

# REFORM OF ANTI-TAX-DEFERRAL REGIMES

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# REFORM OF ANTI-TAX DEFERRAL REGIMES

## Treasurer's announcement

1. On 10 October 2006 the Treasurer issued a Press Release announcing that he had asked the Board of Taxation to undertake two reviews, one of them being of the foreign source anti-tax deferral regimes. The other review is of the unrelated topic of off-market share buy-backs.
2. The Press Release pointed out that Australia has a number of anti-tax-deferral regimes which are designed to prevent resident taxpayers from using foreign entities to defer or avoid Australian tax. The Treasurer referred to business having raised concerns with the Government about these anti-tax-deferral regimes with respect to their complexity and the substantial compliance and administration costs. In addition it is suggested that the rules are poorly targeted and impact on offshore investment decisions that are not motivated by tax deferral reasons.
3. The stated objectives of the review are:
  - To reduce the complexity and compliance costs associated with the anti-tax-deferral regimes including whether the current regimes can be collapsed into a single regime;
  - 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.

4. The Board has appointed a working group consisting of Mr Chris Jordan (Chairman), Mr Keith James and Mr Dick Warburton to oversee the review. The Board will develop a discussion paper and seek stakeholder views through both targeted and public consultation processes. Preliminary submissions are called for prior to the release of the discussion paper.
5. It is expected that the Board will report to Government in mid 2007 on the outcome of the review. Having regard to the various studies that have been undertaken and the reports prepared as a result thereof over the past decade or so one wonders just how much political impetus there is to effect a substantial reform in the nature of composing a set of rules for one anti-tax-deferral regime or at least harmonising the CFC and FIF regimes.

### **History of Taxation of Foreign Source Income**

6. Prior to 1 July 1987 the general approach to alleviate double taxation on foreign source income of residents was to treat that foreign source income either as exempt from Australian tax if it had been subject to tax at source (former section 23(q) of *ITAA 1936*) or as fully rebatable in the case of dividends (former section 46 of *ITAA 1936*). There was in existence a rudimentary foreign tax credit system (FTC) which applied to certain classes of income such as foreign dividends received by individuals (former section 45 of *ITAA 1936*), income from films and shipping and foreign interests and royalties under the *Income Tax International Agreements Act 1953*.

7. Following the recommendations of the Asprey Committee in 1975<sup>1</sup> and the Treasurer's draft white paper published in 1985<sup>2</sup> Australia underwent substantial reform to its jurisdiction to tax. Between 1 July 1987 and 1 July 1990 the exemption system was largely abandoned and a general FTC system was adopted which allowed for credit for foreign tax on a restricted basis in that it was creditable only to the amount of Australian tax on the class of foreign income in question by reference to source country type of income. The imposition of Australian tax and allowance of the FTC required the derivation of the foreign source income by the Australian taxpayer and so tax could be deferred by retaining it in an offshore entity.
  
8. Since 1 July 1990 there has been in place a multi-faceted system consisting of the CFC and FIF regimes together with the transferor trust and deemed present entitlement rules. In summary Australia has three methods of dealing unilaterally with foreign source income and the problem of double taxation namely a combination of exemption, foreign tax credits and accruals rules. The other approach to the elimination of international double taxation is bilateral through the double taxation agreements which are designed to share taxing rights, avoid double tax and prevent fiscal evasion.

## Summary of Present Anti-Tax-Deferral Regimes

### CFC Rules

9. The CFC measures in Part X of *ITAA 1936* require Australian taxpayers to include in assessable income on an accruals basis in the current year a share of income or gains earned by foreign companies in which they have a controlling interest where such income or gains have been retained by the CFC and have not been distributed. The Australian controllers are referred to as attributable taxpayers and the attributable income of a CFC is broadly speaking calculated using the same tax rules which are applicable to Australian resident companies.
10. The amount of a CFC's attributable income depends on whether the CFC is a resident of a listed or an unlisted country the former consisting of seven listed countries Canada, France, Germany, Japan, New Zealand, UK and the US which are closely comparable designated jurisdictions.
11. Section 456(1) of the *ITAA 1936* includes in the assessable income of an attributable taxpayer in relation to a CFC the taxpayer's attribution percentage of the attributable income of the CFC for the statutory accounting period of the CFC that ends in the income year of the taxpayer.

### FIF Regime

12. The FIF regime applies to income and gains accumulating in foreign companies that are not Australian controlled or in foreign trusts that fall

outside the scope of the transferor trust measures. The measures apply to certain foreign life insurance policies that contain an investment component. These provisions apply to taxpayers who have an interest in a FIF or a foreign life policy. An interest in a trust FIF comprises an interest in the corpus or income of the trust or an option convertible note or other instrument that confers an entitlement to acquire such an interest.

13. There are a large number of exemptions from attribution under the FIF measures the principal one being the active business exemption. The FIF regime does not have an exemption for comparably taxed income so that passive investments in a listed country may be subject to attribution under the FIF Regime but if there existed the requisite control the CFC Rules would not apply.

### **Transferor Trusts**

14. The object of the transferor trust provisions in Division 6AAA is to attack discretionary trusts in low trust jurisdictions that are able to accumulate the income free of Australian tax until repatriated to Australia. The Division focuses on transferors and not settlors of trusts and a transfer sufficient to trigger the attribution is broadly defined to cover virtually all direct and indirect transfers of value (including property and services) to a trust and a transfer which of itself creates a trust. A distinction is drawn between a listed country trust estate and an unlisted country trust estate as is the case with the CFC measures.

## **Deemed Present Entitlement Rules**

15. Sections 96B and 96C of *ITAA 1936* may be characterised as a fourth attribution mechanism. The general effect of section 96B is that if a taxpayer has an interest in a non-resident trust estate in relation to the income year that taxpayer is taken to be a beneficiary who is presently entitled to a share of the income from the trust estate of the income year and is not under a legal disability. Section 97 applies to tax the taxpayer in respect of such interest and the amount brought to tax is that referred to in section 96C. Section 96C differentiates between a present entitlement or a distribution within two months after the end of the income year and any other situation. It is not clear whether the use of presently entitled in section 96C includes a reference to deemed present entitlement in section 96B. It is notable that none of the exclusions referred to in the CFC, FIF and transferor trust regimes are included in these provisions.

## **Ralph Review 1999**

16. The CFC and FIF regimes were developed independently approximately three years apart. Initially the FIF regime was to be as a back stop to the CFC regime as is the case in Canada. As is discussed later in this paper this did not occur and there is a lack of symmetry between the CFC and FIF regimes. Although the Ralph Review<sup>3</sup> of international taxation looked at the accruals regimes and made certain sensible recommendations very

few of these were implemented. Nevertheless it is worth considering some of those recommendations.

