Australian Government

The Board of Taxation

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

Discussion Paper

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The Board of Taxation
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REVIEW OF THE FOREIGN SOURCE INCOME ANTI-TAX-DEFERRAL REGIMES

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FOREWORD

Australia's tax arrangements play an important role in overseas investment. It is therefore vital that these settings do not impede Australian businesses from investing and expanding offshore.

The anti-tax-deferral regimes form an integral part of Australia's international tax settings. They are important integrity rules needed to protect the Australian tax base. However, integrity concerns must be balanced against other concerns such as equity, efficiency, simplicity and low compliance costs. These objectives are fundamental to ensuring Australian businesses remain competitive in the global economy.

Regular review of Australia's international tax settings, including the anti-tax-deferral regimes, is essential to ensure that they remain in step with changes in the world economy. The Board therefore welcomes the opportunity to conduct this review of the anti-tax-deferral regimes.

The rules have been subject to previous examination as part of the Review of International Taxation Arrangements (RITA). This Review provides a further opportunity to examine the regimes and address any remaining issues holistically.

Consultations with industry and submissions from interested parties will play a crucial role in shaping the Board's recommendations to government.

R F E Warburton, AO
Chairman, Board of Taxation

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Deputy Chairman, Board of Taxation

EXECUTIVE SUMMARY

Terms of reference

The Government has asked the Board to identify ways to reduce the complexity and compliance costs associated with Australia's foreign source income anti-tax-deferral (attribution) regimes, including whether the regimes can be collapsed into a single regime, and to examine whether the regimes strike an appropriate balance between effectively countering tax deferral and unnecessarily inhibiting Australians from competing in the global economy.

Background

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

Australia's attribution regimes include the controlled foreign company (CFC), the foreign investment fund (FIF), the transferor trust, and the deemed present entitlement rules.

The attribution regimes were designed in the late 1980s and progressively enacted in the early 1990s. Since their introduction, globalisation has significantly affected the business environment faced by Australian businesses and seen them increasingly competing in the world economy. There have also been developments in the broader taxation environment, such as the advent of dividend imputation and the development of transfer pricing, that may have implications for the attribution rules.

Although the attribution regimes were introduced within a relatively close period, they are not fully coordinated. In some cases, more than one regime potentially applies to a particular taxpayer in respect of the same income while, in other cases, different regimes can apply to different taxpayers in respect of the same income. The regimes also lack consistency with none of the regimes universally applying across all entity types.

The way forward

This Review provides an opportunity to consider the attribution regimes in this context. Any changes should strike an appropriate balance between ensuring Australia's tax base is not eroded through the shifting of capital to countries with preferential tax regimes, while at the same time ensuring that Australian businesses with offshore operations can compete effectively in the global economy.

Harmonising the regimes provides the opportunity to address problems with the operation of the existing rules including that the policy objectives of the regimes are appropriately balanced. Greater consistency across the regimes would ensure that, as far as possible, similar investments are treated in a comparable way, in addition to providing potential reductions in complexity and compliance costs.

The discussion paper explores which features of the existing attribution regimes could be drawn together in the development of a harmonised regime. The problems with existing aspects of the regimes are canvassed together with reform options, so that, to the extent that those aspects are retained in the context of a harmonised regime, those problems do not perpetuate.

Changes to the tax laws of the kind explored in this Review will inevitably bring with them associated transitional costs. An assessment must be made of whether these costs would outweigh the ongoing benefits that could be gained from harmonising the regimes. Transitional costs would be reduced if the approach to harmonising the regimes draws heavily on the features and concepts in the existing rules.

AUSTRALIA'S FOREIGN SOURCE INCOME ANTI-TAX-DEFERRAL REGIMES

Chapter 2 considers the key factors that need to be taken into account in considering, at a general level, possible changes to the attribution regimes: the environment in which the regimes operate; the historical development of the regimes; and the policy drivers behind the regimes. It also canvasses the concept of a harmonised regime.

The prospect of harmonising the attribution regimes necessarily infers an amalgam or a consistent application of the features of the existing regimes. The paper conceptualises this by examining the three building blocks common to each regime:

- The kinds of interests and entities to which the attribution regimes should apply (Chapter 3).
- The kinds of income that the attribution regimes should target (Chapter 4).
- The methodologies that should apply for attributing targeted income (Chapter 5).

The design principles for harmonising the attribution regimes, including administration and transitional issues, are then considered in Chapter 6.

INTERESTS AND ENTITIES

Chapter 3 examines a range of issues that are associated with the current regimes in respect of interests and entities and canvasses possible solutions. The Chapter also discusses the implications of a harmonised regime and the extent to which such a regime might deal with these issues in a systemic manner.

Relevant issues canvassed in the Chapter include the ramifications of dispensing with the notions of 'control' and 'associate' within the attribution regimes.

TYPES OF INCOME

Chapter 4 considers how the attribution regimes might better target the kinds of income that present the best opportunity for inappropriate tax deferral. The attribution regimes generally allow deferral for active income, but apply accruals taxation for passive income and base company income. How this is achieved varies across the regimes.

The Chapter considers the mechanisms within the existing attribution regimes for targeting income. Comments are sought on how the operation of the existing regimes can be better targeted, with a focus on achieving more consistent outcomes across the regimes. Some possible further exemptions that might be provided are then considered.

METHODS FOR ATTRIBUTING INCOME

Chapter 5 discusses the appropriateness of the current attribution methods and record keeping requirements, and how they might be improved. The Chapter also considers whether taxpayers should be permitted to choose which attribution method to apply, or whether there should be restrictions on such a choice.

DESIGN PRINCIPLES FOR A HARMONISED ATTRIBUTION REGIME

Chapter 6 provides a blueprint of the various options for harmonising the regimes, and evaluates their respective advantages and disadvantages. The options include:

- maintaining separate regimes but providing more consistent outcomes across those regimes;

- collapsing all of the regimes into a single regime; or
- merging some regimes together (or aspects of the regimes), for example, the CFC and FIF regimes, while maintaining a separate regime for transferor trusts.

A move towards harmonising the regimes does not necessarily imply that one set of rules would apply to all taxpayers and all income in every circumstance. There may need to be differing rules for differing circumstances within a unified framework in order to achieve appropriate and more consistent outcomes.

The Chapter is premised on the assumption that the problems with the existing attribution regimes identified in the preceding chapters will be appropriately addressed in a harmonised regime. The blueprints also assume that the traditional approach of targeting passive income through a range of exemptions or positively defining passive income will continue to apply in the future. Administrative and transitional issues are also discussed.

CHAPTER 1: INTRODUCTION

BACKGROUND TO THE REVIEW

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

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

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

1.4 In announcing the Review, the Treasurer noted that business had raised a number of concerns with the Government about the anti-tax-deferral regimes, including that they are complex and involve substantial compliance and administration costs.

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

REVIEW'S TERMS OF REFERENCE

1.6 Against this background, the Treasurer has asked the Board of Taxation to review the operation of these regimes. The Review's terms of reference are:

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

REVIEW PROCESS

1.7 The Board of Taxation has been tasked with conducting the Review. The Board of Taxation is an independent, non-statutory body established to advise government on various aspects of the Australian taxation system. As part of the Review, the Board will engage in wide public consultation with interested organisations and individuals.

1.8 To facilitate that public consultation process, the Board has developed this paper as a basis for further discussion. In developing the paper the Board has conducted some targeted consultations with key stakeholders. Drawing on those consultations and other information, this paper canvasses issues that have already been brought to the attention of the Board and poses questions to be addressed as part of the consultation process. The paper provides a framework for consideration of the key issues so that they can be addressed in a systematic way. It is not expected that all stakeholders will necessarily respond to all of the issues and questions identified. Rather, some stakeholders may only wish to respond to those issues of direct relevance to them. A summary of the questions raised in the discussion paper is provided in Appendix A.

1.9 The consultation process will provide an opportunity to discuss the issues canvassed in more detail. The Board is also planning consultation forums during the consultation period as a further mechanism for obtaining views and to assist stakeholders in preparing written submissions. Submissions and other advice will be considered by the Board before presenting its recommendations to Government for consideration later this year.

1.10 Given the time available, and the potential breadth of issues associated with the Review, these recommendations will necessarily focus on high level design principles. The Board envisages that a further process would then occur, involving consultation with industry, to settle the details under those principles, including in respect of the draft legislation.

1.11 The Board anticipates that, by inviting comment at this early stage, it will allow industry to become actively involved in determining the outcomes of the Review. This will ensure that changes to Australia's anti-tax-deferral regimes appropriately balance the policy objectives of the regimes (see Chapter 2).

1.12 While related international tax issues may be raised as a result of this Review, the Board intends to confine its deliberations to those matters that directly relate to Australia's anti-tax-deferral regimes. For example, the Board does not intend to reconsider the possible provision of franking credits for foreign tax paid by offshore subsidiaries of Australian companies (this issue formed part of the Board's *Review of International Taxation Arrangements* report to Government in 2003[1]). In a similar vein,

1 Recommendation 2. 1(1).

although the Board has received representations that the taxation of foreign hybrids is an emerging issue needing attention, it does not intend to consider these issues to the extent that they involve a wider application of the tax laws.

1.13 Finally, the Board does not intend to consider the Government's previous announcement to repeal the deemed present entitlement rules (see Appendix B). This announcement implements the Board's recommendation from the Review of International Tax Arrangements to simplify the taxation treatment of foreign trusts. The Board notes that this announcement is consistent with the general thrust of harmonising the existing regimes and continues to have the Board's endorsement.

MAKING SUBMISSIONS

1.14 The Board welcomes submissions on the issues raised in this discussion paper. The closing date for submissions is 6 July 2007. Submissions may be sent:

By email to:

taxboard@treasury.gov.au

By facsimile to:

(02) 6263 4471

By post to:

Foreign Source Income Anti-Tax-Deferral Review
Board of Taxation Secretariat
C/ - The Treasury
Langton Crescent
PARKES ACT 2600
AUSTRALIA

1.15 Submissions should include a brief summary of major points and recommendations. They should also include contact details so that, if required, the Board can contact those making the submission to discuss the points raised. Submissions will be published on the Board's website (www.taxboard.gov.au) unless it is clearly stated that the submission is confidential.

CHAPTER 2: AUSTRALIA'S FOREIGN SOURCE INCOME ANTI-TAX-DEFERRAL REGIMES

BACKGROUND

2.1 This Chapter considers the key factors that need to be taken into account in considering, at a general level, possible changes to Australia's anti-tax-deferral regimes ('attribution regimes'): the environment in which the regimes operate; the historical development of the regimes; and the policy drivers behind the regimes. It also canvasses the concept of a harmonised regime.

International tax arrangements

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

2.3 For individuals, taxation of worldwide income is important in achieving the principles of vertical equity (the higher an individual's income, the higher the average rate of tax) and horizontal equity (individuals on the same income pay the same amount of tax). The latter principle is also important for economic efficiency in minimising distortions in economic choices.

2.4 To ensure residents cannot undermine these principles by accumulating foreign source income offshore and thereby defer, or even avoid, Australian tax, attribution rules apply to tax residents on an accruals basis on their share[2] of foreign source income accumulated in an offshore entity.[3] This ensures offshore investments are not favoured over domestic investments for taxation reasons.

2.5 In balancing integrity and compliance cost concerns, the rules are only intended to apply in situations where the risk of inappropriate tax deferral is the greatest. An outline of the current attribution regimes — the controlled foreign company (CFC), the

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2 Detailed rules apply to determine a taxpayer's share of foreign source income accumulated in the offshore entity.

3 The possibility of deferral arises as a result of two structural features of the tax laws. First, the treatment of an entity as a taxable entity separate from its owners and, second, the treatment of the entity located offshore as a non-resident of the country in which the owners are resident. See further: Arnold B, *The Taxation of Controlled Foreign Companies: An International Comparison*, Canadian Tax Foundation, Toronto, 1986.

foreign investment fund (FIF), the transferor trust, and the deemed present entitlement regimes — is provided at Appendix B.

2.6 Australia's attribution regimes were designed in the late 1980s and progressively enacted in the early 1990s. There have been significant changes in the economic context in which these regimes operate since that time. There have also been developments in the broader taxation environment that may have implications for the attribution regimes. This Review provides an opportunity to consider the regimes in the context of these changes.

ENVIRONMENT IN WHICH THE REGIMES OPERATE

Economic context

2.7 Since the attribution regimes were introduced, globalisation has significantly affected the business environment faced by Australian businesses and seen them increasingly competing in the world economy. There have been dramatic increases in the mobility of capital, particularly portfolio capital. More generally, the greater mobility of labour when combined with the mobility of capital and developments in communications has seen the modern multinational enterprise become a more mobile organisation.

2.8 As integration and liberalisation of world markets, including capital markets, increases and the number of multinational companies grows, investment and capital flows may become more sensitive to taxation arrangements.

2.9 The greater mobility of capital places increased pressure on the taxation arrangements of the jurisdiction in which the capital is located. Capital will tend to migrate towards jurisdictions where tax is the lowest (assuming other motivating factors remain equal).[4] The lower level of taxation may be because of minimal or no taxation (tax havens) or preferential tax regimes specifically designed to attract highly mobile capital. Where tax does influence those decisions, transparency, simplicity in the law and tax administration also matter.

2.10 The global economy has altered the business environment in such a way that it is desirable for countries to ensure that impediments do not stand in the way of residents

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4 Non-tax factors, such as market proximity, are usually more important in determining the location of direct investment. Other significant non-tax factors include the quality of infrastructure, location of other like firms in an industry, presence of related industries, labour force skills and productivity, and political and economic stability.

Portfolio flows of capital are usually more sensitive to tax considerations than direct investments. However, non-tax factors such as market size and openness, efficiency of transactions, and information asymmetries are also important factors. See further: Treasury, *Review of International Taxation Arrangements: A Consultation Paper*, AGPS, Canberra, August 2002.

who wish to expand their activities offshore. As firms reach the limits of possible growth in Australia, they are faced with the need to consider expanding offshore. This is not only true for Australian multinational firms but equally relevant for Australian managed funds.

2.11 The trend towards lower trade barriers has seen greater cross-border flows of goods and services. In particular, the growth in the globalisation of services has seen an increasing level of sourcing of service inputs from abroad. This trend is relatively recent compared to the well-established practice of sourcing manufacturing parts offshore. It reflects changing business models where companies source services from specialised firms as an alternative to in-house production. This development has been triggered by technological advances, such as the development of broadband networks and the digitisation of services, and the emergence of a global labour market of highly skilled mobile workers.

2.12 Although there are no official statistics measuring the extent of international sourcing, estimates suggest that it will accelerate in most Organisation for Economic Cooperation and Development (OECD) countries in coming years.[5] International sourcing generally involves functions that are easy for companies to purchase externally due to their intensive use of information technology and low need for face-to-face contact.

2.13 The attribution regimes need to be assessed to determine whether they apply appropriately in the context of this recent and potential growth in the globalisation of services. Moreover, in an increasingly globalised and borderless economy, Australia's international taxation arrangements play an important role in ensuring that Australia remains an important location for regional headquarters and that Australian multinationals are able to compete in global markets.

Taxation developments

2.14 The business model under which these expanded global operations operate has evolved from the period in which the attribution regimes were first developed. International trade has increased between related parties compared to unrelated parties. Transfer pricing has therefore taken on a more important role. As the attribution regimes are also concerned about such transactions given the potential for tax advantage, Australian-owned companies must deal with two sets of rules, often with significant overlap, and both involving high compliance costs. Moreover, the ongoing development of Australia's transfer pricing rules[6] has mitigated the potential

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5 See further: OECD, *Growth in Services: Fostering Employment, Productivity and Innovation*, Meeting of the OECD Council at Ministerial Level, 2005.

6 Primarily through ongoing administrative development, rather than legislative change.

erosion of Australia's tax base for international related-party transactions. In turn, this may have reduced the need for certain aspects of Australia's CFC rules.

2.15 Additional relevant features in the development of Australia's taxation arrangements include the dividend imputation and self assessment systems. While introduced prior to the attribution regimes, it has now become clear that the imputation system has created strong incentives for domestic over foreign investment, reducing the incentive to accumulate income offshore. The attraction of franking credits has led to shareholder demands for dividends, resulting in Australian listed companies having amongst the highest payout ratios in the world.[7]

2.16 The introduction of self assessment at a similar time to the introduction of the attribution regimes has changed the relationship between the Australian Taxation Office and taxpayers together with their tax advisers. The onus of responsibility for making a tax assessment now belongs to taxpayers, with significant penalties for serious errors (where reasonable care has not been taken). Within this context, the attribution regimes, which are often cited as being among the most complex rules in the tax laws, impose significant risks on resident taxpayers.

2.17 While business considerations are the key drivers, the mobility of capital makes it easier today for multinationals to take advantage of tax havens and preferential tax regimes. In the past, incentives under preferential tax regimes have generally been aimed at the goods sector to attract manufacturing operations. More recently, countries have increasingly used tax incentives to attract mobile capital, including portfolio investment.

The way forward

2.18 Against the backdrop of these economic and taxation changes, the Board welcomes the opportunity to review the attribution regimes and looks forward to providing advice to the Government on possible changes to the rules. Any changes should strike an appropriate balance between ensuring that Australia's tax base is not eroded through the shifting of capital to countries with preferential tax regimes, while at the same time ensuring that our businesses with offshore operations can compete effectively in the global economy.

2.19 The Board also sees the Review as providing an opportunity to maintain the momentum that started with the Government's implementation of the 2003 Review of International Taxation Arrangements (RITA) reforms. These reforms made a positive contribution towards ensuring that Australia remains an important location for regional headquarters and that Australian multinationals are able to compete in global markets.

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7 Kohler A, 'Beware the debt-equity pendulum', *The Age*, 7 December 2005, p 12 and Griffin P, 'Directors' job bedevilled by privateers', *Australian Financial Review*, 14 March 2007, p 59.

