuation funds.

43 In these cases, under the terms of such funds there would be no buy back offered by the fund and the investor could not use the market value method.
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Unless the foreign fund could gain the benefit of the active business exemption, the same issue arises for this fund as for a single purpose investment fund.\(^{44}\)

f) **Bed and breakfast arrangements**

The so-called ‘bed and breakfast’ arrangements are mentioned briefly in the Discussion Paper,\(^ {45}\) and can be entered for two reasons.

First, as identified in the Discussion Paper, it is not uncommon for a funds manager to review their portfolio prior to year end and to sell down passive FIF interest to ensure that they fall within the balanced portfolio exemption. However, these transactions are not necessarily conducted in a way which raises tax policy issues as the usual ‘bed and breakfast’ arrangements. Typically, the disposals are on market. The fund manager may or may not repurchase the shares. Even if the purpose of the transaction is to fall within the de minimis exemption, where the transaction is on market and involves real market risk it is difficult to see why the behaviour should be viewed adversely. If the policy is to be below the 10% threshold at year end, how one achieves this should be irrelevant. If this is not the intention, the policy should change and be expressed to be different.

However, all of this is merely indicative of the more fundamental problem. Once it is accepted that the industry as a whole does not invest to gain the benefit of tax deferral, and the industry as a whole is forced into this behaviour, then it indicates that the FIF measures must be operating incorrectly for the funds management industry.

Second, ‘bed and breakfast’ arrangements are sometimes entered to reduce compliance costs, thereby triggering a tax liability and occur either under the CFC or under the FIF measures. In the case of the FIF measures, there is little basis for an argument that the transaction was undertaken to avoid Australian tax. In our experience, the fund manager does not know whether the inclusion of an amount under the anti-tax-deferral measures would be more than, or less than, the amount triggered by the disposal. These disposals can incur substantial transaction costs and can expose the taxpayer to commercial risk, if only for a few days.

In either case there is no reason to force the taxpayer to incur compliance costs when the same outcome could be achieved by a taxpayer choice. Further, there is no reason why a formal tax election needs to be made. The choice can be evidenced by the way in which the tax return is lodged.

It is difficult to see how a choice to deem an amount to be sold could ‘institutionalise’ avoidance. The possibility of avoidance (and we do not accept that the FIF measures appropriately isolate cases of avoidance) arises if the investment is not realised. Selling the interest in the foreign entity eliminates the purported ‘avoidance’ (that is, the holding of foreign interests) that the current taxation measures seek to overcome.

\(^{44}\) The active business exemption might be available on a consolidated basis if the underlying investment is active and the interposed investments can be treated consolidated. This might not be the case if the underlying investments are not wholly owned or there are other investors at lower tiers (as is the case in Example 1 and Example 2) that dilute the interest of the entry level fund to less than 50%.

\(^{45}\) Para 4.87 of the Discussion Paper
Types of Income

Australian public company exemption

Questions 4.20 and 4.21

Should a public company exemption be included in the attribution regimes? If so, why?

Could a more generic approach to defining an accumulation vehicle be used to address neutrality concerns? If so, how?

We submit that an exemption from the anti-tax-deferral rules should be provided for publicly listed companies and trusts for the reasons set out below.

We accept that this might create some non-neutrality with companies and other vehicles that are not listed that also invest offshore and have high distribution policies. However, we submit that some level of non-neutrality will inevitably occur in any anti-tax-deferral measures. Given the proportion of listed foreign multinationals to non listed multinationals, the advantages of providing an exemption far outweigh the non-neutralities.

We further submit that it might be possible to develop a comparable exemption for unlisted vehicles that are unlikely to be used as accumulation vehicles. This does not, however, obviate the imperative for an exemption for publicly listed vehicles.

Comments

Internationally-oriented Australian listed public companies need imputation relief for dividends paid to Australian residents from foreign income. If this partial imputation credit is not allowed then public companies need proper recognition (non-taxation) of foreign income so as to remain competitive internationally (that is under CIN policy). A public company exemption from the anti-tax-deferral rules is a useful policy mechanism.

Australian public companies have a significant incentive under the Australian dividend imputation system to pay franked dividends to their Australian shareholders. This is recognised in materials available to the Government and to the Board, confirming that payout ratios by Australian companies are high when compared with other countries.

Australian shareholders in Australian companies are disadvantaged in respect of their companies’ foreign income. The companies in receipt of dividend income from foreign companies, which has not previously been attributed, are exempt on that dividend income. So the dividend income does not add to the company’s stock of franking credits and thus the relevant income is subject to tax when dividends are eventually distributed to Australian shareholders and foreign shareholders (apart from the impact of the foreign income conduit regime).

We submit that there is basis for the Government considering an exemption for Australian widely held public companies from the anti-tax-deferral regimes.

The key characteristics supporting an exemption for widely held public companies are:

- Public companies are likely to be wholly business focussed, rather than on deferral of Australian income;
- The distribution policies of widely held public companies mean that they do not artificially restrict the payment of dividends to Australian and other shareholders; and
- The perceived revenue risks of such a policy improvement are smaller than for any other Australian taxpayer group, for the reasons below.
We strongly submit that special consideration for widely held public companies is appropriate given that widely-held Australian publicly-listed companies can demonstrate a lower level of revenue risk in their tax dealings, from a combination of:

- Public companies having strong auditing requirements;
- Public companies’ public filing of financial statements, which are open to searching scrutiny by analysts and media;
- Strong governance and business focus including their array of independent directors, and governance by the ASX and ASIC in a manner different to private companies, trusts and individuals;
- The desire of investors for franked dividends;
- The stronger scrutiny by the ATO of widely held larger entities, through the Large Business & International segment;
- The continued application of transfer pricing and Part IVA rules to such companies given their stronger documentation practices than for privately owned entities; and
- Their likelihood of not making decisions for reasons other than business expansion.

As a result special treatment for widely held public companies is a useful addition to the measures to reduce unnecessary, unproductive, CFC and FIF compliance tasks.

It might be suggested to the Board that a public company exemption can be replicated, in effect, by a combination of the other exemptions proposed in this submission. That proposition cannot be tested at this stage, so we submit that a broad exemption is appropriate.

It might also be suggested to the Board that such an exemption for every listed public company is inappropriate and further conditions are required. We do not consider that further conditions are necessary. If the Board considered that there were integrity concerns, notwithstanding the numerous factors listed above demonstrating low revenue risk from such an exemption, these additional factors might be considered in the detailed design phase.

Foreign public company exemption

Question 4.22

Could a foreign public company exemption consistent with that in the FIF regime be applied across the attribution regimes?

We submit that an exemption applying on a wide ranging basis across the various anti-tax-deferral regimes should apply to investments in foreign public companies.

Comments

The stock exchange listing method applying under the FIF active business test and the specific exemptions for publicly listed companies engaged in some passive activities means that most interests in foreign publicly listed companies are exempt. We support the introduction of an exemption applying on a wide ranging basis across the various anti-tax-deferral regimes for foreign public companies.

We recognise the concern that a foreign public company exemption expressed too broadly might raise integrity concerns in relation to companies incorporated and listed in jurisdictions whose capital markets do...
not have the necessary integrity or transparency of the major capital markets, and whose public companies might mask mere accumulation activities.

The Government accepted in 1989\textsuperscript{46} that annual distribution of most of the returns would prima facie overcome the deferral problem associated with the accumulation of income offshore. However, it was also identified that any distribution test based on distributions from the first tier would not overcome the problem of deferral in lower tiers. We do not believe that this issue is insurmountable. For example a distribution test on a worldwide consolidated basis should address the issue. We submit that this policy should be explored.