17. The Ralph Review did not recommend any major reform of the CFC measures noting that they had been reviewed substantially in 1997. Paragraph 32.7 of the report stated that the breadth of other business tax proposals precluded immediate legislative reform and that reducing compliance costs was a high priority.
18. In Chapter 32 the Ralph Review identified a number of key policy issues associated with improving the anti-tax-deferral rules however they did not relate to the CFC regime. First of all it considered the active business exemption in the FIF measures. Option 1 was to remove the exemption thereby largely taxing all FIF investments on a current basis.<sup>4</sup> Another option was to replace the exemption with a differentiation between non-portfolio and portfolio investments with the active income test in the CFC measures being the basis of an exemption for non-portfolio holdings in FIFs.<sup>5</sup> This would result in greater symmetry in the exemptions available under the CFC and FIF measures and if the test is failed the FIF measures could apply provided that taxpayers were able to obtain the necessary financial information to see whether or not they pass the active income test.
19. With respect to portfolio investments the Ralph Review recommended a jurisdictional exemption as to interests in company FIFs that are taxed on a worldwide basis in a listed comparable tax country having an effective anti-

tax-deferral regime.<sup>6</sup> There would be difficulty for portfolio investors in determining whether a company FIF is taxed on this basis and it would be impractical for many investors to obtain this information.

20. A further recommendation was that an interest in widely held foreign fixed trusts could be treated in the same way as interests in companies. Interests in these trusts could therefore continue to be subject to the FIF measures but also qualify for the active business exemption which was then available only for interests in company FIFs.<sup>7</sup>
21. With respect to closely held fixed trusts, that is one where five or fewer Australian beneficiaries have 50% or greater interest in the income or property of a trust, the deemed present entitlement rules in the general trust provisions could be removed and the FIF rules could be extended to apply to such interests in a calculation method tightened to require a net income calculation therefor.<sup>8</sup>
22. As to fixed trusts that are neither widely nor closely held the Ralph Review recommended that these should continue to be subject to the FIF measures with a limitation that the market value method for determining FIF income should apply only for interests in widely held fixed trusts.<sup>9</sup>
23. The Ralph Review suggested that special rules should be developed for foreign discretionary trusts as they present particular difficulties in respect of deferral of income. Such trusts could be subject to the transferor trust measures if the resident transferor can be identified. Where this is not

possible an interest charge could apply to distributions of low taxed profits from these trusts. There is overlap in the anti-tax-deferral rules with respect to discretionary trusts and this could be reduced if an exemption from the FIF measures were provided for fixed interests in a discretionary trust where the trust is subject to the transferor trust measures.<sup>10</sup>

## **Globalisation And The World Economy**

24. Prior to the introduction of anti-tax-deferral regimes civilised countries exerted control over foreign investment by means of central banks restricting the outflow of funds. In the case of Australia the *Banking (Foreign Exchange) Regulations* required the approval of the Reserve Bank of Australia for the transfer overseas by Australian residents of all but modest amounts of money and the Australian dollar was set at a fixed rate which did not reflect on a current basis the balance of trade between Australia and other nations.
  
25. By reason of advances in technology particularly during the past fifteen to twenty years there has been a transformation of the world economy with significant emphasis on the provision of services rather than labour and increased mobility of capital. Vast sums of money are transferred electronically on a 24/7 basis. At the high end of the market skilled labour is increasingly mobile. The reduction in tariffs world-wide has led to greater cross-border flows of goods and services. In order to be truly competitive

companies have to organize their affairs so as to take advantage of economies of scale that exist around the world.

26. This necessarily involves the creation and use of corporate entities in many different jurisdictions. The motive for this is not the deferral of taxation but rather to increase the efficiency and profitability of the underlying business of the group. Increasingly Australian companies have sophisticated offshore operations and they are competing on the world stage with North American, European and Asian multinationals. Australian companies should be free to shift capital to locations which have lower rates of taxation than here within the framework of their global operations.
27. In the global economy there are international supply chain processes and shared service centres located in places such as India. Increasingly Australian companies establish regional headquarters in offshore locations which reflects the predominance in international trade of the provision of services rather than labour.
28. Various studies and reviews carried out by the Treasury Department and the Board of Taxation have made it abundantly clear that Australia's taxation system needs to be substantially revised as a result of the significant transformation of the world economy. There appears to be unanimity as to this basic proposition.

## OECD – Harmful Tax Competition

29. In 1987 the OECD published four studies dealing with international tax avoidance and evasion targeting the use of tax havens and the abuse of bank secrecy<sup>11</sup>. The catalyst for these studies appears to have been two major United States Government studies namely the *Gordon Report*<sup>12</sup> and the *Tax Havens in the Caribbean Basin Report*<sup>13</sup> the former of which noted that banking deposits in tax havens had increased from U.S. \$11 billion in 1968 to U.S. \$385 billion in 1978.<sup>14</sup>
30. One of the four OECD studies was entitled, “*Taxation and the Abuse of Bank Secrecy*” and it concluded that bank secrecy provisions were being used to hide funds derived from illegal activities, such as drugs trafficking and stolen goods, as well as to frustrate exchange control measures<sup>15</sup>. In April 1990 the OECD released a report called a *Survey of Taxpayers’ Rights and Obligations*<sup>16</sup> and in February 1994 a document titled *Tax Information Exchange between OECD Member Countries: A Survey of Current Practices*<sup>17</sup>. Those surveys revealed that in most countries information on taxpayers’ files was kept secret by tax officials and reference was made to the rights of taxpayers as to notification, consultation and intervention in the event that information about their affairs was being sought by a taxation administration from another country.
31. In April 1998 the OECD issued a report entitled *Harmful Tax Competition: An Emerging Global Issue*<sup>18</sup>. This report contained a detailed examination

and analysis of the attributes of tax havens and the essential characteristics of harmful preferential tax regimes; and it highlighted the lack of effective exchange of information with respect to both these subjects. The report contained a number of specific recommendations in three broad categories namely domestic legislation and practices; tax treaties; and the intensification of international co-operation including access to banking information for tax purposes. The report classified countries into three groups namely member countries that were committed to abolishing their existing harmful tax practices; tax havens against which defensive measures ought to be taken; and non-OECD countries with whom there should be dialogue to bring them within the aims of the project.

32. In March 2000 the OECD issued a report entitled *Improving Access to Bank Information for Tax Purposes*<sup>19</sup> which detailed the types of information that tax authorities should be able to obtain from banks relating to their customers. The report concluded that by reason of increased globalisation of trade and commerce, advances in computer technology and liberalisation of capital movements there existed greater opportunities for taxpayers to escape taxes legally by taking advantage of restrictive bank secrecy jurisdictions particularly where assets and activities were hidden through layers of entities in offshore banking accounts.
33. In April 2000 the OECD published a list of seven unco-operative jurisdictions that had refused to make a public commitment to eliminating tax competition. These seven countries are described as “the gang of

seven” although Vanuatu has since agreed to abolish some of its harmful tax practices. The other six countries were Bermuda, Cayman Islands, Cyprus, Malta, Mauritius and San Marino<sup>20</sup>.

