



Australian Government

The Board of Taxation

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

A Report to the Assistant Treasurer and Minister for
Competition Policy and Consumer Affairs

the **board** of **taxation**
www.taxboard.gov.au

The Board of Taxation
September 2008

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CONTENTS

FOREWORD	V
EXECUTIVE SUMMARY	1
Introduction.....	1
CHAPTER 1: INTRODUCTION	5
Background to the review.....	5
Review’s terms of reference.....	5
The review team.....	5
Review process	6
Discussion Paper	6
Position and Issues Papers.....	7
Submissions	8
Board’s report.....	8
Future consultation.....	8
CHAPTER 2: BACKGROUND	9
Australia’s international tax system.....	9
Background	9
The current tax environment	9
Economic context.....	10
The way forward.....	14
CHAPTER 3: RECOMMENDED REFORMS	15
High-level design	16
CFC reforms.....	20
Listed public company exemption	20
Worldwide effective tax rate rule.....	21
Sufficient distribution rule.....	22
Worldwide passive income rule.....	22
The active/passive divide	22
A modernised approach.....	24
Intra-group income	26
Base company income	27
Superannuation exemption	32
Attribution methodologies.....	34
Branch-equivalent calculations	35
Section 404 and associated issues.....	36

Specific anti-roll-up fund measure.....	37
Transferor trust reforms.....	38
GLOSSARY.....	41
APPENDIX A: LIST OF SUBMITTERS	45
APPENDIX B: ATTENDEES AT CONSULTATION MEETINGS	47

FOREWORD

The Board of Taxation is pleased to submit to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs this report following its review of the foreign source income anti-tax-deferral regimes.

The Board established a Working Group, chaired by Mr Chris Jordan, to conduct the review. The Board conducted extensive consultation with industry and received assistance from officials from the Treasury and the Australian Taxation Office. The Board would like to thank all of those who so readily contributed information and time to assist the Board in conducting the review.

There is widespread appreciation of the economic importance for the Australian economy to continue to globalise, and the benefits that this brings to Australia.

Australia's tax policy, including the foreign source income anti-tax-deferral regimes, plays an important part in ensuring the country's ability to sustain and improve its competitiveness in a changing global environment.

The Board believes that the recommendations contained in this report will make an important contribution towards ensuring that Australia's tax policy does not unnecessarily impede Australian businesses with offshore operations while maintaining appropriate levels of integrity.

On behalf of the Board, it is with great pleasure that we submit this report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs.

R F E Warburton AO
Chairman, Board of Taxation

C D Jordan AO
Chairman of the Board's Working Group
Deputy Chairman, Board of Taxation

EXECUTIVE SUMMARY

INTRODUCTION

On 10 October 2006 the former Treasurer asked the Board of Taxation to undertake a review of the foreign source income anti-tax-deferral rules. Following the announcement of the review, the Board conducted targeted consultations and, drawing from these consultations, developed a discussion paper, which was released on 25 May 2007.

Drawing on further consultations and submissions in response to the discussion paper, the Board released a position paper which set out the Board's views on the high-level principles that should apply in the future design of the rules.

To assist in settling the detail underlying these principles, the Board released several issues papers which expanded on key topics in the Board's position paper.

Since the foreign source income anti-tax-deferral rules were first introduced, globalisation has significantly affected the business environment faced by Australian businesses and seen them increasingly competing in the world economy. While integrity continues to be a feature of these rules, the Board wishes to ensure that the integrity objective is better balanced with other objectives such as efficiency, equity, simplicity and low compliance costs. These objectives are fundamental to ensuring that Australian businesses remain competitive.

The Board heard during consultations and from submissions that, while the concept of a single harmonised regime had some appeal, the merits of designing reforms around an existing framework in the controlled foreign company (CFC) rules carried far more appeal.

This report puts forward the Board's final recommendations to the Government for consideration. These recommendations represent the Board's considered views on the design of the foreign source income anti-tax-deferral rules going forward and have been developed through consultations with and submissions from industry and tax practitioners.

The Board's key findings are:

- The CFC provisions are retained as the primary set of rules designed to counter tax deferral arrangements.
 - The CFC provisions are modernised by updating the definitions of what constitutes active and passive income together with the removal of the base company income rules.
 - The existing exemptions within the CFC rules are retained, including the listed country and Australian financial institution subsidiary exemptions, and additional exemptions are introduced in certain circumstances for Australian listed public companies and complying superannuation entities.
 - A choice of attribution methods apply (the branch-equivalent calculation, market value, and deemed rate of return methods) where taxpayers are required to include attributable income in their assessable income.
 - The CFC provisions are rewritten in the *Income Tax Assessment Act 1997* (ITAA 1997).
- The foreign investment fund (FIF) provisions are repealed and replaced with a specific anti-roll-up fund measure targeting accumulation funds that reinvest interest-like returns.
 - In the absence of FIF rules, closely held fixed trusts are brought into the rewritten CFC rules.
 - The deemed present entitlement rules are repealed.
- The transferor trust rules are retained with amendments to enhance their effectiveness and improve their integrity.

The Board's specific recommendations are:

Recommendation 1

Retain the CFC provisions as the primary set of rules designed to counter tax deferral arrangements.

- Rewrite the rules into the *Income Tax Assessment Act 1997*.
- Apply the rewritten CFC rules to closely held fixed trusts.
- Amend the rules to ensure that non-common law entities that confer ownership rights cannot avoid the operation of the CFC rules.

Repeal the FIF and deemed present entitlement regimes.

Recommendation 2

Exempt Australian listed public companies from the rewritten CFC rules provided they satisfy at least one of the following eligibility criteria:

- A comparable worldwide effective tax rate rule.
- A sufficient distributions rule.
- A maximum worldwide passive income rule.

Recommendation 3

Retain and modernise the existing legal-based definitions of passive income by addressing the constraints of the eligibility criteria as set out in paragraphs 3.37 to 3.38.

Facilitate a group approach to determine eligibility for the CFC active income exemption.

Recommendation 4

Remove the base company income rules.

Develop express integrity rules only where they are clearly needed and justified.

Recommendation 5

Exempt complying superannuation funds from the CFC rules.

Recommendation 6

Allow taxpayers to choose from the branch-equivalent calculation, market value or deemed rate of return attribution methods.

Recommendation 7

Retain the tax laws approach for the CFC branch-equivalent calculations.

Recommendation 8

Repeal section 404 of the *Income Tax Assessment Act 1936* and its attendant list.

Amend the non-portfolio dividend exemption in section 23AJ of the *Income Tax Assessment Act 1936* by:

- allowing other equity-like features to be taken into account to demonstrate ownership (including rights to dividends, capital and returns upon winding-up); and
- precluding all debt-like interests.

Recommendation 9

Replace the current FIF rules with a specific anti-roll-up fund measure, with the broad design features of the measure being modelled on the principles set out in paragraph 3.90.

Recommendation 10

Remove the control requirement for pre-commencement and pre-resident transferor trusts.

For foreign entities with multiple resident transferors, base the amount of income attributed to each transferor on the respective value of the property or services they transfer to the foreign entity and that, where it is not possible to determine this value, the transferor is deemed to hold a 100 per cent interest in the foreign entity.

Consider further technical issues with the transferor trust rules as part of consultation on any draft legislation.

CHAPTER 1: INTRODUCTION

BACKGROUND TO THE REVIEW

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

1.2 These regimes include the controlled foreign company (CFC) rules, the foreign investment fund (FIF) rules, the transferor trust rules and the deemed present entitlement rules. The regimes are designed to ensure that no undue tax deferral benefit arises as a result of resident taxpayers accumulating income in offshore entities.

REVIEW'S TERMS OF REFERENCE

1.3 The Board of Taxation was tasked to review the operation of these regimes. The review's terms of reference are:

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

1.4 The review addresses a number of concerns raised by business about these regimes, including that they are complex and involve substantial compliance and administration costs. Business has also raised concerns that, in some cases, the regimes are poorly targeted, impacting on offshore investment decisions that are not motivated by tax deferral reasons.

THE REVIEW TEAM

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

1.6 The Board appointed a Working Group of its members comprising Chris Jordan AO (Chairman), Keith James, and Dick Warburton AO to oversee the

review of the attribution rules. The Working Group was assisted by members of the Board's Secretariat and Treasury's Attribution Project Team.

1.7 The Board also engaged Professor Richard Vann (The University of Sydney) and Professor Lee Burns (The University of Sydney) to provide technical advice on the operation of the existing attribution rules and on possible options for reform.

1.8 In addition, the Board consulted with the Treasury on the development of the current policy and legislation relating to the attribution rules and with the Australian Taxation Office about its administrative practices for these regimes.

REVIEW PROCESS

1.9 The Board has consulted widely in developing the recommendations in this report. The Board's consultation processes involved:

- preliminary targeted consultation with key stakeholders representing the various sectors impacted by the attribution rules;
- the development of a discussion paper which was released in May 2007;
- holding consultation meetings in Sydney and Melbourne during July 2007 to explore the issues raised in the discussion paper;
- the development of a position paper which was released in March 2008;
- the development of issues papers which were released in May 2008;
- holding further consultation meetings in Sydney and Melbourne in late May and early June 2008 to explore the issues raised in the position and issues papers; and
- inviting written submissions on each of the papers to assist with the review.

