

TAX BULLETIN

AN UPDATE PUBLICATION
FOR OUR CLIENTS

21 February 2011

REFORM OF THE FOREIGN SOURCE INCOME DEFERRAL PROVISIONS

Overview

On 17 February 2011, the Treasury released Exposure Draft (ED) legislation, outlining proposed changes to the tax treatment of income derived through foreign investments. These provisions affect Australian taxpayers who derive income indirectly through foreign controlled or un-controlled investments. The proposed application date of the measures is unclear. However, given the breadth of the changes we recommend that taxpayers begin to examine how they may be impacted by these proposed measures.

While not complete, the ED legislation is only 34 pages and is a vast improvement over the original provisions introduced some 30 years ago that spanned over 250 pages. The reduction in size has been achieved by a more targeted approach and a simplification of the many tests and calculations.

The Government's aim for the reforms is to reduce complexity and compliance costs, thereby improving the competitiveness of Australian businesses with offshore operations and encouraging foreign groups to establish regional headquarters in Australia. Whilst the new measures are likely to reduce complexity, we believe that further improvements are still required to address a number of compliance issues with some of the calculations and methodologies adopted.

The reforms also include a re-write of the dividend exemption provisions that will advantage some taxpayers and disadvantage others. These new provisions will allow exempt dividends to flow through interposed trust and partnerships. However, the measures also seek to restrict certain exempt dividends to equity interests (i.e. to the exclusion of preference shares).

Other key changes contained in the ED include focusing the rules on single Australian controllers, providing relief for intra-group transactions, treating rent in respect of real property as being active income, changes to the treatment of royalty income, and removing the base company income rules. The foreign branch exemption provisions have also been simplified in the re-write.

Submissions on the ED legislation are due on 18 March 2011. Pitcher Partners will be making a submission on these measures and you are welcome to contribute any issues or concerns that you may have with the proposed measures.

The proposed foreign accumulation fund (FAF) provisions

The first ED released by Treasury relates to the taxing of foreign income that is derived through investments in non-controlled foreign entities. As outlined in the Treasury press release, these provisions are designed to address the most abusive cases of deferral in the non-control environment. Accordingly, as the provisions are targeted, it is expected that the provisions will only attribute income to an Australian taxpayer in very limited circumstances. That being said, taxpayers will still be required to determine whether their foreign investments are within the parameters of these provisions on an annual basis.

These provisions will replace what were previously known as the foreign investment fund (FIF) provisions, which were repealed with effect from 1 July 2010.

The ED targets non-controlled investments in foreign accumulation funds (FAFs). Generally, to determine whether an entity is “not-controlled” for the purpose of the FAF provisions, the ED proposes to use the definitions contained in the accounting standards AASB 127 and 131.

It is proposed that FAFs will be defined as a fund with direct holdings of debt interests (i.e. interest bearing investments) representing at least 80% of gross assets, where the fund does not distribute more than 80% of the realised gains and profits derived during the relevant year. A typical example of such a fund would be a bond fund that accumulates a proportion of its income on an annual basis (i.e. at least 20%). While the ED proposes bright line tests (which are a welcomed addition to the previous draft), it is noted that the requirement to determine “market values” of underlying investments and “realised profits” of the FAF may be problematic for some investors where the information may not be readily obtainable by a small investor (e.g. having a 1% interest in the FAF entity).

Where an investment is a FAF, a taxpayer will be required to include distributions received from the FAF in its assessable income, as well as include changes in the market value of the FAF that has occurred during the relevant period.

As the provisions are quite targeted to a specific type of investment, exclusions proposed in the ED are limited to complying superannuation funds and life insurance companies that invest (directly or indirectly) in FAFs. In particular, it is highlighted that the proposed measures do not include a *de minimis* test.

On an initial review, the move to targeted legislation is welcome, as taxpayers would have greater certainty as to which investments could result in attribution under the new regime. However, the proposed provisions leave open the ability to add any type of FAF investment through regulations. Accordingly, it is questioned whether the Government will see fit to retain the limited (targeted) approach of the FAF provisions in the long term, or whether they will gradually seek to expand the provisions over time.

The proposed controlled foreign companies (CFC) provisions

The second ED focuses on the taxation of income derived indirectly through controlled foreign companies (CFCs). Again, control is proposed to be determined using accounting principles contained in AASB 127 and 131.

Where an Australian resident taxpayer has an interest in a company that is controlled by the taxpayer and its associates, adjusted passive income of the CFC will be attributed to the investor and included in their assessable income. Such income will be called their attributable income.

The proposed rules have been greatly simplified in determining the attributable income of a CFC as compared to the current regime. First, there are a number of exclusions that apply at an entity level. Where such exclusions do not apply, attributable income of the CFC is limited to adjusted passive income of the CFC. In determining the adjusted passive income, the provisions will require one to first determine the “prima facie passive income” of the CFC. Such income is defined as being returns on debt and equity interests, payments of rent and annuities, payments of royalties, and profits on financial arrangements and passive assets. Once such income is determined, exclusions and inclusions are then applied at an income level. While many of these exclusions and inclusions are similar to those currently contained in

the CFC provisions, there are a number of new improvements and watchouts that taxpayers should be aware of.