2.20 At least 21 countries, mostly OECD members, have attribution rules and a number of these countries have recently reviewed, or have signalled their intention to review, the operation of their rules (including New Zealand, the United States, the United Kingdom, France and Canada).[8]

2.21 As Australian businesses, both large and small, seek opportunities offshore, Australia's international tax settings cannot operate to the disadvantage of these enterprises compared to their global competitors. In today's competitive environment where countries constantly seek to attract evermore financial and human capital, our international tax settings, even if competitive now, can become uncompetitive in a relatively short period of time.

EVOLUTION OF AUSTRALIA'S ATTRIBUTION REGIMES[9]

2.22 In considering the direction in which Australia's attribution regimes should be heading, it is important to consider where they came from and how they have evolved over time. This assists in understanding how Australia arrived at the current rules and what issues were considered in the past.

Initial development

2.23 In 1988, the Government released *Taxation of Foreign Source Income — A Consultative Document*.[10] The Consultative Document proposed a single attribution regime that applied to Australian residents with an interest in foreign private companies and to a 10 per cent or greater interest in foreign public companies.[11]

2.24 As originally outlined in the Consultative Document, the scope of the proposed regime applied to both control and non-control cases. While an exemption was

8 Some European Union countries are reviewing their rules including as a result of a European Court of Justice decision which questioned the validity of the United Kingdom's CFC rules operating within the European Union unless there was a strong tax avoidance motive.

9 For a fuller explanation see: Burns L, 'Rethinking the Design of Australia's CFC Rules in the Global Economy', *Bulletin for International Fiscal Documentation*, vol 59 no. 7, 2005, pp 262-280.

10 Until 1987, Australia generally exempted income sourced in another jurisdiction if that income had borne any foreign tax. Similarly, there were no accruals tax requirements for income derived in tax havens. In 1987, a foreign tax credit system was introduced. Foreign source income, including dividends received, became subject to Australian income tax with a credit given for foreign tax paid. A worldwide, rather than country by country, basis for assessing foreign income was adopted. With the reduction in the Australian company tax rate to 39 per cent, it was considered that there was little to be gained in taxing foreign source dividends where the foreign country had a similar tax system to that in Australia. Thus, from 1 July 1990, dividends derived from comparable tax jurisdictions were again exempt from tax.

11 Although Australia introduced attribution rules in the early 1990s, some discussion regarding the need for attribution rules occurred in the 1975 Asprey report and in the Government's 1985 paper *Reform of the Australian Taxation System: A Draft White Paper*. Among other recommendations, the Draft White Paper recommended adopting measures to ensure that foreign income earned by domestically controlled foreign companies and trusts could not be sheltered in tax havens.

proposed for comparably taxed profits, no exemption was proposed for active income. Under the proposal, an Australian resident shareholder's interest in the income of the foreign company would be calculated according to Australian tax law and included in the shareholder's assessable income — that is, 'branch-equivalent taxation'.

2.25 After public consultation, the Government released in 1989, *Taxation of Foreign Source Income: An Information Paper*, which proposed several key modifications to the proposals set out in the Consultative Document. Seminal amongst these were the inclusion of a control rule and an active income exemption.

2.26 The Information Paper proposed a control rule on the basis that it was unreasonable to apply attribution regimes to shareholders who were unable to bring about the benefit of deferral, together with recognition that only controlling shareholders would have the necessary information to perform branch-equivalent calculations. Importantly, the control rule served to distinguish between attribution and legitimate deferral.

2.27 The inclusion of an active income exemption narrowed the scope of the rules, leaving active income to benefit from deferral. The exemption was justified on the basis that there may be legitimate commercial reasons for an Australian company to establish foreign active operations through an offshore subsidiary. On the other hand, the Information Paper explained that the elimination of deferral for passive income was necessary as the location of passive investment is often just a matter of portfolio choice without any great economic significance, with tax considerations likely to be significant in the location of the investment. Where choice has economic significance, such as spreading of risk through diversifying a portfolio, tax should not be an important factor.

2.28 Australia implemented CFC rules with effect from 1 July 1990, becoming the eighth country to adopt such rules.[12] The rules closely followed the design in the Information Paper.

2.29 After previously being foreshadowed for consideration in the Information Paper, the Government enacted the FIF regime with effect from 1 January 1993.[13] The FIF regime is a separate stand-alone attribution regime applicable in non-control cases.[14] Under the FIF rules, proxy or surrogate calculation methods apply to attribute income to resident taxpayers, recognising that those with non-controlling interests often would not have access to the information necessary to prepare branch-equivalent calculations.

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12 CFC rules had already been introduced in the United States, Canada, France, Germany, Japan, the United Kingdom and New Zealand.

13 A further information paper was released in 1992 which explained the proposed operation of, and policy behind, the FIF rules. The paper was entitled *Taxation of Interests in Foreign Investment Funds: An Information Paper*.

14 While the 1989 Information Paper appeared to contemplate anti-deferral rules only applying to arrangements intended to avoid the CFC rules, the FIF regime that was enacted was based on a separate stand-alone anti-deferral regime applicable in non-control cases.

2.30 The FIF rules apply to interests in foreign companies and trusts. They have an active business exemption that applies only to interests in foreign companies. The design of the exemption is different from that in the CFC rules. While the active income exemption under the CFC rules is modelled on the nature of the income derived by the CFC, the exemption that applies under the FIF rules is based on the nature of the activities undertaken by the entity.

2.31 Although the control rule was originally intended to distinguish between legitimate deferral and attribution, the introduction of the FIF rules signalled a fundamental shift in its purpose. It assumed the function of steering taxpayers to the most appropriate regime to eliminate deferral. If the taxpayer can prepare branch-equivalent calculations, the CFC rules would apply and, if they cannot, the FIF rules would apply. Underlying this is the assumption that 'control' is an appropriate barometer for determining whether or not taxpayers are in a position to perform branch-equivalent calculations.

2.32 Many OECD countries with CFC rules also introduced FIF rules at the same time or shortly afterwards. The rationale often cited is that it is necessary to prevent domestic revenue leakage that would otherwise result from portfolio investment. Countries with FIF regimes that complement their CFC rules include the United States, Germany, New Zealand, Canada, and the United Kingdom.[15]

2.33 The Consultative Document and Information Paper also proposed a separate attribution regime, the transferor trust regime, which would apply to income accumulated in a foreign discretionary trust for the potential benefit of Australian residents.

2.34 Since the discretionary nature of such trusts makes it difficult to tax potential beneficiaries of the trust income, the transferor trust rules apply to tax the person who transferred value to the trust (the 'transferor'). The rules work on the assumption that the transferor is unlikely to transfer value to a foreign discretionary trust unless they are expecting to benefit from the transfer.

2.35 In contrast to the American influence over the design of Australia's CFC regime,[16] it has been suggested that Australia's transferor trust rules owe their heritage to the United Kingdom which introduced rules to prevent transfers of assets to overseas trusts to defeat the country's pre-war death duty regime in the 1930s.[17]

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15 Some overseas FIF regimes are significantly different to Australia's FIF arrangements. In some cases FIF rules only apply where a tax avoidance motive exists (for example, Canada) while other rules seek to subject capital gains to income tax treatment (for example, the United Kingdom).

16 The Australian CFC regime was based on the model designed by the administration of President John F Kennedy and enacted in Congress in 1963.

17 See further: Bevan C, 'Reform of the Taxation of Foreign Trusts in Australia and the United States: A Comparative Analysis', *Australian Tax Review*, vol 35, no. 1, 2006, p 22.

2.36 Although there is no active income exemption under the transferor trust rules, there is a comparable tax exemption that is based on the same listing of comparable tax countries as applies under the CFC rules. The income attributed to the transferor is based on branch-equivalent calculations or, where information is insufficient, a deemed rate of return.

2.37 An interest charge also potentially applies to distributions by a foreign trust to a resident beneficiary where the income has not previously been subject to tax. Although the interest charge was enacted as part of the transferor trust regime, it potentially applies to any foreign trust (other than a public unit trust) with resident beneficiaries.

2.38 The interest charge was modelled broadly on the interest charge that applies under the United States' passive foreign investment company regime (the equivalent of Australia's FIF regime). However, the United States interest charge, unlike its Australian equivalent, applies as an attribution method in its own right rather than as a fall-back to attribution.

2.39 The Government enacted a fourth attribution regime known as the deemed present entitlement rules at the same time as the FIF rules were enacted. While the policy underlying these rules is difficult to discern, it seems that they are primarily aimed at income accumulating in closely-held fixed trusts. Australian academic, Professor Lee Burns, explains that '[T]his class of trust is not covered by the CFC rules as those rules apply only to companies. As the beneficiary should be able to do branch-equivalent calculations, it is not appropriate to subject these interests to the FIF rules, hence the inclusion of the deemed present entitlement rules'.[18]

2.40 Consistent with the treatment of trusts under the transferor trust and FIF rules, there is no active income exemption under the deemed present entitlement rules. Further, there is also no comparable tax exemption. As a result, the deemed present entitlement rules are the most extensive of the attribution regimes.

2.41 The Ralph Review of Business Taxation recommended the repeal of the deemed present entitlement rules, with interests taxed under these rules to be covered by the FIF rules unless there are foreign beneficiaries, in which case any amount not taxable under the FIF rules would be taxable to resident transferors under the transferor trust rules. The Government accepted the recommended reforms which were initially to be effective from 1 July 2001.[19] However, implementation of these reforms was deferred and they were referred to the Board as part of RITA. The Board recommended that the Government proceed with these reforms and, although the Government accepted the Board's recommendation, the reforms are yet to be implemented.

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18 Burns L, *Australia's Foreign Income Anti-deferral Rules: Current Law and Future Directions*, Annual Meeting of the New Zealand Branch of the International Fiscal Association, March 2007, p 10.

19 Attachment H of Treasurer's Press Release No. 74 of 1999.

Subsequent changes

2.42 The CFC comparable tax exemption was modified in 1997. As explained below, the comparable tax exemption under Australia's attribution rules is based on a designated jurisdiction approach, with the exemption applying to a list of countries designated as comparable tax countries. In 1997, the list of comparable tax countries was reduced to seven closely comparable tax countries.

2.43 It was not until the Government's RITA reforms that further change occurred in relation to the attribution rules. The most significant RITA reform, however, was not to the attribution rules themselves, although it impacted on the operation of the CFC rules. It was the extension of the dividend participation exemption to all non-portfolio dividends and not just those paid out of comparably taxed profits.[20] This had the effect of extending the active income exemption at the time of attribution to the time of repatriation. Consequently, any income not taxed under the CFC (or FIF) rules is now also exempt if repatriated as a participation dividend.

2.44 The RITA reforms also included two further changes to the attribution regimes: first, changes were made to the comparable tax exemption by moving to a specific listing approach in relation to designated concession income arising in comparable tax countries; and second, the scope of base company income as it applies to services was narrowed.

Policy drivers

Policy benchmarks

2.45 The economic impact of systems of taxation of foreign source income is commonly assessed in terms of two competing benchmarks: Capital Export Neutrality (CEN) and Capital Import Neutrality (CIN).[21] CEN would require all capital owned by Australians to be taxed at Australian rates of tax whether it was invested in Australia or overseas. It is argued that this leads to an efficient allocation of capital and labour. CIN, on the other hand, would require that foreign source income be subject to the rate of tax prevailing in the country in which it is earned. According to this benchmark, income earned by Australians overseas should not be subject to further tax in Australia regardless of the tax rate in the foreign country. It is argued that this makes Australian businesses more competitive in foreign markets.

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20 An equivalent exemption for capital gains was also introduced following RITA.

21 A third neutrality benchmark, *national neutrality*, aims for neutrality in residents' investment decisions on the gross return to their country of residence, with the pre-tax return on domestic investments matching the post-foreign tax return on foreign investments. To achieve this benchmark, the foreign investment income of a resident investor would need to be taxed without deferral at the same domestic tax rate as domestic income and with foreign tax treated as a deductible expense.

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

2.47 The appropriate benchmark to apply in relation to the taxation of active business income derived overseas has been subject to much discussion. OECD countries, for example, do not approach the issue entirely consistently. However, there seems to be much more consensus that passive income is very mobile and will therefore seek out low-tax environments unless it is effectively taxed at domestic rates as it accrues. Diagram 2. 1 outlines the current Australian position.

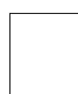
Diagram 2.1: Accruals taxation (CFC model)

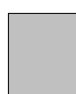
Listed country[22]

Active income	Comparably taxed passive income	Concessionally taxed passive income

Unlisted country

Active income	Passive income


Not subject to accruals taxation


Subject to accruals taxation (unless active income test passed)

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

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

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

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

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

2.51 The Board considers that there are strong reasons to support the continued application of the CIN benchmark for corporates in the development of Australia's attribution regimes. While this may imply little, if any, change is required in the application of the efficiency benchmarks to the current attribution regimes, it is the means by which these benchmarks are given effect and, in particular, what constitutes 'active income' where the vexed issues lie and where careful consideration is needed.

2.52 In other words, the challenge for the Government, and perhaps one of the primary objectives for this Review, is to identify the kinds of income and investment that should receive the benefit of deferral and the kinds of income and investment that should be attributed and taxed on a current basis. While some of the current attribution regimes endeavour to achieve this, it is performed very inconsistently across the regimes. Even where a regime attempts to draw a distinction between legitimate deferral and attribution, there are questions as to whether that boundary has been appropriately drawn. This is the key issue for the Board to consider under its second terms of reference.

Policy objectives

2.53 While these different efficiency benchmarks provide a useful conceptual framework for examining issues, they can point to conflicting policy outcomes and do not give definitive policy guidance. Consideration of compliance and administrative issues, and international obligations and consensus, constrain the adoption of any one benchmark. These considerations suggest that the framework based on CIN and CEN alone will not provide answers in many cases and other criteria will also need to be considered.

2.54 For these reasons, the Board is also of the view that the following, more elementary, policy objectives should be applied in assessing the merits of any possible changes to the attribution rules:

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

2.55 As explained above, although the various attribution regimes were introduced within a relatively close period in the early 1990s, they are not fully coordinated and in some cases more than one regime potentially applies to a particular taxpayer in respect of the same income. In other cases, different regimes may apply to different taxpayers in respect of the same income.

2.56 Further complications arise as a result of some regimes granting specific exemptions which may be clawed back by the operation of another regime. The regimes also lack consistency in that none apply universally across all entity types.

2.57 As a result, the current arrangements create inappropriate investment distortions as the same in-substance investment may attract different tax treatment. For example, some exemptions that apply under one regime to a particular type of entity do not apply to an equivalent entity under another. Even within the same regime, exemptions are sometimes confined to certain entities to the exclusion of others. These differing outcomes contradict the tax principle that equivalent investments should be treated similarly (that is, the principle of investment neutrality).

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

2.59 The level of complexity that accompanies the CFC rules drew comment from Australian taxation academic, Professor Richard Vann, who made the following remark shortly after the CFC rules were introduced:

> '… [B]y common consent, this is the most complex legislation arising out of the tax reform that has been a feature of the last half dozen years in Australia and in other countries. The text of the legislation found in Part X of the *Income Tax Assessment Act 1936* is forbidding in the extreme. Before getting through the 26 pages of definitions with which the Part begins, most readers will be looking for a way of easing the pain. The Explanatory Memorandum provides only temporary relief as it quickly slips into the "paraphrase the section" mode with which tax students are all familiar … Part X, which is more or less contemporaneous with the simplification exercise[23], shows no signs whatever of simplification aspirations, not to mention plain language or any other commonsense drafting principles. The legislation was bound to be complex, but it need not be obscure. Why, for example, does it take well over 100 pages of Part X to get to the point of the whole exercise, the inclusion of certain amounts in the assessable income of Australian resident taxpayers? Surely the crucial operative provisions of any tax legislation should come at the beginning and not the end? Moreover, Part X and associated provisions are full of drafting defects … [T]hese kinds of defects destroy the only possible reason for the tortuous drafting of Part X, the prevention of tax avoidance by covering all possibilities. It should be clear by now that complexity of legislation does not defeat tax avoidance based on drafting deficiencies. The only solution to this problem is legislation that spells out its purpose and carries it out in simple language, assisted by sensible administrative regulations and rulings and interpretation of legislation by courts. The pressing need for simplification of legislation has to be emphasised again and again until the message is accepted by government and the bureaucracy. It is a five-year task to get the current legislation into reasonable shape, but there is no reason why simplification principles cannot be applied to new legislation now. In the meantime we have to cope with what we get. In this case, Part X.'[24]

2.60 In a similar vein, Professor Brian Arnold commented in a paper he recently delivered at an Australian tax conference that:

> '[I]f we examine the way in which the Australian CFC rules are organised, the deficiencies are readily apparent and significant. The charging provision, section 456, does not appear until over 280 pages and over 140 sections into the legislation. Division 1, entitled "Interpretation", contains the definitions section and several important rules that appear to have been placed randomly … There is no apparent rationale for the organisation of the Australian CFC rules. The location of the charging provision is

23 See Treasurer's Press Release No. 13 of 1990.

24 Vann R, forward to Burns L, *Controlled Foreign Companies: Taxation of Foreign Source Income*, Longman Professional, Melbourne, 1992, p xi.

> bizarre. The location of the supporting rules, exemptions, and relief provisions seems to be random. Only the record keeping provisions are sensibly placed.'[25]

2.61 In terms of integrity, recent initiatives have meant that many of the traditional compliance risks associated with the attribution regimes are no longer relevant or becoming less relevant in today's global environment. The major risk associated with both the transferor trust and the CFC regimes is the concealment of offshore assets. Types of concealment range from simple non-disclosure through to structuring of arrangements that seek to circumvent the control tests or investing in entities not covered by these regimes.