34. In 2003 the OECD issued a report entitled *Improving Access to Bank Information for Tax Purposes*<sup>21</sup> and there is now a common understanding amongst OECD members on this topic as to what tax fraud involves and the measures to be taken to counter this. The notion of tax fraud in the report transcends what would be regarded for the purposes of Australian law as involving tax evasion or avoidance.
35. By virtue of article 26 of the OECD Model Convention<sup>22</sup> and article 26 of the U.N. Model Convention<sup>23</sup> the primary responsibility for determining whether or not there are any valid reasons for declining a request for information is upon the applicant state.
36. It can be concluded that the OECD has achieved a great deal in combating harmful tax competition and that it will press forward to further improve the position. The OECD has been able to encourage non-OECD economies to improve access to bank information for all tax purposes. Further pressure can be brought to bear by the OECD within the context of countries from Eastern Europe applying for membership of the European Union.
37. It is a fact of life that countries will offer incentives to attract foreign capital and thus source country taxation of capital income is relatively low leaving it to the residence country to do most of the taxing. The OECD has

encouraged both members and non-members to introduce CFC and FIF regimes so as to ensure that foreign income emanating from tax havens and preferential regimes is taxed on a current basis. The result seems to be that source country taxes have decreased and residence country taxation is becoming more common and increasingly complex.

38. As noted above the OECD has had a large measure of success in encouraging tax havens and countries with preferential regimes to enter into information exchange agreements with a view to residence countries obtaining access to sufficient information to levy and collect taxation of foreign source income.

## **CFC Rules**

### **Historical perspective**

39. Australia introduced the CFC rules with effect from 30 June 1990. The USA introduced such rules in 1962 and thereafter Canada, France, Germany and Japan and the United Kingdom followed suit in the 1970s and the early 1980s. There are now twenty-three countries that have such regimes.
40. The broad design of the Australian CFC regime remained unchanged until 2004 when the *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004* (the NITA 2004 reforms) came into force. In 1997 the CFC regime was amended by listing certain

countries as comparable tax countries. Under the present system there are now seven listed closely comparable countries as referred to above.

41. In May 2002 the Treasurer requested the Board of Taxation<sup>24</sup> to undertake a review of Australia's international tax arrangements particularly as to whether they impeded Australian companies from expanding offshore. A stated object of the review was to examine claims that the rules were complex, imposed significant compliance costs on business and were out of step with modern business practices<sup>25</sup>. To assist the Board of Taxation Treasury prepared a consultation paper in August 2002<sup>26</sup>. Following public consultations the Board of Taxation submitted a two volume report to the Treasurer on 28 February 2003<sup>27</sup>.
42. Most of the recommendations made by the Board of Taxation to reform the foreign source income rules were accepted by Treasury<sup>28</sup> however the CFC rules were not substantially changed. The central aspect of the NITA 2004 reforms was the extension of the participation dividend exemption to all participation dividends whereas previously the exemption applied only to dividends paid out of comparably taxed profits. The participation dividend is a dividend paid by a foreign company to an Australian resident company that has a 10% or greater interest in the voting power of the foreign company<sup>29</sup>.
43. The extension of the participation dividend exemption is a radical shift in the policy underlying Australia's foreign source income rules by relying

upon capital import neutrality and has placed more pressure on the CFC regime because any foreign source income not taxed on a current basis can be repatriated tax free.

44. The Australian CFC rules have been subjected to detailed scrutiny and examination particularly by Professor Lee Burns who is the author of several publications on the subject. In an article published in July 2005<sup>30</sup> Professor Burns reached a number of conclusions as to the design of Australia's CFC rules within the context of the global economy as follows:

- the design of the control and substantial shareholder rules of the CFC regime should be improved so as to ensure that they better co-ordinate with the FIF rules;
- work should be carried out to identify in a meaningful way the criteria for determining what a comparable tax country is and to identify the tax concessions in such countries;
- the CFC rules inappropriately cover base company income having regard to the existence of the transfer pricing rules in Division 13 of *ITAA 1936*;
- empirical work needs to be carried out on the continuing use of tax havens;
- rules designed to push down the responsibility for attribution to a lower-tier listed country should be very carefully drafted.

45. In an article published in June 2006<sup>31</sup> Professor Burns has carried forward his analysis of the CFC regime and expanded upon his examination of these complex provisions.

### **Development of the CFC measures**

46. The original conception of the CFC measures was that they would be anti-deferral mechanisms aimed at foreign companies resident in a small number of low tax jurisdictions irrespective as to whether the foreign company was controlled by Australians.
47. Following consultation the approach was expanded so that the measures were anti-avoidance provisions rather than pure anti-deferral mechanisms and were based on an entity approach whereby the CFC was to be tested to determine whether it was mainly engaged in activities that would not lead to the minimisation of Australian tax through a range of specified activities. If the minimisation of tax was present all of the income profits and gains of the CFC were to be subject to attribution. If there was no substantial minimisation of Australian tax the income profits and gains of the CFC would not be subject to any attribution. Whether a CFC was predominantly engaged in active business is to be measured by reference to the gross non-active income as a percentage of the total income. If the non-active income is greater than 5% of the total income the CFC fails the test.

48. In its final form the above approach was altered and it was decided that a transactional approach would be used under which the individual transactions were tested and the identified income profits and gains would be subject to attribution.
49. The change in emphasis from a purely entity approach to an entity and transactional approach should have resulted in a redesign of these measures but that did not occur and thus they lack cohesion. The main problem is that a transactional approach requires a more precise analysis of the categories of income profits and gains that may be subject to attribution.
50. The income profits and gains that were taken into account as passive or tainted were not precisely articulated and defined. They were chosen merely as items that may indicate that the CFC was not predominantly engaged in active business to determine whether all of the income profits and gains were to be attributed. The approach was accepted as being imprecise however this lack of precision in the development of the non-active categories was used also to test the income profits and gains that might be attributed. Those categories of income profits and gains designed for one purpose were used for a different purpose.
51. The problem was exacerbated in 1997 with the restriction of the countries that would be treated as comparable. The result of the extension of the countries to which the full CFC measures apply and problems with the

imprecise categorisation of income subject to attribution have been vastly magnified.

### **The Rationale for a CFC Regime**

52. The central purpose of CFC rules should be to eliminate deferral by postponing the payment of current taxation of foreign income that has economically accrued to a taxpayer through the taxpayer's ownership interest in a foreign entity.
53. The possibility of deferral arises by reason of two structural features of income tax:
  - the treatment of a company as a taxable entity separate from its owners; and,
  - the treatment of a company incorporated abroad as a non-resident of the country in which the owners of the company are resident.
54. The combination of these two principles enables foreign income derived by a non-resident company to be outside the Australian tax base even though the ultimate beneficial owner of the company is an Australian resident.
55. The benefit of deferral creates a bias in favour of foreign investment over domestic investment. The principle of *capital export neutrality* contends that Australia's tax rules should not discriminate between domestic and foreign investment whereas the principle of *capital import neutrality* dictates

that all those competing in the same market should be subject to the same tax burden.

56. Changing the residence rules is a matter that has been considered. It should be noted in this context that the personal attachment to a jurisdiction for a company comes from the attachment of the beneficial owners. The existing tests of corporate residence are well entrenched and understood. In complex corporate groups there may be difficulties in identifying the ultimate beneficial owners of a company and enforcing a company's tax liability may not be possible if the company does not have any assets in the jurisdiction.
57. The alternative to changing the residence rules is to ignore the separate legal status of the foreign company and treat its income as belonging to its owners. This advances the taxing point to the time of derivation by the foreign company rather than the time of distribution to the shareholders. The effect of the CFC rules is to treat the foreign company as if it were a branch rather than a subsidiary. Thus taxation under the CFC rules is often referred to as "*branch equivalent taxation*". CFC rules are a second best solution to the problem of deferral as it involves taxing someone other than the legal person that derived the income.