Entity level exclusions

There are two main exclusions proposed to apply at an entity level. Firstly, if the Australian taxpayer is either a complying superannuation fund or life insurance company, the measures propose to exclude the entity from being an attributable taxpayer. In addition, if the CFC only derives a small amount of prima facie passive income (i.e. 5% of total turnover based on its financial accounts), the provisions will also not apply.

Unqualified exclusions relating to passive income

Where the entity level exclusions do not apply, the ED proposes two unqualified exclusions for passive income. The first is in relation to all rental income derived from real property (recognising the immobility of such income). The second is in relation to income derived by a CFC of a listed country, where such income is comparably taxed.

Qualified exclusions relating to passive income

A number of qualified exceptions are then provided for passive income. Such exclusions are qualified as they do not apply if a deduction is allowed in Australia for the respective passive income of the CFC.

The first qualified exception is a significant proposed change, involving CFC grouping. Under this proposal, passive income derived by a CFC group entity from another CFC group entity will be excluded (provided it is not deductible to the CFC group entity in Australia). While this new rule will help to ensure that attribution does not occur for internal transactions, it is highlighted that a CFC group will only exist if there is only one attributable taxpayer in relation to the CFC group. This requirement is expected to limit the availability of this exception for many groups (e.g. where two or more associated entities own 100% of the shares in a group of CFC entities).

The second qualified exception is for passive income that is inherently connected with an active business (i.e. the proposed active business income exemption). The scope of this exemption has been substantially revised from that circulated in the July 2010 CFC consultation paper. While the prior discussion paper outlined what would have been a fairly broad exception, the proposed ED provides for a very stringent and narrow active business rule. The proposed provision requires the prima facie passive income to be attributable to a permanent establishment, to arise from market competition, and to arise substantially from the ongoing use of labour. Furthermore, there would need to be a substantial connection between the permanent establishment and the source of income, the relevant market and labour for this exclusion to apply. Based on the qualifications to this rule, the active business income exemption has been drafted very narrowly. It is likely that the provision will not apply to appropriately exclude items inherently connected with a business. Furthermore, in many cases we believe that there will be an increase in certain passive income being attributed to Australia as compared to the current regime. We believe it will be critical for this issue to be raised with Treasury and that the exclusion is more appropriately drafted.

The third qualified exception is provided for certain income of an AFI subsidiary (being a CFC that is a subsidiary of an Australian Financial Institution).

Inclusion for royalty income

Royalty income will be specifically included as adjusted passive income where it arises from a matter or thing that has been transferred from an Australian resident entity to the CFC and has not been substantially developed, altered or improved by the CFC. This rule is, however, still subject to the entity level exceptions and the unqualified exceptions (outlined above).

Repatriation of dividends from the foreign entity and double tax relief

A number of provisions have been included to avoid double taxation of the Australian investor. This includes a credit approach as well an exemption on dividends.

It is proposed that a credit equal to the attributable amount included in the assessable income of an investor for a period will arise at the start of the investor's income year. These credits will then be applied to any distribution or disposal proceeds from a CFC or FAF occurring on or after the day the credits arise, in order to treat those amounts as non-assessable and non-exempt (NANE) income.

Furthermore, the payment of dividends from a CFC will be treated as NANE, where it is paid on an equity interest and the Australian taxpayer either holds what is called an enhanced direct ordinary membership interest (EDOMI) of at least 10% in the foreign company, or alternatively is an attributable taxpayer. The term EDOMI interest replaces what is currently known as a non-portfolio interest, and will simply be measured as the direct holding of ordinary shares in the foreign company by the relevant investor (subject to the indirect rules proposed, which are outlined below). A similar rule is proposed for interests in FAF entities that are trusts.

The above proposals seek to remove the current ability to claim exemptions on dividends where the shares in the foreign company are "debt interests" or are non-ordinary shares (e.g. preference shares). However, the proposals also seek to expand the range of exemptions for dividends that are received by a company indirectly through a partnership or trust. Currently, an exemption is not provided for indirect dividends received by companies. This is a welcome proposed change, which will allow greater flexibility in the structuring investments in foreign entities.

Finally, we highlight that the ED does not provide for deductions to be claimed where they relate to the earning of NANE income outlined above. Such deductions are currently allowed under the current regime. We believe that this is an oversight in relation to the ED and will be corrected in future drafts.

Treatment of foreign branches

The treatment of foreign branches under the measures is also proposed to be simplified, by effectively deeming the foreign branch to be treated as a CFC and aligning the treatment of the branch profits with the treatment of CFC income.



Proposed application date

The EDs are silent on the application date proposed for the new legislation. Furthermore, there are no proposed provisions outlining the transition from the current CFC regime to the proposed regime.

As there are currently no provisions that deal with non-controlled investments, one would expect the FAF provisions to be implemented by the Government as soon as possible. However, as those proposed FAF provisions rely on many of the core definitions contained in the proposed CFC provisions, it is questionable whether the legislative package will be in an appropriate state for introduction by 1 July 2011.

In any event, taxpayers should now be considering this package of proposed amendments and what they may mean for the taxation of their foreign investments.

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FURTHER INFORMATION

In Victoria, the Pitcher Partners representatives named below can be contacted for further details on the issues raised in this Tax Bulletin. In all other states please contact your regular Pitcher Partners tax contact in any member firm.

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