Discussion Paper

1.10 The discussion paper was developed as a basis for further discussion. In developing the paper the Board conducted targeted consultations with key stakeholders.

1.11 The views received in the targeted consultation process assisted the Board in developing the discussion paper which was released in May 2007.

1.12 The discussion paper outlined:

- The key factors that needed to be taken into account in considering, at a general level, possible changes to the attribution rules: the environment in which the

regimes operate; the historical development of the regimes; and the policy drivers behind the regimes. It also canvassed the concept of a harmonised regime.

- The range of issues that are associated with the current regimes in respect of interests and entities and canvassed possible solutions.
- How the attribution rules might better target the kinds of income that present the best opportunity for inappropriate tax deferral.
- The appropriateness of the current attribution methods and record keeping requirements, and how they might be improved.

1.13 Following the release of the discussion paper, the Board conducted further consultation forums in Sydney and Melbourne in June 2007 as an additional mechanism for obtaining views and to assist stakeholders in preparing written submissions. The Board received over 25 submissions in respect of the issues raised in the discussion paper.

Position and Issues Papers

1.14 In response to submissions and consultations, the Board prepared a position paper to provide a framework for further consideration of the key issues so that they could be addressed in a systemic way. Given the time available, and the potential breadth of issues associated with the scope of the review, the position paper set out the Board's considered views on the high-level principles that should apply to the future design of the attribution rules.

1.15 To provide a framework for consultation and to focus attention on issues requiring particular development, the Board released issues papers on the following five key topics:

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

1.16 To settle the detail underlying the high-level principles, the Board conducted further consultation forums in Sydney and Melbourne in May 2008 as well as more targeted consultations in early June 2008. The Board received over 20 submissions in response to the issues raised in the position and issues papers.

1.17 Consultations and submissions also raised related international tax issues, particularly in relation to the taxation of foreign hybrid limited partnerships. The Board notes these issues but considers them to be outside this review's terms of reference. Consequently, the Board has not made any recommendations on these issues.

Submissions

1.18 The Board acknowledges the assistance provided by those who made submissions to the review. In total the Board received 45 submissions in response to the discussion paper, the position paper and the issues papers. These submissions made a vital contribution to the review and, together with views expressed during consultations¹, were integral in helping to shape the recommendations contained in this report. Except for those made in confidence, submissions will be published on the Board's website and a list of individuals and organisations that provided public submissions to the review is at Appendix A.

BOARD'S REPORT

1.19 The Board has considered the issues raised by stakeholders in their submissions and at the consultation meetings. However, the Board's recommendations reflect the Board's independent judgment, after taking into account all of the information and experience available to it.

FUTURE CONSULTATION

1.20 In presenting its recommendations to the Government, the Board also recommends that further consultations be undertaken as part of the legislative design process to settle the detail surrounding any reforms to the attribution rules.

1.21 As part of this process, the Board sees merit in Treasury, when developing any draft legislation, involving the Board and other stakeholders that have participated in the review's processes. The review has been well-served by these participants and their further involvement will help ensure that Australia has world-class attribution rules.

1 A full list of organisations that were represented at the consultation meetings is available in Appendix B.

CHAPTER 2: BACKGROUND

AUSTRALIA'S INTERNATIONAL TAX SYSTEM

Background

2.1 Australia's tax policy is an important contributor to the country's ability to sustain and improve its competitiveness in a changing global environment. Australia's international taxation system must remain attuned to global investment trends to support investment by Australians abroad and to attract foreign investment to Australia.

2.2 To enhance the competitiveness of Australia's international tax settings, Australia has made a number of recent changes to its international tax system, including in more recent times through the Review of International Taxation Arrangements (RITA). In a climate of global tax competition Australia cannot afford to rest on its laurels. This review of the attribution rules provides an opportunity for another instalment of reforms that recognises that ongoing changes are necessary if Australia is to keep pace with changes in the global business environment.

The current tax environment

2.3 Australia's attribution rules form an integral part of Australia's international taxation system. They are important integrity rules needed to protect Australia's residence-based taxation system. The rules are designed to prevent resident taxpayers benefiting unduly from deferring the payment of tax by accumulating income or assets in foreign companies or trusts.

2.4 Australia's 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. Examples of tainted income include interest, royalties, dividends, amounts arising from certain related-party transactions, and capital gains made on tainted assets.

2.5 In a similar vein, Australia's FIF rules broadly apply to Australian residents with non-controlling shareholdings in foreign companies, or with interests in foreign trusts or beneficial interests in foreign life insurance policies. These rules apply to

approximate a resident taxpayer's share of the undistributed profits of a FIF and to assess the taxpayer on those profits.

2.6 For trusts not subject to the FIF rules, the transferor trust rules are designed to ensure no undue tax deferral benefit arises as a result of income accumulating in, generally, foreign discretionary trusts.

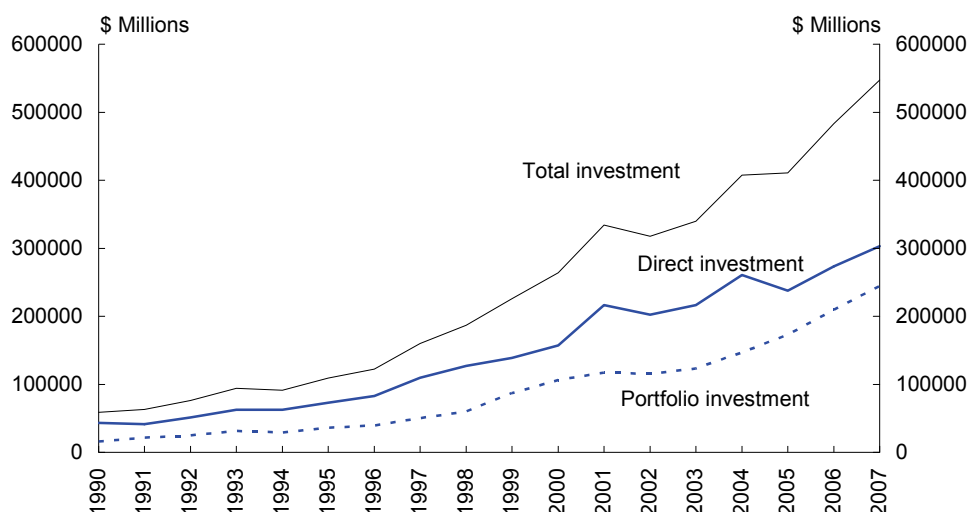
2.7 The deemed present entitlement rules generally apply to interests in closely held foreign trusts and other interests in foreign trusts that are exempt from the FIF rules. These rules prevent tax deferral by deeming beneficiaries to be presently entitled to a share of profits accumulated in a foreign trust based on their rights to receive distributions from the trust in the future.

2.8 However, the integrity risk that these rules are designed to address, particularly the CFC and FIF rules, must be balanced against other policy objectives such as equity, efficiency, simplicity and low compliance costs. These objectives are fundamental to ensuring Australian businesses remain competitive within an increasingly globalised world economy. The overwhelming message that the Board heard during the review process is that the current rules, and in particular the FIF rules, are not appropriately balanced as they impose compliance costs that far exceed the potential integrity risk they are designed to counter.

Economic context

2.9 Ensuring the competitiveness of Australia's international tax system is especially important given the changes in the global economic landscape in recent years. As Chart 1 illustrates, Australian investment abroad has increased markedly since the attribution rules were introduced with the consequence that Australian businesses with offshore operations and investments abroad have had increased exposure to the attribution rules.

Chart 1: Increasing investment abroad
Australian investment in equity interests abroad, 1990-2007



Source: Balance of Payments and International Investment Position; ABS publication 5302.0; March 2008.

2.10 In just over two decades, the stock of Australian foreign direct investment (FDI) abroad has increased more than fifteen fold, reaching \$318 billion at the end of 2007. The principal destinations for Australian FDI are the United States, the United Kingdom and New Zealand. Just under 90 per cent of Australian outward FDI is to OECD countries. The principal destinations for investment in Asia are Singapore and Hong Kong. The stock of Australian investment in major markets such as China, Indonesia and India is small but is growing.²

2.11 While FDI into Australia is coming more from outside of OECD countries, Australia's outward FDI is becoming more concentrated in OECD countries.³ Many OECD member countries have tax treaties with Australia and tax systems that, broadly speaking, are comparable to that of Australia's (thereby mitigating the extent to which attribution rules are needed).

2.12 According to the Department of Foreign Affairs and Trade, the increase in outward investment reflects the globalisation of Australian business, many of which are expanding their presence offshore to spread market and production risks, to achieve economies of scale, to be closer to shareholders and customers and to secure access to deeper capital markets.⁴

2 In contrast, the stock of FDI in Australia has grown six fold, reaching \$357 billion at the end of 2007. The largest foreign direct investors in Australia are the United States, the United Kingdom and Japan.

3 Largely due to increases in investment in the United States, the EU (excluding the United Kingdom) and New Zealand. *'Review of Export Policies and Programs Issues Paper'*, Department of Foreign Affairs and Trade, 2008.

