New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004
New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004

Bernard Pulle
Economics Commerce and Industrial Relations Section
12 May 2004
Contents

Purpose .................................................................................................................. 1

Background ......................................................................................................... 2

Main Provisions ................................................................................................ 3

Schedule 1- CGT concession for shares held by Australian holding companies or
controlled foreign companies in active foreign companies ............................ 3

Who and what shares will this measure apply to? ................................. 3

Meaning of voting percentages that an entity has in a foreign company? .. 4

What is the meaning of direct voting percentage? ................................. 4

What is the meaning of indirect voting percentage? ............................... 4

Reduction in Capital Gains and Losses from Certain CGT Events based on active
foreign business asset percentage (AFBAP) to total assets ......................... 5

Market value method for working out AFBAP .......................................... 5

Book value method for working out AFBAP ............................................. 5

Default method for working out AFBAP .................................................. 6

What are active foreign business assets of a foreign company? ............... 6

Assets excluded in working out AFBAP under proposed subsection 768-540(2) 7

Modifications of measures for working out total assets and active foreign business
assets for Australian Financial Institutions (AFI) ..................................... 7

Modifications of measures for working out the active foreign business asset
percentage for insurance companies ....................................................... 7
The following abbreviations and acronyms are used throughout this Bills Digest.

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFBAP</td>
<td>active foreign business asset percentage</td>
</tr>
<tr>
<td>ATO</td>
<td>Australian Taxation Office</td>
</tr>
<tr>
<td>CGT</td>
<td>capital gains tax</td>
</tr>
<tr>
<td>Consultation Paper</td>
<td>Treasury’s consultation paper, Review of International Taxation Arrangements</td>
</tr>
<tr>
<td>ITAA 1936</td>
<td><em>Income Tax Assessment Act 1936</em></td>
</tr>
<tr>
<td>ITAA 1997</td>
<td><em>Income Tax Assessment Act 1997</em></td>
</tr>
<tr>
<td>RITA</td>
<td>Review of International Tax Arrangements</td>
</tr>
<tr>
<td>the Board</td>
<td>Board of Taxation</td>
</tr>
<tr>
<td>the Board’s Report</td>
<td>Board of Taxation’s Report, International Taxation – A Report to the Treasurer</td>
</tr>
</tbody>
</table>
New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004

Date Introduced: 1 April 2004
House: House of Representatives
Portfolio: Treasury

Commencement: Formal provisions of the bill commence on Royal Assent. The various measures contained in the bill have various application dates, which are indicated in the Main Provisions section of this Bills Digest.

Purpose

There are 3 Schedules to the bill and the main purpose of each Schedule is set out below.

• Schedule 1 to this bill amends the income tax law to ignore capital gains and losses arising from capital gains tax (CGT) events happening to shares in foreign companies which are held either by Australian companies or by controlled foreign companies in certain, specified circumstances. Broadly, the gains or losses will be disregarded to the extent that the foreign company has an underlying active business.

• Schedule 2 to this bill extends the existing exemptions for branch profits earned in, and non-portfolio dividends paid from, certain listed countries to all countries. It also changes the existing classification of countries as broad-exemption listed countries, limited-exemption listed countries or unlisted countries to either listed or unlisted countries.

• Schedule 3 to this bill amends sections 448 and 450 of the Income Tax Assessment Act 1936 to reduce the scope of tainted services income. Tainted services income will, in general, no longer include income from services provided by a company to a non-resident associate, or the overseas permanent establishment of an Australian resident.

Generally, the purpose of the measures in the bill is to improve the international competitiveness of Australian companies.

*Warning:* This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments. This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
Background

1. On 2 May 2002 the Treasurer announced details of a review of international tax arrangements (RITA) concentrating on at least four principal areas:

   - the dividend imputation system's treatment of foreign source income,
   - the foreign source income rules,
   - the overall treatment of 'conduit income', and
   - high level aspects of Double Tax Agreement (DTA) policy and processes.

2. The consultation paper titled – Review of International Tax Arrangements – Consultation Paper was released by Treasury on 19 September 2002. This paper explored a range of international tax issues that may affect the attractiveness of Australia as a place for business and investment and identified options for consultation to be conducted by the Board of Taxation.

3. After extensive public consultation the Board of Taxation reported to the Treasurer on 28 February 2003. This report was titled – Review of International Tax Arrangements: A Report to the Treasurer.

4. On 13 May 2003, the Treasurer released the report of the Board of Taxation and announced the Government's response. To enable public consultation to be undertaken on the design of legislation, including addressing integrity issues, the Treasurer announced that the majority of reforms will not commence until 1 July 2004 or later. It was also announced that the package will be introduced in tranches. The Explanatory Memorandum to the bill states that following on from a new tax treaty with the United Kingdom and the New International Tax Arrangements Bill 2003, the measures contained in this bill are a further substantial instalment of those reforms.