2.62 According to the Australian Taxation Office, the information provided to it in relation to the current regimes is not complete, possibly highlighting that the attribution rules appear to be very complex for many taxpayers. Tax administrations face practical limits and inherent difficulties accessing information in respect of offshore transactions.[26] As a result, it is likely that there is under-reporting of investments in foreign jurisdictions. These problems are often exacerbated by tax havens and countries with preferential tax regimes limiting access to information.

2.63 The complexity of the regimes continues to mean that, in a number of cases, taxpayers do not complete the relevant sections of their income tax returns. The Board is aware of concerns that the significant compliance costs often incurred under the existing regimes, sometimes simply to establish that a taxpayer is ultimately exempt from attribution, may lead to the undesirable situation whereby taxpayers may consider non-compliance to be the more cost-effective option.

2.64 Balancing the information requirements of the Australian Taxation Office, so that the attribution rules can be properly administered, and the cost of compliance of those rules is also of concern to the Board. Accordingly, the evidence and reporting requirements associated with the regimes will need to be considered as part of this review.

2.65 In relation to capability issues, a significant body of anecdotal evidence suggests smaller businesses, individuals and their advisors have limited knowledge of the assessment, record keeping and reporting requirements of the four attribution regimes. The demand for tax agent and other advisory services to comply with other more common tax and accounting obligations inhibits the building of essential capability.

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25 Arnold B, *Is There a Better Way? A Drafting Perspective on the Australian CFC Rules*, Australian Tax Research Foundation Conference, 2007, p 47.

26 In managing the impact of globalisation on tax compliance, many tax administrations, including Australia, are pursuing information gathering strategies that depend on international cooperation between jurisdictions.

ACHIEVING GREATER CONSISTENCY

2.66 A key consideration for the Board is ensuring that the balancing of policy objectives is achieved consistently across the attribution regimes. This is particularly important in respect of the first terms of reference. Greater consistency across the regimes would also ensure that, as far as possible, similar taxpayers and income are treated in a similar way, in addition to providing potential reductions in complexity and compliance costs.

2.67 However, a harmonised regime does not necessarily imply that one set of rules would apply to all taxpayers and all income in every circumstance. Where appropriate, there may need to be differing rules for differing circumstances. The challenge will be identifying those rules or principles that are capable of application across all the regimes and those special circumstances that require differences in treatment.

2.68 Options for achieving greater consistency include:

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

2.69 Irrespective of the ultimate design approach, any one of these options has the potential to address the distortions that are currently entrenched across the various regimes by providing more consistent outcomes. Further, the different options have the potential to significantly reduce compliance costs for taxpayers by reducing the need for taxpayers to determine whether attribution occurs under the CFC, FIF, transferor trust or deemed present entitlement rules.

2.70 Importantly, harmonising the regimes also provides the opportunity to address the issues canvassed throughout this discussion paper to ensure that the policy objectives of the regimes are appropriately balanced.

2.71 While changes to the tax laws of the kind explored in this Review will inevitably bring with them associated transitional costs, an assessment needs to be made of whether they are of such a magnitude that they would outweigh the significant ongoing benefits that could be gained from harmonising the regimes. Transitional costs would be reduced if the approach to harmonising the regimes draws heavily on the features and concepts in the existing rules, something the Board strongly advocates.

2.72 The Board understands that there are many issues within the current attribution rules on which industry wants immediate action. For example, the Australian Taxation Office's *CFC Issues Register*[27] has for some time had many outstanding issues that remain unresolved. The Board considers that the scope of the issues across all of the attribution rules, many of which are much more significant than those listed on the CFC Issues Register, means that it is better to deal with them in a holistic and systemic fashion, rather than progressively.

2.73 While the timing of Australia's review of the foreign source income attribution rules is very apt, the Board believes it imperative that a more formal monitoring and review mechanism is adopted so that these rules are reviewed regularly to ensure their efficiency and international competitiveness. This Review provides the perfect stimulus for ongoing arrangements of this kind to proceed on this footing.

2.74 As it is now almost 20 years since the original consultation on and development of the attribution regimes, a more fundamental review is required to ensure that the policy objectives of the regimes are clarified and appropriately balanced.

2.75 Hence, the Board proposes a two-pronged strategy. First, to look at the fundamentals of the system to see if greater consistency across the attribution rules can be achieved, including through harmonising the current arrangements. Second, while it is intended that the many small technical issues that have been identified will inform the higher level policy design of the system, the Board does not intend to deal specifically with these issues. Rather, these issues would be addressed in the policy and legislative design stages.

2.76 Fundamental review, such as what this Review entails, necessarily can only occur on a less frequent basis since business and government alike require stability in the basic structure and operation of the tax system. The narrower progressive review processes that have occurred in the past, and that the Board supports for the future, can and should be used to address the many specific problems that are identified over time in existing policy and rules to ensure their ongoing efficiency and international competitiveness. The Board believes that this Review provides a strong foundation for not only setting the credentials for fundamental review, but also for entrenching regular and ongoing review processes.

CONCEPTUAL APPROACH

2.77 The Board is open-minded about the possibility that there may be other approaches that could deliver on the Government's policy intent in respect of the

27 See http://www. taxboard. gov. au/content/rita_report/rtf/Att2. rtf. The CFC issues register is drawn together by the Foreign Source Income Subcommittee of the National Tax Liaison Group. The Board acknowledges that RITA has addressed some of the issues.

attribution rules, and the Board welcomes comment in this regard. However, this discussion paper has been prepared on the basis that the broad framework of the existing attribution regimes are likely to be retained, whether as continuing but more consistent separate stand-alone regimes, a single harmonised regime, or a mixture of both. In forming this view the Board notes that international practice does not reveal any alternatives to addressing tax deferral arrangements other than through a combination of CFC, FIF, and transferor trust type rules. An outline of the different attribution regimes that apply across the world is provided at Appendix C.

2.78 As noted, however, the Review involves more than just redrafting the current law to achieve greater consistency. Fundamental to the review process is the requirement to canvass problems with existing aspects of the regimes together with reform options so that, to the extent that those aspects are synthesised into a new regime, whether harmonised or separate stand-alone rules, those problems do not perpetuate.

2.79 With this in mind, the discussion paper proceeds by examining the three key building blocks each of the regimes currently share.

2.80 First, it is necessary to determine the interests in foreign entities that should be subject to attribution. Ideally, interests in all types of foreign entities should be covered, including foreign companies and trusts. Other foreign-formed entities for which there is no legal equivalent in Australia, such as foundations and anstalts, could also be included. The definition of an interest in a foreign entity should be broad enough to cover all such entities.

2.81 Second, the rules need to target income that presents the best opportunity to defer, or avoid, tax. In the context of the existing attribution regimes, this translates into rules that seek to exclude certain kinds of income including active income, comparably taxed income, and income that qualifies for a de minimis exemption. Currently, not all attribution regimes include each of these exemptions and, when they are included in more than one regime, the design often differs.

2.82 Finally, the methodology for attributing the targeted income needs to be determined. As explained above, the regimes currently deploy several different approaches which are intended to be used according to the level of information taxpayers have in respect of their foreign investment. Critical in this regard is the notion of control, which acts to steer taxpayers to the most appropriate regime for eliminating deferral.

2.83 The Chapters that follow have been arranged against the framework of these three building blocks:

- Interests and entities that should be subject to the attribution rules (Chapter 3).
- Types of income that Australia's attribution regimes should target (Chapter 4).

- Methods for attributing targeted income (Chapter 5).

2.84 The final chapter, Chapter 6, provides an overview of the different design options that could be applied in the development of a harmonised regime. The Chapter provides a blueprint of these options and evaluates their respective advantages and disadvantages. The Chapter also explores various administration and transitional issues.

CHAPTER 3: INTERESTS AND ENTITIES

BACKGROUND

3.1 The first of the three building blocks shared across the current attribution regimes is the identification of the kinds of interests and entities to which the attribution regimes should apply.

3.2 This Chapter examines a range of issues that are associated with the current regimes in respect of this building block and canvasses possible solutions consistent with the policy objectives outlined in Chapter 2. The Chapter also discusses the implications of a harmonised regime and the extent to which such a regime might deal with these issues in a systemic manner.

3.3 The Chapter invites comment on these issues together with other approaches that might remedy the problems identified.

STRUCTURE OF CURRENT ATTRIBUTION REGIMES

3.4 Chapter 2 provided an account of the kinds of interests and entities to which each of the attribution regimes apply. In summary:[28]

- Foreign companies controlled by Australian residents are subject to the CFC rules. Branch-equivalent calculations are required to be performed in respect of attributable income. If the CFC fails the active income test, its tainted income (that is, passive income and base company income) is generally attributed. There is an exemption for comparably taxed income.

- Foreign companies not controlled by Australian residents and widely-held fixed trusts are subject to the FIF rules. If the foreign entity is not eligible for any of the FIF exemptions, proxy calculations are required to be performed in respect of attributable income. The FIF rules contain an active business exemption but it is restricted to companies. A limited comparable tax exemption also exists for certain investments in the United States.

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28 In addition, certain foreign hybrid limited partnerships are treated as flow-through vehicles under Australia's income tax laws. In broad terms, the Australian resident partners are subject to tax on their share of the partnership's income (active or passive).

- Foreign discretionary trusts are subject to the transferor trust rules. The income attributed to the transferor is based on branch-equivalent calculations. If a transferor cannot perform branch-equivalent calculations, a notional interest rate applies to the value of the transferred property or services. Although there is no active income exemption under the transferor trust rules, a comparable tax exemption based on the CFC rules applies.

- Closely-held fixed trusts are subject to the deemed present entitlement rules. Ordinarily, all of the foreign trust's income including active and comparably taxed income is attributed to Australian resident beneficiaries on a branch-equivalent basis.

3.5 The basic features are summarised in Table 3.1 below.

Table 3.1: Interest and entities comparison

	CFC rules	FIF rules	Transferor trust rules	Deemed present entitlement rules
Foreign companies	Yes — if interest held is a controlling interest	Yes — if interest held is a non-controlling interest	None	None
Foreign trusts	None[29]	Yes — if not subject to transferor trust rules (usually widely-held fixed trusts)	Yes — for certain transfers of goods or services (usually to discretionary trusts)	Yes — if not subject to FIF or transferor trust (usually closely-held fixed trusts)

3.6 Table 3.1 shows that the cumulative enactment of the attributions rules has generally resulted in the rules effectively providing complete coverage for all arrangements involving Australian residents holding interests in offshore entities.

3.7 However, the differing entry conditions that each regime uses, along with the diverse attribution approaches and outcomes that can arise under each regime, result in taxpayers with similar investments being treated differently. For example, some exemptions that apply under one regime do not apply under another and exemptions that apply within a regime apply to certain entities and not others.[30]

3.8 In the global economy, where commercial reasons may dictate the use of one entity over another, it is not desirable for these kinds of inconsistencies and distortions to arise.

29 Although the CFC rules are specifically designed to deal with interests held in foreign companies, the rules also contain provisions to cover situations where a foreign trust has been interposed before the foreign company. For these trusts, there are similar interest requirements to those applicable to companies.

30 The FIF active income exemption, for example, only applies to companies.

ISSUES WITH CURRENT ARRANGEMENTS

Control test

3.9 A central feature of the current attribution rules is the notion of control. It has either a direct or residual role in each of the four regimes.

3.10 When initially enacted, the CFC control rule was used to identify those taxpayers for whom it would be reasonable to apply attribution rules as they were best able to bring about the benefit of deferral. The control rule also recognised that only controlling shareholders would have the necessary information to perform branch-equivalent calculations.

3.11 The 1989 Information Paper noted that:

> 'In the submissions lodged in response to the Consultative Document, the use of Australian tax rules for the calculation of income attracted widespread criticism. It was contended that Australian resident shareholders would be unable to obtain the necessary information where there was no control of the non-resident company: and that it would be extremely onerous to make a complete recalculation of the income, even if control existed, where active income was involved.
>
> The inclusion of a control rule and an active income exemption minimises these problems. In view of those concessions, alternative methods of calculations (such as the use of commercial profits) are unnecessary. The only basis of calculation of the attributable income of a CFC will be Australian tax law, effectively treating the company as if it were a resident of Australia. This is consistent with the requirements of most countries with CFC legislation'.[31]

3.12 As noted in Chapter 2, following the introduction of the FIF rules, the purpose of the CFC control rule shifted from distinguishing between cases of legitimate deferral and attribution, to a signpost as to whether attribution occurred under the CFC rules or the FIF rules.[32]

3.13 The difficulty with this approach is that some taxpayers that are directed to the FIF rules can in fact apply the CFC rules (and be better off) and vice versa. This would not be so significant if the regimes provided equivalent outcomes but, as evident from the discussion in Chapters 4 and 5, this is often not the case.

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31 Treasurer, *Taxation of Foreign Source Income: An Information Paper,* AGPS, Canberra, 1989, paragraph 5.2.

32 See further Burns L, 'The Border Between the Controlled Foreign Companies and Foreign Investment Fund Regimes', *University of New South Wales Law Journal Forum*, 2000, pp 51-54 and Burns L, 'Rethinking the Design of Australia's CFC rules in the Global Economy', *Bulletin for International Fiscal Documentation*, July 2005, pp 262-280 and Burns L, 'Reform of Australia's CFC Rules', *Australian Tax Forum*, 2006, 21, pp 149-219.

3.14 Moreover, given the integrity purpose that the control rule originally served, it is not surprising that it is a very complex and extensive concept imposing significant compliance costs. Practitioners often criticise the control test as being so complex that it is difficult to apply. In other cases, practitioners criticise the potential breadth of the rule. Closely linked to the control test is the term 'associate' which often draws the same criticism as the control rule.

3.15 Furthermore, there are other anomalies that exist with the current CFC control test.[33]

- A taxpayer may satisfy the CFC *subjective de facto control test*[34], but cannot be an attributable taxpayer as they do not hold a legal interest that is capable of being quantified. The 100 per cent deeming of control under the de facto control test is not carried through to the calculation of attribution percentage, which is based on actual legal interests.

- The control rule only applies where the foreign company is closely-held by Australian residents. A resident in a similar closely-held arrangement with non-residents will not be considered as having control of the foreign entity with the result that the FIF rules potentially apply instead. This difference in treatment appears at odds with the realities of an increasingly globalised economy and the greater mobility of capital as investors from different countries are now more easily able to come together to make decisions that could result in deferral benefits.

3.16 A control rule also forms part of the transferor trust rules, although it has a more limited role than the control rule applying under CFC rules. Under the transferor trust rules, control of a foreign trust is relevant where:

- transfers of property to a foreign discretionary trust were made prior to the commencement of the transferor trust measures; or

- transfers of property to a foreign trust were made by a non-resident who later becomes an Australian resident.

3.17 Collapsing or merging the regimes has the potential to address several deficiencies that exist across the regimes.

3.18 First, it would address the distortionary effects that exist across the regimes that undermine the principle of investment neutrality. Second, the interaction problems that can arise as a result of concurrently applying multiple regimes would be addressed. Finally, removal of the requirement to rely on the terms 'control' and 'associate' would significantly reduce compliance costs for taxpayers by removing the

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33 Ibid.

34 In general terms, a foreign company is a CFC under the *subjective de facto control test* if a group of five or fewer Australian residents has real or economic control of the foreign company.

need for taxpayers to determine whether attribution occurs under the CFC, FIF, transferor trust or deemed present entitlement rules.[35] For instance, the Board is aware that the current rules create some concerns for the property trust sector, requiring them to ensure investment structures put in place as part of their genuine commercial activities remain wholly within the FIF or deemed present entitlement regimes rather than also being subject to the transferor trust rules.

Applicable interests

3.19 As explained above, the touchstone that determines which attribution regime applies to resident taxpayers is a function of the type of foreign entity in which the taxpayer holds an interest and the magnitude of that interest as measured by the control test.

3.20 While the concept of control may not be required under harmonised arrangements, it would still be necessary to identify the kinds of interests to which such arrangements should apply.

3.21 A starting point for doing this may be the term 'membership interest' in the current tax laws.[36] This term applies to interests in companies and fixed trusts but not to transferors or the objects of a discretionary trust as they do not have a legal interest of the kind that is contemplated by the term 'membership interest'.

3.22 The transferor trust rules instead deem those that have transferred value to the trust (the 'transferor') to be the attributable taxpayer. This approach is generally consistent with other countries' rules, including the United States' Grantor Trust rules, although the respective regimes have several features that are not shared.[37]

3.23 Sydney barrister, Christopher Bevan, explains that the identification of an attributable taxpayer in this way creates interaction problems and the possibility of double taxation in respect of the same amount of trust income.

> 'The FIF regime is designed to ensure that a taxpayer with an interest in a FIF is excluded from the FIF regime if the interest is subject to the CFC or transferor trust measures. The exclusion from the FIF regime applies if that taxpayer is an attributable taxpayer under the transferor trust measures. A taxpayer who has been attributed income under the FIF regime may well be a different taxpayer to that who is treated as an attributable taxpayer for the purposes of the transferor trust measures in respect of exactly the same amount of net income of the trust. This result can arise because, under the transferor trust measures, the critical question is whether the taxpayer has at any time directly or indirectly

35 The terms 'control' and 'associate' would need to be retained, however, given their use in other areas of the tax laws.

36 Definition of 'membership interest', section 995-1, *Income Tax Assessment Act 1997*.

37 See further, Bevan C, 'Reform of the Taxation of Foreign Trusts in Australia and the United States: A Comparative Analysis', *Australian Tax Review*, vol 35 no. 1, March 2006, pp 7-51.

transferred value to the foreign trust; whereas in order to have to have an interest in a foreign trust for FIF purposes, the taxpayer need only have an interest in the corpus or income of the trust or an entitlement to acquire such an interest at the end of the year of income.'[38]

3.24 A possible solution to this problem would be to modify the notion of membership interest (for the purposes of the attribution rules) so that it better targets potential beneficiaries rather than transferors. Options that may be available include creating interests by reference to an examination of the history of previous distributions to Australian beneficiaries[39], or for a default assessment to apply that targets the distribution of previously untaxed passive income.[40] Where these alternatives do not provide appropriate outcomes, the rules could target transferors.