4 Department of Foreign Affairs and Trade, *'Review of Export Policies and Programs'*, Key Issues Paper, 2008.

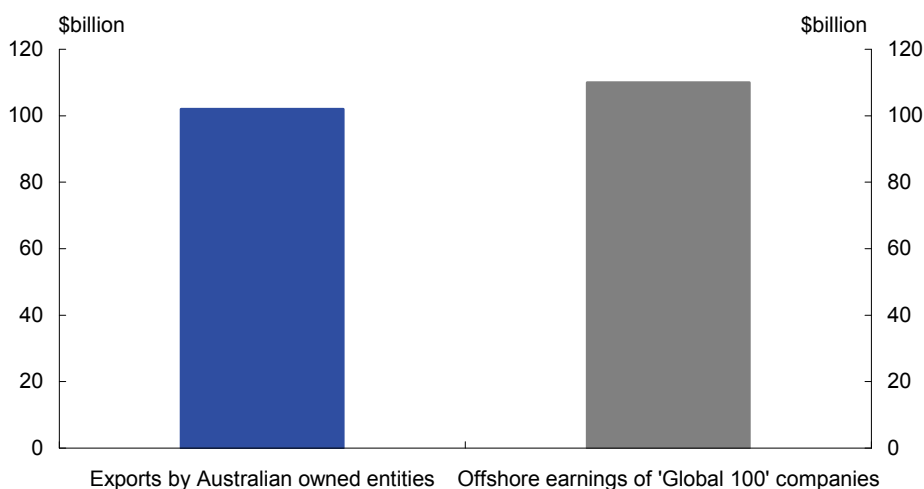
2.13 The increase in outward FDI has been driven largely by growth in the finance and insurance sector, reflecting the benefits of being physically located in an export market.⁵ The number one driver for offshore expansion is reportedly to increase revenues/expand market share, with taking control of the supply chain and decreasing costs coming equal second. The dominant barriers to international expansion are a lack of local business and market knowledge and access to finance.⁶

2.14 McKinseys have noted that the greater complexity of products and services, higher energy prices, and increasing financial volatility as the key factors influencing supply chain strategies. In their experience:

‘... when possible, companies seek to maximize economies of scale in the supply chain, and many companies treat it as a shared utility of the broader organisation—not only to take advantage of synergies, but also to strengthen their operational expertise.’⁷

2.15 Reflecting the increase in outward FDI, it is estimated that sales made by the offshore entities of Australian-owned companies have now caught up with the value of Australian-owned goods and services exports.⁸

Chart 2: Goods and services offshore revenue



5 Outward FDI in this sector has doubled in value from \$48 billion in 2001 to \$102 billion in 2006. Mining-related outward FDI has also increased threefold, from \$9 billion in 2001 to \$26 billion in 2006. Property and business services related outward FDI increased from \$1 billion in 2001 to \$7 billion in 2006. Source: *International Investment Position*; ABS publication 5352.0; 2006.

6 Export Finance and Insurance Corporation, *Global Readiness Index Report*, April 2008, p 6.

7 McKinsey Quarterly, September 2008, *Managing global supply chains*.

8 Exports by Australian owned entities in 2007 were \$102 billion, compared with \$110 billion for the offshore earnings of Global 100 companies. Export Finance and Insurance Corporation, *Global Readiness Index Report*, April 2008, p 5.

2.16 The Export Finance and Insurance Corporation has observed:

‘In the past, when overseas trade and investment barriers were higher and the digital revolution hadn’t yet started, Australian companies of necessity had to look mainly to the national marketplace. Any overseas sales were made chiefly by exporting from Australian shores. But in today’s highly integrated world economy, companies increasingly target a world marketplace and are prepared to locate the different stages of their production and supply chains wherever the business benefit is greatest – and regardless of whether it is onshore or offshore. No longer is it the case that the Australian economy pays for its import needs mainly with exports; it is now just as likely to pay its way with earnings from offshore affiliates.’⁹

2.17 These trends raise a number of issues regarding the attribution rules and the general framework of trade policies and programs that Australia should maintain in the future. The attribution rules need to ensure that they do not unnecessarily impede Australian businesses from being competitive in their expansion into international markets.

2.18 Clearly, since the attribution rules were introduced, globalisation has significantly affected the business environment faced by Australian businesses and seen them increasingly competing in the world economy. As integration and liberalisation of world markets, including capital markets, increases and the number of companies grow, investment and capital flows may become more sensitive to taxation arrangements.

2.19 Globalisation has altered the business environment in such a way that it is desirable for governments to ensure that impediments do not stand in the way of residents 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.

2.20 The business model under which these expanded global operations are conducted has evolved from the time the attribution rules were first developed. Ongoing changes to Australia’s taxation system (including the development of the transfer pricing rules, dividend imputation system and self-assessment system), as well as changes to Australia’s regulatory environment, mean that the operation of the attribution rules needs to be critically examined.

2.21 Improving international competitiveness is critical to Australia’s capacity to succeed in international markets and to attract foreign investment. International competitiveness is determined by a range of factors, including the cost of inputs,

9 Export Finance and Insurance Corporation, *Global Readiness Index Report*, April 2008, p 5.

productivity levels and the capacity of firms to penetrate markets and to gain access to global supply chains and networks. Productivity is, in the long term, the key to building a more internationally competitive Australian economy.

The way forward

2.22 To complement the review's terms of reference, the Board developed further criteria to assess the merits for change to Australia's attribution rules with a view to improving the productivity of Australian businesses with offshore operations and increasing their international competitiveness. These criteria included:

- 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 taken of complexity, 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.

2.23 The Board issued a series of consultation papers to assist in the analysis of these criteria. The Board's May 2007 discussion paper posed the question of whether harmonising some or all of the existing attribution regimes would help reform and modernise the rules, as well as address a number of issues that exist across the regimes.

2.24 After undertaking consultations and examining submissions, the Board considered that the focus of the reforms should not be on harmonisation itself but rather on the range of policy factors that are relevant in decisions to engage in undue deferral of taxation. The Board reasoned in its position paper that these factors are more important considerations when evaluating possible reforms to the attribution regimes. Accordingly, the Board identified a number of policy factors across three different levels – the resident investor level; the resident entity level, where the foreign investment is made indirectly; and the foreign entity level – to help set out its considered views on the high-level principles that should apply in any future design of the attribution rules.

2.25 The release of a number of issues papers following on from the position paper and subsequent consultations has allowed the Board to formulate its final recommendations in respect of reforms to the attribution rules. These recommendations are set out in Chapter 3.

CHAPTER 3: RECOMMENDED REFORMS

3.1 The Board has identified a range of significant reforms that will assist the competitiveness and productivity of Australian businesses with offshore operations while ensuring an appropriate level of integrity remains to prevent undue tax deferral.

3.2 In summary, the Board recommends that:

- The CFC provisions are retained as the primary set of rules designed to counter tax deferral arrangements.
 - The CFC provisions are modernised by updating the definitions of what constitutes active and passive income together with the removal of the base company income rules.¹⁰
 - The existing exemptions within the CFC rules are retained, including the listed country and Australian financial institution subsidiary exemptions, and additional exemptions are introduced in certain circumstances for Australian listed public companies and complying superannuation entities.
 - A choice of attribution methods apply (the branch-equivalent calculation, market value, and deemed rate of return methods) where taxpayers are required to include attributable income in their assessable income.
 - The CFC provisions are rewritten in the ITAA 1997.
- The FIF provisions are repealed and replaced with a specific anti-roll-up fund measure targeting accumulation funds.
 - In the absence of FIF rules, closely held fixed trusts are brought into the rewritten CFC rules.
 - The deemed present entitlement rules are repealed.
- The transferor trust rules are retained with amendments to enhance their effectiveness and improve their integrity.

3.3 The reforms proposed by the Board will ensure Australia has a world-class attribution regime and that the reformed rules keep abreast of changes occurring in the

¹⁰ See further, Recommendation 4. The Board supports the removal of the base company income rules, with express rules only used if and where necessary to ensure appropriate levels of integrity.

global business environment. The proposals will provide significant scope to reduce red-tape and compliance costs while maintaining the integrity of Australia's tax base. In particular:

- The recommendations will have a positive impact on Australia's offshore investment performance and enhance the productivity of Australian businesses and improve their international competitiveness.
- The managed funds industry and other investors affected by the FIF rules will achieve significant reductions in compliance costs. This is consistent with the Government's commitment to develop Australia as a financial services hub and to cut red-tape.
- The modernisation of the active/passive definitions will benefit Australian businesses operating offshore by reducing their compliance costs and improving their competitiveness and productivity in global markets.
- The repeal of the FIF rules in conjunction with the relocation of the CFC rules into the ITAA 1997 will provide scope to both simplify the tax law and take a significant step towards consolidating the two income tax acts.

HIGH-LEVEL DESIGN

3.4 The Board heard during consultations and from submissions that, while the concept of a single harmonised regime that the Board had previously considered had some attraction, the merits of designing reforms around an existing framework in the CFC rules carried far more appeal.

3.5 Submissions that favoured retention of the CFC rules observed that retention of an existing regime provided the advantage of familiarity with existing provisions for taxpayers and their advisers which in turn would lower transitional costs. Submissions further commented that the retention of the CFC rules would ensure that the rules were well-targeted, applying in cases where the capacity to orchestrate inappropriate deferral outcomes was the greatest (ie, in control cases). Shaddick and Spence, in their submission, expressed support for retention of the CFC rules and repeal of the FIF rules as follows:

'We are of the view that the most discordant and confusing provisions are those in Part XI of the *Income Tax Assessment Act 1936* (the FIF rules). We submit that Part XI should be repealed (along with the deemed present entitlement rules). We consider that the basic structures of Part X (the CFC rules) and Division 6AAA (the Transferor trust rules) are sound, and that they can be improved by piecemeal amendment.

