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## New International Tax Arrangements Bill 2003

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New International Tax Arrangements Bill 2003

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# New International Tax Arrangements Bill 2003

**Date Introduced:** 4 December 2003

**House:** House of Representatives

**Portfolio:** Treasury

**Commencement:** Royal Assent

## Purpose

The purpose of the Bill is to continue the program of modernisation of Australia's international tax system by reducing unnecessary tax compliance burdens for the superannuation and managed funds industries.

## Background

### A Brief Description of Some International Tax Issues

Australian taxation law contains foreign investment fund rules (FIF) which prevent tax avoidance that may occur through the deferral of Australian tax by those who accumulate 'passive income' (such as dividends and interest) and the conversion of such income to capital gains. FIF is designed to address the situation where such funds are accumulated by Australian taxpayers in low tax or tax-free countries. These rules are necessary but they can impose high compliance costs, especially for some Australian managed funds. There is scope for more flexibility in these rules to enable Australian managed funds and the superannuation industry to improve their competitiveness.

Businesses in Australia that seek finance from abroad are usually required to withhold a proportion of their interest payments and remit that amount to the Australian Taxation Office – a form of interest withholding tax (IWT). In some circumstances, companies—as distinct from unit trusts—can receive an exemption from IWT on certain loans. The managed funds industry tends to operate through unit trust structures and does not enjoy this exemption—unless a unit trust arranges to interpose a company which will undertake the borrowing of overseas loans and the payment of interest. There is scope for introducing uniform treatment in this area.

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Australian companies with offshore operations can operate through foreign corporate entities that they control. This has taxation implications in terms of the income or royalty derived by the controlled foreign company (CFC). Australian taxation law contains CFC rules that impose informational and compliance costs on Australian companies with operations offshore. The various categories of income and the taxation tests that can be subject to CFC rules have made compliance a burden for business in some cases. There is scope for some reform.

Australian taxation law has rules that deal with transfer pricing. Companies with overseas operations may sell property or services to each other. In doing so there is scope to artificially structure the pricing in such a way as to either lower assessable income or, alternatively, increase allowable deductions. The transfer pricing rules are necessary to counter tax avoidance and the rules authorise the adjustment of profits between related parties to reflect 'arm's length' dealings for taxation assessment. In certain circumstances, disallowance of certain claims imposes a withholding tax which in turn can result in double taxation. The issue of double taxation can be relieved, at present, for interest payments but not for royalty payments. There is scope to provide uniformity in the area of royalty payments.

## **The Government's policy commitment**

At the request of the Government, the Board of Taxation reviewed Australia's international taxation arrangements and the Board reported to the Treasurer on its findings on 28 February 2003.<sup>1</sup>

Budget 2003-2004, which was delivered on 13 May 2003, contained the following announcement about reforming Australia's international tax system:

### **Commonwealth Budget—Overview 2003-04**

Following the Review of Australia's International Taxation Arrangements, the Government is announcing a package of reforms that continues the Government's commitment to improve the international competitiveness of Australian business.

#### **Improving offshore competitiveness**

To maintain Australia's status as an attractive place for business and investment, the tax system needs to continually adapt to the increasingly integrated global business environment. With these issues in mind the Government undertook a Review of Australia's International Taxation Arrangements.

After an extensive consultation process conducted by the Board of Taxation, the Government is announcing its response to the review.

This package of reforms will help Australian business integrate further into the international economy by improving the competitiveness of Australian companies

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with offshore operations. It will also encourage the establishment in Australia of regional headquarters for foreign groups.

The reforms will

- reduce the compliance costs associated with the controlled foreign company rules
- reduce tax on certain forms of foreign business income and gains
- modernise Australia's tax treaty network
- better target the foreign investment fund rules.<sup>2</sup>

The Hon Ross Cameron MP, Parliamentary Secretary to the Treasurer, introduced this Bill on 4 December 2003 and announced that it follows the recent enactment of legislation to authorise a new comprehensive tax treaty with the United Kingdom.<sup>3</sup>

## Press commentary

On the broader issue of the reform of Australia's international tax laws, Allesandro Fabro writing in the *Australian Financial Review* on 9 May 2003, noted that business looked to the reforms as a step that would 'lower the cost of capital for Australian multinationals and reduce the incentives for them to move offshore'.<sup>4</sup> Fabro also commented:

