21 June 2007

Yet Another – and Needed – Review of the Foreign Source Income Anti Tax-Deferral Regimes

In October 2006, the Treasurer requested the Board of Taxation to review Australia’s foreign source income anti tax-deferral regimes – that is, Australia’s regimes that seek to prevent taxpayers deferring Australian tax by storing foreign source income in offshore entities.

The Board of Taxation has now released its Discussion Paper outlining options and inviting submissions for the way forward. It is also currently holding public meetings. Submissions on the Discussion Paper are due by 6 July 2007.

This represents a significant opportunity to achieve a much more business friendly tax regime for the ever increasing foreign operations of Australian residents.

1. Background

Australia currently has four regimes directed to preventing the deferral of Australian tax by accumulating foreign source income offshore:

- The controlled foreign company (CFC) rules that target passive and related party income derived in low tax countries by foreign companies controlled by five or fewer Australian residents.
- The foreign investment fund (FIF) rules that primarily target portfolio investment by Australian residents in foreign entities deriving passive income, though the regime is broad in operation and can catch much more.
- The transferor trust rules that target discretionary trusts set up offshore by Australian resident settlors with income derived in low tax countries.
- The deemed present entitlement rules that substitute for the normal trust taxation rules in respect of foreign trusts not caught by the other regimes (the purposes of which have never been clearly explained or justified).

Australia’s foreign source income rules have not been short of reviews. The rules initially took five years to be developed (1988-1992). The CFC rules were considerably tightened in 1997 following a Treasury Information Paper (1996). The Review of Business Taxation (1999) recommended a comprehensive review of the foreign source income rules which it did not have the time to consider fully given its large agenda. In the meantime, the Review recommended (a) the repeal of the deemed present entitlement rules and (b) limiting the coverage of the FIF and transferor trust rules. The Government accepted both recommendations.
The further review recommended by the Review of Business Taxation was entrusted to the Board of Taxation and its work eventually led to a Treasury Discussion Paper, Review of International Tax Arrangements (2002), a three volume report by the Board to the Treasurer (2003) and series of amendments to the tax legislation (2004-2005). The focus of the Board’s work over this period was broader that just the anti-deferral regimes: most of the major changes were in related areas such as the participation exemption for dividends, the extension to capital gains, the foreign conduit income measures and indirectly also the changes to the rules for taxing capital gains of non-residents announced in the 2005 Budget. The major CFC changes were the considerable narrowing of the income that was taxable in the seven listed countries and of the tainted services income rules.

The Board of Taxation also recommended yet another review of the FIF regime. It was unable to find a formulation that would invoke the regime just for foreign entities that were set up principally for the storing of purely passive foreign source income. The main problem was considered to be tracing through entities in situations where the Australian resident is a portfolio investor and thus would have difficulty in obtaining information on lower tier entities. The difficulty is this: if only the income of the first tier offshore entity had to be tested under the FIF regime, that entity would simply invest in one or more other foreign entities that stored passive foreign income and thus itself would not have any income which attracted the operation of the regime. One important impetus behind the recommendation for a further review was the vibrant Australian funds management industry which punches far above its weight on an international scale – for example, Australia’s managed property fund industry is the second largest in the world after the US – and is significantly impeded by the FIF regime.

The announcement by the Treasurer in October 2006 pursued the Board’s recommendation for a further review of the FIF measures. The review announced by the Treasurer is, however, broader than originally suggested by the Board as it encompasses all the anti-deferral regimes. Important intervening events have seen continued lobbying by business about the anti-deferral regimes generally, articles written by Professor Lee Burns suggesting that the anti-deferral regimes could be merged, and the on-going efforts to locate the income tax law in one Act. After the repeal of inoperative provisions in 2006 and simplified superannuation reforms in 2007, the bulk of the 1936 Act is now made up of the anti-deferral international tax rules.
2. What is not being reviewed

The Paper indicates that the Board will not be considering three issues related to the anti-deferral regimes:

- The Board recommended in 2003 that Australia extend its imputation regime to payments of foreign income taxes. The Government rejected this proposal "at this time" but business has continued to lobby on the issue. The Board’s decision was viewed by one media outlet, probably wrongly, as a rejection of the idea.