3.25 While these alternatives are worthy of consideration, it is also necessary to consider whether the transitional costs associated with moving to such a fundamentally different system would outweigh the benefits and whether a harmonised regime might effectively deal with the kind of interaction and double tax problem identified above.

Q3.1 For discretionary interests, should the attribution rules focus on potential beneficiaries rather than transferors? If so, why, and how?

3.26 A consistent approach to identifying relevant interests would also provide the opportunity to address some areas of uncertainty that exist under the current laws.

3.27 For example, the Australian Taxation Office recently issued a ruling (TD 2007/D2) to clarify whether the CFC regime applies to an Australian taxpayer who has an interest in a foreign company that is limited by guarantee rather than by shares.

3.28 There is also the related issue of entities that are classified according to their legal form rather than their economic substance. This issue can manifest in several ways.

3.29 First, the treatment of foreign-formed entities that have no legal equivalent in the investor's home country creates a potential integrity problem and creates further distortions of the kind described above. For example, an Australian resident may have an interest in a foundation or anstalt.[41]

38 Ibid, p 19.

39 In a similar manner to the pattern of distribution test in the trust loss provisions.

40 In a similar manner to the default assessment that applies under section 99B of the *Income Tax Assessment Act 1936*.

41 Although an attributable interest may crystallise, no attribution percentage generally arises because this requires an ability to quantify a discrete legal interest, a feature that does not always exist in the case of foundations or anstalts. The transferor trust rules, however, could apply in such circumstances.

3.30 Second, for some taxpayers the level of their investment is not properly recognised for attribution purposes. Currently, although taxpayers may hold, in substance, a significant interest in a foreign entity it does not qualify for treatment under the CFC rules. The consequence is that the interest is taxed under the FIF rules and the CFC exemptions, that may have otherwise been available, have no application. This outcome occurs because entry into the CFC rules turns on the legal notion of control, a concept that is not recognised in many non-common law countries.[42] For these reasons it makes it difficult, for example, for an Australian bank with an interest in a foreign bank to qualify for a CFC exemption because restrictions imposed by the foreign government mean that the control requirement cannot be fully satisfied even though the Australian bank has a substantial economic interest.[43]

3.31 Finally, there are circumstances where taxpayers have an economic interest in a foreign entity but not a legal interest. Taxation Ruling TR 2002/3 sets out some circumstances where certain rights held by taxpayers would not constitute an interest in an entity under either the CFC or FIF rules notwithstanding taxpayers may have a significant economic interest.

Q3.2 What aspects of the current rules create uncertainty in identifying relevant interests? How should those aspects be clarified?

Q3.3 Are economic interests that are not recognised legally for the purposes of the attribution rules a concern? If not, why?

Q3.4 To what extent does the Government's announcement[44] to align the definition of non-portfolio dividend with economic ownership concepts affect your answer to Q3.3?

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42 The definition of 'control' requires, amongst other things, controlling voting rights. In some countries, governments prevent taxpayers from holding such rights, although they may permit significant rights in respect of dividends and capital. China is often cited as a jurisdiction where it is difficult to establish a controlling interest.

43 Related to this, the Government announced in the 2006-07 Budget an amendment to ensure consistent tax treatment of foreign dividends received by Australian companies, whether the dividends are received directly or indirectly through a CFC. Currently, foreign dividends from significant (non-portfolio) holdings are not subject to tax in Australia. However, while this treatment is intended to be restricted to non-portfolio dividends, the current law allows portfolio dividends to be treated in the same way where they are derived indirectly through a CFC. Changes to the definition of a non-portfolio dividend to align it with economic ownership concepts were also announced.

44 See footnote 43.

ATTRIBUTION RULES AND NON-RESIDENT BENEFICIARIES

3.32 As explained in Chapter 2, the RITA reforms were designed to ensure that Australia remains an important location for regional headquarters and that Australian multinationals are able to compete in global markets.

3.33 As part of those reforms, changes were made to Australia's conduit taxation arrangements to reduce the Australian taxation consequences for non-residents deriving foreign income through investments made in Australian entities. These reforms were directed at improving Australia's attractiveness as an investment choice for non-residents. The reforms ensured that Australian taxation is not levied on certain foreign income derived indirectly by non-residents via an interposed Australian entity.

3.34 Despite these amendments, the interaction of the FIF rules and the general trust provisions results in an outcome that appears contrary to this position. The Australian Taxation Office's interpretative decision ATOID 2005/200 concludes that a trustee of an Australian trust will be subject to tax on the trust's attributed FIF income even though all the beneficiaries of the trust are non-residents. The ATOID explains that this outcome arises because it is not possible for trustees to exercise a valid entitlement in favour of a beneficiary if the income is merely a notional amount (that is, a construct of the tax laws).

Q3.5 How should the attribution rules be modified to ensure that they do not disrupt conduit income arrangements for non-residents?

Chapter 4: Types of income

Background

4.1 The second of the three building blocks shared across the current attribution regimes is the identification of particular types of income that should be targeted.

4.2 As discussed in Chapter 2, the attribution regimes generally allow deferral for active income (a CIN approach) but apply accruals taxation for passive and base company income (a CEN approach). How this is achieved varies across the regimes.

4.3 The CFC regime takes the general approach of identifying the income to be targeted for attribution; that is, a positive listing approach. The FIF regime, in contrast, includes all income as potentially attributable and then applies various exemptions to carve out certain interests and entities. The transferor trust regime applies to Australian residents who have directly or indirectly transferred value to a foreign trust, with some exemptions.

4.4 Apart from the control concept, the level of information taxpayers have in respect of their foreign investment underlies the various attribution rules. This is reflected in the different approaches taken in the regimes to the exemptions that are available, whether a positive listing approach is taken, calculation methodologies, the treatment of lower tier entities and various other features.

4.5 These structural differences, in how the current attribution regimes identify attributable income, are relevant when considering how any new exemptions from attribution or the listing of attributable income might be applied going forward to achieve improved consistency of outcomes.

4.6 This Chapter considers how the attribution regimes might better identify attributable income to reflect the policy objectives outlined in Chapter 2.

4.7 The discussion is structured by first considering the features of the existing attribution regimes. Comments are sought on how the operation of the existing regimes could be better targeted, with a focus on achieving more consistent outcomes across the regimes. Some possible further exemptions that might be provided are then considered.

4.8 As outlined in Chapter 2, the Board considers that there is significant merit in harmonising the regimes, especially the CFC and FIF rules, or, at the very least, applying a more consistent approach across separate stand-alone regimes.

4.9 In considering the various options for targeting types of income, an appropriate balance between often competing policy objectives needs to be achieved. In general terms, the fewer the provisions to remove entities or activities from the attribution rules the simpler but less precisely targeted the attribution rules will be. Conversely, increasing the number of more tightly targeted provisions to develop a more precisely specified set of rules may come at the cost of increased complexity and compliance costs.

4.10 The Board will take particular account of the objectives of ensuring that Australian businesses with active offshore exposure are not made uncompetitive and that appropriate account is taken of market and business factors. The complexity, compliance costs, and administrative costs of targeting the rules, as well as the level of risk to the revenue, also need to be carefully considered.

FEATURES OF THE ATTRIBUTION REGIMES

4.11 As explained earlier, Australia currently has four attribution regimes. The basic features of those regimes are summarised in Table 4.1 below.

Table 4.1: Comparison of income targeted across attribution regimes

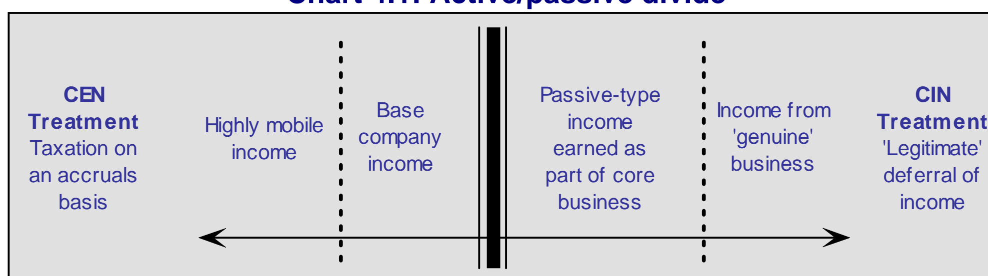
	Active income exemption	Comparable tax exemption	De minimis exemption	Other exemptions
CFC rules	Yes — income and entity aspects	Yes — list of seven closely comparable tax countries	Yes — listed country only	
FIF rules	Yes — entity	Yes — United States only	Yes — listed and unlisted countries, balanced portfolio	Complying superannuation funds, employer-sponsored foreign superannuation, deceased estate
Transferor trust rules	No	Yes — CFC list applies	Yes — listed country only	Family trust, deceased estate, arm's length
Deemed present entitlement rules	No	Yes — United States only	No	

IDENTIFICATION OF ACTIVE INCOME

Background

4.12 Australia's international tax arrangements generally exclude active foreign income from Australian taxation. This policy also extends to the operation of the CFC and FIF rules, although each regime uses a different approach in achieving this outcome. However, as shown in Chart 4.1 below, the active/passive income divide is not clear cut, with some income being treated differently depending on the circumstances in which it is derived. For example, some income that is highly mobile, and nominally should be given passive income treatment, is instead treated as active income if it is derived as part of genuine commercial activity. Conversely, some active income is treated as tainted income (see paragraph 4.13) if it is derived from related-party transactions.

Chart 4.1: Active/passive divide



4.13 The CFC regime provides an active income exemption where 95 per cent or more of the gross turnover of the CFC is not tainted income. In summary, tainted income comprises:

- passive income — highly mobile income which can easily be shifted to a tax haven and includes dividends, interest, royalties, rents, annuities and capital gains; and
- base company income — active income generally derived from a related-party transaction that may have the effect of shifting profits to a CFC, possibly to take advantage of the active income exemption.

4.14 If the CFC passes the active income test none of its tainted income is attributed. Where the CFC fails the active income test, the only income that is attributed is the CFC's tainted income. Even then, if the CFC is located in a comparable tax (listed) country, only certain designated concession income is attributed.

4.15 The FIF regime provides an active business exemption for interests in foreign companies where the company is principally engaged in certain activities, referred to as 'eligible activities'. Agriculture and the management of funds are examples of eligible activities. Taxpayers must apply either the 'stock exchange listing' or 'balance

sheet' method to determine whether the business is principally involved in eligible activities.

4.16 If the FIF passes the active business test, none of its income is attributed. Where the FIF fails the active business test, unlike the CFC rules, all of the FIF's income is attributed.

4.17 Within the FIF regime there are also several further exemptions for interests in publicly listed companies. The exemptions apply to interests in foreign banks, foreign general insurance companies, foreign real property companies, and certain other foreign companies. There is also an exemption for interests in certain foreign life insurance companies.

The active/passive divide

4.18 Australia's attribution regimes were conceived in the late 1980s when Australia's investment profile was dominated by trade in goods and relatively little in the way of services. As noted in Chapter 2, since then Australia's trade and investment profile has significantly changed, particularly in the services sector.

4.19 To the extent that taxation rules developed nearly 20 years ago have not evolved with emerging business trends, higher compliance costs will inevitably result as the circumstances in which they operate changes. The definitions that distinguish active and passive income under the CFC regime illustrate this point.

4.20 The distinction between active and passive income is relevant for two aspects of the CFC rules. First, as explained above, it determines eligibility for the active income exemption and, second, it identifies the income that is potentially subject to attribution if the active income exemption is not satisfied. This contrasts with the FIF regime approach, whereby all income is attributed unless exempted.

4.21 The CFC rules make allowance for income that would ordinarily be classified as passive because it is highly mobile, but is derived by a CFC that is actively engaged in the business of deriving that income. In these cases, the income is treated as active notwithstanding that it is passive in form. Examples of this include:

- interest derived by a CFC where it is an Australian financial institution subsidiary whose sole or principal business is financial intermediary business;
- passive income derived by life and general insurance companies if certain conditions are met;
- passive income derived from the management of real and other property if certain conditions are met; and

- royalties derived by a company engaged in owning and managing intellectual property if certain conditions are met.

4.22 Notwithstanding these exceptions, questions have been raised about the continuing relevance of the various restrictions placed on the use of these rules.

Example 4.1

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.

4.23 The restriction of the financial institution exemption to Australian financial institutions may be seen as providing additional integrity to the attribution rules (that is, there is greater assurance that Australian financial institutions are genuinely engaged in active business given the prevailing prudential environment). This may be appropriate in the context of continued financial innovation which could enable the conditions to be readily manipulated, particularly offshore.

Example 4.2

Many major property development companies have a business model in which they take an interest in a foreign company that owns foreign commercial property, such as an office block or shopping centre, and use a separate company to manage the property.

As a distinction is made between rental income derived in the course of carrying on a business and other rental income on the basis of whether the recipient is directly or indirectly involved in the management of the property, rental income under such business structures may be classified as passive.

4.24 It has been suggested that such returns, although nominally passive in nature, represent the returns from genuine commercial activity, and should be given active income treatment. The company's activities would not seem to be more passive because of contracting out the management of the land and buildings (that is, engaging a specialist manager) than employing staff to carry out those functions. Also, rent on real property is not highly mobile as the underlying activity is the buying and selling of real property, which is location dependent.

4.25 The Board is also aware of concerns that the attribution regimes may operate to the disadvantage of growing Australian businesses developing operations offshore.

Example 4.3

An Australian company has successfully developed its business in Australia such that the next step is expansion into offshore markets. A subsidiary company is established in the United States, but the capital used in support of the expansion of the business in the United States cannot be deployed immediately. The funds are invested by the United States subsidiary at commercial rates of return in expectation of drawing down the funds as required to fund the expansion of the business.

The interest earned on the investments represents a relatively large proportion of the earnings of the offshore company in this growth phase of the business. The interest may be tainted income and subject to attribution under the CFC regime.

4.26 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.

Q4.1 Is passive income appropriately defined, given the need to strike a balance between compliance costs and integrity?

Q4.2 Are there examples of income that is currently categorised as passive but should be treated as active? How should such examples be accommodated?

Q4.3 What other improvements could be made to the operation of the active income and business exemptions to address difficulties and reduce compliance costs?

Q4.4 Are there better alternatives to the CFC approach of positively listing passive income?

Intra-group financing arrangements

4.27 One form of passive income for which Australia does not provide an exemption, even though there may be a case for it to be classified as active, is income derived from intra-group financing arrangements.

4.28 Multinational groups may be organised to have one member providing centralised financial management services to the other members of the group. The benefits of such arrangements are that financial expertise can be provided in-house, and economies of scale used to lower financing costs. Intra-group financial payments under such arrangements would normally be channelled through the financial specialist member of the group for on-payment to third parties. Such financial payments may be treated as passive income under the attribution rules.

4.29 Due to the highly mobile nature of financial arrangements, such structures could be readily used to shift income for tax advantage[45], even if the primary driver is commercial requirements.

4.30 Relief from the taxation of income received from a related party by a CFC that performs such an intra-group financing role could be based on the circumstances in which the income is received. For example, the United States recently moved to an approach where 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 income of the related CFC.[46]

Q4.5 Is it possible to provide an intra-group financing exemption, having regard to integrity and compliance costs?

Q4.6 How could an intra-group financing exemption be defined, and why is such an approach preferred?

Base company income

4.31 The attributable income of a CFC includes base company income, which comprises tainted sales income and tainted services income. Base company income is generally active income from business transactions between related parties. Such transactions may be used to shift profits from Australia to a CFC, possibly to take advantage of the active income exemption and more favourable taxation of the profits of the CFC.

4.32 It is often suggested that Australia's transfer pricing rules have matured to the point that there is no longer a need to retain base company income rules. In broad terms, Australia's transfer pricing rules seek to ensure that correct prices are applied in respect of transactions between related parties.

45 The ability to shift income may be constrained by transfer pricing and thin capitalisation regimes.
46 Notice 2007-9, published on 12 January 2007.

4.33 However, the base company income rules are not only concerned about whether related-party transactions are conducted at arm's length. The base company income rules also seek to ensure that service activity that could be conducted either in Australia or in another jurisdiction is not shifted outside Australia due to tax differences. That is, as the income from the activity is taxed at the Australian rate of tax, the investor should be indifferent to the location of the activity from a tax perspective. The application of the transfer pricing rules alone would not achieve this outcome as active income earned at arm's length in a CFC would be subject to tax in that jurisdiction.

4.34 The effect of the current approach is that an Australian investor may be placed at a competitive disadvantage compared to another investor in the same country with the same business structure. This is because the Australian, rather than the local, level of tax is being applied.

4.35 In practice, as international trade has increased between related parties relative to unrelated parties, the transfer pricing rules have become increasingly relevant. Consequently, the application of both the transfer pricing regime and the attribution rules can impose high compliance costs on Australian businesses.

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. Use of the tax system to achieve non-tax policy objectives can add to the complexity of the system.

4.37 Internationally, some countries have moved to relax their base company income rules. The United States recently[47] narrowed the operation of its foreign base company income rules by excluding services income where the CFC has added sufficient value to the services provided (and not merely acted as a post box to shift services activity offshore).

4.38 Another relevant factor within the context of harmonised arrangements is that the base company income concept would be difficult to apply consistently outside of the current CFC regime (that is, the motivation for related-party transactions outside of control situations is not likely to be as evident and requisite information levels might not be as readily available). It may not be appropriate, therefore, to retain the base company income concept unless its operation within a harmonised regime could be contained to circumstances that would fall broadly within the current CFC regime.

Q4.7 Do the base company income rules need to be retained? If not, why?