### **Control and Substantial Shareholder Rules**

58. The original rationale for the control rule is fairness that is to say the ability of the domestic shareholders to require the foreign corporation to distribute

income. The issue is whether identifying those who can control the distribution policies of an entity is an indicator of those who can make branch equivalent calculations.

59. In considering concentration of control where in Australia there is a broad based stand alone anti-deferral regime consisting of the FIF rules it may be more relevant to distinguish between publicly listed and private companies.
60. Another issue is why members of the controlling group have to be resident in the same country. It should not be assumed that in a tightly held private company the shareholders would be strangers wherever they may reside.
61. The Treasurer's 1988 Consultative Document<sup>32</sup> proposed branch equivalent taxation for Australian residents with an interest in a non-resident private company no matter how small an interest and a substantial shareholder rule (based on a 10% threshold) for Australian residents with an interest in a non-resident public company. This proposal was too broad as it applied to private companies because there would be many cases where domestic shareholders do not have access to the information necessary to make branch equivalent calculations. This defect can be cured if it is confined to closely held private companies regardless of whether there is Australian control because it is reasonable to assume that every member of a closely held private company will have access to the necessary information wherever they may reside.

62. There is valid reason to conclude that it is not necessary to have both a concentration requirement as part of the control rule and a substantial shareholder rule.

### **Entities other than Companies**

63. Because Australia's CFC rules apply only to entities that are companies there are many forms of entities that it does not embrace. In the case of limited partnerships if that partnership's country of formation taxes the partnership on a look through basis it would not be a resident of that country as its tax laws would not need a test of residence for the partnership. This has the result that a limited partnership treated as a CFC would be classified as a resident of an unlisted country by default.
64. A carve-out has been established for foreign hybrid limited partnerships pursuant to section 830-10 of *ITAA 1997* which makes such an entity subject to the ordinary partnership provisions. Thus the income of a foreign hybrid limited partnership is taxed on a look through basis so that there is no deferral of Australian tax in relation to any of its income whether active or passive. This carve-out does not solve problems including whether income retains its character as it passes through a partnership; whether the partners can nominate that particular classes of income can be allocated to partners; and whether income passes through on a pro rata basis.

65. With respect to unit trusts although economically similar to a company these entities cannot be a CFC. At present they are covered by the FIF rules even if Australian residents closely control the trust. Because the active income exemption under the FIF rules does not apply to trusts all of a trust's income is attributed and thus there is no deferral.
66. At present the three principal entities that may be used by Australian residents for offshore investment activities are subject to different tax treatment. A foreign company closely held by Australian residents will be taxed on a branch equivalent basis under the CFC rules. A foreign unit trust held closely by Australian residents is subject to the FIF rules. A foreign limited partnership closely held by Australian residents is subject to normal partnership taxation.
67. An additional complication with the CFC rules relates to the classification of entities for which there is no domestic equivalent such as a foundation or *anstalt*.

### **Comparable Tax Exemption**

68. The net present effect of the rules is that there is an exemption for comparably taxed income which is based on the designation of a short list of closely comparable countries now known as listed countries and formerly known as broad exemption listed countries. These countries are USA, United Kingdom, Canada, New Zealand, France, Germany and Japan<sup>33</sup>.

69. There have not been any enumerated legislative criteria for the listing of countries as comparable tax countries. The Board of Taxation in February 2003 recommended that the Government develop and publish such criteria<sup>34</sup>. Although this recommendation has been accepted in principle the criteria have yet to be developed and promulgated by Treasury.
70. With respect to the scope of the comparable tax exemption one has to have regard to the fourteen items of eligible designated concession income that have been listed on a country by country basis. There have been some interesting and questionable inclusions. In order for any amount to be attributed it must be both tainted income and eligible designated concession income. In this context Australia should consider whether it is worthwhile policing specific tax concessions that are provided by largely comparable tax regimes and it is suggested that the availability of foreign tax concessions should not theoretically impact on the revenue collected in Australia.
71. The compliance benefits to taxpayers of listing a country should outweigh the upfront and administrative costs of listing, identifying and monitoring designated concession income and potential revenue risks. What then should be the criteria for designating a comparable taxation system? It has been suggested that the general statutory company tax rate should be not more than five percentage points below the Australian company tax rate. The income and profits of a corporation should be the basis upon which company taxation is levied. Furthermore passive income, tainted services

income and tainted sales income should be included in the income tax base of resident companies and branches without significant tax concessions when compared to relevant Australian treatment.

72. There should be evidence that the country's tax system has sufficient integrity by way of an effective and transparent tax administration which responds effectively to tax evasion and avoidance by legislative initiatives.
73. The tax administration of such a country should make readily available and disseminate on an ongoing basis adequate information and statistics from public sources with respect to the essential features of the operation and administration of the taxation system.
74. As to the existence of a double tax agreement with Australia the better view would appear to be that the non-existence of a treaty does not necessarily mean that the other country has a tax system which is neither sufficiently comparable to that of Australia nor transparent and effective. Furthermore the fact that Australia has entered into a double tax agreement with a country does not of itself indicate that there is sufficient comparability and transparency although without such attributes it is difficult to understand why the Australian Government would be minded to expend the time and effort and considerable resources involved in negotiating a treaty.
75. A question arises as to whether it is pertinent to consider the rate of dividend withholding tax ("DWT") in the context of a general downward trend in DWT rates.

76. Opinions differ markedly as to whether it is necessary that a country have a general anti-avoidance rule and/or a series of specific anti-avoidance rules.
77. A central issue is whether it is necessary that a country has a CFC and FIF regime or accruals taxation provisions similar to those in Australia and other OECD countries.
78. There can be little doubt that China and India will increasingly be the locations for huge amounts of investment from Australia. At present their income tax systems are not sufficiently comparable to that of Australia however a policy decision will have to be made in the not too distant future as to how any income accumulated in those countries which is presently caught by the CFC and FIF regimes is to be treated.
79. There has been an ongoing review of other countries including Singapore, Malaysia, South Korea, Italy, Spain and Taiwan.
80. With respect to Italy the company tax rate was reduced to 33% as from 1 January 2004 and it has completed a round of company tax reform aimed at improving its comparability with other western European nations. Italy has a CFC regime which was introduced in 2000 but it has abolished the imputation system, thin cap rules and a participation exemption.
81. Malaysia's corporate tax rate is 28% although certain companies with a smaller paid up capital benefit from a 20% tax rate. The maximum rate will be reduced to 27% in 2007 and 26% in 2008. As from 2004 all foreign

sourced income received in Malaysia by residents has been exempt from tax.