The way forward, initially, might be to list an array of comparably-regulated capital markets, covering the US (should the suggested exemption for CFC under listed countries announced by the Government not be implemented), the European and selected other capital markets where there can be confidence as to the appropriate regulatory supervision and quality of the capital markets not to cause inappropriate outcomes from such an exemption. At a later time, when this approach had been bedded down, other jurisdictions and markets could be added to the list.

\textsuperscript{46} Taxation of Foreign Source Income – An Information Paper April 1989
Methods for Attributing Income

Overview

In the Discussion Paper the following statement is made:

‘To ensure that taxpayers are subject to consistent tax treatment, all methods should result in a similar amount being assessed to the Australian resident taxpayer. This amount should approximate the amount that would be assessable on a similar domestic investment, keeping in mind the need to balance complexity and compliance costs.’

(Emphasis added)

We are unsure whether the statement ‘…amount should approximate the amount that would be assessable on a similar domestic investment’ refers to a comparison with the investment by the entity and not with the investment by the taxpayer and whether it means that there is no intention to distinguish between taxpayers. If our understanding is correct, we restate our position that we are not convinced that the same policy should apply to both passive and active investors.

In any event, we take issue with the statement that ‘all methods should result in a similar amount being assessed to the Australian resident taxpayer’. In our view this is not achievable or even desirable.

It should be expected that some investors will have access to little information regarding the specific underlying income and gains of a CFC. Therefore, it can be expected that one of the proxies for the calculation of the attributable income will be a market value method (in essence an entity approach). Similarly, another of the proxies for the calculation of the attributable income is likely to be a deemed rate of return method. In neither case can it be expected that the amount of attribution will approximate that calculated under a transactional approach.

In a case where a taxpayer has the requisite access to information use of a particular method for the calculation of the attributable income cannot be mandated. This is the very issue that is problematic under the existing regimes.

It would therefore appear that the only methods the outcomes of which might be comparable would be a branch equivalent method under a transactional approach and an accounting method under a transactional approach.

Further, by fixing the attribution interest as the greatest of these entitlements, there is the potential for attribution that is greater than the economic interest.

Calculation of the amount of the attribution

We submit that an attributable taxpayer should not be subject to attribution that is disproportionate to the taxpayer’s entitlement or potential entitlement to the profits that give rise to the attribution.

Comment

As alluded to in our comments regarding Question 3.2, the existing CFC measures can give rise to attribution that is disproportional to the taxpayer's entitlement to the profits that give rise to the attribution. This arises in part, because the existing measure uses as a basis for attribution the combination of paid-up share capital, the rights to vote, the right of a shareholder to participate in decision making regarding the distribution of profits, the rights to distribution of capital or profits on winding-up and the rights to distributions of capital or profits otherwise than on winding-up. A similar approach is taken in determining a taxpayer’s attribution interest in respect of the calculated profit of a FIF. However, by fixing the

47 Para 5.12 of the Discussion Paper
Methods for Attributing Income

Attribution interest as the greatest of these entitlements, there is the potential for attribution that is disproportionate to the current or future entitlement to the underlying profits that gave rise to the attributable income.

This can be illustrated by the following example.

**Example 1 – Redeemable Preference Shares**

Assume that a foreign company has issued ordinary shares. Of those shares 50% are owned by residents in Australia. Assume it has also issued redeemable preference shares (‘RPSs’) in an unrelated Australian company giving an entitlement to a 10% non-cumulative deferred return and those shares and the profits arising in the year in question carry 20% of the voting rights in the foreign company. Under the terms of the RPS it is clear that, on an objective analysis, the RPS holder will be entitled to only 10% of the profits of the company. Attribution would occur on the basis of the greater of those rights and the RPS holder would be taxed on 20% of the profits without any prospect of ever receiving this return.

While this is a relatively common form of disproportionate attribution other forms of disproportionate attribution can occur in any case where shareholders have differential rights to profits.

**Example 2 - Interaction with special features of offshore companies**

Under the laws of certain countries, such as the Cayman Islands, the law permits the segregation of assets and liabilities of a company amongst various ‘portfolios’ in a way which binds third parties. Such entities are known as segregated portfolio companies (‘SPCs’).

Each class of shares in an SPC represents a different portfolio of investments and each investor’s return on their respective class of shares will track the return on the portfolio allocated to their share class. An SPC may pay a dividend in respect of the segregated portfolio shares of any class whether or not a dividend is declared on any other class of segregated portfolio shares.

The CFC rules do not specifically address SPCs. Currently, the rules assume a common class of shares in determining the ‘interests’ of shareholders. They do not contemplate entities with notionally segregated portfolio holdings.

The calculation of the attribution percentage cannot be done on a share class by share class basis, but rather needs to be done on the whole of the profits of the SPC.\(^{48}\)

The impact of this is that the taxpayer’s attributable income may bear little relation to its economic entitlement to distributions from the SPC. Indeed, a taxpayer may be attributable on the overall profits of the SPC, even where the taxpayer’s portfolios have only generated losses.

To illustrate, assume there is an SPC with 3 classes of shares carrying the same rights. Taxpayer 1 owns 100% of the 100 class A shares; Taxpayer 1 owns 100% of the 50 class B shares, and Taxpayer 2 owns 100% of the 50 class C shares. Further assume that the Class A profits = $10; the Class B profits = $5; and the Class C profits = $5.

The attribution percentage of Taxpayer 1 will be 75%, being \((100+50)/(100+50+50))\).

The distribution that can be made to Taxpayer 1 = $10 + $5 = $15 and the attributable income of Taxpayer 1 will be $15, being 75% x $20.

However, if it is assumed that the Class A profits = $5; the Class B profits = $5; and the Class C profits = $10, the distribution that can be made to Taxpayer 1 = $5 + $5 = $10. However, the attributable income of Taxpayer 1 is still $15.

\(^{48}\) Section 362 provides that the attribution percentage of an attributable taxpayer at a particular time is the sum of the direct and indirect attribution interests in the CFC held by the taxpayer. In determining “direct attribution interest” in a CFC, section 356 looks at the rights of the shareholders to the capital or profits of the company.
Question 5.1

How could the current attribution methods be improved to resolve the distortions that currently exist (both across the regimes and within the regimes)?

We submit that the policy development inherent in Taxation Law Amendment (2007 Measures No. 4) Bill 2007 provides support for a policy improvement to allow companies currently limited to using the branch equivalent method under the CFC rules to have an additional option to use the FIF methods, thus harmonising the calculation methods under the new anti-tax-deferral regimes.

We further submit that the key reforms required in relation to foreign conduit entities are:

- Alignment of the compliance mechanisms, at the very least for widely held managed funds;
- Consideration of exemption of widely held managed funds as discussed below;
- If an exemption for widely held managed funds is considered not to be feasible, a focus on streamlined and harmonised compliance. We submit that consideration should be given to calculation of attributable income using;
  - Australian tax rules modified to streamline the calculations, as recommended for CFCs, or
  - Possible use of the tax rules of the foreign source country, at least for conduit entities in comparable tax countries.

Comments

Irrespective of whether or not the anti-tax-deferral regimes are harmonised, it appears to us that maximum flexibility should be provided to taxpayers to allow them to choose the method of attribution that best suits their purposes. In a non-harmonised anti-tax-deferral regime we envisage that in respect of an interest in a particular foreign entity, the taxpayer may choose that the interest be taxed under the CFC or FIF measures.