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47 Notice 2007-13, published on 9 January 2007.

Q4.8 Would the removal of the base company income rules create an unacceptable revenue risk? If not, why?

Q4.9 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?

COMPARABLE TAX (LISTED COUNTRY) RULES

Background

4.39 A listed country approach is used to different extents in all of the attribution regimes.

4.40 Under the CFC regime, the exemption applies to seven closely comparable tax countries. The CFC rules use a listed country exemption to reduce compliance costs as CFCs in these countries represent less of a revenue risk than CFCs in other countries. A CFC in a listed country is not subject to attribution of its tainted income, except for tainted income benefiting from designated concessions and other limited categories.[48] The seven listed countries are: the United States, the United Kingdom, Japan, Germany, France, Canada and New Zealand. Most of Australia's direct investment offshore is located in these countries.

4.41 From the point of view of taxpayers, the listed country approach provides a degree of certainty in the application of the CFC rules. However, for tax administrators the listed country approach requires continual monitoring of worldwide tax systems, which can be a very time consuming and difficult task.

4.42 Under the FIF and deemed present entitlement regimes, an exemption applies only to certain entities resident in the United States, but the exemption is a complete exemption in contrast to the CFC approach.

4.43 Under the transferor trust regime, only designated concession income of a trust in a listed country is attributable. For trusts in unlisted countries all income is attributable, subject to other exemptions. The same list of countries that applies under the CFC regime also applies for the purposes of the transferor trust regime.

48 Attributable income may arise from foreign source income of the CFC that has not been subject to tax in a listed country, the notional application of the trust rules (Division 6 Part III *Income Tax Assessment Act 1936*), the FIF and transferor trust rules.

Issues

4.44 A listed country approach has been used as a proxy for a comparable tax test. However, entities resident in comparable tax countries can still be used as offshore accumulation entities, or be involved in offshore accumulation of passive income. This can arise from the general design of a country's tax rules and interactions between the different rules across countries.

4.45 While it is possible that countries could be added to an exemption country list, the detailed criteria used in assessing a country's suitability for inclusion (or exclusion) needs to be clearly established to provide transparency and certainty of the underlying policy. Further, an up-to-date list of eligible designated concession income would need to be maintained if the current hybrid attribution approach of the CFC regime is maintained.

4.46 The fact that a country has a particular company tax rate, or a tax treaty with Australia, or is a major trading partner, cannot alone be used to decide if a country can be listed. Many countries meeting these criteria would not tax passive income sufficiently given a general move worldwide towards implementing favourable taxation arrangements to attract globally mobile capital. However, the level of Australian outbound investment flows and the presence of a tax treaty could be criteria that would help decide which countries to consider for inclusion.

4.47 An effective offshore accumulation vehicle needs income to be largely exempt from host country taxation. For example, a United States entity that receives flow-through tax treatment in the United States could accumulate income in the entity without concurrent United States taxation (as the United States considers it to be foreign source income flowing through to non-residents) and without Australian taxation (as no dividends are paid).

4.48 Furthermore, even a company that is generally subject to tax in a comparable tax country can act as a conduit for investing in an offshore accumulation entity, unless that country also has robust attribution rules. For example, a New Zealand company is exempt from New Zealand CFC or FIF attribution to the extent that its shareholders are eligible non-residents. Accordingly, non-New Zealand residents could use these companies to hold interests in offshore accumulation entities.

4.49 An alternative approach used by some countries[49] is to apply a comparable tax exemption based on the level of foreign tax payable on a CFC's income compared to the domestic level of tax that would have been payable on the same income. The level of foreign tax is sometimes measured against statutory tax rates, effective tax rates or actual tax paid. The comparison is usually left to taxpayers to self assess.

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49 Examples include Denmark, Finland, Germany, Japan, Norway, Portugal, Spain, France and the United Kingdom.

4.50 It has been argued that the same outcome as an effective rate of tax test might be achieved by widening the number of countries regarded as listed countries.

4.51 There is less need for a listed country approach if active income is properly excluded. If the main concern is not the revenue currently collected from taxing passive income, then the attention of the attribution regimes could focus more on ensuring that the active income exemptions are properly targeted.

4.52 Businesses, on the other hand, have raised the legitimate concern that the abolition of a country list could result in an increased compliance burden. An investor can usually readily identify the country in which an investment is made. A country list could serve the purpose of a simple initial filter to determine the further application of the attribution rules. However, the more a country list relies on identifying specific details of a country's tax system, such as concessional tax arrangements, the greater the administrative burden in maintaining a current list.

Q4.10 Would the listed country approach need to be retained if the definition of passive income was narrowed (or active income better targeted)?

Q4.11 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?

De minimis thresholds

4.53 Under the CFC regime, a de minimis exemption applies only for CFCs in listed countries. It applies if the sum of the amounts included in the notional assessable income of a CFC does not exceed the lesser of $50,000 or 5 per cent of the gross turnover of the CFC.

4.54 No attribution occurs under the FIF regime where the extent of the tax advantage is relatively minor, either in relative terms (the 10 per cent balanced portfolio exemption) or absolute terms (the $50,000 small interest de minimis exemption). There is no country limitation.

4.55 A de minimis exemption also applies under the transferor trust regime for small amounts derived by a trust estate, based on either $20,000 or 10 per cent of the net income of all trust estates attributed to the taxpayer. The income attributed to a taxpayer is affected by the country of residence of the trust (see paragraph 4.43).

4.56 As the purpose of a de minimis or small investor exemption is to exclude certain investors from the attribution regimes based on a balanced consideration of compliance costs and revenue at risk, there is a good case for the threshold(s) to be regularly reviewed to maintain this role. Apart from the increase in the balanced

portfolio exemption in the FIF regime to 10 per cent as part of RITA, the thresholds for the exemptions in the CFC, transferor trust and FIF regimes have not been increased since the rules were enacted.

Q4.12 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?

Q4.13 Should the de minimis exemptions operate on a more consistent basis across the regimes? If so, how could this be achieved?

OTHER APPROACHES TO TARGETING

Background

4.57 Several of the exemptions under the attribution regimes do not fall readily into the active income, comparable tax or de minimis categories.

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

4.59 The FIF regime also provides an exemption for an interest in a FIF that is an employer-sponsored foreign superannuation fund. The FIF must be a superannuation fund maintained by the employer, for the benefit of the employees, and the interest held by an employee or former employee.

4.60 An interest in a FIF that is trading stock and for which an election to use market value is in place is exempt from the FIF rules.

4.61 The transferor trust regime provides an exemption for a transferor who has transferred property or services to a discretionary trust estate provided the transfer was made at arm’s length. There are also exemptions for family trusts and a deceased estate exemption, under certain conditions.

Issues

4.62 The exemption in the FIF regime for complying superannuation funds raises issues about how an exemption, based on the criteria that minimal or no tax deferral benefits are involved for the investor, should be specified. It has been suggested that the exemption is too narrow.

Example 4.4

A complying superannuation fund holds an interest in a trust. If an entity other than a complying superannuation fund also holds an interest in the trust, even a tax-exempt entity, the FIF complying superannuation fund exemption is not available.

4.63 It could be argued that other entities that derive minimal or no tax deferral benefits for the investor should be able to hold interests alongside complying superannuation funds.

4.64 It has also been suggested that the FIF exemption for interests in employer-sponsored foreign superannuation funds is too narrow.

Example 4.5

A non-resident leaves their current employment to move to Australia. They rollover their employer-sponsored superannuation fund into another superannuation fund that has lock-in arrangements similar to those in Australia. The FIF regime may apply to an interest in that fund as it is not employer sponsored.

4.65 While a re-assessment of the level of the FIF de minimis rule may assist in this area (see paragraphs 4.54 and 4.56), the issue of whether and how neutrality of treatment of seemingly similar investments would be achieved remains unanswered.

4.66 Also in the FIF regime, if listed unit trusts are used to invest into a particular industry rather than through a listed company, there may be different outcomes for a taxpayer as unit trusts do not receive the same exemptions as listed companies.

Example 4.6

An Australian wishes to invest in the Canadian oil and gas industry. Traditionally, Canadian listed unit trusts are used for such investment. However, such an investment would be subject to the FIF rules, whereas if a Canadian listed company was used the investment would be exempt from FIF attribution.

4.67 This apparent anomaly raises a more general question about the extent to which neutrality in outcomes for taxpayers using different investment structures should be pursued.

Q4.14 Could the exemptions for entities or investment arrangements that pose little or no tax deferral risk be improved? If so, how?

Q4.15 How could the exemptions be modified to ensure greater investment neutrality?

FURTHER APPROACHES TO TARGETING

4.68 Some other countries have additional exemptions that are not a feature of Australia's attribution rules. These exemptions could be considered as part of better targeting the attribution rules.

4.69 Such exemptions can operate at two levels. First, to specify whether the attribution rules should apply at all and, second, if they do apply, further exemptions could act as filters to streamline and make more certain what income is subject to attribution.

4.70 Exemptions necessarily involve a balance between the risk to the revenue, compliance costs and administration. This balance may change over time, so it is important to consider the scope and design of the exemptions now and into the future.

4.71 The following exemptions could be considered as part of reducing the complexity and compliance costs associated with the attribution regimes (see further below):

- a motivation or purpose test;
- a managed fund exemption;
- an Australian public company exemption; and
- a foreign public company exemption.

Q4.16 Are there other exemptions or approaches that could be considered? If so, why?

Motivation or purpose test

4.72 One alternative approach that has been raised is a motive or purpose test. 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.

4.73 One of the issues with a purpose test is the ability of taxpayers to apply it with certainty and of the Australian Taxation Office to administer it. This might turn on the factors involved in determining whether avoidance has occurred. For example, if the factors can readily and objectively be applied then the test might be simpler to administer and comply with than other anti-avoidance measures. Such factors might

include, for example, whether the effective rate of tax approximates that of Australia, as well as other relevant commercial considerations.

4.74 The Board notes that such a test has the potential to introduce uncertainty for taxpayers and administrators alike. In a self assessment environment, it could create difficulties where the calculation of liability depended on the actions of the Commissioner and the Commissioner had not made a decision by the time taxpayers lodged returns.

Q4.17 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?

Managed fund exemption

4.75 Offshore funds such as overseas unit trusts and collective investment vehicles have a long-established position of importance among the range of savings and investment products available to Australian residents.

4.76 The need to build a more efficient system of international tax for funds management is underpinned by a number of community-wide considerations. Australia as a key global player in visible exports and imports needs a sophisticated financial system to facilitate these transactions, and funds management is an integral component of a developed financial system.

4.77 In addition, as a net importer of capital, Australia needs to have an international tax regime that gives better access to international markets to reduce the cost of capital. Retirees and long-term savers also need access to international capital markets to gain diversification and optimal risk and return outcomes.

4.78 Additional inflows of funds management dollars assist the Australian community in two key ways: by allowing Australian investors to benefit from lower-cost fund management services arising from economies of scale; and by generating additional growth possibilities which benefit the community at large.

4.79 At the same time, however, allowing the unfettered use of offshore accumulation entities would enable resident taxpayers to increase after-tax returns by substantially reducing the Australian tax payable on their passive investment income. Such an outcome would be contrary to the goal of taxing resident individuals on their worldwide income, pose a risk to the revenue base, and favour the use of particular offshore managed funds over Australian managed funds.

4.80 The global availability of investment opportunities in offshore accumulation entities located in tax havens and low-tax countries is substantial for highly mobile

forms of capital. Offshore accumulation entities also can be established in non-tax haven countries to take advantage of favourable taxation arrangements designed to attract such investment.

4.81 FIF interests that are not exempt are taxed on an accruals basis and attribution accounts need to be maintained to prevent double taxation when income is finally repatriated or the FIF interest is sold. The maintenance of accounts imposes significant compliance difficulties, particularly for Australian managed funds. This is because each investor in the fund must have separate attribution accounts maintained on their behalf. Moreover, attribution account percentages change and each account needs to be revised as unit holders enter and exit the fund.

4.82 Such compliance concerns often cause investors and their fund managers to avoid the complex FIF rules by selling sufficient non-exempt FIF interests immediately before year end so that they fall within the 10 per cent balanced portfolio exemption (so-called 'bed and breakfast' arrangements).

4.83 The challenge in designing a FIF regime for managed funds is to find the balance that appropriately addresses the needs of government, managed funds and the investors themselves. Among other things, this means a system that:

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

4.84 Various options have been identified for consideration in designing the attribution rules to better take account of managed fund arrangements.

4.85 Some of the rules could act as an initial filter to determine whether managed fund arrangements fall within the attribution rules in the first instance. This would obviate the need for the attribution rules to apply any further.

4.86 For those managed fund arrangements remaining within the attribution rules, other rules could then streamline the operation of the attribution rules to provide greater certainty of outcomes. As part of this, the operation of the attribution calculations might also be simplified and streamlined (see Chapter 5).

4.87 While some of the following rules have been canvassed more generically, they might also be considered specifically in the context of the funds management industry.

- Provide access to calculation methodologies that would obviate the need for bed and breakfast arrangements. At present managed funds can reduce the compliance cost impact of the FIF regime by selling and buying their portfolio back-to-back to the extent required to come within the balanced portfolio exemption. While a notional recognition of this practice would reduce the costs incurred, this might have broader implications as it would legitimise arrangements designed to avoid taxation consequences, even if a primary motivating factor is reducing compliance costs.

- Adopt a CFC-like listed country exemption (or develop comparable tax criteria). If offshore investments are in a country meeting certain criteria, it would be accepted that tax advantage was not being sought. This would place reliance on the operation of that country's tax system covering the further investment of funds into other jurisdictions.

- Increase the balanced portfolio exemption from 10 per cent to, say, 25 per cent. This has the potential to significantly reduce compliance costs while still limiting opportunities to pursue strategies of income accumulation offshore for tax advantage.

- Develop a distribution requirement or accumulation vehicle criteria. If a managed fund makes sufficient regular distributions of income to Australian investors, there is less risk of funds being accumulated offshore to obtain a tax advantage for Australian residents. The United Kingdom's rules, for example, contain criteria to test whether offshore funds qualify as 'distributing' funds, including a distribution test and rules covering sub-funds in which a managed fund might invest.

Q4.18 For managed funds, how could the rules better target offshore income accumulation?

Q4.19 Could any changes for managed funds apply more broadly to cover, for example, companies? If so, why and how?

Australian public company exemption

4.88 It has been suggested by some that widely-held listed Australian public companies should not be subject to the attribution rules. In the ordinary case, the demands of shareholders of public companies are argued to be such that a public company will make regular distributions. Thus, there is less likelihood that a public company will invest offshore to gain a tax deferral benefit.

4.89 It has also been argued that the dividend imputation system creates strong incentives for domestic over foreign investment, reducing the need for attribution rules.

4.90 Such an exemption may be viewed as a simpler, blunter approximation of whether an entity is an accumulation vehicle. However, the exemption may create inappropriate incentives for public companies to modify their investment strategy by seeking to exploit tax deferral benefits through offshore investment. More generally, the commercial environment may evolve such that distribution policies change and investor expectations of distributions as opposed to growth stocks will vary among industry sectors.

4.91 Providing an exemption for a particular class of entity inevitably raises issues about neutrality of treatment with other resident companies and entities that might also make regular distributions, and are also less likely to invest offshore to defer income (such as widely-held private companies).

Q4.20 Should a public company exemption be included in the attribution regimes? If so, why?

Q4.21 Could a more generic approach to defining an accumulation vehicle be used to address neutrality concerns? If so, how?

Foreign public company exemption

4.92 An exemption for investments in foreign public companies has been suggested on a similar basis to the one for Australian public companies discussed above. That is, the demands of shareholders are such that a public company will tend to make regular distributions.

4.93 This is already a feature of the FIF regime. The stock exchange listing method applying under the 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.

4.94 The existing exemptions in the FIF regime apply only if the company is listed on an approved stock exchange. Confining the exemption to approved stock exchanges would limit the possibilities for abuse, but would also retain the administrative burden of maintaining a list of stock exchanges.

4.95 The more general application of such an exemption raises practical difficulties in defining a 'public company'. The concept of widely-held of itself may be insufficient without further conditions to address the range of company structures and regulatory

practices that exist worldwide. Also, not all public companies are necessarily under shareholder pressure to make regular distributions if shareholders have a preference for capital returns, or the company can provide superior returns by re-investing profits.

Q4.22 Could a foreign public company exemption consistent with that in the FIF regime be applied across the attribution regimes?

CHAPTER 5: METHODS FOR ATTRIBUTING INCOME

BACKGROUND

5.1 The final aspect of the three building blocks shared across the current attribution rules is the methodologies used to calculate the income of the foreign entity and attribute it to Australian residents. Currently, there are several different methods under the various regimes.

5.2 This Chapter discusses the appropriateness of the current attribution methods and record keeping requirements. It also considers how the current methods and record keeping requirements might be improved to reflect the policy objectives outlined in Chapter 2.

CURRENT ARRANGEMENTS

5.3 The attribution regimes each adopt different methods to calculate the income of the foreign entity that is attributable to resident taxpayers. Different methods exist largely to accommodate presumptions about the level of information taxpayers have in respect of their foreign investment. The various methods are outlined in summary form in Table 5.1.

5.4 Where taxpayers have a controlling interest in the foreign entity (that is, under the CFC and transferor trust regimes), they are generally assumed to have sufficient information to calculate the taxable income of the foreign entity on a branch-equivalent basis.[50]

5.5 By contrast, where taxpayers do not have a controlling interest (that is, under the FIF regime), they are assumed to have insufficient information to perform full branch-equivalent calculations. Instead, proxy methods such as 'market value' and 'deemed rate of return' are used to approximate taxable income figures. A simplified branch-equivalent method, referred to as the 'calculation method', is also available under the FIF rules.

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50 A deemed rate of return method exists as a back-up in the transferor trust regime for instances where taxpayers have insufficient information to perform branch-equivalent calculations.