The main focus of our submission is that the FIF rules should be repealed. The main reasons, among many, are:

- a) the FIF rules rarely apply in any event; successive new exemptions have tended to erode the broad principles which were claimed to support the design of the original measure;
- b) the exemptions from the FIF rules are numerous, but somewhat fickle and scattered (for example, in Division 8: why is only the USA thus favoured?);
- c) taxpayers with sufficient resources can “buy” their way out of the FIF rules by acquiring sufficient exempt FIF interests to dilute their non-exempt FIF interests to less than 10 per cent of their FIF portfolios (Division 14 of Part XI);
- d) importantly, it can be reasonably predicted that complying superannuation funds will, in future, constitute the prime source of portfolio investment by Australians. Such superannuation funds are exempted from applying the FIF rules by virtue of Division 11A of Part XI. Accordingly, an increasing and dominant number of FIF investments will fall outside the ambit of the FIF rules; and
- e) the FIF rules are poorly understood and inadvertently overlooked by many (otherwise) honest and compliant taxpayers.¹¹

3.6 Similarly, Pitcher Partners explained in their submission:

‘We believe that the foreign investment fund (“FIF”) regime should be repealed as they:

- a) Create a bias against foreign investment; and
- b) Present a compliance burden that the middle market does not have the ability/resources to cope with;

If the complete repeal of the FIF regime is not acceptable, we believe that the list of exclusions needs to be revised to ensure that the regime targets the specific behaviour that is unacceptable to the Government.

...

Whilst we do not support the retention of the FIF regime in so far as it targets foreign investment generally, we do believe that the CFC regime could be

11 Shaddick and Spence submission, 6 July 2007, pp 1-2.

improved by incorporating into that regime many of the elements in the FIF regime.

We believe that there is a role for the transferor trust regime. We would recommend that the “gateway issues” (targeted taxpayers and entities) should be separated from the equivalent rules in the redesigned CFC regime.¹²

3.7 Although many stakeholders understood the desire of applying broad FIF-like rules to bring about a single unified regime, stakeholders also cautioned about the prospect of applying broad rules to specific circumstances involving controlling arrangements, particularly in respect of maintaining the integrity of the rules.

3.8 Against this background the Board recommends that the CFC rules be retained. This will ensure that a fully tried and tested regime will continue to apply where the risk of tax deferral is greatest and will result in lower transitional costs. Apart from being internationally consistent¹³, retention of the CFC rules may lead to a simpler implementation process as the reforms can be referenced against an existing framework. The Board also notes that the relocation of the CFC rules into the ITAA 1997 together with the repeal of the FIF rules provides a significant advancement towards a single income tax act. Currently, the CFC, FIF, transferor trust and deemed present entitlement regimes account for nearly 25 per cent of the *Income Tax Assessment Act 1936* (ITAA 1936).

3.9 While the Board advocates the retention of the CFC rules, the Board is satisfied that the problems associated with the FIF rules are best dealt with by repealing those rules, rather than retaining them and amending them in a piecemeal fashion.

3.10 The problem with the FIF rules is that, within a non-control environment where taxpayers have limited information about their foreign investment, it is inherently difficult for the rules to target those cases where the risk of deferral is greatest.

3.11 Within this environment the current FIF rules initially capture a wide array of non-controlling interests, with a very extensive range of exemptions then potentially applying to keep certain taxpayers out of the regime. While the end result is that taxpayers often have little to declare in the way of FIF income, the course taxpayers need to navigate to get to this outcome is littered with very high compliance costs. Any attempt to modify the FIF rules to better target them with additional exemptions would inevitably result in adding further complexity.

3.12 The Board is satisfied that a far better approach is to specifically target the kind of income or activity that should be caught rather than the current ‘everything in’ approach. Details of the specific anti-roll-up measure are set out in paragraph 3.90.

12 Pitcher Partners letter accompanying their submission, 9 July 2007, pp 1-2.

13 According to Treasury’s *Review of International Taxation Arrangements* (August 2002), at least 21 countries have CFC rules (p 33).

3.13 A consequence of removing the FIF and deemed present entitlement¹⁴ rules means it will be necessary to incorporate closely held fixed trusts into the CFC rules. This is consistent with the approach taken under the equivalent United States and New Zealand CFC provisions. Identification of the kinds of closely held fixed trusts that should come into the CFC rules should be done in consultation with industry during the legislative design stage.

3.14 Removal of the FIF rules will cut a swathe through the complexity and compliance costs that are a current trait of the attribution rules. The Board heard repeatedly that the FIF regime imposes very high compliance costs on taxpayers, costs that are disproportionate to the level of risk involved. In some cases, it is difficult for them to demonstrate eligibility for a FIF exemption notwithstanding that the taxpayer's investment is not providing a tax deferral advantage.

3.15 For managed funds, the compliance costs associated with maintaining attribution accounts under the FIF rules is of such a magnitude that fund managers often choose to sell FIF interests immediately before the end of the income year even though this taxes what would have otherwise been an unrealised gain.

3.16 A consequence of repealing the FIF regime is that it will simplify the taxation of foreign trusts as well as removing the need to address the many FIF issues raised in the Board's discussion paper. For example, fund-level accounts for managed funds, a distribution exemption, and changes to the balanced portfolio exemption, will not be needed.

3.17 To enhance the integrity of the attribution rules, reforms would also need to address an integrity concern that was referred to in the position paper concerning arrangements that could circumvent the operation of the attribution rules through the use of non-common law entities.¹⁵ The Board explained in its position paper that it would be concerned if there were interests of a kind that conferred equivalent ownership rights to traditional equity holdings (for example, shares in a company) but because they took a different legal form are able to avoid the operation of these rules.

3.18 Non-common law entities often have no legal equivalent in Australia, having some features like a company and others like a trust. While these entities are generally classified as companies for Australian tax law purposes, they may avoid the operation of the current CFC rules. The rules require a resident taxpayer to have a traceable legal interest in the foreign entity, a feature these entities often do not exhibit, in order to determine an attribution percentage.

14 In its May 2007 discussion paper, the Board explained that it would not revisit the former government's decision to repeal the deemed present entitlement rules as this was consistent with harmonising the existing regimes and continued to have the Board's endorsement.

15 For example, anstalts, foundations and stichtings.

Recommendation 1

Retain the CFC provisions as the primary set of rules designed to counter tax deferral arrangements.

- Rewrite the rules into the *Income Tax Assessment Act 1997*.
- Apply the rewritten CFC rules to closely held fixed trusts.
- Amend the rules to ensure that non-common law entities that confer ownership rights cannot avoid the operation of the CFC rules.

Repeal the FIF and deemed present entitlement regimes.

CFC REFORMS

Listed public company exemption

3.19 In its discussion, position and issues papers, and during consultations, the Board raised the prospect of an Australian listed public company exemption.

3.20 The Board noted that, together with incentives for paying Australian tax under the dividend imputation system, listed public companies are subject to very high standards of governance and prudential requirements that will mitigate the extent to which such companies are likely to seek a tax deferral benefit.

3.21 The genesis for the listed public company exemption was that, unlike many other CFC exemptions, a listed public company exemption could apply as a high-level and more immediately accessible exemption, thus significantly reducing compliance costs for eligible companies. Under the current CFC rules, to demonstrate eligibility for the active income exemption companies must, on an entity-by-entity basis and for every transaction that it enters into, classify all of its income as either active or passive. Even for businesses with relatively small offshore operations, such a process imposes considerable compliance costs. For businesses with wide-scale foreign operations the compliance costs associated with this process are overwhelming.¹⁶

3.22 The Board recognised, however, that such an exemption did not come without risk and posited the idea that various eligibility criteria should accompany the exemption to maintain appropriate levels of integrity. These included minimum franking and dividend payout ratios, and restrictions on the level of passive income and activity.

16 During consultation the Board heard from some taxpayers that the cost of compliance with the CFC rules exceeded the amount of tax they were required to remit.

3.23 While the listed public company exemption was warmly supported by industry, the suggested eligibility criteria did not, as a whole, receive endorsement.

3.24 Industry recognised that integrity criteria were a necessary feature of such an exemption and provided a number of alternative eligibility rules as a substitute to those put forward by the Board. These eligibility rules, which the Board supports, are based on notions of a comparable worldwide effective tax rate; sufficient distributions; and limitations on the derivation of worldwide passive income.

3.25 To ensure compliance costs are kept to a minimum, the data required to demonstrate eligibility for these three rules would be based on the listed public company's accounting information without adjustment for tax purposes. The Board considers that these rules should apply as alternatives, as satisfaction of any one of the criterion alone would evidence that the foreign investment has not been entered into to extract an inappropriate tax deferral benefit. An alternative approach of requiring taxpayers to satisfy all three of the rules would do little more than impose higher compliance costs without a commensurate increase in integrity.

3.26 The Board is also aware that there may be a perception that, by restricting the exemption to listed public companies, they are getting preferential treatment in comparison to, say, large private companies. However, the Board notes that, as the exemption turns on the company's accounting information, it is necessary to ensure that those accounts have been prepared in accordance with the utmost probity, including in accordance with international accounting standards and independently audited. While this is a mandatory accounting requirement for all listed public companies, less stringent requirements typically apply for other businesses.