82. Australian investment into South Korea is significant and the corporate tax rate there is 27.5% as from 1 January 2005. There are rules prohibiting companies from tax haven activity and harsh penalties for tax evasion. There are some doubts about the system's transparency and the complexities of the system generally.
83. The corporate tax rate in Spain is 30% and its basic principles of corporate taxation are as for the rest of the European Union. The administration has comprehensive powers to collect information and impose significant penalties for tax evasion.
84. Australia's direct foreign investment into Taiwan is quite small and the corporate tax rate is 25%. The taxation system there is somewhat limited in scope.
85. Another country being considered is Chile where Australia has a fair amount of trade but the corporate tax rate is only 17%.
86. With respect to China there is a lack of available meaningful information and one understands that the tax system is undergoing rapid change and development and is still in an early and unsophisticated stage. Certain more serious offences attract capital punishment. At present it is doubtful

that Treasury could monitor the Chinese tax system sufficiently if it was a listed country.

87. The corporate tax rate in India is 35%. It would appear that tax evasion is a very significant problem in India which may be a reflection of the corruption of the officials. There has been a tendency in the past for the introduction of retrospective legislation which may be a disincentive to foreign investors. India has introduced a transfer pricing regime and is considering introduction of CFC and thin cap rules.
88. There is significant foreign direct investment in Singapore by Australian companies however the company tax rate is 20% and Singapore has a territorial system of levying taxation.
89. In a submission made to the Board of Taxation in 2002 KPMG<sup>35</sup> proposed a somewhat radical staged reform of the foreign source income rules (“FSI rules”). Stage one would provide a general exemption from the FSI rules for all income sourced in the seven listed countries. This would address about 75% by value of investment of Australian FSI issues. Stage two would extend the general exemption to all income sourced in countries on the initial BELC list. In this respect Australia would be relying upon that country’s foreign source income and related anti-avoidance rules to provide the integrity and comparability to that which would be expected under Australia’s rules. This would be a significant compliance cost saving and avoid duplication of similar attribution rules in those countries. Stage three

would examine and extend the general exemption to other countries considered to have comparable tax arrangements to the initial seven and those on the BELC list. This is a sensible course of action to adopt.

90. It is increasingly likely that Australia will undertake more trade in the Asian region and the Government needs to determine as a matter of policy whether investment by Australian companies in Asia should be encouraged notwithstanding that the tax regimes of these countries differ markedly from Australia. In this context it is necessary also to consider which countries are suitable candidates for the negotiation of double taxation agreements with Australia.
91. It may be sufficient that Asian countries have a comprehensive income tax base and a headline corporate tax rate that is say at least 80% of the Australian corporate tax rate. If such a country has a double tax agreement with Australia then there seems to be no particularly valid reason why the CFC rules should apply to investments in such countries.

### **Active Income Exemption**

92. Most countries exempt active income from attribution under the CFC rules.

The tainted income basket usually comprises:

- Passive income;
- Base company income that is income (sales and services income) diverted to a tax haven through related party transactions.

93. There are problems in identifying passive income particularly with respect to sophisticated financial instruments. There is a critical question as to whether base company income should be subject to attribution under the CFC rules having regard to the transfer pricing rules which are being enforced more rigorously; this is discussed further infra. It is notable that the Board of Taxation has recommended that both the tainted sales and tainted services income inclusions be repealed.

### **Active Business Test**

94. Consideration should be given to establishing a safe harbour measure based upon an active business test. Such a test could be based upon the equivalent test in the FIF regime or the capital exempt activities rule in the United Kingdom CFC provisions.

95. This test would provide that a CFC is exempt from attribution in a year of income if its assets are predominantly used to carry on an active business. One approach is to have a definition which excludes companies:

- whose predominant activity is the earning of passive income;
- which predominantly engage in providing services to or trading with an Australian resident controller or a resident associate of that controller.

96. Companies which are directly or indirectly holding companies for subsidiaries would satisfy this test as would companies that undertake

commercial share trading activities. It may be appropriate to superimpose a purpose test as appears in the equivalent United Kingdom provision.

97. The active business test should permit an active service business to be performed by a CFC provided that it has adequate commercial substance although of course there may be difficulty in delineating the parameters of commerciality and in differentiating between active and passive business activities.
98. In essence if the CFC conducts an active business then it should not be subject to attribution however if this is not the case then the income derived should be attributed and taxed with an offsetting foreign tax credit.

### **Base Company Income and Transfer Pricing Rules**

99. The generally accepted use of the term *base company income* is that it is active income being sales and services income which has been diverted to a tax haven or preferential tax regime through related party transactions thereby permitting what would otherwise be domestic income to become foreign income of a non-resident company.
100. The base company rules overlap with the transfer pricing rules which apply only if the Commissioner determines that they should apply; the CFC rules apply automatically. In the event that the Commissioner elects to apply the transfer pricing rules it is necessary to reconcile the two regimes in relation to the same transaction. Section 400 of *ITAA 1936* contains a

reconciliation rule which purports to give priority to the transfer pricing adjustment however there is a residual application of the CFC rules. To a large extent whether the CFC rules apply may depend upon whether the CFC adds value however it is not an all or nothing threshold as with the transfer pricing rules. The CFC rules are excluded if the CFC passes the substantial alteration test.

101. There are two sources of law relevant to transfer pricing in Australia being Division 13 of Part 3 of the *ITAA 1936* and the equivalents of Article 9 of the OECD Model Convention in the various double tax agreements to which Australia is party<sup>36</sup>. These agreements have the force of law in Australia pursuant to section 4(1) of the *International Tax Agreements Act 1953*. Whilst there have been decisions relating to the process adopted by the ATO in making transfer pricing adjustments there is no case law about the way in which the appropriate methodology to be applied should be determined.

102. By reference to a speech made by Commissioner Carmody in 2002<sup>37</sup> it appears that in the 3<sup>1</sup>/<sub>2</sub> years to 31 December 2001 the ATO made transfer pricing adjustments totalling over \$2 billion. In addition it established a formal program known as the *Transfer Pricing Record Review* which in its first four years of operation reviewed the documentation of over 400 taxpayers. In addition there has been a significant amount of audit activity in this field which is being conducted with continuing vigour.

103. There seems to be consensus that the ATO has been effectively enforcing the transfer pricing rules and thus a strong case can be made out for not including base company income in the CFC rules. Moreover the indiscriminate application of the transfer pricing rules to CFCs creates unnecessary compliance costs for Australian taxpayers.

## **FIF Regime**

### **Objects of FIF measures**

104. The FIF measures reflect several conflicting policy objections. First, they seek to prevent the avoidance of the CFC regime. In the absence of the FIF measures eleven or more unrelated Australian residents could establish a foreign company in a tax haven to accumulate passive foreign source income. It is apparent however that the FIF measures are intended to have a much broader application.

105. The second objective of the FIF regime, which encompasses the first objective, is to reduce the scope for the deferral of Australian tax or Australian residents investing in foreign entities that are outside the CFC and foreign trust rules. However, not all investments in foreign entities falling outside these rules are intended to be subject to the FIF measures. Only interests in foreign entities that are primarily passive have been targeted. Where Australian residents invest in foreign companies engaged in active business or invest in foreign property the FIF measures will not apply.