- The Australian tax treatment of foreign hybrids such as LLCs and limited partnerships continues to cause problems for Australian business but the Board is not pursuing this issue as it involves broader considerations than just the anti-deferral regimes. This decision may turn out to be unfortunate as certain of the problems highlighted by the Discussion Paper are essentially hybrid issues.

- The Board will not be revisiting its recommendation for the abolition of the deemed present entitlement rules, a recommendation which the Government has already accepted twice. This issue is regarded as settled.

The first two issues are regarded by the Board as beyond its terms of reference.

3. Process

It is almost inevitable that tax reviews get mixed up with federal elections in Australia, given the three year electoral cycle, and the current exercise is no exception. A comprehensive redesign of rules that were originally five years in the making will inevitably take some time but time is short if the Board is to report to the Government before the next election as the terms of reference require. Perhaps for this reason, as well as the desire to explore the possibility of a unified regime, the review is to proceed in two stages.

The first stage will be concerned with "high level design principles," Treasury-speak for the basic structure of the regimes, including the possibility of collapsing them into one or two rather than three regimes (assuming the deemed present entitlement rules are already expunged).

The second stage will consider the detailed rules and their drafting which will be subject to another round of consultation. In this stage in particular, the Discussion Paper indicates that detailed rules would draw as far as possible from familiar existing concepts and rules. What would be significantly different is the way in which they are combined.

Business may find the fairly vague and somewhat nebulous proposals in the Discussion Paper hard to assess, but it is worth the effort as some of the proposals involve potentially large roll-backs of the current rules.
As might be expected from the background recounted above, this review will not be the last. In fact, the Board wants to institutionalise the process of reviewing the international anti-deferral rules because the on-going effects of globalisation mean that a country needs to be nimble in its responses to competitive pressures on its international tax rules. On the other hand, stability is a value to be weighed and so the Board sees its future reviews as in the nature of fine-tuning.

4. Policy

Nonetheless, the basic policy settings for taxation of foreign source income are regarded by the Board as having been settled by its 2003 Report and the Government’s response.

Those settings are that direct investment abroad by Australian companies which generate active income will not be taxed in Australia, either on the distribution to the Australian company or the sale of the shares in the foreign company. This policy applies to foreign investment by Australian companies directly or through foreign entities and whatever the level of tax on the income in a foreign country. This policy is seen as important for allowing Australian companies to compete on even terms in all foreign countries, both high- and low-tax countries.

The policy is similar for income from portfolio investment in foreign entities that derive primarily active income: the income received by Australian individuals, companies and funds management entities will only be taxed in Australia on realisation of that income, that is, when it is distributed from the foreign entity or interests in the foreign entity are sold by Australian investors.

Where, however, Australian residents invest in foreign entities deriving mainly passive foreign income that is rolled up in the entity, the policy intention is that the income is to be taxed to the Australian residents on some form of accruals basis. That is, the income will be taxed to residents before being realised by them in the form of distributions from the foreign entity or on the sale of the interests held in the foreign entity.

The difficulty is to give effect to this broad policy in concrete terms and the Board sees the current project as directed to a redefinition of the regimes, rather than a change in broad policy direction. In setting the new boundaries of the regimes, the Board proposes to take account of the following factors:

- International competitiveness of Australian businesses;
- Market and business factors such as changes in the international economy over the last decade arising as part of globalisation, including particularly the growth in international provision of services and international outsourcing by business of routine functions;
- Complexity, and compliance and administrative costs; and
- Last, and probably least, the level playing field and risk to the revenue.
5. Convergence of anti-deferral regimes

The most significant possible change as noted above is collapsing all or some of the existing regimes. Essentially this would involve looking for common or preferred approaches in each of the three major building blocks of the current regimes:

- the entities, and interests in them, which are potentially subject to the anti-deferral regimes;
- the various tests which are used as the means of targeting passive income; and
- the methods of calculating the attributable income under the regimes for those cases which fall within them.