3.27 The Board recognises that, in respect of each of these rules, there are a number of alternative bases and tolerance levels that need to be settled in order for the Australian listed public company exemption to become operational. Issues such as whether the criteria should be tested on a year-to-year basis or whether they should be tested on the basis of a trend (for example, a 'three out of the last five years' concept) would also need to be determined.

Worldwide effective tax rate rule

3.28 If an Australian listed public company's income tax expense as a proportion of its worldwide profits is approaching equivalent Australian levels of taxation, it is unlikely that the listed public company is engaging in inappropriate tax deferral. For example, if the global income tax expense for an Australian listed public company is, say, \$28 million and its worldwide profit is \$100 million, this may be acceptable for the exemption to apply having regard to the level of deferral risk and the associated compliance costs. In a sense, this approach is similar to how some tax jurisdictions apply an equivalent listed country exemption, focussing on a requisite level of foreign tax rather than on whether the business is located in a country that applies a broadly

comparable tax regime (for example, the CFC regimes of Japan, France, and Portugal incorporate variations of this approach).

Sufficient distribution rule

3.29 If an Australian listed public company's dividend payout ratio is of such a magnitude that, measured across the group, most of the profit is being distributed to shareholders, it is unlikely to be engaging in a systemic pattern of inappropriate tax deferral. For example, if the value of dividends paid to shareholders during the year by the listed public company is, say, \$65 million and its worldwide profit is \$100 million, this may also be acceptable for the exemption to apply having regard to the level of deferral risk and associated compliance costs.

Worldwide passive income rule

3.30 If an Australian listed public company's worldwide passive income as a proportion of its worldwide profits is negligible, it is unlikely that the listed public company is extracting a material tax deferral benefit. For example, if the value of global passive income is less than \$5 million and its worldwide profit is, say, \$100 million, this may also be acceptable for the exemption to apply. This test could operate in a similar fashion to the current CFC active income exemption, albeit on a consolidated or group basis. Further, the financial accounting information that this criterion relies should be much more readily accessible than the calculations needed to demonstrate eligibility for the current CFC active income exemption.

Recommendation 2

Exempt Australian listed public companies from the rewritten CFC rules provided they satisfy at least one of the following eligibility criteria:

- A comparable worldwide effective tax rate rule.
- A sufficient distributions rule.
- A maximum worldwide passive income rule.

The active/passive divide

3.31 As the Board's discussion paper noted, Australia's attribution regimes were conceived in the late 1980s and borrowed heavily from the approach adopted in the United States dating back to the early 1960s. The definition of passive income is very broad, covering virtually all forms of income that have traditionally been classified as investment income. The definition is applied on a company by company basis, covering transactions within a corporate group as well as those occurring with third parties.

3.32 The distinction between active and passive income is relevant for two aspects of the CFC rules. First, it determines eligibility for the active income exemption and, second, it identifies the kind of income that is potentially subject to attribution if the active income exemption is not satisfied.

3.33 As outlined in Chapter 2, Australian direct investment abroad now rivals foreign investment in Australia, and sales by overseas branches, subsidiaries and joint ventures of Australian-owned companies have increased markedly to rival the value of Australian-owned goods and services exports. Australia is more reliant than ever on the gains to be achieved from accessing world markets and reaping the benefits of the returns from outbound foreign investment.

3.34 While submissions varied in their suggestions to improve the definition of active and passive income, two main themes were observable: the current active/passive divide is outdated and needs to be significantly narrowed taking account of developments in the business environment; and intra-group income should not be considered when determining if foreign income is passive. The ICAA outlined the problems with the current approach as follows:

‘Since the anti-tax-deferral regimes were developed based on 1980s perceptions and business practices, Australian businesses have become much more strongly engaged in business activities globally. The business activities, conducted in many countries, no longer represent merely exports from Australia but involve supply chains within single company groups and within networks of unrelated companies, including jointly owned activities and entities involving related and unrelated parties.

...

The treatment of passive income in the current rules focuses to a significant extent on the activities or functions of a particular entity, that is, an individual company CFC or a company, trust or other interest which is a FIF. If the entity operates within a corporate or trust group, and performs one function in the overall business activities of the entire group, the classification of the entity or of its income under the active/passive income divide leads to inappropriate outcomes.

In essence, the anti-tax-deferral rules discriminate against multiple-entity foreign activities as distinct from single-entity foreign activities.

...

The recommended approach is for the Australian anti-tax-deferral rules to deal with grouping, for purposes of all the tests which characterise the activities of a

particular group, to ensure that functions performed by other CFC-like entities are taken into account.¹⁷

A modernised approach

3.35 The Board heard during consultations that there are various problems with the operation of the definitions used to distinguish active and passive income.

3.36 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 despite it being passive in form.

3.37 Notwithstanding this allowance, the current rules are not without their problems, particularly in respect of the inflexibility within the eligibility criteria. 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.
 - The definition of ‘financial intermediary business’ has remained static while the nature and scope of activities ordinarily carried on by financial intermediaries (including banks and their subsidiaries) has expanded in the years since the definition was inserted. The definition of ‘financial intermediary business’ could be updated to take into account activities ordinarily carried on by financial intermediaries including banking, financing and leasing activities.
- Passive income derived from the management of real and other property if certain conditions are met.
 - The current definition only allows rental income to be treated as active where the directors or employees of a CFC provide property management services, and the CFC is located in the country where the land is located. These restrictions do not allow for different ownership and management structures. A broader definition could exclude rental from attribution where the attributable taxpayer is engaged in ownership, development or management of property.
- Royalties derived by a company engaged in developing, owning and managing intellectual property if certain conditions are met.
 - The current definition does not allow for situations where the royalty income is from an associate, even if that associate is in the same jurisdiction.

17 ICAA submission, 7 August 2007, pp 15-17.

One proposal is that income from or in connection with intellectual property should be excluded from attribution where the attributable taxpayer is engaged in development, ownership and/or exploitation of that intellectual property.

3.38 The Board recommends that the existing legal-based approach to defining passive income be retained as the foundation of a modernised approach. In doing this the Board also recommends that the inflexibilities with the current rules including those referred to above be removed.

3.39 The advantage of this approach is that basing amendments on existing well-understood concepts will provide greater certainty in respect of the changes being recommended.

3.40 Late in the consultation process the Board also heard of an alternative approach using a principles-based test to target income that provides the greatest incentive to seek inappropriate deferral outcomes.

3.41 This kind of income could typically be interest-like (or non-contingent), and subject to relatively low levels of risk. It was reasoned that such an approach better recognises the change in the way investment is conducted (professional active management of investments). The recognition of the importance of risk tends to mean that only safe interest-like returns, such as provided by government bonds and bank call deposits, should be treated as 'passive'. In such cases, there is a simple investment choice and little possibility of active management in most cases (with the possible exception of finance businesses).

3.42 This kind of approach would eliminate a number of forms of income currently classified as passive such as rent, royalties, dividends, commodity-related financial instruments and gains on the underlying assets producing such income, except where the return concerned is effectively low risk and interest-like.

3.43 The potential benefit of this approach lies with its conceptual attractiveness, and if it can be made to work, would better target the deferral problem.

3.44 On the other hand, the approach is unlikely to be as prescriptive as the current law and hence would be less certain both in what it includes and in what it excludes. Such an approach would also represent a fundamental shift, with areas of uncertainty for taxpayers and the revenue. For these reasons, the Board is not in a position to recommend this approach unless, possibly during further consultation on draft legislation, it can be demonstrated to the satisfaction of government that the obstacles outlined above can be overcome.

Intra-group income

3.45 The current attribution rules generally attribute passive income irrespective of whether the income was derived from related or unrelated parties. By contrast, many submissions consider that passive income should only be attributed in respect of income derived from unrelated parties. This is on the basis that income derived within a corporate group offshore is irrelevant to whether it should be taxed in Australia. If, for example, intra-group financial engineering offshore is directed to avoiding foreign tax, it should not be a policy concern of the Australian attribution rules.

3.46 The general tax policy context has changed considerably since the enactment of the original CFC rules. The corporate group approach has come to be accepted as generally the preferable approach. The most notable Australian example is the consolidation regime but the approach has also been adopted (in a much more simplified form) in international measures including thin capitalisation and the participation exemption for non-portfolio shareholdings in foreign companies.

3.47 The United States recently moved to an approach where dividends, interest, rent, 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.¹⁸ However, it can be complex to apply such an approach at the separate entity level.

3.48 Accordingly, it is proposed that a group approach be developed for applying the CFC active income test. The Board recommends that where an Australian resident either consolidates or equity accounts the income of a CFC in which it has an attribution interest under Australian or equivalent accounting standards, then the testing of the CFC should also be done on a consolidated basis. Under this approach, for example, only the passive income of the CFC from parties outside the accounting consolidation or equity accounting group would count and be compared with total income from third parties of the CFC calculated on the same basis. An advantage of this approach is that existing accounting information and rules would be used, rather than developing an additional set of rules in the tax law.

3.49 This approach would be consistent with one of the integrity measures for the listed public company exemption (that is, the ratio of worldwide passive income to global profits).