If the taxpayer chose the FIF measures the system would operate as follows:

- All of the existing FIF exemptions would apply;
- If the attributable income of the FIF was to be calculated, the four methods would be available – the market value method, the calculation method (perhaps, unlike now, based on the accounting information), branch-equivalent calculation and the deemed rate of return method.
- If the taxpayer chose the calculation method or the branch equivalent method and the FIF had an interest in a lower tier FIF, the same choices could be made for the lower tier. Unlike the current position, this procedure could continue through an unlimited chain of FIFs.

If the taxpayer chose the CFC measures the system would operate as follows:

- All of the existing CFC exemptions would apply;
- If the attributable income of the CFC was to be calculated, the branch equivalent method and the simplified branch equivalent method (based on accounting information) would apply.
- If the CFC had an interest in a lower tier entity, the same choices could be made for the lower tier. Once the FIF treatment had been chosen there would be no opportunity to return to CFC treatment at a lower tier. The FIF treatment for the inclusion of an amount in the attributable income of a CFC would operate in the same manner as it would for a resident taxpayer.
Methods for Attributing Income

Question 5.2

How could the current branch-equivalent calculation approach be improved? Would the adoption of the FIF calculation method adequately address concerns in relation to complexity and compliance costs?

We submit that the current branch-equivalent calculation approach can be improved in a manner consistent with the comments below.

Comments

A full calculation of attributable income on a taxable income equivalent is, at best, theoretically appropriate. Even so, the calculation of the attributable income can be complex, and as an integrity issue, this theoretical outcome is often outweighed by associated compliance costs.

We propose various improvements in the branch equivalent calculation.

- The application of the full Australian tax law to a foreign entity carrying on foreign operations is inappropriate, because it has the effect that every time an amendment is made to Australian tax law there needs to be a corresponding consideration of whether or not the amendment should apply in calculating the attributable income. In our response to Question 5.3 we detail how this mechanism should be modified.

- We submit that an additional improvement to the branch-equivalent calculation method could allow greater use of accounting profits for purposes of calculating attributable income, certainly where the CFC entity is audited and operates in a country which has applied International Financial Reporting Standards or (notably in relation to the US) internationally recognised accounting standards.

Question 5.3

Which provisions of the Australian tax laws should be excluded from branch-equivalent calculations and why?

We submit that the provisions of the Australian tax laws that impose significant compliance and/or are not necessary to protect the integrity of the Australian tax base when applied in the calculation of attributable income should be excluded from branch-equivalent calculations.49

These provisions include the foreign exchange rules, section 51AD, Division 16D and proposed Division 250, the capital allowance provisions, the capital revenue distinction in respect of repairs and maintenance, the treatment of provisions and the denial of entertainment expenditure.

Comments

Much of the practical complexity and compliance costs result from the difficulties of applying the full branch equivalent basis of taxation. The issues here include the necessary access to information and the book to tax adjustments for foreign entities that are necessary in circumstances where it is not reasonable to expect that any deferral or arbitrage advantage is likely.

We have previously highlighted to the Board some of the issues that are in the calculation of attributable income on a broad equivalent basis. We reproduce this in full below.

“Some examples of the compliance issues are as follows.

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49 Disregarding specific provisions of the Income Tax Acts or modifying the application of those provisions, where appropriate, has been a feature of the calculation of the attributable income of a CFC since the introduction of the CFC measures
Methods for Attributing Income

Foreign exchange effects
In calculating the attributable income of a CFC an attributable taxpayer must convert amounts to Australian dollars on a transaction by transaction basis, unless it lodges an election to calculate the attributable income in the currency used by the CFC (that is, it makes a functional currency election). Even where a functional currency election is made it is still necessary to translate other currencies into the functional currency according to the currency translation rules.

It is not clear what integrity concern would arise if the CFC was simply allowed to calculate the attributable income on an alternate reasonable basis. This would then allow the CFC to use the currency in which it keeps its accounts and the conversion from foreign currency to the currency of account would follow the accounting treatment.

Application of s 51AD and 16D
Section 51AD operates to deny deductions otherwise allowable to owners of leased property where the property is financed ‘wholly or predominantly’ by non-recourse debt and various other conditions are met. One such condition includes that, whilst the lease is in force, the leased property is, or is to be, used by the lessee otherwise than wholly and exclusively for the purpose of producing assessable income. This would cover the use of property by a tax exempt body or a non-resident.

Where these conditions are satisfied, the owner of the property is deemed not to have occupied or used the property or held the property for use, for the purpose of producing assessable income or in carrying on a business for such purpose, In this respect, no ownership deductions (such as depreciation, interest, repairs) would be available. The effect of the provision is in our view draconian. In order to avoid the outcome, Australian investors are compelled to finance the development less than 50% by non recourse debt. Clearly, this places the investor at a disadvantage vis a vis other investors in that jurisdiction.

In circumstances where Section 51AD does not apply, Division 16D must still be considered. Put broadly, Division 16D applies to similar arrangements and in similar circumstances as section 51AD. The Division operates to deny capital allowance deductions attributable to owners of leased property where the lease is a finance lease or similar arrangement and the end-user /lessee is non-taxable. The rationale for this approach is that the owner effectively transfers risk and benefits of ownership to the lessee/user and, as such, should not receive the benefit of the capital allowance deductions.

In substitution for the denial of deductions in respect of capital expenditure on property, in effect Division 16D treats the arrangement as a loan. Broadly, the lease payments made by a tax-exempt lessee are classified as consisting of non-assessable repayments of principal and taxable payments of interest. Accordingly, the overall effect of treating the arrangement as a loan should essentially be a timing difference for tax purposes, rather than an outright denial of ownership deductions as is the case with Section 51AD.

The application of Section 51AD and Division 16D to a CFC context is theoretically misplaced. Moreover, even if it were not, on any proper balancing of compliance cost versus risk to the revenue, the application of these provisions in a CFC context cannot be justified.

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50 Issues arise with the timing of the election to use the functional currency rule which mean that, where a person becomes an attributable taxpayer during a statutory accounting period of the CFC the attributable taxpayer may only use the functional currency if the election is made within 90 days of the start of the statutory accounting period. Therefore, taxpayers who become attributable taxpayers after this period cannot make the functional currency election.

51 We believe Treasury has some sympathy with this view.
Methods for Attributing Income

Depreciation
Depreciation rates on plant and equipment vary from country to country. In Australia tax deductions for depreciation seldom equate to book depreciation and the book to tax adjustments require systems to be put in place to capture the information. Further, Australia has from time to time allowed accelerated depreciation. There is little likelihood that the systems necessary to capture this information will be maintained. We note that in this case the CFC may be required to maintain three sets of records – one for accounting, one for foreign tax purposes and another for calculating attributable income.

Repairs and maintenance
As for depreciation, different countries have different regimes for the deductibility of capital expenditure on repairs and capital improvements on a current basis or on an amortisation basis. In Australia, the distinction between repairs (deductible) and capital improvements (amortisable) is based on a body of case law. Even where the same distinction between repairs and capital improvements exists in the foreign country, the basis for making the distinction will be different. Once again, there is little likelihood that the systems necessary to capture the requisite information will be maintained.

Tainted sales and services income
Where tainted sales and services income is involved the issues become more complex. These issues will arise because tainted sales income will arise for distribution companies and substantial tainted services income could arise where services are provided to an Australian resident (or the Australian branch of a non-resident). Some examples of the issues are as follows (note that these examples are based on real life scenarios).