5. The New International Taxation Arrangements Bill 2003 was introduced into the House of Representatives on 4 December 2003. The Bill passed the House of Representatives on 4 March 2004 and was introduced into the Senate on 10 March 2004. The Bill has been referred to the Senate Economics Legislation Committee for inquiry and report by 12 May 2004.

Warning:

This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.

This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
Main Provisions

Schedule 1- CGT concession for shares held by Australian holding companies or controlled foreign companies in active foreign companies

Item 3 of Schedule 1 of the Bill which will insert proposed Subdivision 768-G provides a reduction in capital gains and losses from CGT events in relation to non-portfolio interests of an Australian holding company or a controlled foreign company in active foreign companies. The gain or loss is reduced by a percentage called the active foreign business asset percentage (AFBAP) under proposed subsection 768-505(2) that reflects the degree to which the assets of the foreign company are used in an active business. In the case of a controlled foreign company, the rules will apply in the calculation of the controlled foreign company’s attributable income under Part X of the ITAA 1936.

Who and what shares will this measure apply to?

Proposed section 768-505 provides that the Australian holding company of a share in a foreign resident company must satisfy the following tests to be eligible for the CGT reduction in proposed Subdivision 768-G:

(a) the holding company must hold a direct voting percentage of 10% or more in the foreign resident company when the CGT event happens; and

(b) the requisite share interest was held by the holding company for a continuous period of at least 12 months in the two years before the CGT event; and

(c) the share in the foreign resident company must not be an eligible finance share or a widely distributed finance share as defined in Part X of the ITAA 1936.

The Explanatory Memorandum states in paragraphs 1.37 and 1.38 that the requirement in relation to minimum shareholding and minimum period of holding are included to ensure that the relief is limited to structural holdings of the Australian company and not to mere temporary investments in a foreign resident company. Further, it adds that the intention of this measure is to allow companies to restructure their foreign structural holdings without being overburdened by Australian tax considerations.

The Explanatory Memorandum in paragraph 1.22 states that an eligible finance share or a widely distributed finance share are excluded as such shares are in substance the equivalent of debt and the relief measure is intended for equity interests.
Meaning of voting percentages that an entity has in a foreign company?

Proposed section 768-550 and proposed section 768-555 provide definitions of direct voting percentage and indirect voting percentage respectively that an entity may have in a foreign company. There is also a definition of total voting percentage in proposed section 768-560 as being the sum of the direct voting percentage and indirect voting percentage.

What is the meaning of direct voting percentage?

The direct voting percentage that an entity has in a foreign company follows section 160AFB of the ITAA 1936 under proposed paragraph 768-550(1)(a). It is equal to the voting interest it holds in that foreign company as a percentage of the voting power of that company. However, proposed subsection 768-550(2) modifies the application of section 160AFB by providing that an entity is not the beneficial owner of a share in a foreign company if a trust or a partnership is interposed between the entity and the trust. In consequence, where a trust or a partnership is so interposed, proposed paragraph 768-550(1)(b) provides that the direct voting percentage is zero.

What is the meaning of indirect voting percentage?

An entity’s indirect voting percentage in a subsidiary company as defined in proposed subsection 768-555(1) provides for a situation when there is one or more interposed intermediate companies or a chain of intermediate companies between the entity and the subsidiary.

The indirect voting percentage is worked out by multiplying:

(a) the entity’s direct voting percentage in an intermediate company:

by:

(b) the sum of:

(i) the intermediate company’s direct voting percentage in the subsidiary; and

(ii) the intermediate company’s indirect voting percentage in the subsidiary

Proposed subparagraph 768-555(1)(b)(ii) states that in determining the intermediate company’s indirect voting percentage it should be worked out under one or more other applications of proposed section 768-555 in an attempt to avoid the circularity of this definition.

Warning:
This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.
This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
Reduction in Capital Gains and Losses from Certain CGT Events based on active foreign business asset percentage (AFBAP) to total assets

Proposed Subdivision 768-G sets out the manner in which the AFBAP is to be worked out. It offers the holding company the option of two methods to work out the AFBAP under proposed section 768-515. The options available are the market value method provided in proposed subsection 768-510(2) or the book value method provided in proposed section 768-510(3). Failure to qualify for these options will result in the application of a default method set out in proposed subsection 768-510(4).

Market value method for working out AFBAP

The market value method can be chosen if there is sufficient evidence of the market value at that time of the CGT event of:

(i) all assets included in the total assets of the foreign company at that time; and

(ii) all active foreign business assets of the foreign company at that time.