18 Notice 2007-9, Internal Revenue Service, published on 12 January 2007.

Recommendation 3

Retain and modernise the existing legal-based definitions of passive income by addressing the constraints of the eligibility criteria as set out in paragraphs 3.37 to 3.38.

Facilitate a group approach to determine eligibility for the CFC active income exemption.

Base company income

3.50 The current CFC rules provide that the attributable income of a CFC includes base company income, which is generally active income from sales and services transactions between related parties.

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

3.51 In response to RITA, the Board recommended¹⁹ that the base company income rules be abandoned, subject to certain restrictions for income or gains derived through designated tax havens, and that services that are considered to raise particular integrity issues be dealt with expressly rather than all services being broadly included as is currently the case.

3.52 In arriving at this recommendation, the Board explained:

‘Where the concern is transfer pricing out of Australia, the Board considers that Australia’s transfer pricing regime is sufficient and reliance could be placed solely on the transfer pricing rules, not the CFC regime. Where the concern is the movement of service capacity from Australia, the issue for taxation of income from services under the CFC rules is in essence no different to that for sales income. Different treatment would disadvantage companies deriving services income internationally compared to others.’²⁰

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

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

3.53 In broad terms, Australia's transfer pricing rules, and the transfer pricing rules of other countries, seek to ensure that, for taxation purposes, prices applied in respect of transactions between related parties are based on an assessment of what the prices would have been if determined at arm's length.

3.54 However, the base company income rules go further than this. Regardless of whether sales and services transactions are conducted fully at arm's length, the base company income rules include certain income from sales and services in a CFC's attributable income. The base company income rules serve as a blunt instrument for removing any taxation incentive for conducting activity offshore, regardless of whether genuine business operations are being conducted. That is, all income defined as tainted is subject to attribution without an examination of whether deferral is involved. This approach is at odds with the Board's general position that the attribution rules should not apply to active businesses.

3.55 Submissions were generally in agreement that the transfer pricing rules have become sufficiently developed since the CFC rules were introduced to not require the attribution rules to act as a bolster²¹. The Tax Institute of Australia explained in their submission:

'We would submit that there is no tax policy basis for the tainted services income (TSI) definition to include income earned by a CFC from providing services to Australian customers, especially customers who are not associates of the CFC.

International transfer pricing tax laws, which are the single biggest tax issue facing most multinational businesses, simply do not permit the 'deflection' of services income to a low-tax country.

...

In our view, there is no tax policy justification for continuing the position that taxes an Australian shareholder on its share of income from a CFC's sales to its Australian customers. Such a policy inhibits the offshore expansion of Australian multinationals, including via investment in joint ventures and creates a tax and compliance cost that is not faced by other participants in international markets.'²²

3.56 In a similar vein, Deloitte, in their submission explained:

'We believe that there appears to be a limited need to retain the base company income rules. We note that amendments to the tainted services income definition

21 There are various ways in which the base company income rules act as a bolster. Among these are: relieving pressure on the transfer pricing rules to strike an appropriate price, as any income transferred offshore for too low a price remains subject to Australian tax; and complying with the base company income rules requires information to be provided to the tax authorities that might otherwise only be available on request if the CFCs involved were not subject to attribution.

22 Tax Institute of Australia submission, 6 July 2007, pp 7-8.

through RITA have greatly reduced the application of this provision. Furthermore, we believe that the increase in the application of the transfer pricing rules in a global economy has also reduced the extent to which these provisions are required. Accordingly, we do not believe that additional compliance costs are warranted when compared to the limited risk posed to the revenue in respect of such transactions. Should the Government consider certain types of business income to be “inappropriate”, then this should be identified and consulted upon.²³

3.57 Even if there were some justification for such a bolstering role, the Board is concerned that genuine business operations are being caught up in the base company income rules, and potentially placed at a competitive disadvantage to their offshore competitors due to the compliance costs and tax costs imposed.

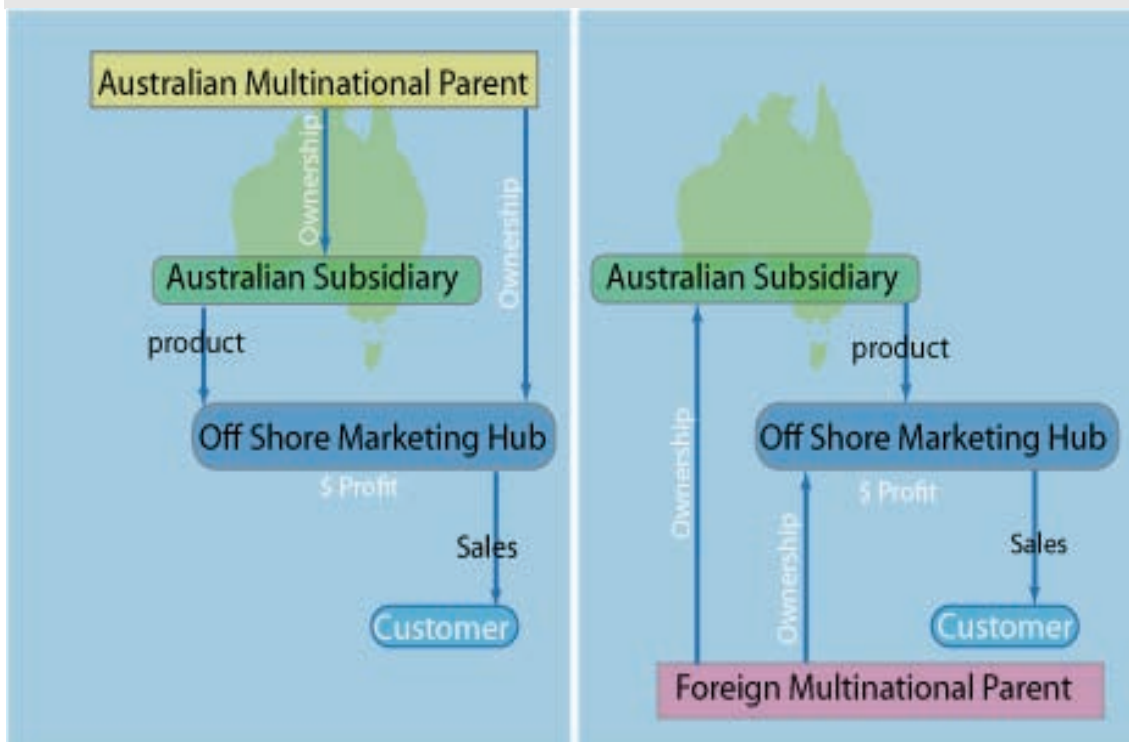
3.58 The practical effect of the base company income rules is that an Australian investor may be placed at a competitive disadvantage compared with another investor in the same country with the same business structure. Quite apart from the compliance costs that may be involved, the Australian, rather than the local, level of tax is being applied. This has real world consequences for the competitiveness of Australian based multinationals compared to their foreign owned counterparts. The potential negative impact on Australian based companies of the base company income rules is illustrated in Example 3.1.

23 Deloitte submission, 16 July 2007, p 8.

Example 3.1

An Australian headquartered company operates a marketing hub company offshore to service its Australian and worldwide clients. The products marketed by the marketing hub company are sourced from Australia and worldwide operations. Australian products are sold to the marketing company at an arm's length price in accordance with Australian transfer pricing rules. The marketing hub company is wholly owned by the Australian company. The marketing hub is a CFC with the result that the income relating to the products sourced from Australia is treated as tainted sales income and subject to attribution (and notwithstanding the price struck in respect of the sale of the products conforms to Australia's transfer pricing rules).

An offshore headquartered company also operates a similar operation, but the Australian operations and marketing hub company are owned directly by the offshore parent company. The marketing hub company is not subject to the respective attribution rules of the parent company's home country tax rules, nor is it subject to Australia's attribution rules.



3.59 The base company income rules need to strike a balance between ensuring the competitiveness of Australian multinationals and base protection concerns (that is, the risk that highly mobile services businesses would move to low tax jurisdictions for tax reasons, reducing Australia's tax base and service jobs.). As outlined in Chapter 2, Australian businesses have continued to expand their activities into global markets, placing greater pressure on the attribution rules to better balance the international competitiveness of Australian business with integrity concerns.

3.60 The base company income rules are premised on removing tax incentives for Australian companies to conduct activities from offshore, rather than conducting the

same activity in Australia and exporting from Australia. However, outward FDI and exports are not necessarily complements for Australian companies, given that Australia's major outward FDI destinations are different to its major export destinations. Whether outward FDI is a substitute for exporting from Australia to the same markets depends on whether the investor would be both willing and able to export to the same market in the absence of outward FDI.²⁴

3.61 The operation of the base company income rules needs to be balanced against government objectives of meeting the future challenges of globalisation and building a tax system which is internationally competitive.²⁵ The Board notes that this is consistent with the Government's current objective of improving the export competitiveness of Australian business in the goods and financial services sector.²⁶ Active business income is increasingly taking on the characteristics of mobility, which can make it more difficult to distinguish from passive income.

3.62 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 relative to their competitors.

3.63 The Board questions whether the base company income rules should play a role over and above the transfer pricing rules in an increasingly globalised economy. The application of the attribution rules in the current blunt fashion adds to the costs of Australians doing business offshore compared to their competitors. Australia's attribution rules need to be set with an eye to positioning Australia's competitiveness in the global economy for the next decade and beyond.