106. The third objective is by way of the limited application of the FIF regime to investments in primarily passive foreign entities reflecting a clear policy of permitting Australian residents to diversify their investment portfolios by making legitimate foreign investments either directly or indirectly through foreign companies engaged in active business.
107. It may be inferred that the Government did not intend to discourage Australian residents from acquiring interests in foreign companies and trusts but to ensure that such interests are taxed on a basis reasonably comparable to the taxation of interests in domestic entities.
108. As a final objective there was a clear desire to minimize compliance problems with taxpayers and administrative problems for the ATO. The Government recognized that many non-controlling Australian resident investors in foreign entities would not have access to much information concerning the underlying income of the entities. The extremely generous *de minimis* exemption and the stock exchange listing method for the active business exemption provide clear indications that the intention was to minimize compliance and administrative difficulties.<sup>38</sup>
109. In summary the essential purpose of the FIF measures is to counter the avoidance of paying tax in the current year of income as a result of holding substantial passive investments in non-resident entities. Specifically they seek to overcome the deferral advantage from escaping liability for Australian tax on a current basis where the income is never returned to

Australia and to deny the advantages arising from the conversion of lowly taxed or untaxed income of an entity into a tax exempt form, for example loans or more favourably taxed receipts like capital gains. The measures apply to any proprietary interest or right to acquire (see definition in section 488 of *ITAA 1936*) such an interest (as defined in section 483 of *ITAA 1936*) in a foreign trust or company or a life assurance policy issued by a foreign entity.

110. The FIF measures apply only if the resident's interest is held at the end of the year of income and the notional accounting period of the FIF ends during that year. The FIF provisions have caused funds managers to do wash sales on 30 June in each year disposing of their entire portfolio and reacquiring it rather than having to deal with the compliance burden of the FIF measures. This is as a result of the short term holding exemption contained in section 485 of *ITAA 1936*.

111. It is suggested that individual investors wanting to avoid tax would not invest through fund managers and therefore that the measures may be entirely wrongly targeted.

### **Shortcomings of FIF Regime**

112. There is anecdotal evidence which suggests that the FIF regime does not raise very much revenue. The response of Government is that the regime is a prophylactic measure that is, it is not there just to collect revenue directly but to deter people from setting up tax deferral arrangements and

thus change behaviour. It is suggested that the low amount specifically collected as FIF income is an indication that the regime is well designed and is working effectively. Needless to say it is difficult to contend otherwise in the self-assessment environment.

113. There are classification problems with the FIF regime in determining whether a company is principally engaged in eligible activities. Stock exchanges and services such as Bloombergs and the Standard and Poor's Index have approved classification systems. It is not helpful when the classification is "diversified financial services".
114. When one moves to the balance sheet test to determine whether more than 50% of the value of the company's assets and its subsidiaries are used in eligible activities there is usually very little information in the financial statements which enables an answer to this question to be given with a high level of integrity. There are further problems in understanding the nature and location of the activities of the subsidiary companies.

### **Portfolio Investment**

115. With respect to portfolio investment there is an enormous amount of analysis involved in identifying the true nature of the target company's activities. Funds managers typically will have one trust of offshore equities, one trust of Australian equities and one each of offshore bonds, Australian bonds, property and cash. A number of different products can be created

by unit trusts holding units in other trusts and building up several levels of trusts.

116. As the attributed income works its way up this chain of trusts through each trustee being presently entitled to a share of it until it reaches the ultimate beneficial unit holder, the attribution rules require an attribution account to be kept at each level. Each trust in which the ultimate beneficial owners hold units can have tens of thousands of unit holders leading to an equal number of attribution accounts. Each time one of these tens of thousands of investors redeems a unit or acquires a new unit there is a shift in the proportion that each of those investors own in each underlying investment of the company. There are tens of thousands of attribution account entries and in a large funds management structure this happens many times a day.

117. The focus on classification and attribution is on a single point in time namely the end of a tax payer's year of income and the suggested solution is to ensure that you do not own the offensive companies at that point in time. It is too risky to sell the shares at the end of the last trading day of the year and to buy them back at the beginning of the first trading day of the new year because there could be a significant market shift even overnight. Instead the solution is to sell the shares off-market giving up ownership across the critical point in time and later buy them back off-market from that same counterparty at the same price. There may be a fee payable to the counterparty for doing this and stamp duty considerations.

The ATO is aware of this mechanism and it has been noted in the minutes of the NTLG Foreign Source Income Subcommittee.

118. The 2004 NITA Reforms have increased the proportion of the exemption for offshore portfolios from a 5% to a 10% threshold.
119. There are significant taxpayer time and compliance costs in calculating the amount of FIF income because the regime applies to too wide a variety of foreign investments and imposes undue limitations on deductible losses.
120. The FIF regime is inconsistent with global trends in investment behaviour and acts as a significant disincentive to Australian investors availing themselves of the opportunity to invest overseas. In addition it makes Australia less attractive as a regional location for global fund managers and provides a competitive disadvantage.

### **Reform of FIF Regime**

121. Listed below are suggested “piecemeal” reforms of the FIF regime upon the assumption that it remains as a separate set of rules:
  - The FIF regime should apply only to trusts or entities which carry on passive investment activity which should not include investing in real property and hedge funds;

- The definition of “eligible activity” should be expanded to include fund management services as well as investment and real property in hedge funds;
- All FIFs which are resident in a listed country should be excluded from the regime;
- FIFs which are otherwise subject to a comparable or acceptable FIF accruals type tax regime in a foreign country should be excluded from the regime;
- FIFs which distribute a certain portion of income within a minimum period of time to its Australian investors should be exempted;
- Complying superannuation funds, life companies and registered management investment schemes should be exempted;
- It should be made clear that the FIF regime applies only where the CFC rules do not apply;
- The FIF regime should take precedence over other regimes which apply to trusts; and
- Funds which follow a widely recognized index such as the FTSE or Dow Jones should be exempted.<sup>39</sup>

## Deemed Present Entitlement Rules

122. An investment in a foreign trust is potentially subject to, in descending application, the FIF measures, the deemed present entitlement rules and then Division 6AAA of the 1936 Act.
123. It has been proposed that the FIF rules alone should apply to foreign fixed trusts except where foreign beneficiaries exist. In other words there is a strong case to be made for removal of the deemed present entitlement rules.
124. The effect of sections 96A to 96C of *ITAA 1936* is that if the FIF measures do not apply to an interest in the foreign trust in any year, the Australian resident beneficiaries of the trust must include in their assessable income for the year their share of the net income of the trust computed in accordance with Australian income tax law to which they are presently entitled. A beneficiary is considered to be presently entitled to any income distributed to the beneficiary in the year or within two months of the end of the year however this rule applies only if the beneficiaries of the trust are entitled to all of the trust's net income or if the trust distributes or allocates all of its net income to beneficiaries in the year or within two months of the end of the year. In any other case the beneficiary's share of the net income of the trust is that net income multiplied by the greater of the beneficiary's proportional entitlement (not present entitlement) to the income or capital of the trust.

125. The purpose of these provisions is the elimination of the benefit of deferral of Australian tax where an Australian resident beneficiary of a foreign trust has a vested right to the income or capital of the trust presently or at some future date. There are a number of difficulties which include that the provisions do not apply at all where the foreign trust is completely discretionary or where the interests of the Australian resident beneficiaries of the foreign trust are discretionary. With a completely discretionary trust the Australian resident beneficiary is taxed only on any distributions received from the trust.
126. A more fundamental difficulty is that it will often be impossible for Australian beneficiaries to compute their share of the net income of a foreign trust in accordance with Australian tax law and so such beneficiaries may prefer to be subject to FIF measures rather than be exempt from them.