- **Provisions** – One of the common add back items in the preparation of a corporate tax return in Australia is add backs for provisions such as long service leave and annual leave. This is merely a result of the difference between accounting and tax. There seems little justification for making these adjustments in the calculation of the attributable income. The matter might be less onerous where the tax law of the foreign country allows a deduction for the provision in question on the same basis as does Australia, since at least in that case the process is already undertaken for the purposes of meeting the tax obligations in the that country, but the reasonable expectation is that applying Australian law will impose an additional level of compliance. We suggest that this is a case where there is minimal or no risk to the revenue.

- **Entertainment expenses** – Currently, entertainment expenses may be disallowed in Australia. Therefore, by applying a notional calculation of Australian tax law in the calculation of the attributable income of the CFC such adjustments will need to be maintained, notwithstanding that the CFC is unlikely to have systems that will enable this information to be captured. However, the realistic prospect of material risk to the revenue of this is negligible.

Others
The list above is not intended to be exhaustive. In particular, it would appear that Division 240 could be disregarded. The amendments under TOFA 3 & 4 would also need to be examined.
Methods for Attributing Income

Questions 5.4, 5.5 and 5.6

How could the market value method be improved?

How should the deemed rate of return be changed to better approximate returns on foreign investment? To what level and why?

Could the deemed rate of return method be applied consistently across all the attribution rules?

We submit that the simplest mechanism would be to set the rate the deemed rate of return at a lower level. However, the ‘fair dividend rate’ method as used in New Zealand is a viable option. At this stage, we have not examined each of the methodologies as this is a design consideration.

We further submit that the market value method could be extended to a wider variety of non-listed foreign entities.

We further submit that any minor design features that currently give rise to inappropriate outcomes are technical issues that should be considered in the design phase.

We submit that the deemed rate of return method can be applied consistently across all the attribution rules.

Comments

As set out in the Discussion Paper, the deemed rate of return has traditionally been set relatively high to encourage investors to use the other attribution methods where possible. This rate is penal and does not reflect commercial reality in terms of return of investment. In the Discussion Paper, it has been suggested that to the maximum extent possible, the different methods for attribution should approximate economic outcomes. It is self-evident that the penal rate of return does not achieve this. Further, as an anti-deferral mechanism, the deemed rate of return only needs to be high enough to remove the integrity concern. Therefore, if a deemed rate of return is slightly lower than the economic return, no adverse integrity issues should arise.

Each of the methods used for the calculation of the amount to be attributed should be available to all taxpayers. Under a non-harmonised regime, taxpayers that fall within either regime may suffer the same constraints – that is, they do not have access to information to make calculations under the branch equivalent or calculated profits basis. Therefore, they must have an alternative method.

Under a harmonised regime, it is self-evident that all attribution calculation methods must be available to all taxpayers irrespective of their interest.

Question 5.7

What other attribution methods are viable alternatives? Would these methods strike an appropriate balance between compliance, complexity, integrity and neutrality?

We submit that accounting profits should be used in the calculation of the attributable income under any of the anti-tax-deferral regimes.

52 FIF Information Paper, 1992
**Methods for Attributing Income**

**Comments**

*Calculation of CFC income using accounting profits*

At present there are different bases for the calculation of the attributable income of a CFC and the calculated profits of a FIF. In particular, a CFC is required to calculate the income of a CFC applying a full branch equivalent basis, whereas a FIF may (by election) calculate the FIF income by reference to accounting profits. This treatment goes to the heart of the compliance and administrative difficulties with the CFC measures.

As an aside, we note that a CFC might need to prepare accounts that are in accordance with local accounting requirements; accounts that are in accordance with the accounting requirements of the parent; tax accounts for compliance with the foreign country’s tax law; adjustments to the accounts to apply the active income test and tax accounts for compliance with the CFC measures. Obviously, the Australian Government can do nothing about the first three, but unless unavoidable it should impose as little additional compliance encumbrance as possible.

We suggest that little integrity concern would arise if the CFC was simply allowed to calculate the attributable income on an alternate reasonable basis. Using accounting income for attributing income to a CFC will eliminate many of the complexities of the branch-equivalent calculation.

We submit that with the introduction of IFRS there will be less divergence in calculating accounting profits globally. In addition, simplification of the existing branch-equivalent calculation through the removal of complex tax specific provision will mean that the outcomes will not differ as much as they have historically.

*Use of consolidated accounts*

One simplification option not addressed in the Discussion Paper is for a taxpayer to use the consolidated accounts of a CFC group in calculating attributable income. A recent example of the use of consolidated accounts is in the CGT participation exemption reforms introduced in 2004.

Advantages of this approach are as follows:

- It would eliminate CFC attribution in relation to intra-group transactions. Such transactions are economically neutral and will generally only have a tax impact in the foreign locations in which the CFCs operate, i.e. they are not undertaken for Australian tax deferral reasons.

- It would eliminate the need to prepare CFC calculations for each CFC in a group. This could result in a significant cost saving in the case of large multinational groups that are CFCs for Australian tax purposes.

- It would overcome the inability to group losses between CFCs. An issue that is not discussed in the Board's paper is the inability under current rules to group or transfer CFC tax losses between CFCs, even where the CFCs are within a 100% owned group located in a foreign country that permits loss grouping.

Allowing grouping would remove the current bias against multinational groups, as opposed to single-entity CFCs. Such loss grouping should be allowed in the CFC context for the same reasons that it is permitted in the Australian domestic law, namely economic neutrality. Again, mismatches in profitability between foreign companies in a CFC group (for example, resulting from intra-group transactions) should not represent a risk to the Australian revenue.
Question 5.8

Should taxpayers be permitted to choose which attribution method to apply or should some restrictions apply?

We submit that taxpayers should be permitted to choose the most appropriate attribution method so that all taxpayers can be treated consistently.

Comments

A choice of methods will allow taxpayers to choose the attribution method that best suits their needs. It also ensures that taxpayers are treated consistently by providing all taxpayers with access to the same set of methods and therefore the same potential tax treatment. Choice also encourages investment neutrality by allowing the same method to be used for interests in different foreign entities.

The Discussion Paper queries whether choices potentially could result in increased compliance cost. However, we agree with the view outlined in the Discussion Paper that taxpayers are less likely to trial different methods or switch between methods to reduce their tax liability if distortions inherent in the optional methods are reduced so that all methods impose similar tax liabilities. Thus, good tax policy has the potential to not only reduce compliance costs but also reduce the need for integrity rules to prevent switching.

The full range of potential approaches can be illustrated as follows.

<table>
<thead>
<tr>
<th>Taxpayers having access to detailed information (currently, the CFC group)</th>
<th>Taxpayers having limited access to information (currently, the FIF group of taxpayers)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch equivalent basis</td>
<td>Yes – by election*</td>
</tr>
<tr>
<td>Simplified branch equivalent</td>
<td>Currently available – by election</td>
</tr>
<tr>
<td>Mark to market</td>
<td>Currently available – base case for non listed equities</td>
</tr>
<tr>
<td>Deemed rate of return</td>
<td>Currently available – base case for listed equities</td>
</tr>
</tbody>
</table>

* As proposed in *Taxation Law Amendment (2007 Measures No. 4) Bill 2007.*

Questions 5.9 and 5.10

How should the percentage of income attributed be determined where the taxpayer has no fixed, legal interest in the foreign entity?

Is it practicable to calculate attributable income on the proportional value of the property or services transferred (rather than attributing all income of the foreign entity)?