Three convergence possibilities are canvassed:

- A single regime covering CFCs, FIFs and transferor trusts;
- One regime for what are currently CFCs and FIFs with another regime for transferor trusts; and
- Three regimes as at present but with much greater use of common concepts and rules.

The Discussion Paper leans in favour of a single regime. This may be viewed with concern by business as effectively mixing up the different categories of taxpayers who use offshore entities to derive foreign source income – multinational and funds management businesses on the one hand, and high net wealth individuals on the other. But it can also be viewed as an opportunity to get the most generous treatment out of existing possibilities and/or to eliminate some of the existing features that are difficult to work with across all regimes.

One example given in the Discussion Paper is the different tests used to distinguish active from passive income in the CFC and FIF regimes. The CFC regime uses a combination of comparable tax countries, the 95% active income test and tainted income as the major tests in targeting the CFC regime. The FIF regime uses tests based on 50% of the types of assets of entities to eliminate them from the regime. A combined regime might use the 50% asset method, along with comparable tax country test, to eliminate a large range of foreign entities and countries from accrual altogether.

One possible benefit of a combined regime mentioned in the Discussion Paper is that it would be difficult to fit tainted sales and services income concepts into such a combined regime. Instead the transfer pricing concerns covered by these parts of the accruals regimes could be left to be dealt with by transfer pricing rules, while the concern with outsourcing services to foreign countries might be abandoned altogether.

Aside from the discussion of the overall structure of the regime, the Paper also canvasses issues arising in relation to each of the three building blocks.
6. Interests and entities covered

Generally, it is proposed that the rules would continue to be targeted on the same kinds of interests and entities as at present, that is, shares in foreign companies and interests in foreign trusts (or the settlor in the case of trusts where the interests cannot be readily identified). The interests covered would be narrowed under one possibility raised in the Paper, the use of the membership interest definition currently used for consolidation. In the case of companies for example, this definition covers shares but excludes debt interests such as most kinds of redeemable preference shares. Conversely, the Paper asks taxpayers to consider a definition expressed more in terms of economic interests which might bring options and other derivatives within the regimes.

The application of the rules in relation to exotic foreign entities that do not have exact Australian equivalents (such as anstalts and foundations) is proposed to be clarified though it is not suggested exactly how.

Under a converged regime or regimes, the complications of the control rule in the CFC regime could disappear. The Paper suggests that the control rule at the moment simply serves as a signpost between the CFC and FIF regimes and their different calculation methods. Instead of a control rule, taxpayers could be given elections among calculation methods.

Greater equivalence across entities could also be achieved under converged regimes. At the moment the CFC regime applies to companies only, the FIF regime to companies and trusts and the transferor trusts rules to trusts only, while within the FIF regime there are more generous exemptions for companies compared to trusts.

7. Types of income targeted

In a structural sense, converging the regimes may lead to more generous overall common exemptions as discussed above. The Discussion Paper also canvasses a number of specifics issues involved in targeting. This is the most critical part of the regimes that might change.

In relation to passive income, the Paper canvasses the problem of defining passive income by its nature (interest, rent etc) rather than by the kind of activity in which it arises. Specific issues discussed in the Paper include whether the concept of an the subsidiary of an Australian financial institution is too limited, and the related issue of in-house finance companies. One suggestion is to look through the income of the latter type of company to the kind of income generated by the group of which it is part. In relation to rent, there is some discussion of the problems that the current regimes create for integrated property development and investment companies in which Australia has developed specialised expertise. Finally, the problems of start-up companies which often have passive investment income while they gear up their active business operations are mentioned.

Generally, the Paper does not canvass detailed solutions on these issues, but rather seeks suggestions. Business may be encouraged that the Paper is raising some of the right questions.
On the other hand, the discussion of comparable tax (listed) countries is less encouraging. It conveys the idea that the bureaucracy does not like maintaining lists based on relatively general criteria. The 2003 Report by the Board of Taxation suggested expanding the current list of seven comparable tax countries but the current Discussion Paper may involve some retreat from that position.