Table 5.1: Comparison of methods for attributing income

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

5.6 Internationally, many countries apply substantially the same mix of attribution methods as Australia. However, some countries (for example, the United States) do not have a deemed rate of return method, while others (such as New Zealand) have more than one method that taxes residents at set rates.

ISSUES WITH THE CURRENT ARRANGEMENTS

5.7 Although the various regimes provide different attribution methods, they all share the same objective of including in a resident taxpayer's assessable income their share of foreign income that has been identified as receiving an inappropriate deferral benefit.

5.8 To perfectly approximate the amount of Australian tax payable, the taxpayer would need to apply the full extent of the Australian tax laws to the targeted foreign income. While the CFC, transferor trust and deemed present entitlement rules apply this branch-equivalent approach, they do so in different ways which creates inconsistencies and distortions. Ideally, each regime would apply a consistent approach to identify the amount of the income that is subject to attribution.

5.9 In cases where it is not reasonable to apply branch-equivalent calculations, proxy calculations apply as an alternative. Under the FIF rules, the taxpayer has the choice between a calculation method, market value or deemed rate of return method. Even within these rules, significant inconsistencies and distortions arise — taxpayers are often forced to use the market value method (despite this method capturing unrealised gains) since the deemed rate of return method uses a high rate and taxpayers may not have the necessary information to use the calculation method.

5.10 These inconsistencies and distortions are exacerbated by the rules that currently restrict access to particular regimes. A common complaint is that taxpayers under the FIF rules are prevented from applying the CFC rules (and the exceptions), notwithstanding they have the information necessary to prepare branch-equivalent calculations. A consistent approach to the operation of these calculations and the liberalisation of access to the calculations would address many of these distortions.

Q5.1 How could the current attribution methods be improved to resolve the distortions that currently exist (both across the regimes and within the regimes)?

5.11 The paragraphs below explore specific problems with the existing attribution methods and discuss how these problems lead to the inconsistencies and distortions outlined above. Comments are sought on how the current arrangements might be improved to resolve specific problems associated with each method. Comments should also focus on addressing the current distortions that exist both within and across the regimes.

5.12 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.

Branch-equivalent calculations

5.13 The CFC, transferor trust and deemed present entitlement rules apply the domestic tax rules to calculate the income of the foreign entity as though it were an Australian resident (that is, on a branch-equivalent basis).

5.14 The FIF regime also contains a simplified branch-equivalent calculation referred to as the 'calculation method'. The difference between the two is that, under the CFC rules, the CFC is deemed to be a resident company and the full range of the Australian income tax law is applied accordingly. Under the FIF rules there is no equivalent deeming, instead the FIF provisions themselves prescribe a modified taxation calculation.

5.15 Australia's taxation laws are often criticised for their complexity and the difficulty taxpayers have in applying them to their individual circumstances even where the taxpayer derives solely Australian sourced income. When these laws are applied in a branch-equivalent context, it is not surprising that these complexities and difficulties are significantly amplified: taxpayers must apply the Australian tax laws to foreign source income and apply them in respect of another entity, albeit one that they might control.

5.16 It has been suggested that, rather than applying full branch-equivalent calculations, a far simpler approach (which might borrow from the FIF calculation method) is needed. Such an approach could avoid the need to impose a full overlay of Australian tax law and, provided it produced an outcome that was not materially

different from the amount of taxable income that would have arisen on the equivalent domestic investment, could significantly ease compliance costs for affected taxpayers.[51]

5.17 It has also been suggested that, from a policy perspective, it is not always appropriate to apply the full extent of the Australian tax laws as some provisions are not relevant within the context of foreign investment. The operation of section 51AD is often cited as an example in this regard.[52]

5.18 Harmonising the various branch-equivalent methods provides an opportunity to address these compliance and complexity concerns as well as addressing distortions that arise by virtue of the different approaches to branch-equivalent calculations across the regimes. Harmonisation not only allows differences to be reconciled (for example, the treatment of lower tier entities), it also allows for similarities across the various methods to be streamlined.

Q5.2 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?

Q5.3 Which provisions of the Australian tax laws should be excluded from branch-equivalent calculations and why?

Market value method

5.19 The market value method is one of three methods used for calculating FIF income. This method taxes residents on the movement in the market value of the foreign entity over the accounting period. A cash surrender method, which is similar to the market value method, applies for foreign life policies. The issues discussed below in relation to the market value method could therefore equally apply to this method.

5.20 Business has commented that the market value method inappropriately captures unrealised gains. Some claim that this is undesirable since the taxation of gains is brought forward and taxed as income in the current period. This does not generally occur on domestic investments where gains are taxed only when they are realised and,

51 Some examples of adjustments that might need to be made which are unlikely to motivated by tax deferral considerations include: the application of the foreign exchange conversion rules; the application of section 51AD and Division 16D of the *Income Tax Assessment Act 1936*; distinguishing between repairs and maintenance; the application of Australian rate and bases for depreciation; adjusting for provisions such as long service and annual leave; adjusting for non-deductible entertainment expenses; and the application of Division 16E of the *Income Tax Assessment Act 1936*.

52 Section 51AD acts to prevent the transfer of benefits, through leasing arrangements, from taxable entities to non-taxable entities by denying certain deductions.

in certain cases, are discounted.[53] It also does not occur on other foreign investments where the FIF calculation method is used.

5.21 New Zealand recently adopted a new 'fair dividend rate' method which partly addresses this issue. The method is similar to a deemed rate of return method but with a much lower rate. If the amount of income attributed is calculated by reference to a lower rate, the prospect of unrealised gains being attributed becomes less of a concern. The fair dividend rate method is discussed further below.

5.22 The market value method is the most commonly used method for investors with FIF interests. It is also used internationally due to its simplicity and the resulting low compliance costs. While other methods (such as the calculation and branch-equivalent methods) may result in lower attributable income, they are more complex and compliance intensive.

5.23 Mark-to-market methods are used in other parts of the tax law including in the taxation of financial arrangements. Ideally, the operation of the market value method in the attribution rules should be consistent with the operation of these methods.

Q5.4 How could the market value method be improved?

Deemed rate of return method

5.24 A deemed rate of return method is available under the FIF regime and the transferor trust regime. Under both regimes, residents are taxed at a deemed rate on the value of their investment in the foreign entity. Under the FIF regime, the value of the investment is the consideration paid for the FIF plus any previous years' attributed income. Under the transferor trust regime, the value of the investment is the market value of the property or services plus any previous years' attributed income.

5.25 Currently, the rates differ across the regimes. Under the FIF regime, the deemed rate is the statutory interest rate plus 4 per cent. Under the transferor trust regime, the deemed rate is the statutory interest rate plus 5 per cent. The statutory interest rate is based on the monthly average yield of the 90 day bank accepted bills rate.

5.26 Internationally, many countries base their rates on similar benchmarks. In New Zealand, the rate is the interest rate on 5 year government bonds plus 4 per cent. In Canada, the rate is the 90 day average Treasury bills rate plus 2 per cent.

53 Some financial investments, however, may be taxed on an accruals basis under the Taxation of Financial Arrangements rules.

5.27 The deemed rate of return has traditionally been set relatively high to encourage investors to use the other attribution methods where possible. The Government's 1992 FIF Information Paper explains:

> 'The Government intends that [the deemed rate of return method] be used as a fall-back for those types of investment that are unable to be taxed under the other methods of taxation. Since taxpayers may be able to earn quite high pre-tax rates of return from some FIF investments in some low-tax jurisdictions, the deemed rate of return has to be quite high if it is not to encourage taxpayers to try and use the deemed rate of return as their preferred taxing method. ' [54]

5.28 While this original focus on ensuring the integrity of the Australian revenue remains important today, other objectives such as low compliance costs and complexity also need to be appropriately balanced in settling on a deemed rate. A rate that is too high entrenches the distortions discussed previously whereby investors either avoid using the deemed rate of return method or face a penal rate on their overseas investment. A rate that is too low creates a bias in favour of overseas investment and introduces a revenue risk.

5.29 Part of the difficulty in setting an appropriate rate is that different investments have different rates of return. A single rate could, at best, reflect mean or median returns. Multiple rates, although a better indicator of returns, are complex and compliance intensive.

5.30 A starting point might be to examine New Zealand's recently adopted 'fair dividend rate' method which taxes portfolio investments at a lower deemed rate of return.[55]

5.31 Regardless of the rate, there is significant potential to streamline the deemed rate of return methods. Providing a more consistent approach would remove the distortions which currently apply and ensure that investors are tax-neutral between different overseas investments.

Q5.5 How should the deemed rate of return be changed to better approximate returns on foreign investment? To what level and why?

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

55 The fair dividend rate method taxes residents on 5 per cent of the opening market value of their investments. If the investor is an individual or family trust and where returns are lower than 5 per cent of market value, tax may be paid on the lower amount. Where it is not possible to obtain a market value, the investor can use the cost base as a proxy for market value. Both the fair dividend rate method and its cost-based variant are available for investments of less than 10 per cent in foreign companies as well as for certain collective investment vehicles investing in foreign entities. See further: Policy Advice Division, Inland Revenue New Zealand, *New Tax Rules For Offshore Portfolio Investment in Shares*, 23 February 2007.

Q5.6 Could the deemed rate of return method be applied consistently across all the attribution rules?

OTHER POSSIBLE METHODOLOGIES

5.32 The current attribution methods have various shortcomings. These generally arise due to the need to balance information availability, integrity, compliance and complexity. There may be other methods that strike a better balance between these competing objectives.

5.33 Internationally, the same methods generally apply as those used in Australia. One exception is New Zealand which, in addition to Australia's methods, has an accounting profits method.[56] Business has suggested that this option may also be suitable for Australia. Since accounting profit figures are readily available to most businesses, this option would substantially reduce compliance costs. However, compliance cost reductions should only be pursued in so far as they do not pose an unacceptable risk to revenue or bias investment decisions. The appropriateness of tying domestic tax laws to externally determined standards also needs to be considered.

Q5.7 What other attribution methods are viable alternatives? Would these methods strike an appropriate balance between compliance, complexity, integrity and neutrality?

CHOICE BETWEEN MULTIPLE ATTRIBUTION METHODS

5.34 Currently, the CFC control rule and the various rules which give priority of application to one regime over another dictate which attribution method(s) the taxpayer must use. While a choice of methods is available within the FIF and transferor trust regimes, this choice is often limited by practical constraints and the penal outcomes that are said to accompany some of the methods. Limitations are also imposed on the taxpayer's ability to switch between methods under the FIF regime.[57]

5.35 In general, choice is desirable in that it allows 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

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56 Australia's FIF calculation method, despite requiring fewer adjustments and therefore more closely approximating accounting profit than the CFC branch-equivalent calculations, still relies on Australian tax law to calculate the income of the FIF.

57 Taxpayers are restricted from electing to use the calculation method if they have used the method previously but have since ceased to use that method.

neutrality by allowing the same method to be used for interests in different foreign entities.

5.36 However, choice may have some disadvantages. If investors can choose between multiple methods, they often trial all methods before choosing the one with the lowest tax liability. Choice can therefore result in high compliance costs for investors. After initially considering all methods, however, taxpayers could be expected to choose a certain method and, assuming that the business does not change substantially, continue to use that method. Consequently, to the extent that compliance costs are likely to arise, these may only be of an initial transitional nature.

5.37 Furthermore, if distortions are reduced so that all methods impose similar tax liabilities, taxpayers are less likely to trial different methods or switch between methods to reduce their tax liability. This not only reduces compliance costs but reduces the need for integrity rules to prevent switching.

Q5.8 Should taxpayers be permitted to choose which attribution method to apply or should some restrictions apply?

Proportion of the foreign entity's income attributed to taxpayers

Attribution and discretionary interests

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

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

5.40 One alternative may be to tax residents on the 'percentage transferred' as a portion of the corpus of the foreign trust. This idea was proposed in the Consultative Document but was rejected in the subsequent Information Paper due to concerns that residents may not have sufficient information to determine the 'percentage transferred'. However, it may be possible to attribute income based on the percentage transferred, with the current arrangements retained where taxpayers do not have

sufficient information (that is, deeming the interest to be 100 per cent). The United States and the United Kingdom generally attribute income in this way.

5.41 Similar issues also apply in attributing income from non-common law entities. These entities do not fit neatly within the existing regimes since, like transferor trusts, they do not involve a fixed legal interest.

Q5.9 How should the percentage of income attributed be determined where the taxpayer has no fixed, legal interest in the foreign entity?

Q5.10 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)?

Part-year ownership of an interest in a foreign entity

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

5.43 To ensure that all interests in foreign entities are subject to the same tax treatment, income should be attributed to residents in a consistent manner (that is, either apportionment should apply or not apply) across all interests in foreign entities. The appropriate treatment of attributable income should reflect the resident's right to receive that income. Apportionment should arguably only apply if the resident has no claims to income earned before the interest in the foreign entity was acquired.

Q5.11 Should attributable income be apportioned to reflect part-year ownership of the foreign entity, and how would apportionment apply?

INTERACTION OF CAPITAL GAINS TAX PROVISIONS AND ATTRIBUTABLE INCOME PROVISIONS

5.44 Currently, attributable income arising from a taxpayer's interest in a foreign entity is included in the taxpayer's assessable income. When the interest is sold, the capital proceeds are reduced by amounts that have been previously attributed but not distributed. This avoids double taxation by ensuring that amounts previously taxed as income are not subsequently subject to capital gains tax. However, this can create distortions by subjecting what would otherwise be a capital gain to income tax

treatment. Distortions arise since capital gains are generally taxed more concessionally than ordinary income (for example, CGT discounting).

5.45 This problem primarily arises as a result of taxing, on a current basis, unrealised gains. While the use of branch-equivalent calculations would address the problem, not all taxpayers have sufficient information to use branch-equivalent calculations.

Q5.12 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?

ATTRIBUTABLE INCOME AND DISTRIBUTIONS

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

5.47 The CFC and FIF legislation are highly prescriptive as to how attribution accounts should be maintained. While some guidance is necessary (to ensure a minimum level of reporting and to provide taxpayers with a degree of certainty as to their account keeping responsibilities), the high level of prescriptivism impedes the flexibility of taxpayers. If the rules were less prescriptive, taxpayers may be able to achieve significant compliance savings by adopting methods which better suit their needs and tie in with other reporting requirements.

Q5.13 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?

Tracing and crediting attributable income

5.48 The general operation of the accounts is the same under all regimes. The account is credited when income is attributed and debited when income is distributed. However, the process for calculating and crediting attributable income differs slightly across the regimes.

5.49 Under the CFC regime, attributable income is calculated separately for each CFC in a chain of CFCs. Each CFC's account is then credited to reflect the amount attributable from that CFC.

5.50 Under the FIF regime, the taxpayer often does not have the necessary information to calculate the income of lower tier FIFs and credit each FIF's account

separately. Consequently, the taxpayer calculates the income of the FIF directly held, with the value of lower tier FIFs included in this amount. If the calculation method is used to calculate the value of lower tier FIFs, the income of the FIF directly held is apportioned and credited to the accounts of lower tier FIFs. If the market value or deemed rate of return method is used, the income of lower tier FIFs is implicitly included and is therefore not separately identified and credited. Consequently, accounts cannot be kept for lower tier FIFs where either the market value or deemed rate of return method is used. Since the calculation method cannot be used beyond second tier FIFs, accounts are only kept for a maximum of three tiers of FIFs. This is in contrast to the CFC regime where accounts are kept for unlimited tiers of CFCs.

5.51 Despite the differences across the regimes, the amount credited under the CFC and FIF rules is generally the same. Consequently, there may be scope to reduce compliance costs by harmonising the record keeping requirements.

Q5.14 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?

Reconciling distributions

5.52 The current system of recording distributions is very complex. As previously discussed, distributions are tracked against attributable income using attribution accounts. The accounts prevent double taxation by ensuring that previously attributable income is exempt on distribution.[58]

5.53 However, the non-portfolio dividend exemption can also apply to exempt the same income.[59] This exemption applies to dividends received by Australian companies from foreign companies. (The exemption applies regardless of whether the dividend income has been previously attributed.)

5.54 While the two exemptions may overlap, the non-portfolio dividend exemption only applies to Australian companies that have an interest of 10 per cent or greater in a foreign company. The non-portfolio dividend exemption also does not allow taxpayers to claim foreign tax credits — a benefit which is available under the previously attributable income exemptions.

5.55 Despite the imperfect overlap between the two exemptions, there may be opportunities to rationalise the provisions to reduce the compliance burden on business.

58 Sections 23AI and AK of the *Income Tax Assessment Act 1936*.
59 Section 23AJ of the *Income Tax Assessment Act 1936*.

Q5.15 How could the reconciliation of dividends that are referable to previously attributable income be streamlined and simplified?

CHAPTER 6: DESIGN PRINCIPLES FOR A HARMONISED ATTRIBUTION REGIME

BACKGROUND

6.1 The preceding Chapters explored problems that exist in the current attribution regimes against the common building blocks that the regimes share: interests and entities; the kinds of income that should be attributed; and methods for attributing that income.

6.2 The Chapters also examined how harmonising the regimes might address these problems by providing a more consistent approach to attribution. Chapter 2 explained that harmonising could take various forms including by:

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

6.3 This Chapter provides a blueprint of each of these options and evaluates their respective advantages and disadvantages. The blueprints are presented as high level design alternatives as further information needs to be drawn from consultation and feedback elicited from this discussion paper.

6.4 Furthermore, the blueprints do not revisit the problems canvassed in the preceding chapters, rather they assume that the issues will be appropriately addressed in the more detailed design. To assist in the explanation, the blueprints also assume that the traditional approach of targeting passive income through a range of active income or entity exemptions, or positively defining passive income, will continue to apply in the future.