As we understand the above questions, they deal with the application of the transferor trust measures. As previously stated, this submission does not address the operation of those measures. As such, we have not commented on the above questions.
Methods for Attributing Income

Design features for attribution

Questions 5.11 and 5.12

Should attributable income be apportioned to reflect part-year ownership of the foreign entity, and how would apportionment apply?

Should the attribution rules be modified to improve their interaction with the CGT rules? If so, why, and how could this be achieved having regard to other policy objectives including complexity and simplicity?

We submit that attributable income should be apportioned to reflect part-year ownership of the foreign entity. We believe that the methodology for the apportionment should be considered in the design phase.

We submit that capital gains derived and capital losses incurred by a CFC should be included in the calculation of the net capital gain or loss of the attributable taxpayer.

We further submit that losses derived by a CFC should be attributed to the attributable taxpayer for offset against other attributable income.

Comments

In the original development of the CFC measures, a decision was made that attribution on a part year basis was undesirable. In contrast, under the FIF regime income is only attributable in proportion to the number of days that the resident has held the FIF interest. There were several causes for the decision to attribute on an all or nothing basis under the CFC measures.

First it was considered that the compliance associated with part year calculation would not justify the more precise determination of underlying income and gains that accrued to the attributable taxpayer during the period of ownership.

However, often, it is possible to determine the income and gains that were derived in the period up until the taxpayer took an interest in the CFC. This was recognised in respect of capital gains (but not revenue gains) and gains derived prior to the acquisition of an interest in the CFC are now excluded from attributable income. Further, capital gains (but not revenue gains) that accrued prior to the time that the taxpayer acquired an interest in the CFC are now excluded by deeming the underlying asset to have been acquired at the time the taxpayer took an interest in the CFC.

Second it was considered that a potential dividend exemption or reduction of consideration on the disposal of the interest in the CFC would ultimately compensate (at least in part) for the attribution of income and gains that did not accrue to the attributable taxpayer.

However, as dividends are now fully exempt, the value of the exemption that might otherwise arise because of the previous attribution is no longer available. Further, the present value of a reduction in consideration on disposal of the shares will be considerably less than the present value of the tax on the attribution of income and gains that did not accrue to the attributable taxpayer.

Last, the full year attribution to the year end owner was consistent with the economic effect on a shareholder that acquired an interest in an Australian company part way through the taxpayer’s year of income. In this case, the purchaser would suffer the economic effect of the taxation since the payments of tax would be an impost on the company arising from income and gains that may have arisen prior to the shareholder having an economic interest in the company. It was expected that this uneconomic effect
would be taken into account in the negotiation of the consideration on acquisition of the shares. While this has some basis in fact if the seller and the purchaser are both attributable taxpayers, it suffers from the flaw that the seller may be a non resident who will not be willing to compensate the Australian resident purchaser. In addition, transactions by an overseas vendor to prepare the target for sale may trigger potential CFC issues for an Australian purchaser. An Australian purchaser may not have the opportunity to identify all potential CFC liabilities in a target during the due diligence process and, even if those liabilities can be identified and quantified, a foreign vendor normally will be unwilling to provide warranties and indemnities for the purchaser's Australian tax liability.

The precise mechanism for achieving this would need to be reviewed in the design phase. However, two means immediately suggest themselves.

- The first would be to ‘rule the books’ at the point where the taxpayer became an attributable taxpayer. This would precisely identify the income and gains derived after the taxpayer became an attributable taxpayer. This would be best applicable where the attributable taxpayer acquired the foreign entity, since in these circumstances it is likely that completion accounts would be prepared, which would facilitate calculations of the income and gains derived before and after the acquisition of the interest in the foreign entity.

- The second mechanism would be to determine the attributable income and amortise the amount on a straight line basis. This would be more appropriate where the taxpayer became an attributable taxpayer in circumstances where no completion accounts were prepared (for example, in the case of an acquisition of a significant stake). Because the taxpayer’s ability to apply the various mechanisms (whether under the two mentioned or others) is likely depend on the circumstances, including the access to information, it is conceivable that a choice of methods would need to be allowed. Since this is an issue for the first year of attribution for a particular taxpayer there is no apparent integrity issue that would arise as a result of a choice.

Treatment of losses and capital gains under the CFC measures

The process for the inclusion of attributable income of a CFC in assessable income involves first calculating the attributable income and then including that attributable in the taxpayer’s assessable income as foreign income on revenue account. The nature of the amounts taken into account in determining the underlying attributable income of the CFC is irrelevant. Similarly, under the calculation method in the FIF measures, no account is taken of the nature of the underlying income and gains that are taken into account in determining the calculated profit.

Since the calculation of the attributable income on a branch equivalent basis involves a degree of lifting of the corporate veil, there is no intrinsic reason why a net capital gain derived by a CFC cannot be included in the attributable taxpayer’s assessable income on capital account. Similarly, there is no intrinsic reason why a loss of a CFC cannot be attributed to the attributable taxpayer and be available to offset other income of the attributable taxpayer (or at a minimum amounts included in the attributable taxpayer’s assessable income in respect of attribution from other entities). We understand that the bases for these design features were as follows:

- It was suggested that attribution of losses to be allowed as a general deduction would be inconsistent with the general principle that Australian domestic income should bear Australian tax.

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53 Provision would still need to be made for uplifts for assets for the purpose of determining the gain on disposal of an asset (applicable to all disposals and not, as is currently the case, merely for the purposes of the CGT provisions).

54 This straight line apportionment is the mechanism that is currently provided for in attribution under the calculated profits method under the FIF measures.

55 Para 6.13 of the Information Paper
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- It was also suggested that the attribution of losses would be inconsistent with the domestic treatment of losses where the attributable taxpayer owned less than 100% of the CFC. This was based on the position that an Australian company could not access the losses of another company unless the companies were part of a wholly owned group.\(^{56}\) This justification did not explain why the attribution of losses from 100% subsidiaries was not allowed on a quarantined basis.

- It was also suggested that losses should be offset between CFCs in the same wholly owned group. This was denied and no reason was given for this.\(^{57}\)

We suggest that the bases for these conclusions were not compelling at the time the CFC measures were introduced, nor are they compelling now. Further, as far as we are aware, the reason for the attribution of the net capital gain on revenue account was not articulated. Therefore, we suggest that this issue needs to be revisited.

Attribution accounting and record keeping

Questions 5.13, 5.14 and 5.15

*How could the complexity and compliance costs imposed on taxpayers by the current record keeping requirements be reduced? In particular, is it necessary for the rules to be so prescriptive?*

*How could the complexity and compliance costs associated with tracing income through lower tier entities be reduced? Is it possible to achieve consistency across the regimes?*

*How could the reconciliation of dividends that are referable to previously attributable income be streamlined and simplified?*

We submit that 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.

Further, we submit that 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 different for the anti-tax-deferral measures.

Comments

We have for some time expressed the view that the law surrounding the exemption for dividends paid out of attributed income and for the reduction of consideration on disposal of an interest in a CFC could be simplified. In this respect we note that the rules were developed at a time when certainty of the operation of the law was demanded. This was especially demanded under the CFC measures and was not merely a reflection of drafting style. Under the FIF rules, the same principles were applied and the attribution accounts were merely transposed. It is doubtful whether at that stage any separate policy consideration was given to the manner in which these rules should be developed.

The purpose of the attribution accounting was threefold – it allowed an exemption for income that was directly or indirectly attributable to previously attributed income; it allowed a deduction for expenses where the return would otherwise be exempt (for example under section 23AJ) and it allowed for a foreign tax credit when additional taxes were paid on remittance of a dividend out of previously attributed income.