The Paper does develop in some more detail the idea in the 2003 Report that led to the removal of complying superannuation entities from applying the FIF regime. It raises the possibility that there may be broader categories of entities which could be regarded as not motivated in a business sense by deferral of Australian tax. Apart from widening the super fund exemption and removing the obvious candidate of tax exempt Australian entities (charities and the like), the Paper discusses the possible exclusion of Australian listed companies and even foreign listed companies (though with less enthusiasm in the latter case). While a blanket exemption is probably not workable for Australian listed entities, it should be possible to define high distribution listed companies (such as 50% or more of reported earnings), though the Paper does not make such specific suggestions.

As noted above, the problems of the FIF regime for the funds management industry were the prime motivator for the current review and accordingly a number of possible changes are canvassed specifically for funds managers but also with the possibility of wider application:

- Obviating the need for bed and breakfast arrangements under which fund managers sell and buy back investments in order to meet the 10% balanced portfolio limit in current law (though no details are given of how this might be done);
- Development of comparable tax criteria for eliminating countries from attribution (compare the discussion of listed countries above);
- Increase of balanced portfolio exemption to 25%;
- Developing exclusions for distributing foreign funds (that is, funds which annually distribute all or most of their income and income of underlying entities).

In a more general vein, the Paper discusses the possibility of a motive test for exclusion from the accruals regimes, though not with any obvious enthusiasm.

Finally, the Paper suggests bringing de minimis exclusions from the various accruals regimes into line and regularly reviewing the thresholds (which have not been increased since the regimes were introduced).
8. Methods for attributing income

Along with the possibility of election among calculation methods for attributable foreign income under the accruals regimes referred to above, the Paper discusses some specifics of the various calculations required under the regimes.

For taxpayers which have the information to do a full calculation of actual income of foreign entities, the Paper raises the possibility of using the simpler FIF calculation that is based on accounting information across all regimes rather than the detailed Australian tax calculation currently required under the CFC and transferor trust regimes.

The Paper notes that the mark-to-market method is the most commonly used method under the current FIF regime for cases where taxpayers do not have either the necessary information or the desire to do detailed calculations, despite the acknowledged defect of this method – it captures unrealised gains on foreign assets and treats them as ordinary income. The common use of the mark-to-market method arises at least in part because the deemed rate of return method deliberately uses a very high deemed rate to make it the method of last resort.

The main possible change canvassed in the Paper, though not in quite these terms, is to reverse the ordering of the two methods by lowering the deemed rate of return. The Paper notes that New Zealand has recently introduced a 5% deemed dividend method based on the market value of the foreign investment at the start of the year. This idea has appeal particularly if regard is had to the basic concern of the foreign accruals regimes: sheltering passive income from Australian tax. The typical example noted above is a foreign fund that rolls up interest income. If the distinction between passive and active income is essentially a matter of risk, then investments producing returns beyond the safe interest rate can effectively be characterised as active. Hence, the use of a more reasonable deemed rate of return like 5% is a reasonable proxy for taxing low risk foreign investment producing rolled up income; this is what the threshold tests discussed above are trying to isolate as the subject of the accruals regimes.

The Paper also discusses problems of part year income, the effective conversion of capital gains to ordinary income under the regimes and some of the complexities arising from tracking accrued income that is taxed under the regimes to ensure that it is not taxed again. It recognises that there are considerable compliance problems with these rules but is short on specifics for fixing them apart from making the tracking rules less prescriptive. Again, suggestions are sought to overcome the problems.

One possible downside of making calculation methods elective is that excluding types of income from the calculation can only be done effectively for a full calculation of actual income. The market value and deemed rate of return methods have no dependence on the actual income of the entity and the type of income. Hence, if targeting tainted income as in the current CFC regime is to remain, it would only be possible for cases where a taxpayer elects a full calculation.
9. Consultation and submissions

The window for submissions is closing quickly because of the constrained timetable. The Board of Taxation is holding public meetings shortly and submissions are due by 6 July 2007. Nonetheless, the review represents an excellent opportunity for business to bring about considerable improvements to the overall structure of the current regimes and reduction in their overly-intrusive operation. We suggest that clients actively consider making submissions.

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

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