MAINTAINING SEPARATE REGIMES WITH MORE CONSISTENT OUTCOMES

6.5 As implied, this approach involves minimal change as separate stand-alone regimes are retained: that is, the retention of the CFC, FIF, and transferor trust regimes.

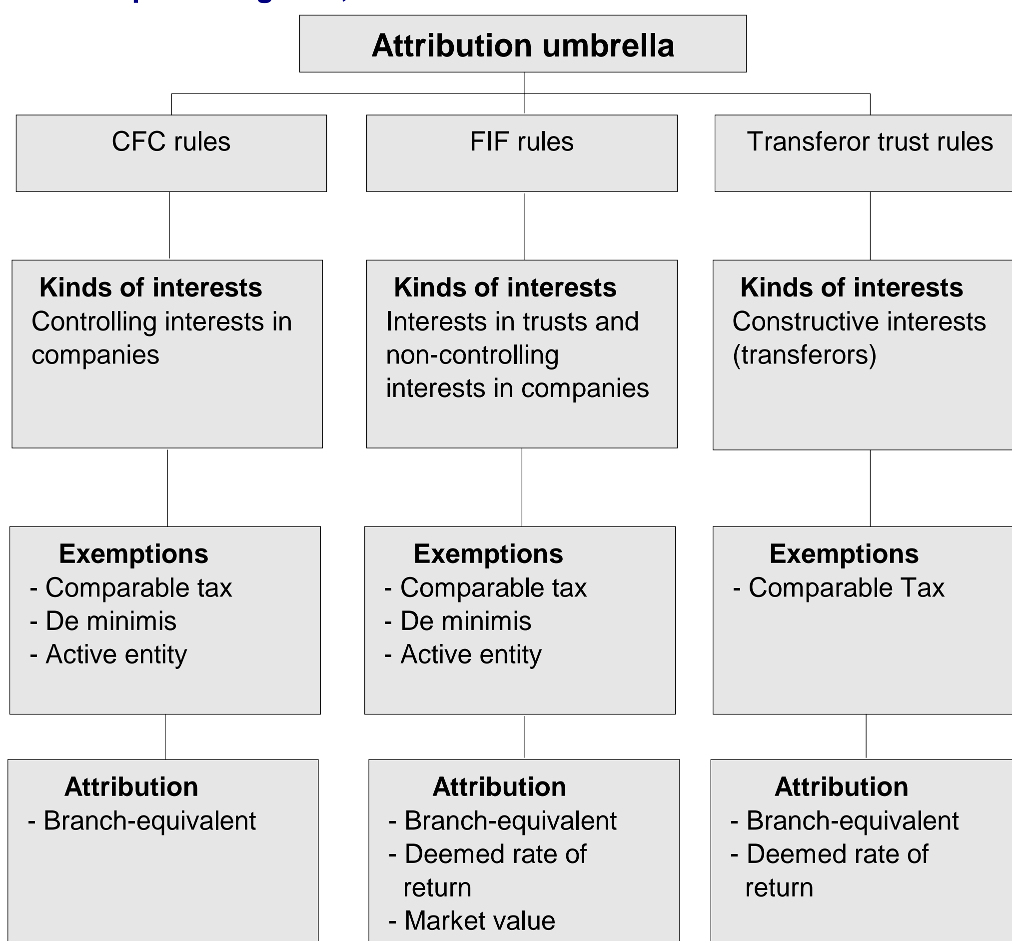
6.6 In retaining separate regimes, however, a more consistent approach to the operation of exemptions and the methods for attributing income could be used. For example, the active business test that applies to companies under the FIF rules could be extended to include trusts. Similarly, the different approaches to branch-equivalent calculations across the regimes could be standardised.

6.7 The primary benefit of this option is that it is likely to impose the lowest transitional costs since changes could be achieved by modifying the rules as they currently apply in the *Income Tax Assessment Act 1936*, rules with which taxpayers and practitioners are already familiar.

6.8 The disadvantage of this approach is that, in maintaining separate regimes, interaction problems across the regimes may continue to arise. Furthermore, separate regimes will continue to impose the high levels of complexity and compliance costs that are a feature of the current arrangements. In this regard, the retention of signpost rules, including the notions of 'control' and 'associate', will need to continue.

6.9 Schematically, this approach can be illustrated as follows:

Option A: Separate regimes, more consistent outcomes



COLLAPSING THE REGIMES INTO A SINGLE REGIME

6.10 This option involves collapsing the current stand-alone regimes into a single regime. One of the challenges in achieving this outcome is to identify those features of the existing regimes that should be drawn together and applied within a single regime.

6.11 It is relatively easy to prescribe that interests caught by the existing attribution rules would be covered under a single harmonised regime. However, it is a more difficult proposition to harmonise the rules relating to the kinds of income that are subject to attribution and the method for attributing that income within a single regime.

6.12 The barrier to harmonising these features is the level of information available to investors about the nature of their foreign investment. Recognising this, the FIF rules provide an active income exemption by reference to the nature of the activity undertaken by the investment entity (information that is more likely to be readily available), as opposed to the nature of income derived by the entity, which is a feature of the CFC rules. Similarly, the FIF rules provide alternative methods for attributing

income recognising that taxpayers, in many situations, will not have the information necessary to perform branch-equivalent calculations.

6.13 Chapter 5 noted that this asymmetrical information problem could be addressed by offering taxpayers the freedom to choose between a range of attribution methods and by better aligning the outcomes each of these methods produce.

6.14 While information asymmetry would prevent many FIF-type interests applying the CFC active income exemption, the same problem should not exist in the case of applying FIF-type exemptions to corresponding CFC interests. For this reason, it should be possible to devise a single regime that applies the existing FIF-style exemptions, exemptions which are not referable to the nature of the income derived by the foreign entity. Such exemptions could include:

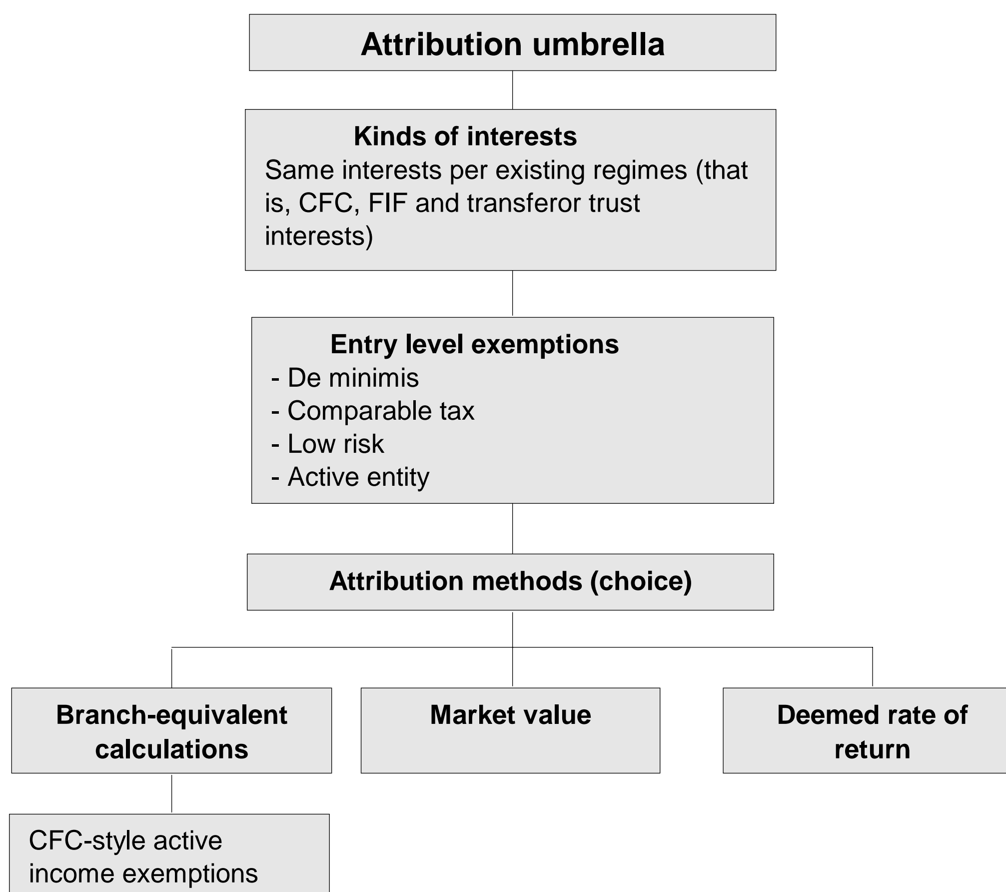
- investments that satisfy de minimis thresholds (including the absolute de minimis thresholds and the balanced portfolio exemption, both adjusted to levels identified in consultation as being appropriate);
- investments in comparable tax countries (relying on the CFC list of countries, with the addition of other countries identified in consultation);
- investments by low risk entities (including superannuation funds, together with additional low risk entities identified in consultation, such as, tax-exempt entities); and
- investments in active entities (including the existing active entities identified under the FIF rules, together with additional active entities identified in consultation).

6.15 Significant compliance costs are often incurred under the existing regimes simply to establish that a taxpayer is ultimately exempt from attribution. Pitching these exemptions at the initial entry level in the design of the rules should help address this concern.

6.16 Applying these exemptions should go a long way towards better targeting the kind of income that presents the best opportunity for inappropriate deferral. However, to ensure that the exemptions that exist under the current regimes are perfectly duplicated it may be necessary to replicate the active income exemption that applies under the CFC rules. This exemption, however, requires investors to hold high levels of information. Under a single regime approach, it would therefore be necessary to confine access to the CFC active income exemption to circumstances where taxpayers elect to apply branch-equivalent calculations.

6.17 Schematically, a single regime could look something like this:

Option B: Single regime



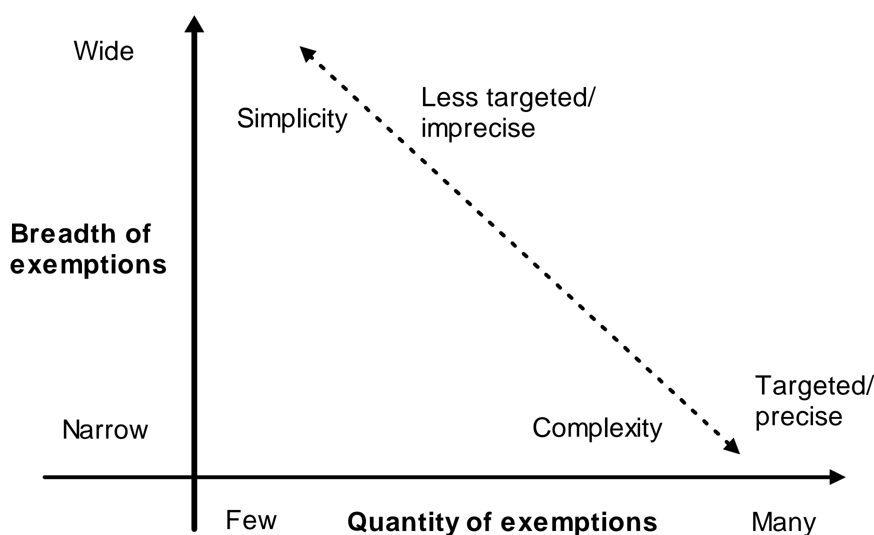
6.18 As explained in Chapter 4, in considering design options, it is necessary to strike an appropriate balance between competing objectives. While the provision of fewer but broader exemptions brings with it the benefit of simplification and potential compliance cost savings, it also means that the exemptions are blunt and less precise. Depending on the circumstances, this could potentially work to taxpayers' advantage, particularly if the current FIF active business threshold of 50 per cent is extended to what are currently CFC interests (the CFC active income exemption applies a 95 per cent threshold).[60] Conversely, increasing the number of more narrowly targeted exemptions brings more precision but comes at the cost of increased complexity and compliance costs.

60 Under the FIF regime, a company passes the active income test if 50 per cent or more of the value of its assets give rise to active income. (This approach is used in several different countries.) In contrast, the CFC active income exemption applies where 95 per cent or more of the CFC's income is not tainted income. If the CFC passes the active income test, none of its tainted income is attributed. On the other hand, if 5 per cent or more of the CFC's income is tainted income, only its tainted income is attributed.

6.19 There are a range of other factors that are relevant in identifying the optimal balance including:

- whether the retention of a CFC-style active income exemption would provide any further coverage than the operation of a FIF-style active business exemption operating at a higher level;
  - The retention of a CFC-style active income exemption that did nothing more than provide the equivalent, or less, coverage as a FIF-style active business exemption would do nothing more than impose additional complexity and compliance costs.
- whether the extension of a FIF-style active business exemption to what are currently CFC interests would produce an unmanageable revenue risk for government;
  - This could be mitigated by adopting the FIF approach of attributing all of the entity's income where the FIF-style active business exemption is failed, rather than the CFC approach of attributing only the entity's tainted income. Such an approach would have the additional benefit of reducing complexity and compliance costs.

6.20 Simplistically, the challenge can be depicted as follows.



6.21 The main benefits of a single regime would be the permanent and ongoing reductions in complexity and compliance costs. A single regime would draw together, under a single umbrella, features that are currently used across multiple regimes. In turn, this would address the interaction and distortionary problems discussed in earlier chapters. The removal of the notions of 'control' and 'associate' would remove inappropriate barriers that prevent taxpayers from accessing exemptions or attribution methods that exist in alternative regimes.

6.22 The disadvantage of a single regime is that it would impose higher initial transitional costs in comparison to the alternative options. As explained earlier, however, these costs would be mitigated by drawing from the existing rules. Much of the knowledge base and familiarity with the current regimes would continue to be relevant.

MERGING SOME REGIMES, OR ASPECTS OF REGIMES

6.23 This option is an amalgam of the two previous options. It would involve merging some of the current regimes, say, for example, the CFC and FIF regimes, and leaving the transferor trust regime as a separate regime.

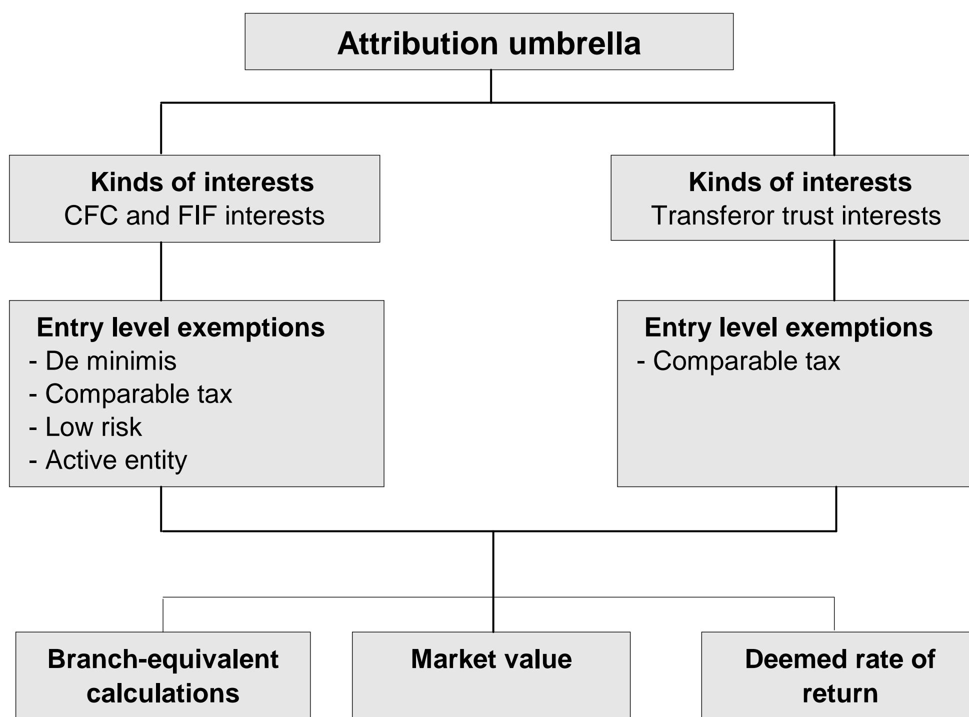
6.24 A common theme that has been put to the Board in support of this approach is that the CFC and FIF regimes have greater capacity to be merged as those regimes are primarily concerned with the corporate sector, whereas the transferor trust rules are mainly concerned with high wealth individuals and closely-held trusts.

6.25 Such an option would, however, still aim for a consistent approach to the operation of exemptions and attribution methods. An alternative sub-option would be to retain separate regimes but to merge various features of those regimes. For example, separate regimes could be retained with the methods for attributing income universally applied.

6.26 This option would involve lower initial transitional costs than adopting a single regime but the possible benefits would not be as great in terms of simplicity and compliance cost reductions. However, the benefits of this option are likely to be greater than those that could be achieved by maintaining entirely separate regimes, although the transitional costs would likely be higher.

6.27 Schematically, this approach can be depicted like this:

Option C: Merging some regimes (or aspects of regimes)



Q6.1 To what extent would harmonising the regimes benefit taxpayers? Would these benefits outweigh the associated transitional costs?

Q6.2 Of the three harmonisation options, which one is preferred and why? Are there different approaches to harmonisation that should be considered?

Q6.3 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?

Q6.4 If the FIF-style active business exemption was extended to what are currently CFC interests, would that produce an unmanageable revenue risk for government? If not, why?

Q6.5 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?

TAX ADMINISTRATION AND TRANSITIONAL ISSUES

Tax administration

6.28 An essential component to any good taxation system is the need to have appropriate administrative systems in place for all users of the system.