\(^{56}\) Para 6.11 of the Information Paper

\(^{57}\) Para 6.12 of the IP
Methods for Attributing Income

The introduction of the general dividend exemption has reduced (but not eliminated) the situations where double taxation could arise and the deductibility of all interest subject only to thin capitalisation has reduced (but not eliminated) the circumstances where losses and outgoings would not be allowable because a dividend paid out of attributed income would be exempt under section 23AJ. Further, the incidence of additional tax on dividends paid out of income that has been attributed is less than might originally have been expected.

We also note that the tracing required under the attribution accounts is not as relevant under the FIF measures because the attribution is more likely to occur at the level of the first tier FIF.

Therefore, because the exemption provided under section 23AI is less likely to be used an exemption based on a general statement of principle is more likely to satisfy the needs of taxpayers and the Commissioner. This statement of principle could be based on the same principles upon which the accounts themselves were developed, which were as follows:

- An amount should not be included in assessable income to the extent that it was attributable referable (directly, or indirectly through interposed partnerships, trusts or foreign companies) to an amount that had previously been included in the taxpayers’ assessable income under the anti-tax-deferral regimes and not previously taken into account to allow an exemption (or a reduction of consideration on disposal of an interest in a foreign entity).

- The exemption should be available irrespective of whether or not the distribution was related to the profits arising from the amount that gave rise to the attribution.

- The taxpayer should be allowed maximum advantage from the exemption by treating the income as exempt under section 23AI (unless the taxpayer chose not to do so).

- Foreign taxes attributable to that distribution, whether imposed directly or on an underlying distribution, should be creditable.

- A distribution exempt under section 23AI should be treated as assessable income for the purposes of allowing a deduction for losses or outgoings or for allowing a foreign tax credit.

- To the extent that there has previously been attribution which has not given rise to an exempt distribution, any consideration on disposal of an interest in a foreign entity, the holding of which gave rise to attribution, should be reduced.

The provision would apply irrespective of the anti-tax-deferral regime that gave rise to the attribution. Examples of how the taxpayer might apply this could be provided in the Explanatory Memorandum and the attribution accounts could be repealed. The law would be simplified, taxpayers may be able to achieve compliance savings, and there is no reasonable expectation that there would be any cost to either the taxpayer or the revenue.

This does not change the policy for the tracing of attributable income. It might be possible to achieve additional compliance savings by recording attribution accounts at the level of the first tier CFC or FIF. In this case any distribution from that first tier entity could be exempt without regard to the source of the profits. At the extreme, attribution could be aggregated so that any distribution in a subsequent year would be exempt to the extent that there has previously been attribution. In the time allowed we have not had the opportunity to explore the advantages and disadvantages of each approach and these can be explored in the design phase.
Harmonisation of the regimes

The Treasurer stated that one of the objectives of the Review is to reduce the complexity and compliance costs associated with the anti-tax-deferral regimes including whether the current regimes can be collapsed into a single regime (Press Release No. 109 of 2007).

The Board considers that the harmonisation of the regimes could take various forms including, but not limited to, the following three options:

- Option A: Maintaining separate regimes but providing more consistent outcomes across those regimes;
- Option B: Collapsing all of the regimes into a single regime; or
- Option C: Merging some regimes together (or aspects of the regimes), for example, the CFC and FIF regimes, while maintaining a separate regime for transferor trusts.

The Board is open-minded about the possibility that there may be other approaches that could deliver on the Treasurer’s objectives (paragraph 2.77 of the Discussion Paper).

Consistent with our earlier submission of March 2007, we strongly contend that provided the significant problems and concerns arising from the current operation of the various regimes are addressed we support the combination of anti-tax-deferral regimes. However we emphasise that the unification of the regimes will not achieve the desired goals of reducing the complexity of the legislation and the compliance costs associated with the practical application of the measures unless it is accompanied by significant changes to the measures as discussed herein.

To the extent that these concerns can be addressed in a manner which also results in a harmonisation of the regimes, substantial practical compliance benefits may arise. We have discussed this matter further below.

Questions 6.1, 6.2 and 6.5

To what extent would harmonising the regimes benefit taxpayers? Would these benefits outweigh the associated transitional costs?

Of the three harmonisation options, which one is preferred and why? Are there different approaches to harmonisation that should be considered?

Should the transferor trust rules be harmonised with the other attribution rules? If not, why? Is justification on the basis that they target different taxpayers sufficient? What integrity issues could arise if the transferor trust rules were harmonised with the other rules?

We endorse the harmonisation of the CFC measures, the FIF measures and Division 6. However, we submit that the transferor trusts should be excluded from a harmonised regime for the reasons set out below.

To the extent that Option C (harmonisation of the FIF and CFC regimes) can be undertaken without adversely impacting taxpayers, in a manner consistent with our submissions above, we prefer Option C. However, as stated above, we emphasise the need for maximum flexibility that will allow taxpayers to choose the most appropriate basis for attribution.
Harmonisation of the regimes

Comments

To the extent that the problems and concerns with the existing regimes can be addressed in conjunction with the harmonisation of the anti-tax-deferral regimes, we have outlined below our observations on some of the relevant issues pertaining to the harmonisation of the regimes.

In our view, Option A (ie, maintaining separate CFC, FIF and transferor trust regimes) is not optimal because even though the outcomes across the regimes may be more consistent under Option A (as compared to the existing regimes), the practical difficulties associated with the application of the existing regimes would continue (e.g., the difficulties of applying the existing definitions of “control” and “associate” would likely continue under Option A).

We believe that Option B (ie, a single regime combining the CFC, FIF and transferor trust regimes) is not practically feasible solely for the reason that the transferor trust rules target different taxpayers as compared to CFC and FIF rules. Broadly stated, the transferor trust rules apply to Australian residents who have directly or indirectly transferred value to a foreign trust whereas the CFC/FIF regimes apply to Australian residents that have a certain interest in a foreign entity. This means that the identification of the attributable taxpayer in the context of a CFC/FIF is fundamentally different to that of a transferor trust.

The Board has indicated that this problem could be resolved in a number of ways including creating relevant interests by reference to an examination of the history of previous distributions to Australian beneficiaries akin to the pattern of distribution test in the trust loss provisions or perhaps a default assessment could apply to target the distribution of previously untaxed income (paragraph 3.24 of the Board Discussion Paper). 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.

Our above comments are consistent with the general contention put to the Board that the transferor trust rules do not significantly impact corporate Australian taxpayers and are predominantly limited to high wealth individuals and closely-held trusts (paragraph 6.24 of the Discussion Paper). As such, in our view, the exclusion of the transferor trust rules from the harmonisation of the anti-tax-deferral regimes should not be disadvantageous to corporate taxpayers.

To the extent that it is possible to unify the CFC and FIF regimes in a manner which results in all attributable taxpayers having access to all the applicable exemptions and concessions, regardless of their particular fact pattern, we support Option C (ie, the harmonisation of the CFC and FIF regimes). However, given that there is a fundamental economic difference between portfolio investors and non-portfolio investors, a harmonised approach would need to make certain allowances and compromises to cater for all attributable taxpayers. We are concerned that these allowances and compromises could be disadvantageous to certain attributable taxpayers depending on the particular facts and circumstances.

To the extent that these allowances and compromises are disadvantageous, we submit that it is possible to eliminate the control rule so that taxpayers have the option of determining the most appropriate attribution methodology. Obviously, our previously recommended improvements to the anti-tax-deferral measures would still be incorporated in any system that distinguished between portfolio and non-portfolio taxpayers.