### **Resident Public Unit Trusts**

127. There are serious difficulties in identifying the FIF interest in investment portfolios and in reporting accurately to investors about FIF income and losses, distributions and gains and losses on the disposal of FIF interests.
128. It has been suggested that the *de minimis* exemption for investors in resident public unit trusts should be withdrawn. Another suggestion is that resident public unit trusts should be taxed as companies or should be

allowed to sell any FIF interests before the end of each year and reacquire them after the beginning of the next year.

129. Trusts are often used to carry on an active business and indeed the use of trusts for certain business purposes is encouraged or required in some countries. Thus an interest in a foreign trust could be allowed to qualify for the active business exemption subject to certain criteria limiting the possibility of abuse. Consistent with this would be the creation of an exemption restricted to public unit trusts which are listed on an approved stock exchange. A blanket denial of the exemption to all interests in foreign trusts is too restrictive.

130. Perhaps the best way to eliminate the compliance problems for resident public unit trusts and other taxpayers is to narrow the scope of the FIF measures. Thus if the active business exemption is modified it should be possible for Australian investors, especially institutional investors, to avoid acquiring FIF interests. If there is to be no active business exemption then the adoption of a more generous *de minimis* rule for public unit trusts and other institutional investors should be given serious consideration.

### **Section 47A – Deemed Dividends**

131. The effect of section 47A(1) of *ITAA 1936* is to ensure that otherwise taxable dividends are not disguised as loans or other payments. The provision applies where a company, being a CFC resident in an unlisted country, has profits immediately before a distribution time and has made a

“distribution payment” after 30 June 1990 that would otherwise not be a dividend. The subsection deems the distribution benefit to be a dividend paid to the recipient as a shareholder out of profits at the distribution time, to the extent that the CFC had profits immediately before the distribution.

132. It is difficult to understand why it is that section 47A, which contains an exceedingly complex set of provisions, survived the 2004 NITA reforms whereby the amendments to section 23AJ of *ITAA 1936* permit the repatriation of participation dividends from both listed and unlisted countries.

### **Targeting Problem**

133. An essential problem is to identify the observable characteristics of a company with tax deferral. The fact that a company is based in a comparatively taxed country does not necessarily reveal very much. We do not know what is below the head company because there could be a wholly owned subsidiary in a tax haven enabling complete deferral.

134. In attempting to target tax deferral a more direct approach would be to analyse the profit and loss statement of a company and to enquire whether if a company’s tax expense divided by its accounting profit is high enough then that should be an indicator that there is no significant tax deferral.

135. The problem with this approach is that tax law does not place much faith in the integrity of reported accounting profits. Accounting profit can be quite a

different concept to the tax base used in Australia particularly from a timing point of view. The method of accounting for tax differs significantly around the world and in any event accounting profit can be quite illusory. Militating against this sceptical view about reported accounting profits are the stock exchange listing rules and the carrying out of independent audits as required by corporate regulators.

### **Statistical Issues**

136. The Board of Taxation<sup>40</sup> has concluded that the value of outbound foreign investment by Australian companies and other entities now exceeds that of inbound foreign investment. Furthermore a great deal of the outbound foreign investment is in the seven listed countries (approximately 80%) which have comparably based taxation systems.
137. So far as is known neither Treasury nor the ATO keep any statistics that reliably record what revenue is collected by the various accruals regimes. The only available information is to be gathered from examining individual tax returns. As already noted it is blandly stated that the amount of revenue collected is immaterial and indeed even if there be a relatively small amount of revenue collected this is not necessarily inconsistent with the measures being an effective deterrent.
138. It follows that it is not possible to demonstrate by any arithmetical or other meaningful calculation that there is a net benefit or detriment to the economy by reason of the present form and structure of the accruals

regimes. Whilst industry and commerce have loudly complained for many years about the substantial compliance costs for Australian entities investing overseas, which proposition is not seriously challenged by either Treasury or the ATO, once again there are no available figures upon which reliance can be placed.

## **Overview and conclusions**

139. The business of managing other people's money is a major financial activity around the globe and by world standards Australia has a sophisticated industry. Thus we have an opportunity to be a global or regional financial centre particularly in the Asian time zone.

140. Much of the criticism levelled at the CFC regime results from the unnecessary prolixity and complexity of the provisions dealing with the control and the superimposed substantial shareholder rules. A meritorious fundamental reform would be to permit entities to elect to be treated as a CFC and have their foreign source income calculated on a branch equivalent basis. The utility of such an election would depend of course upon whether the entity has access to sufficiently detailed financial information from the overseas venue to enable a branch equivalent calculation to be made. Where such financial information is available the control and substantial shareholder rules can be dispensed with.

141. Where an entity does not have access to sufficiently informative financial data then it will have to accept one of the available proxy methods of

valuation prescribed in the FIF regime that is to say market value or deemed rate of return.

142. It is well worth bearing in mind that the original concept for the FIF regime was an anti-avoidance measure as a backup regime and not as a set of rules that would provide a different framework from the CFC regime. It is a matter of much regret that the CFC and the FIF regimes were developed separately approximately three years apart.

143. The Australian CFC regime subjects to taxation Australian residents who are substantial shareholders in certain foreign companies and it was intended that the control and substantial shareholder rules delineate the border between attribution and deferral. The FIF regime targets any Australian resident who has an interest in a non-resident company that is not subject to the CFC regime.

144. The CFC regime has an exemption for active income and there is a complicated set of conditions and tests to pass in order to obtain this exemption. These include keeping recognized accounts and complying with substantiation requirements as provided by section 432 of *ITAA 1936* and passing the tainted income ratio prescribed by section 433 of *ITAA 1936*. There is a definition of gross tainted turnover in section 435 of *ITAA 1936* which picks up passive income and tainted sales and services income. By way of contrast the FIF regime prescribes an active business exemption by means of two methods. The first is the Stock Exchange

listing method using Stock Exchange categorization or international sectoral classification to establish a company's principal activity. The other method is the balance sheet method from which it should appear that at least 50% of the assets of a company are not for use and certain proscribed business activities.

145. There is a clear need for the CFC and FIF regimes to have an identical set of rules which exempt active business income. Neither of the present different systems are satisfactory however as already discussed in this paper one suggested solution is to compare the accounting profit and tax expense of an entity.
146. Another major reform should be that the exemptions for comparably taxed income should apply equally to the CFC and FIF regimes. It is neither coherent nor logical to have an exemption applying to the CFC regime for all comparably taxed income but not for the FIF regime. The only exception in the FIF regime is for certain U.S. comparably based taxation as a result of a great deal of political pressure applied by the U.S. Government to the Australian Government.
147. It is acknowledged that managing a large white list of comparably taxing countries can be time consuming and cumbersome however the Australian Government treaty network provides a mechanism whereby the essential integers of the countries with whom we have double tax agreements can be measured and analysed. With the exception of countries such as

Singapore and Malaysia, which have territorial based taxing rights, there should be a prima facie assumption that all of the countries with whom Australia have entered into double tax agreements have sufficiently comparable taxation systems.