A number of surveys in recent years has decried Australia's international tax regime as onerous and discouraging to offshore investment.<sup>5</sup>

## Main Provisions

### Schedule 1—Foreign investment funds

#### *Income Tax Assessment Act 1936 (the Act)*

Part XI of the Act deals with taxation liability on any share of income from certain foreign investment funds and foreign life assurance policies. Within Part XI is section 470 which provides relevant definitions. **Items 2 to 7** provide additional definitions that enable complying superannuation entities, certain assets of life insurance and certain fixed trusts to be exempted from the FIF rules in Part XI. A technical explanation of the new definitions is found at paragraphs 1.5 to 1.8 of the *Explanatory Memorandum* to the Bill. **Item 1** is a consequential amendment only.

**Item 8** inserts a new **Division 11A** into Part XI of the Act. This new Division contains **proposed new sections 519A and 519B** which provide the exemption mechanisms for

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certain foreign investment fund income, specifically, 'virtual PST—pooled superannuation trust—assets' (i.e. assets that support the complying superannuation business of life insurance companies), segregated exempt assets (i.e. assets that support annuity and pension business of life insurance companies) and interests held by complying superannuation entities. Cases study examples are provided in the *Explanatory Memorandum* at pages 10–11.

Division 14 of Part XI currently provides an exemption from the FIF rules where the taxpayer's otherwise non-exempt investment is no more than 5% of all the taxpayer's FIF interests. Non-exempt interests involve compliance costs. The threshold of 5% is lifted to 10% by **Items 9 to 13**. The aim of this proposed reform is to allow Australian investors greater flexibility in offshore portfolio diversification. The exemption is referred to as the 'balanced portfolio exemption'.

### **Schedule 2—Interest withholding tax exemption for certain unit trusts**

Schedule 2 provides a proposed exemption from IWT for interest paid to certain eligible unit trusts. An exemption is already available for companies. As noted above, the managed funds industry tends to operate through unit trust structures and does not enjoy this exemption. **Item 5** inserts a **new section 128FA** in Division 11A of Part III of the Act to enable unit trusts to be treated the same as companies. Division 11A deals with the liability to pay tax on dividends, interest and royalties paid to non-residents. **Items 1 to 4** and **Item 6** (day of application) are consequential amendments only.

### **Schedule 3—Attributable income of CFCs**

**Item 1** in Schedule 3 will enable regulations to define more precisely the type of income categories that can be attributed to CFCs. As noted above, the current more open-ended system can impose unnecessary informational and compliance burdens. The aim of the reform is to provide identification in the regulations of the type of income that is subject to compliance requirements.

### **Schedule 4—Preventing double taxation of royalties subject to withholding tax**

**Item 1** in Schedule 4 enables the Commissioner of Taxation to alleviate any likely double taxation under the transfer pricing rules in relation to royalty payments. As noted above, a current mechanism already exists to relieve certain interest payments covered by the transfer pricing rules from the potential for double taxation.

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## Endnotes

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- 1 A summary of the recommendations of the Board of Taxation's report on reforming Australia's international taxation arrangements and the Government's response can be found in the Media Release 'Review of International Taxation Arrangements' (No. 032), issued by the Treasurer, the Hon Peter Costello MP, and located on ParlInfo at: <http://parlinfoweb.parl.net/parlinfo/Repository1/Media/pressrel/NFC960.pdf>.
- 2 The *Commonwealth Budget–Overview 2003-04* can be found at the following web site: <http://www.budget.gov.au/2003-04/overview/html/overview-18.htm>.
- 3 The Hon Ross Cameron MP, Parliamentary Secretary to the Treasurer, Second Reading speech, New International Tax Arrangements Bill 2003, House of Representatives, *Debates*, 4 December 2003, p. 23767. The Bills Digest prepared by Brendan Bailey for the International Tax Agreements Amendment Bill 2003, which covers the new tax treaty with the United Kingdom, is at: <http://www.aph.gov.au/library/pubs/bd/2003-04/04bd041.htm> on ParlInfo. A more detailed summary of the recommendations of the Board of Taxation review's report on reforming Australia's international taxation arrangements can be found on ParlInfo at: <http://parlinfoweb.parl.net/parlinfo/Repository1/Media/pressrel/NFC960.pdf>.
- 4 Allesandro Fabro, 'Big business wins budget tax breaks', *Australian Financial Review*, 9 May 2003, p. 1.
- 5 *ibid.*

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