We agree with the Board’s comments (at paragraph 5.35) that the provision of a choice for an attribution methodology would ensure that all taxpayers are treated consistently with access to the same set of methods and it encourages investment neutrality by allowing the same method to be used for interests in different foreign entities, irrespective of whether harmonisation is ultimately achieved.
Harmonisation of the regimes

Benefits to Taxpayers from Harmonising the Regimes and the Associated Transitional Costs

It is very difficult to predict, with any degree of certainty, the benefits that could arise from a unified CFC/FIF regime and the transitional costs associated with such a regime without first ascertaining how the harmonised CFC/FIF regimes could practically operate.

However, we anticipate that the benefits would include the following:

- Significant savings in compliance costs.
- Taxpayers could have alternative methods for the calculation of attributable income.
- No adverse consequences would arise from crossing over from the FIF measures to the CFC measures (or vice versa) based on the activities of other taxpayers.
- It would be consistent with the recent approach taken in Taxation Law Amendment (2007 Measures No.4) Bill 2007 in respect of the option for the application of the branch-equivalent calculation test to certain FIF entities.

With respect to the associated transitional costs, the introduction of new measures will inevitably give rise to transitional costs associated with the training of relevant taxpayer personnel on the new rules, changes to systems and processes to allow for the relevant information to be captured and other associated costs. However, in our view, the savings in compliance costs and the benefits arising from greater simplicity are likely to significantly outweigh the transitional costs, especially after the initial transition is undertaken.

Questions 6.3 and 6.4

Under the second option, how could the FIF-style active business exemption apply to eliminate the need to replicate the CFC-style active income exemption?

If the FIF-style active business exemption were extended to what are currently CFC interests, would that produce an unmanageable revenue risk for Government? If not, why?

As discussed above, we do not support the second option (ie, a single regime) for the harmonisation of the regimes. However, the above question is equally applicable, in our view, to all of the Options.

We submit that the FIF-style active business exemption and the CFC-style active income exemption could run as parallel, or alternative, exemptions.

We further submit that a FIF-style active business exemption is consistent with the principles of an anti-tax-deferral regime that seeks to target the cases of worse abuse. As such, we do not believe that it would produce an unmanageable revenue risk for the Government.

Comments

It is likely that many taxpayers would favour the extension of the FIF-style active business exemption to what are currently CFC interests given the lower active business threshold of 50% as compared to the 95% threshold under the CFC active income test. Such an approach would be likely to result in a significant
Harmonisation of the regimes

compliance savings and in our view, is far preferable to the extension of the CFC-style active income exemption to what are currently FIF interests.

While we do acknowledge that the extension of the FIF-style active business exemption to what are currently CFC interests may result in some decreased revenue, we do not accept that it would produce an unmanageable revenue risk. This matter would need to be further explored but we disagree with the suggestion that one of the means by which the revenue risk can be mitigated is by increasing the attribution of an entity’s income, where the FIF-style active business exemption is failed, to all of its income rather than the CFC approach of attributing only the entity’s tainted income. In our view (as discussed above), the anti-tax-deferral measures should seek to attribute only certain classes of passive income and a broader attribution base is likely to attract significant criticism from taxpayers.

Questions 6.6, 6.7 and 6.10

What improvements to tax administration would assist taxpayers meet their obligations under the attribution rules?

What improvements could be made to the administration of the attribution rules that would reduce compliance costs and complexity, while balancing integrity objectives?

What material, information or other support might be needed to ensure a smooth transition to a new regime?

We submit that there are a number of the improvements that could be made to the tax administration system as set out below. Primarily these would revolve around better and more transparent interaction between taxpayers and their representative bodies and the ATO. The new ATD rules should be ‘road tested’ before legislative introduction and an appropriate lead time should be allowed. We do not think at this stage it is appropriate to make more specific recommendations and this should be dealt with in the design phase.

Comments

As identified in the 1998 Review of Business Taxation, tax administration is one of the vital core processes in implementing changes to the business tax system. We strongly contend that significant resources should be dedicated to the ATO to ensure that relevant ATO staff are fully informed of the new rules and are capable of providing taxpayers with sufficient information resources discussing the application of the new rules. In particular, we consider that there are four main areas which would assist taxpayers to meet their obligations under the attribution rules:

- First, to ensure that the attribution rules apply as intended, we believe that the new attribution rules should be “road-tested” with appropriate taxpayers. The results of the road-testing should be evaluated by an appropriate review committee consisting of tax administrators, interested taxpayers, tax academics and representative bodies like the CTA. There should be an adequate timeframe allowed for the road-testing to be undertaken and for the results to be properly examined prior to the release of any exposure draft of the new attribution rules.

- Second, we strongly recommend that the ATO provide guides and other relevant information material to educate taxpayers about the new attribution rules. For instance, the information guides could be similar to the foreign source income rule guides released at the time of the introduction of the existing attribution rules. Certain taxpayers might also find detailed flowcharts or ‘roadmaps’ of the new legislation very helpful in understanding how the rules are intended to apply and the interaction of the
new measures. The lack of sufficient guidance in respect of the existing attribution rules from the ATO has contributed to the existing compliance problems with the current attribution rules\(^{58}\).

- Third, we recommend that a periodical review be undertaken of the new measures, perhaps every four years, consisting of a review committee similar to that discussed above in respect of the road-testing.
- Fourth, there should be sufficient ‘lead-in time’ to ensure that taxpayers have adequate time to obtain sufficient familiarity with the new measures so that any elections, etc can be made within the required timeframe.

**Question 6.8**

*What transitional issues are likely to arise and how should they be addressed?*

| We submit that provided that the transition is appropriately managed by the tax administration it should be possible to mitigate any adverse unintended consequences that could arise. |

As with the introduction of any new measures, it is likely that unintended consequences may arise and it is very difficult, if not impossible, to predict what these consequences could be and how they should be addressed. However, in our view, provided that the transition is appropriately managed by the tax administration (which in our view should include the features discussed above) it should be possible to mitigate any adverse unintended consequences that could arise.

**Question 6.9**

*How should the previously announced transferor trust amnesty be dealt with under harmonised arrangements?*

| As previously stated, this submission does not address the operation of the transferor trust measures. As such, we have not commented on the above question. |

\(^{58}\) For instance, in the 17 years the existing attribution rules have been operating there have been only 3 tax rulings, 15 tax determinations, 15 ATO IDs and 1 taxpayer alert on the CFC/FIF regimes. This can be contrasted to the plethora of ATO guidance on more recent business tax reforms such as tax consolidation and TOFA.
Appendix 1

Examples of Issues Under Transferor Trust Measures

Example 1 – Arm’s length purchases

An Australian company or one of its subsidiaries purchases goods from an unrelated foreign discretionary trust (there is no connection between the company and the trust other than the business relationship). In this case the payment for the goods or services will be a transfer of property to a trust. In the case of a discretionary trust, the Australian transferor will not be subject to the transferor trust measures if (put broadly) the transfer is to a customer and the consideration is arm’s length. However, the same exception does not apply for the purchase of goods from a supplier. If the trust is not a ‘listed country trust estate’ the net income of the trust might be included in the attributable income of the Australian parent company.

In contrast, if the transferor was not carrying on business the transferor will not be subject to the transferor trust measures. Therefore transfers made in the course of a business are (potentially) treated more harshly than transfers outside the course of a business.