3.64 The Board continues to support the removal of the base company income rules, with express rules only used if and where necessary to ensure appropriate levels of integrity. The Board considers that if there were a role for the attribution rules in this area, the type of income being targeted should be more precisely specified to reduce the compliance costs associated with the existing base company income rules. For example, income relating to mobile assets that have been shifted to a low tax jurisdiction without a commensurate presence in the active management of those

24 For example, Australian financial services and insurance companies appear to rely primarily on outward FDI to provide their services through a commercial presence overseas. As it can be difficult to export financial services, this outward FDI may be providing access to a market that would not otherwise have been available to Australian companies.

25 As evidence of the Government's objectives in this regard see the Treasurer's, press release No 93 of 6 August 2008 on the release of the Australia's Future Tax System discussion paper.

26 Review of Australia's Export Policies and Programs, Minister for Trade, press release 21 February 2008.

assets could be the kind of residual application that abbreviated base company income rules target.²⁷

3.65 The Board notes that the 2004 RITA changes²⁸ moved the CFC rules closer to a Capital Import Neutrality (CIN) approach²⁹, and the removal of the base company income rules is another step in this direction.

Recommendation 4

Remove the base company income rules.

Develop express integrity rules only where they are clearly needed and justified.

Superannuation exemption

3.66 In its position paper, the Board explained the rationale for the existing FIF exemption for (trustees of) complying superannuation funds was that, given the lower rate of tax applying to these entities, any tax deferral benefit would be minimal.³⁰ The Explanatory Memorandum accompanying the introduction of the exemption explained that:

‘The tax benefits of investing in FIFs (that is, deferring the derivation of income and converting income into capital gains) are greatest for taxpayers that have high marginal tax rates and can access the 50 per cent CGT discount. The tax benefits of investing in FIFs are much lower for complying superannuation entities that are generally taxed at a flat rate of 15 per cent and can only access a one-third discount on eligible capital gains.’³¹

3.67 For the same reason, the Board considers that the attribution rules should not target those taxpayers that would be lightly taxed, or not taxed at all, as the risk of inappropriate tax deferral is low.

3.68 The Board also noted that the current exemption is narrowly cast and needed to be updated to reflect emerging business practices. A particular concern was the inflexible nature of the exemption that prevented superannuation funds accessing

27 A specific example might include income relating to intellectual property that has been shifted to a low tax jurisdiction.

28 These changes included exempting Australian companies (and their CFCs) from capital gains tax for the sale of certain non-portfolio interests in foreign companies, and extending the exemption for foreign non-portfolio dividends. The scope of the tainted services income rules were reduced, largely excluding from attribution the income of CFCs earned from providing services to their non-resident associates.

29 CIN is an economic 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.

30 Board of Taxation’s *‘Review of foreign source income anti-tax-deferral regimes: Position Paper’* para 4.49.

31 Explanation Memorandum, *New International Taxation Arrangements Act 2004*, para 1.5.

pooling arrangements in order to gain critical mass for on-investment into worldwide markets.³²

3.69 Submissions received were in agreement with the need to improve the operation and flexibility of the existing exemption.

3.70 In response to the Board's discussion paper, the Investment & Financial Services Association (IFSA) explained in their submission that:

'Super funds are currently exempt from the FIF regime, where they invest through an Australian unit trust that is wholly invested in by super funds. However, if they invest into an Australian managed fund that has other investors, the exemption is nullified. IFSA recommends that the current exemption for super funds should be modified to ensure that they retain their exempt status, regardless of whether the fund they are investing is: a) exempt itself or; b) has other investors that are not super funds.'³³

3.71 While the repeal of the FIF regime removes the need to modernise the current FIF exemption, the Board is aware that superannuation funds may nevertheless have similar concerns as a result exposure to the CFC regime. The Association of Superannuation Funds of Australia's (ASFA) submission highlighted an anomaly that can arise for certain superannuation funds whereby, what would otherwise be an exempt FIF investment, is converted into a taxable CFC investment. Their submission noted:

'Section 519B of the Income Tax Assessment Act 1936 exempts trustees of complying superannuation entities and certain fixed trusts from the foreign investment fund (FIF) provisions.

...

However, where multiple funds take up an interest in the same investment there is a likelihood of the extended definition of a CFC being satisfied, thus requiring each of the funds to deal with the CFC provisions.

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

The concern of the superannuation industry is that the reclassification as a CFC occurs not because there is any degree of control exercised by the superannuation

32 Board of Taxation's *'Review of foreign source income anti-tax-deferral regimes: Position Paper'*, para 4.50.

33 IFSA submission, 16 July 2007, p 11.

funds (they are merely passive investors) but rather because of who else invests.’³⁴

3.72 The Board supported improvements to the current FIF exemption for complying superannuation funds, and for similar reasons, given that these entities remain lightly taxed entities, considers that this approach should also be applied in the context of the CFC rules.

Recommendation 5

Exempt complying superannuation funds from the CFC rules.

Attribution methodologies

3.73 In its discussion and position papers, the Board advocated allowing taxpayers to choose the attribution method that best suits their needs rather than restricting taxpayers to a particular method.

3.74 This approach was advocated in the context of an attribution regime applying universally to both controlling and non-controlling interests. However, given the Board’s decision to focus on controlling interests, there is arguably less need to provide taxpayers with a choice of attribution method.

3.75 Despite this, the Board is mindful of comments in submissions which detail the complexity and high compliance costs associated with the branch-equivalent calculations. Concerns, in general, centred on applying the full extent of Australia’s tax laws to determine the attributable income of the offshore entity including the ability to access relevant information. To address these concerns the Board continues to recommend that taxpayers be allowed to choose from the CFC branch-equivalent calculation, the FIF deemed rate of return (including the more accessible rate outlined in the position paper) and the market value attribution methods.

3.76 As discussed in the position paper, integrity rules may be needed to prevent taxpayers alternating between methods from year-to-year.³⁵

Recommendation 6

Allow taxpayers to choose from the branch-equivalent calculation, market value or deemed rate of return attribution methods.

34 ASFA submission, 31 July 2007, pp 1-3.

35 See further: Board of Taxation, *Review of the Foreign Source Income Anti-Tax-Deferral Regimes – Position Paper*, March 2008, para 5.14.

Branch-equivalent calculations

3.77 The Board's previous papers and submissions to the Board highlighted the complexity and high compliance costs associated with the current CFC branch-equivalent calculations which require taxpayers to apply the full extent of the Australian tax laws to foreign entities.

3.78 Blake Dawson Waldron in their submission following the release of the discussion paper explained:

'However, we acknowledge that the "branch-equivalent calculations" method is information-and labour-intensive because it requires the taxpayer to prepare Australian tax calculations solely for the purpose of calculating the amount of attributable income. The Attribution Rules should therefore provide a simplified method, or methods, that taxpayers can choose to use whenever it is unrealistic to expect them to prepare branch-equivalent calculations.'³⁶

3.79 Similarly, the joint Ernst & Young/CTA submission explained:

'To accommodate cases where the attributable taxpayer does not wish to incur the compliance costs of performing a full branch equivalent calculation, or does not have access to the necessary information, several other shortcut bases for the calculation of attributable income should be allowed.'³⁷

3.80 It was suggested in the Board's previous papers that one option to simplify the calculations might be to allow taxpayers to use accounting standards, providing certain conditions were met (for example, requiring the accounts to be audited and prepared using prescribed accounting standards).

3.81 While many submissions supported the use of accounting standards as an option for calculating attributable income, few supported the accompanying conditions. Other submissions, while favouring allowing taxpayers the choice of using either accounting standards or tax laws, stated that, if only one branch-equivalent calculation method were provided, they would favour retaining a tax laws approach.

3.82 Also, many submissions did not favour the use of accounting standards as the basis for the branch-equivalent calculations. Some submissions thought that accounting standards did not provide a sufficient level of integrity while others favoured a tax law based approach due to the tendency of accounting information to capture unrealised gains, and therefore result in higher attributable income.

36 Blake Dawson Waldron submission, July 2007, p 6.

37 Ernst & Young/CTA submission, July 2007, p 3.

3.83 With these comments in mind, and given that the Board continues to favour using a single approach to the branch-equivalent calculations, the Board supports retaining a tax laws approach as the basis for the calculations.

3.84 A tax laws approach has several advantages including familiarity for taxpayers, greater consistency with the domestic law, and certainty of outcomes compared to current outcomes.

3.85 In terms of additional modifications³⁸ to the tax laws approach, the Board's issues paper explained that while the Board believes it desirable to simplify the current calculations, the need for change has been mitigated by the Board's proposals to better target the rules and to allow taxpayers to choose the attribution method which best suits their needs. The removal of the base company income rules will also simplify the calculations. Given these changes, taxpayers may have reduced exposure to the rules or will have the option of reducing compliance costs by choosing to use the market value or deemed rate of return methods.

Recommendation 7

Retain the tax laws approach for the CFC branch-equivalent calculations.

Section 404 and associated issues

3.86 The Board's previous consultation papers identified a deficiency in the CFC rules (section 404 of the ITAA 1936) that allows portfolio dividends to be pooled together and thereby qualify for a dividend exemption (section 23AJ of the ITAA 1936), an exemption that is intended to be restricted to non-portfolio dividends. To address this deficiency, the Board recommends that section 404 be repealed.