6.29 The 1998 Review of Business Taxation[61] identified tax administration as one of the three core processes in implementing changes to the business tax system (the other being policy formulation and development of legislation). Further, it acknowledged that there would be benefits from a system of tax administration that was more responsive to business circumstances.[62]

6.30 In explaining the Australian Taxation Office's approach to international tax administration, Commissioner of Taxation, Michael D'Ascenzo, recently made the following remarks:

> '[W]hat we as tax administrators are working towards is a flexible administration that lets business operate successfully in a competitive market. We are an 'enabling' administration within the parameters of Australia's tax laws.
>
> 'As a tax administration, our objective is to help business understand its rights and obligations, and to make the paying of tax, in accordance with the law, as easy as possible. There is significant comfort and certainty for business in the fair application of the tax laws. For example, we apply the rule of law in our dealings with taxpayers, and taxpayers who are dissatisfied with our decisions have rights to have the matter determined by the Administrative Appeals Tribunal or the courts …
>
> 'One of the Tax Office's most significant challenges is keeping your tax compliance costs as low as possible. It is in no one's interest to create dead weight costs. Our *Large Business and Tax Compliance* booklet provides some pathways that give business the opportunity to minimise their compliance costs in dealing with us.
>
> Research in a recent survey in Europe by AT Kearney[63] found that 64 per cent of global investors identified government regulation as the most critical risk to corporate operations …'[64]

6.31 The increase in economic activity that Australia has witnessed in recent years, coupled with the trend for corporations to integrate their global activities, has added to

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61 Review of Business Taxation, *A Strong Foundation, Discussion Paper: Establishing objectives, principles and processes*, AGPS, Canberra, November 1998, pp 40-41.

62 Ibid, p 117.

63 AT Kearney, *Foreign Direct Investment Confidence Index*, October 2004.

64 D'Ascenzo M, Commissioner of Taxation, *Impact of Globalisation on Tax Administration*, Address to the American Chamber of Commerce, Four Seasons Hotel, Sydney, September 2006.

increasing demands for higher levels of sophistication by tax administrators, both to help business meet their tax obligations, and also to ensure appropriate levels of integrity.

6.32 The United States Internal Revenue Service Commissioner, Mark W Everson, noted at a recent OECD forum that:

> '… enforcement of tax laws has become more difficult as trade and capital liberalisation and advances in communications technologies have opened the global marketplace to a wider spectrum of taxpayers. While this more open economic environment is good for business and global growth, it can lead to structures which challenge tax rules, and schemes and arrangements by both domestic and foreign taxpayers to facilitate non-compliance …'[65]

6.33 More recently, the Report of the *Taskforce on Reducing Regulatory Burdens on Business*[66] noted that tax administration was an area that created compliance cost concerns for business. In this regard, the compliance costs associated with furnishing Schedule 25A[67] return forms is often cited by tax practitioners as being particularly high and demanding. These costs, however, need to be balanced against the inherent difficulties regulators face in terms of collecting information and checking the veracity of returns within a cross border environment.

Q6.6 What improvements to tax administration would assist taxpayers meet their obligations under the attribution rules?

Q6.7 What improvements could be made to the administration of the attribution rules that would reduce compliance costs and complexity, while balancing integrity objectives?

Transitional issues

6.34 Chapter 2 noted the Government's intention to repeal the deemed present entitlement rules, leaving the FIF rules or the transferor trust rules as the only rules applying to interests in foreign trusts.[68] This announcement implements the Board's recommendation from RITA to proceed with the Review of Business Taxation's recommendation to simplify the taxation treatment of foreign trusts. The

65 OECD, *Improving International Tax Compliance and Modernising Tax Administrations*, OECD Forum on Tax Administration, Seoul, September, 2006.

66 Regulation Taskforce, *Rethinking Regulation; Report of the Taskforce on Reducing Regulatory Burdens on Business*, AGPS, Canberra, January 2006, p 110.

67 Schedule 25A Income Tax Return forms are required to be furnished by taxpayers that derive foreign source income.

68 See Treasurer's Press Release No. 44 of 2003, Attachment G.

announcement is consistent with the general thrust of harmonising the existing regimes and continues to have the Board's endorsement.

6.35 The Government also announced changes to the transferor trust rules as part of the 2005-06 Budget. The changes, designed to strengthen the existing rules, were first proposed in the Review of Business Taxation and later endorsed by the Board as part of RITA.

6.36 The Consultation Paper released as part of RITA explained that:

> 'The Review of Business Taxation Recommendations 20. 10 to 20. 12 proposed removing some of the current exemptions for transfers, particularly the 'control test' for offshore discretionary trusts established before the transferor came to Australia or before the transferor trust rules were announced. The recommendations also proposed an amnesty applying to trusts affected by the removal of the exemptions.' [69]

6.37 These changes, together with others of the kind contemplated by this Review, are likely to lead to some associated transitional costs. However, as noted in Chapter 2, these costs need to be weighed against the significant benefits that can be gained from harmonising the regimes. This would be particularly so if the approach to harmonising the regimes draws heavily on the features and concepts in the existing rules.

6.38 Nevertheless, the Board seeks comment on transitional issues that may arise together with approaches that would mitigate these issues during the transitional phase including the position of the amnesty outlined above.

Q6.8 What transitional issues are likely to arise and how should they be addressed?

Q6.9 How should the previously announced transferor trust amnesty be dealt with under harmonised arrangements?

Q6.10 What material, information or other support might be needed to ensure a smooth transition to a new regime?

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69 Treasury, *Review of International Taxation Arrangements: A Consultation Paper*, AGPS, Canberra, August 2002, p 69.

GLOSSARY

Active income

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

Attribution rules

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

Balanced portfolio exemption

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

Base company income

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

Branch-equivalent calculations

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

Capital export neutrality (CEN)

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

Capital import neutrality (CIN)

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

Comparable tax (jurisdictional) approach

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

Conduit rules

Rules that allow foreign income to flow to non-resident investors through an Australian entity (or entities) without any further Australian tax consequences.

Controlled foreign company (CFC) rules

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

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

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

(Eligible) Designated concession income (EDCI)

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

Entity approach

An approach to attributing income. Where an entity is classified as 'active' no income is attributed. Conversely, where an entity is not classified as active all of the entity's income is attributed.

Foreign investment fund (FIF) rules

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

Listed country

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

National neutrality (NN)

An efficiency benchmark advocating that investors should face the same pre-tax return on domestic investments as the post-foreign tax return on foreign investments. This promotes neutrality in residents' investment decisions.

Non-portfolio / portfolio

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

Participation exemption

An exemption, or other form of concessional tax treatment, in respect of

earnings (dividends or capital gains) from significant holdings of shares by one company in another. Participation exemptions are common in overseas tax systems, but take many different forms.

Passive income

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

Tainted income

Tainted income includes passive and base company income.

Tainted sales income

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

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

Tainted services income

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

Transactional approach

An approach to attributing income whereby only income that is classified as passive is attributed. Active income is free from attribution.

Transfer pricing rules

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

Transferor trust rules

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

Unlisted country

A foreign country that is not a listed country.

Appendix A: Summary of questions

Chapter 3: Interests and entities

Q3.1 For discretionary interests, should the attribution rules focus on potential beneficiaries rather than transferors? If so, why, and how?

Q3.2 What aspects of the current rules create uncertainty in identifying relevant interests? How should those aspects be clarified?

Q3.3 Are economic interests that are not recognised legally for the purposes of the attribution rules a concern? If not, why?

Q3.4 To what extent does the Government's announcement[70] to align the definition of non-portfolio dividend with economic ownership concepts affect your answer to Q3.3?

Q3.5 How should the attribution rules be modified to ensure that they do not disrupt conduit income arrangements for non-residents?

Chapter 4: Types of income

Q4.1 Is passive income appropriately defined, given the need to strike a balance between compliance costs and integrity?

Q4.2 Are there examples of income that is currently categorised as passive but should be treated as active? How should such examples be accommodated?

Q4.3 What other improvements could be made to the operation of the active income and business exemptions to address difficulties and reduce compliance costs?

Q4.4 Are there better alternatives to the CFC approach of positively listing passive income?

Q4.5 Is it possible to provide an intra-group financing exemption, having regard to integrity and compliance costs?

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70 See footnote 43.

Q4.6 How could an intra-group financing exemption be defined, and why is such an approach preferred?

Q4.7 Do the base company income rules need to be retained? If not, why?

Q4.8 Would the removal of the base company income rules create an unacceptable revenue risk? If not, why?

Q4.9 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?

Q4.10 Would the listed country approach need to be retained if the definition of passive income was narrowed (or active income better targeted)?

Q4.11 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?

Q4.12 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?

Q4.13 Should the de minimis exemptions operate on a more consistent basis across the regimes? If so, how could this be achieved?

Q4.14 Could the exemptions for entities or investment arrangements that pose little or no tax deferral risk be improved? If so, how?

Q4.15 How could the exemptions be modified to ensure greater investment neutrality?

Q4.16 Are there other exemptions or approaches that could be considered? If so, why?

Q4.17 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?

Q4.18 For managed funds, how could the rules better target offshore income accumulation?

Q4.19 Could any changes for managed funds apply more broadly to cover, for example, companies? If so, why and how?

Q4.20 Should a public company exemption be included in the attribution regimes? If so, why?

Q4.21 Could a more generic approach to defining an accumulation vehicle be used to address neutrality concerns? If so, how?

Q4.22 Could a foreign public company exemption consistent with that in the FIF regime be applied across the attribution regimes?

CHAPTER 5: METHODS FOR ATTRIBUTING INCOME

Q5.1 How could the current attribution methods be improved to resolve the distortions that currently exist (both across the regimes and within the regimes)?

Q5.2 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?

Q5.3 Which provisions of the Australian tax laws should be excluded from branch-equivalent calculations and why?

Q5.4 How could the market value method be improved?

Q5. 5 How should the deemed rate of return be changed to better approximate returns on foreign investment? To what level and why?

Q5.6 Could the deemed rate of return method be applied consistently across all the attribution rules?

Q5.7 What other attribution methods are viable alternatives? Would these methods strike an appropriate balance between compliance, complexity, integrity and neutrality?

Q5.8 Should taxpayers be permitted to choose which attribution method to apply or should some restrictions apply?

Q5. 9 How should the percentage of income attributed be determined where the taxpayer has no fixed, legal interest in the foreign entity?

Q5.10 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)?

Q5.11 Should attributable income be apportioned to reflect part-year ownership of the foreign entity, and how would apportionment apply?

Q5.12 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?

Q5.13 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?

Q5.14 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?

Q5.15 How could the reconciliation of dividends that are referable to previously attributable income be streamlined and simplified?

CHAPTER 6: DESIGN PRINCIPLES FOR A HARMONISED ATTRIBUTION REGIME

Q6.1 To what extent would harmonising the regimes benefit taxpayers? Would these benefits outweigh the associated transitional costs?

Q6.2 Of the three harmonisation options, which one is preferred and why? Are there different approaches to harmonisation that should be considered?

Q6.3 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?

Q6.4 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?

Q6.5 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?

Q6.6 What improvements to tax administration would assist taxpayers meet their obligations under the attribution rules?

Q6.7 What improvements could be made to the administration of the attribution rules that would reduce compliance costs and complexity, while balancing integrity objectives?

Q6.8 What transitional issues are likely to arise and how should they be addressed?

Q6.9 How should the previously announced transferor trust amnesty be dealt with under harmonised arrangements?

Q6.10 What material, information or other support might be needed to ensure a smooth transition to a new regime?

APPENDIX B: THE CURRENT FRAMEWORK OF THE ATTRIBUTION RULES

CONTROLLED FOREIGN COMPANY RULES

B.1 The CFC rules apply to shareholdings in foreign companies that are controlled by Australian residents. To prevent tax deferral, the rules tax resident shareholders on their pro rata share of a CFC's tainted income as it is earned unless the income is comparably taxed offshore or the CFC satisfies an active income test. Broadly, tainted income arises from investments and arrangements that are likely to be significantly influenced by taxation considerations. Examples of tainted income include interest, royalties, dividends, amounts arising from certain related-party transactions, and capital gains made on tainted assets.

B.2 The CFC rules focus on tainted income because it is the most mobile form of income and is thus readily diverted for tax planning purposes to avoid or defer Australian tax. Active income (that is, income other than tainted income) is generally exempt from the CFC rules to allow Australian-based multinationals to compete effectively offshore. Generally, investments that produce active income cannot easily be relocated to defer Australian tax. The risk of tax deferral is therefore relatively low.

TRANSFEROR TRUST RULES

B.3 The transferor trust rules are designed to ensure no undue tax deferral benefit arises, typically permanently, as a result of income accumulating in a foreign discretionary trust for the potential benefit of Australian residents who are mere objects of the trustee's discretionary power in relation to the income and capital of the trust.

B.4 Because it is not possible to tax discretionary objects on a current basis the rules apply to Australian residents who have directly or indirectly transferred value to a foreign trust. These transferors are treated as controllers and are generally taxed on the undistributed profits of a trust even if they cannot benefit from the trust. (The assumption being that a person is not likely to transfer value to a foreign discretionary trust unless the person will directly, or indirectly, benefit from the transfer.) An exemption is provided for amounts that have been comparably taxed offshore.

B.5 Although there is no active income exemption under the transferor trust rules, there is a comparable tax exemption that is based on the same listing of comparable tax countries as applies under the CFC rules. The income attributed to the transferor is based on branch-equivalent calculations. If a transferor cannot do branch-equivalent calculations, the income attributed is calculated by applying a notional interest rate to the value of the transferred property or services, compounded annually.

FOREIGN INVESTMENT FUND RULES

B.6 Broadly, the FIF rules operate to approximate a resident taxpayer's share of the undistributed profits of a FIF and to assess the taxpayer on those profits. An active business exemption is provided for interests in company FIFs engaged in a wide range of activities. A balanced portfolio exemption is also provided to allow small holdings of non-exempt FIFs for diversification purposes. Broadly, the exemption is available for non-exempt FIF investments where their aggregate value is not more than 10 per cent of the total value of FIF investments.

B.7 There are three methods for determining the amount to be taxed under the FIF rules. The market value method relies on the change in value of a FIF interest over a period and therefore can reflect unrealised gains that have accrued to a FIF. Unrealised gains are also effectively taxed under the deemed rate of return method which imputes a rate of return based on the amount invested in a FIF. The advantage of these methods is that they can be applied using only limited information. If more information can be obtained, taxation of unrealised gains can be avoided by using the more precise calculation method.

B.8 The FIF rules are not effective in preventing tax deferral for interests in discretionary trusts because the methods for determining FIF income can only be applied where it is possible to determine a taxpayer's interest in a FIF. The transferor trust rules are the only rules effective in dealing with interests in these trusts.

DEEMED PRESENT ENTITLEMENT RULES

B.9 The deemed present entitlement rules in the general trust provisions apply to interests in controlled foreign trusts and other interests in foreign trusts that are exempt from the FIF rules. These rules prevent tax deferral by deeming beneficiaries to be presently entitled to a share of profits accumulated in a foreign trust based on their rights to receive distributions from the trust in the future. Once again, the rules have limited effect in preventing tax deferral through the use of discretionary trusts because it is not possible to determine a beneficiary's future entitlement to profits accumulated in the trust.

OTHER INTEGRITY RULES

B.10 Through transactions at non-arm's length prices, related parties in different countries can shift income or profits to a lower tax country (and deductions to a higher tax country) and avoid tax. Transfer pricing rules are designed to prevent income being shifted in this way by ensuring more economic prices are charged on transactions between related parties.

B.11 By shifting debt (and therefore interest expenses and deductions) to higher tax countries, related parties in different countries can also minimise their overall tax. Thin capitalisation rules are designed to prevent uneconomic levels of debt being shifted to a higher tax country by denying interest deductions above certain limits.

B.12 These rules help countries protect domestic and worldwide income tax bases from being lost to low-tax countries, while low-tax countries generally do not need these rules.

APPENDIX C: ATTRIBUTION AND OTHER INTERNATIONAL TAX INTEGRITY RULES

Country	CFC rules	FIF or other attribution rules	Thin capitalisation rules	Transfer pricing rules
Australia	Yes	Yes — FIF and transferor trust rules.	Yes	Yes
Canada	Yes	Yes — Foreign Investment Entities (FIE) rules.	Yes	Yes
Ireland	No	No	No — besides a basic deemed dividend rule in certain cases for interest payments to a non-resident company or subsidiary in a non-EU or non-treaty country for interests of at least 75 per cent.	No specific rules, although tax authorities may adjust transaction prices between related parties if arm's length principle has not been observed.
Japan	Yes	No	Yes	Yes
Netherlands	No — although for companies, a statutory valuation rule exists where the (fair market value) gain or loss in participations in passive non-resident companies of at least 25 per cent (those with passive assets) of at least 90 per cent is included in taxable income.	No — although for individuals, the worldwide average net value of assets held as at 1 January and 31 December of the tax year is deemed to produce a 4 per cent net yield, flat taxed at 30 per cent (resulting in 1. 2 per cent tax on the net assets).	Yes	Yes
New Zealand	Yes	Yes — FIF rules.	Yes	Yes

Country	CFC rules	FIF or other attribution rules	Thin capitalisation rules	Transfer pricing rules
Spain	Yes	No	Yes	No specific rules, although tax authorities may adjust transaction prices between related parties if arm's length principle has not been observed.
Switzerland	No	No	Yes	No specific rules, although tax authorities may adjust transaction prices between related parties if arm's length principle has not been observed.
United Kingdom	Yes	No[71]	No — replaced on 1 April 2004 by extended transfer pricing rules.	Yes
United States	Yes	Yes — Passive Foreign Investment Companies (PFICs) rules. (Note that Foreign Personal Holding Companies (FPHCs) rules repealed from 31 December 2004).	Yes	Yes

Source: *International Comparison of Australia's Taxes*, Australian Government, 3 April 2006.

This high level comparison indicates that most of the OECD 10 have CFC rules, while around half have some form of FIF rules. Thin capitalisation and transfer pricing rules are quite common across the OECD 10. Australia has all these integrity rules.

71 The United Kingdom has a modified version of FIF rules that applies to offshore funds.