Example 2 – Employee share schemes for foreign multinationals

A foreign listed multinational company has an employee share incentive plan in place for the employees of the parent company and its non Australian subsidiaries. Under the scheme, the employees might become entitled to shares in the parent company. There is a worldwide arrangement in place that uses an employee share trust to provide the shares to the employees. The subsidiary companies are required to make payments to the trust which the trust uses to purchase on market the shares in the listed parent. This mechanism ensures that the cost of the shares that might be provided in the future is known at the time that the entitlements accrue (that is, it provides an effective hedge against increases in the market value of the shares). However, the employees may not ultimately become entitled to the shares since they might not satisfy the conditions of the share plan (for example, they cease employment before their entitlement under the share plan arises). In any particular year, the payments required by the relevant company are adjusted downwards to take account of the entitlements that do not vest and dividends paid to the trust. The foreign parent would like the employees of the Australian subsidiary to share in the benefits of the employee share plan.

If the Australian company were to implement the employee share plan, the Australian company would transfer property to a foreign trust and might be subject to the transferor trust measures. Because the entitlements under the trust are not fixed the Australian company could become an attributable taxpayer in relation to the foreign trust. If the trust is not a ‘listed country trust estate’ the entire net income of the trust might be attributed notwithstanding that the Australian company will never be entitled to any distribution from the employee share trust. This is a particular concern in relation to dividends that might be derived by the trust on the shares held in the trust.

Forcing the multinational to establish a separate share plan will avoid the issue. However, understandably, the foreign parent is not inclined to establish a separate trust structure for its Australian subsidiary.

Example 3 – Employee share schemes for Australian multinationals

An Australian multinational company wishes to establish for its employees an employee share scheme. For commercial and foreign tax reasons, each foreign subsidiary establishes its own employee share scheme. In other respects, the scheme is as outlined in Example 2. In this case, each CFC will have transferred property to a foreign trust. If the trust is not a ‘listed country trust estate’ the net income of the trust might be included in the attributable income of the Australian parent company, notwithstanding that it is not contemplated that the subsidiary will ever benefit under the arrangement. Again, this is a particular concern in relation to dividends that might be derived by the trust on the shares held in the trust.
Appendix 1
Appendix 2

Proposed modifications to US base company income

The United States has found that its base company rules need adjustment for the global economy, and the Treasury Department and Internal Revenue Service (the IRS) plan to amend certain regulations to make that change. The changes are set out in IRS Notice 2007-9 released on 11 January 2007 for comment. In part, the Notice states as follows.

‘The substantial assistance rules were published as final regulations in 1968 … to treat as foreign base company services income, income received by a CFC from rendering services to an unrelated person where in rendering those services a related person substantially contributes to the CFC’s performance of such services in a manner that suggests that the CFC, rather than the related party, entered into the contract to obtain a lower rate of tax on the service income. Since the regulations were published in 1968, there has been a substantial expansion in the reach of the global economy, particularly in the provision of global services. As a result, many of the U.S. multinationals that provide services outside of the United States currently have globally integrated businesses with support capabilities for unrelated customer projects in different geographic locations, largely based on factors such as expertise and cost efficiencies.

For example, a CFC may contract with an unrelated person to provide installation and subsequent repair services. A related CFC, however, is the foreign corporation that provides the repair services. Although the foreign related CFC that is providing the support services will continue to have foreign base company services income to the extent that it performs those services outside of its country of incorporation, it does not seem appropriate in the current global economy to continue to treat the profits of the CFC contracting to furnish services to the unrelated person as foreign base company services income because of the support services provided by a related foreign person. If the substantial assistance regulations are not amended to deal with these types of businesses structures, the regulations may cause taxpayers to change the way they do business or structure their operations in light of the substantial assistance rules, even if such a structure would be less efficient from a business perspective by, for example, requiring a taxpayer to duplicate a full service infrastructure in each country.

The Treasury Department and the IRS, however, remain concerned about the ability of related United States persons to shift profits offshore to CFCs organized in low tax jurisdictions in cases where the related United States person or persons provides so much assistance to the CFC that the CFC cannot be said to be providing services on its own account and thus acting as an independent entity. Accordingly, the Treasury Department and the IRS will revise the regulations to eliminate the substantial assistance rules, except … certain limited instances in which a United States person or persons provide sufficient assistance directly or indirectly to a related CFC… if the assistance … furnished by the related United States person or persons equals or exceeds 80 percent of the total cost to the CFC of performing the services’.
Appendix 3

Motive test under the UK CFC rules

The UK has a motive test operating as a secondary exclusion from the UK CFC rules. It operates as follows:

‘(3) Notwithstanding that none of paragraphs (a) to (d) of subsection (1) above applies to an accounting period of a controlled foreign company, no direction may be given under section 747(1) with respect to that accounting period if it appears to the Board that -
(a) in so far as any of the transactions the results of which are reflected in the profits arising in that accounting period, or any two or more of those transactions taken together, achieved a reduction in United Kingdom tax, either the reduction so achieved was minimal or it was not the main purpose or one of the main purposes of that transaction or, as the case may be, of those transactions taken together to achieve that reduction, and
(b) it was not the main reason or, as the case may be, one of the main reasons for the company's existence in that accounting period to achieve a reduction in United Kingdom tax by a diversion of profits from the United Kingdom,
and Part IV of Schedule 25 shall have effect with respect to the preceding provisions of this subsection.’

The UK Inland Revenue International Tax Manual states as follows: 59

‘Introduction to the motive test

The sixth and final exemption in ICTA88/S747(1) is the motive test which applies ‘notwithstanding that none of paragraphs (a) to (e) of subsection (1) above [i.e. the other five exemptions] applies’. The motive test was introduced because it proved impractical to devise comprehensive objective tests that ensured that all United Kingdom controlled overseas subsidiaries with profits derived from genuine overseas activities were excluded from the controlled foreign companies’ charge. Its presence in the legislation, however, emphasises the fact that the United Kingdom’s controlled foreign companies’ rules are aimed squarely at countering tax avoidance.

The objective tests provide groups with the certainty that the vast majority of overseas subsidiaries will be exempt from the controlled foreign companies’ rules. The motive test then sweeps up those that, whilst not set up to avoid United Kingdom tax (and therefore not within the intended scope of the controlled foreign companies’ rules), nonetheless do not fit within the specific criteria of the objective tests. The intended result is that only overseas subsidiaries that exist, or carry out transactions, with the aim of avoiding United Kingdom tax will be subject to a charge under the controlled foreign companies’ rules.

Such an approach is, of course, not without difficulties - principally because of two main issues:

59 ‘INTM208010 - Controlled Foreign Companies: exemptions - the motive test' from http://www.hmrc.gov.uk/manuals/intmanual/INTM208010.htm
Appendix 3

- despite numerous valiant attempts there has never been a consensus about what is meant by ‘tax avoidance’ and the term is itself somewhat emotive; one man’s ‘tax avoidance’ is another man’s ‘tax efficiency’; and

- whilst the purpose/reason behind any transaction is basically simply a question of fact, virtually every transaction has a number of different purposes and interpretation of them is inevitably subjective.

The motive test attempts to solve the first problem by:

- avoiding any mention of the term ‘tax avoidance’, settling instead for the rather more neutral concept of a ‘reduction in tax’; and

- providing a statutory definition of what is meant by ‘a reduction in tax’.

The second problem is addressed by means of tests of the main purposes for a controlled foreign company’s transactions and the main reasons for its existence - with each case to be decided on its own facts and circumstances