3.87 The Board also recommends that a deficiency that prevents access to section 23AJ in a full range of equity-like ownership circumstances (currently the exemption is only available to interests with significant voting rights) be addressed by including other equity-like features including rights to dividends, capital and returns upon winding-up. In a similar vein, while section 23AJ currently precludes eligible and widely distributed finance shares from accessing the exemption, the Board also recommends that other debt-like interests should be excluded from accessing the exemption.

38 The current CFC branch-equivalent calculation method contains a number of modifications to achieve deliberate policy outcomes or in recognition that the compliance costs incurred in performing the calculations are disproportionate to the revenue risk. In other cases, it is not readily apparent what the prevailing policy framework is to justify the modification.

Recommendation 8

Repeal section 404 of the *Income Tax Assessment Act 1936* and its attendant list.

Amend the non-portfolio dividend exemption in section 23AJ of the *Income Tax Assessment Act 1936* by:

- allowing other equity-like features to be taken into account to demonstrate ownership (including rights to dividends, capital and returns upon winding-up); and
- precluding all debt-like interests.

SPECIFIC ANTI-ROLL-UP FUND MEASURE

3.88 In the absence of a FIF regime, the Board recognises that a potential risk, albeit small, exists for achieving tax deferral outcomes in non-control cases. However, rather than deploy a broad based attribution regime with wide sweeping exemptions – the approach taken under the current FIF rules – the better approach is to target the most abusive cases. The Board considers that this should be achieved by introducing a specific anti-avoidance rule that applies to offshore accumulation or roll-up funds. This approach is similar to the approach taken in Canada and the United Kingdom.

3.89 To provide appropriate levels of certainty and aid in administration, it would be necessary for the rule to be self-executing. Locating the provision in the CFC rules may assist in this regard and will pick up existing machinery provisions. It would also be necessary for the rule to be narrowly defined as the Board wants to avoid replicating the scope of the current FIF regime via a specific anti-avoidance rule.

3.90 As a starting point, the rule could be based on the following principles, with the details settled in consultation with industry when developing the draft legislation:

- A taxpayer holds an interest in an *offshore accumulation fund*; and
 - An offshore accumulation fund could be a non-resident fund (or like entity) that:
 - : does not materially distribute to resident taxpayers (directly or indirectly) most of its profits and gains; and
 - : the income and gains that the fund makes are subject to low levels of risk (that is, the profits and gains are primarily interest-like and are insulated from foreign currency fluctuations).
- The taxpayer obtains a *tax deferral benefit* in respect of holding that interest; and

- A tax deferral benefit could arise if:
 - : an amount of assessable income is less than what would have been so included for a particular income year, or is deferred to another income year, as a result of holding the interest in the offshore accumulation fund; or
 - : an amount that would ordinarily be included in the taxpayer's income tax return as assessable income is instead included as a capital gain.
- Having regard to the *relevant circumstances* of the investment, it would be concluded that the taxpayer entered into the scheme for a dominant purpose of obtaining a tax deferral benefit.
 - Relevant circumstances could include:
 - : the amount of foreign tax that has already been paid on the income and gains accumulated in the fund (that is, if the foreign tax paid is comparable to the equivalent Australian tax that would have been payable had the income been derived in Australia then no deferral benefit would generally arise);
 - : the tax profile of the resident holding the interest in the fund (that is, if the resident taxpayer is lightly taxed there would be little incentive to defer Australian tax. Conversely, if the taxpayer is capital-advantaged (a preference for CGT over income treatment) then this might indicate an accumulation and deferral strategy); and
 - : whether the foreign income and gains are capable of being distributed (that is, if the foreign income and gains have not been realised then there is little scope for deferral).

Recommendation 9

Replace the current FIF rules with a specific anti-roll-up fund measure, with the broad design features of the measure being modelled on the principles set out in paragraph 3.90.

TRANSFEROR TRUST REFORMS

3.91 The Board proposes maintaining the existing transferor trust rules. Given the interaction of these rules with the general trust provisions, the Board envisages that the transferor trust rules would be retained in the ITAA 1936 for the time being.

3.92 In its position paper, the Board advocated the removal of the control requirement for pre-resident and pre-commencement transfers consistent with the RBT recommendations.³⁹

3.93 The RBT explained that:

‘Transfers made before the operation of the transferor trust measures are currently not covered by the measures unless the transfer was to a discretionary trust and it can be shown that the transferor or an associate is in a position to control the trust. Given the anti-avoidance rationale for the measures, the current restriction relating to control should be removed because:

- discretionary trusts are commonly used to avoid tax by hiding interests residents have in profits accumulating offshore;
- it is difficult to show in practice that a foreign trust is controlled (even though the term has a wide meaning for the purposes of the transferor trust measures) because information that can be obtained by the Australian Taxation Office (ATO) on offshore arrangements and on agreements between related parties is often informal and in the hands of parties in tax havens that have laws against disclosure of information; and
- the income accruing in these trusts has not been taxed since the transferor trust measures commenced in 1990, which represents relief well beyond normal transitional relief.

Prospective residents are allowed by the current treatment to transfer assets to a foreign trust immediately before becoming a resident. Australian tax is thereby deferred or avoided unless it can be shown that the foreign trust is controlled by the prospective resident. Again, this is not appropriate because transferors are then not taxed on income that accrues after they become resident in Australia and are enjoying the benefits of publicly provided services.⁴⁰

3.94 The Board continues to support this proposal but is aware that stakeholders would not support the removal of control in the absence of other improvements to the rules. Various improvements have been raised during consultations which have been noted by the Board and should be considered as part of consultation on any draft legislation. However, any changes also need to be consistent with broader government policy.

3.95 The Board, in its position paper, also supported altering the calculation of the transferor’s attribution percentage in cases where there are multiple transferors. That is, rather than transferors being deemed to have a 100 per cent attribution percentage,

39 See Review of Business Taxation, Recommendations 20.10 and 20.11.

40 Review of Business Taxation, *‘A Tax System Redesigned’*, p 639.

subject to the Commissioner's discretion, the Board proposed that income be attributed to each transferor based on the respective value of property or services they transferred to the foreign trust. Only where this information could not be obtained or evidenced would the transferor be taken to hold a 100 per cent interest.

Recommendation 10

Remove the control requirement for pre-commencement and pre-resident transferor trusts.

For foreign entities with multiple resident transferors, base the amount of income attributed to each transferor on the respective value of the property or services they transfer to the foreign entity and that, where it is not possible to determine this value, the transferor is deemed to hold a 100 per cent interest in the foreign entity.

Consider further technical issues with the transferor trust rules as part of consultation on any draft legislation.

GLOSSARY

Active income

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

Attribution rules

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

Balanced portfolio exemption

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

Base company income

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

Branch-equivalent calculations

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

Capital export neutrality (CEN)

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

Capital import neutrality (CIN)

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

Comparable tax (jurisdictional) approach

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

Controlled foreign company (CFC) rules

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

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

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

Deemed present entitlement

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

(Eligible) Designated concession income (EDCI)

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

Foreign investment fund (FIF) rules

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

Listed country

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

Non-portfolio / portfolio

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

Passive income

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

Tainted income

Tainted income includes passive and base company income.

Tainted sales income

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

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

Tainted services income

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

Transfer pricing rules

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

Transferor trust rules

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

Unlisted country

A foreign country that is not a listed country.

APPENDIX A: LIST OF SUBMITTERS

The following is a list of organisations and individuals who made submissions (excluding confidential submissions) to the Board as part of the review. Several of those listed below made multiple submissions. Submissions can be viewed on the Board's website at www.taxboard.gov.au.

List of organisations providing submissions

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

Organisation (continued)

Taxation Institute of Australia

Telstra Corporation Limited

Thomas, P

APPENDIX B: ATTENDEES AT CONSULTATION MEETINGS

The following is a list of organisations that were represented at the various consultation meetings conducted by the Board as part of the review.

Organisation
AMP Capital
Atanaskovic Hartnell Lawyers
Australian and New Zealand banking Group
Australian Bankers' Association Inc.
Australian Financial Markets Association
The Australian Petroleum production & Exploration Association
Australian Taxation Office
Association of Superannuation Funds of Australia
Babcock & Brown
BHP Billiton Limited
Blake Dawson
BNP Paribas Investment Management
Brambles Limited
Business Coalition for Tax Reform
Business Council of Australia
Clayton Utz
Commonwealth Bank of Australia Limited
Corporate Tax Association
CPA Australia Ltd
Deacons
Deloitte Touche Tohmatsu
Ernst & Young
Gilbert & Tobin

Organisation (continued)

Goldman Sachs JB Were

Greenwoods and Freehills

Institute of Chartered Accountants in Australia

Insurance Council of Australia

Investment & Financial Services Association Ltd

Johnson Winter & Slattery

KPMG

Law Council of Australia

Lend Lease Limited

Minter Ellison Lawyers

National Tax & Accountants' Association Limited

Origin Energy Limited

Perpetual Limited

Phillips Fox

Pitcher Partners

PricewaterhouseCoopers

Property Council of Australia

Qantas Airways Limited

QBE Insurance Group

Shaddick & Spence

Taxation Institute of Australia

Taxpayers Australia

Telstra Corporation Limited

The Treasury

The University of Sydney

Village Roadshow Limited

Westfield Limited