148. In the paper there is discussion about what should constitute a list of criteria to determine whether a country has a comparable taxation system. There seems to be no good reason why Treasury cannot publish a list of criteria in the Income Tax Regulations which can be amended more readily than if forming part of the income tax laws.

149. There seems to be broad agreement that the deemed present entitlement rules at least so far as they apply to fixed unit trusts are not necessary. Such entities should be treated in the same way as companies as is the position in the U.S. and New Zealand.

150. A fundamental defect about attribution under the FIF regime is the measurement of the income of a FIF by the three specified surrogate methods being periodic movement in market value of the shares, the application of a statutory interest rate, or accounting profit. It is contended that these surrogate methods of measurement should apply only where a situation of non-control has been artificially constructed as is the position in Canada.

151. It should not be concluded that control of distribution policy is in all cases an effective indicator of whether the CFC regime should apply. Many

shareholders who have a significant interest in a company falling short of control should have access to the accounting records and financial statements of a company. This gets back to the argument about the election.

152. The transferor trust rules should be retained so as to capture the transfer of substantially valuable assets to a foreign trust.

153. This review of the anti-tax-deferral schemes will be considered against the background of a report issued by the Business Council of Australia on 14 December 2006 which has drawn attention to the statutory rate of taxation applied to corporate profits of Australian corporations as being the OECD average<sup>41</sup>. From a reverse perspective an important conclusion emanating from that report is that Australia's competitiveness as an investment destination for global capital is diminishing. In 1990 Australia had 4.1% of the total world inward foreign direct investment; in 2000 it decreased to 1.92%; in 2005 it stood only at 2.08%.

154. Australia's corporate taxation system has to be viewed in an overall context so that the proposed review of the anti-tax-deferral regimes is linked to what the headline corporate tax rate should be. The OECD average headline rate is 28.4% and the EU average is 24.8%. The average tax rate within the Asia Pacific region sits at 30.1%; this includes USA and Japan.

155. An interesting and sensible development is the initiative announced in the media by the Taxation Institute of Australia namely to suggest that the

draftsmen at the Office of the Parliamentary Counsel should consult directly with tax professionals to help design the laws so as to avoid the use of complex wording shrouded in mystery<sup>42</sup>.

156. It remains to be seen whether the Government has the political will to effect substantial reforms in this area. The drafting and implementation of any reforms will be a lengthy and time consuming process and will overlap the next scheduled Federal election. Exactly what would be the policy of an incoming Labour Government is not presently known.

157. A sceptical view is that any substantial reform and overhaul of the anti-tax-deferral regimes may be put in the too hard basket.

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C.C.Branson

24 January 2007

## Footnotes

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- <sup>1</sup> Taxation Review Committee, Full Report, Canberra, AGPS, at Chapter 17.
- <sup>2</sup> The Treasurer, Reform of the Australian Taxation System, Canberra, AGPS, 1985.
- <sup>3</sup> Review of Business Taxation, A Tax System Redesigned: More Certain, Equitable and Durable, AGPS, July 1999 (“Ralph Review”).
- <sup>4</sup> Ralph Review, supra note 1, at paragraph 32.45.
- <sup>5</sup> Ralph Review, supra note 1, at paragraph 32.46.
- <sup>6</sup> Ralph Review, supra note 1, at paragraph 32.50.
- <sup>7</sup> Ralph Review, supra note 1, at paragraph 32.55.
- <sup>8</sup> Ralph Review, supra note 1, at paragraph 32.58.
- <sup>9</sup> Ralph Review, supra note 1, at paragraph 32.59.
- <sup>10</sup> Ralph Review, supra note 1, at paragraphs 32.62 to 32.65.
- <sup>11</sup> OECD, International Tax Avoidance and Evasion: Four Related Studies OECD, 1987.
- <sup>12</sup> Gordon RA, Tax Havens and Their Use By United States Taxpayers – An Overview, US Department of The Treasury, 1981.
- <sup>13</sup> US Department of The Treasury, Tax Havens in the Caribbean Basin, 1984.
- <sup>14</sup> Gordon, supra note 10, at page 27.
- <sup>15</sup> OECD, Taxation and the Abuse of Bank Secrecy, 1987.
- <sup>16</sup> OECD, Survey of Taxpayers’ Rights and Obligations, 1990.
- <sup>17</sup> OECD, Tax Information Exchange Between OECD Member Countries: A Survey of Current Practices, 1994.
- <sup>18</sup> OECD, Harmful Tax Competition: An Emerging Global Issue, 1998.
- <sup>19</sup> OECD, Improving Access to Bank Information for Tax Purposes, 2000.
- <sup>20</sup> Ruchelman SC and Shapiro S, Exchange of Information (2002) 30 (No 11) Inter Tax 408, at 420.
- <sup>21</sup> OECD, Improving Access to Bank Information for Tax Purposes, 2003 Progress Report, 2003.
- <sup>22</sup> OECD, A Model Double Taxation Convention on Income and on Capital, 1977.
- <sup>23</sup> UN Model Double Taxation Convention Between Developed and Developing Countries, 1980.

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- <sup>24</sup> The Board of Taxation is an independent non-statutory body which advises the Government with respect to the development of tax legislation and the operation of the taxation system in Australia.
- <sup>25</sup> The Treasury, Review of International Tax Arrangements, Press Release No. 2002/21, 2 May 2002.
- <sup>26</sup> Treasury, Review of International Tax Arrangements: A Consultation Paper, Canberra, 2002.
- <sup>27</sup> Board of Taxation, A Report to the Treasurer, AGPS, 2003.
- <sup>28</sup> Treasurer, Review of International Tax Arrangements, Press Release No. 2003/32, 13 May 2003.
- <sup>29</sup> Section 23AJ of the Income Tax Assessment Act, 1936.
- <sup>30</sup> Lee Burns, Rethinking the Design of Australia's CFC Rules and the Global Economy, Bulletin for International Fiscal Documentation, July 2005, page 262.
- <sup>31</sup> Lee Burns, Reform of Australia's CFC Rules, (2006) 21 Australian Tax Forum, page 149.
- <sup>32</sup> Treasurer, Taxation of Foreign Source Income: A Consultative Document, Canberra, AGPS, 1988.
- <sup>33</sup> Section 320 of ITAA 1936 and Income Tax Regulations 1936, Schedule 10.
- <sup>34</sup> Board of Taxation, *supra* note 25, Volume 1, at page 87.
- <sup>35</sup> KPMG Submission, Board of Taxation, Review of International Taxation Arrangements, 31 October 2002.
- <sup>36</sup> OECD, *supra* note 20, Article 9.
- <sup>37</sup> Speech by Commissioner Carmody to American Chamber of Commerce, 14 March 2002.
- <sup>38</sup> Brian J Arnold, Report on the Implementation Issues Arising From the Foreign Investment Fund Legislation, 14 August 1992.
- <sup>39</sup> KPMG Submission, *supra* note 33, at pages 63 to 65.
- <sup>40</sup> Board of Taxation, *supra* note 25, Volume 2, at page 7.
- <sup>41</sup> Corporate Taxation, A Survey by the Business Council of Australia, 14 December 2006.
- <sup>42</sup> Australian Financial Review, 18 December 2006.