This requirement is set out in proposed paragraph 768-510(2)(b).

The method statement to work out the AFBAP for the market value method is set out in proposed section 768-520. The reader should refer to paragraphs 1.70 to 1.78 of the Explanatory Memorandum to the bill for further explanations and examples of the application of the market value method to determine the AFBAP.

Book value method for working out AFBAP

The book value method can only be adopted if there are recognised company accounts of the foreign company as provided in proposed subsection 768-510(3). A definition of the expression ‘recognised company accounts’ will be inserted into section 995-1(1) by item 17 of Schedule 1. Under this definition the recognised company accounts of a foreign company are accounts that are prepared in accordance with:

- the accounting standards prepared by the responsible body in Canada, France, Germany, Japan, New Zealand, United Kingdom (UK) or United States of America (USA), or the international accounting standards; or
- commercially accepted accounting principles that give a true and fair view of the financial position of the foreign company.

The reader should refer to paragraphs 1.79 to 1.98 of the Explanatory Memorandum to the bill for further explanations and examples of the application of the book value method to determine the AFBAP.

Warning:
This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.
This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
Default method for working out AFBAP

The default method prescribes the value of the AFBAP in proposed subsection 768-510(4) and varies depending on whether it is to be applied to a capital gain or capital loss. In the case of a gain, the AFBAP will be 0% and the amount of the gain will be fully taxable. In the case of a loss, it will be 100% and the full amount of the capital loss will be disregarded.

The Explanatory Memorandum in paragraph 1.102 states that the default rule is an integrity measure that aims to prevent a company that has made a capital loss from gaining a benefit just because it has chosen not to calculate the AFBAP under the market value method or the book value method.

What are active foreign business assets of a foreign company?

Proposed sections 768-540 and 768-545 provide a definition of active foreign business assets of a foreign company and which is broadly based on existing definitions in the income tax law of ‘tainted asset’ in section 317 of the ITAA 1936 and ‘active asset’ in section 152-40 of the ITAA 1997.

The following conditions must be satisfied for an asset to be classified as an active foreign business asset of a foreign company.

(a) The asset must be included in the total assets of the company. (proposed paragraph 768-540(1)(a))

(b) The asset must be one of three kinds of assets.

(i) the asset must be used or ready for use in the course of carrying on a business;

(ii) the asset is goodwill;

(iii) the asset is a share. (proposed paragraph 768-540(1)(b))

(c) The asset is not a CGT asset which has the necessary connection with Australia. (proposed paragraph 768-540((1)c))

(d) The asset must not be an excluded asset as defined in proposed subsection 768-540(2). (proposed paragraph 768-540(1)(d))

(e) The asset is not covered by proposed subsection 768-540(4) where the foreign company is an Australian financial institution (AFI) subsidiary. (proposed paragraph 768-540(1)(e)).

Warning:
This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.
This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
Assets excluded in working out AFBAP under **proposed subsection 768-540(2)**

The assets specifically excluded from the definition of active foreign business asset under **proposed subsection 768-540(2)** include financial instruments, certain types of shares, interests in a trust or partnership, life insurance policies, rights or options to certain assets, cash or cash equivalent and assets deriving passive income.

These exclusions are generally based on provisions in tax law dealing with the distinction between active and not active assets or income. Assets whose main use in the course of carrying on business is the derivation of passive investment income such as interest, an annuity, rent, royalties or foreign exchange gains are specifically excluded from the definition of active assets under **proposed paragraph 768-540(2)(g)** except where:

(i) the asset is an intangible asset and its market value has been substantially enhanced through development, alteration or improvement to the asset; or

(ii) the main use for deriving rent was temporary.

**Modifications of measures for working out total assets and active foreign business assets for Australian Financial Institutions (AFI)**

The measures in the Bill provide for the modification of the rules for working total assets and active foreign business assets of AFI subsidiaries in recognition of the fact that financial institutions hold, trade in and dispose of certain financial instruments as part of their active rather than mere passive investment activities. The modifications provide for derivative assets to be included in total assets under **proposed section 768-545** and certain financial instruments to be included in active business assets under **proposed paragraphs 786-540(1)(e) and proposed subsection 768-540(3)**. **Proposed paragraphs 768-540(1)(e) and 768-545(1)(c) and subsection 768-540(3)** provide that the modified rules for working out total assets and active foreign business assets will apply to AFI subsidiaries whose sole or principal business is financial intermediary business. The meaning of both AFI subsidiary and financial intermediary business is the same as the meaning in Part X of the ITAA 1936.

**Modifications of measures for working out the active foreign business asset percentage for insurance companies**

The calculation of the active foreign business asset percentage for foreign life and foreign general insurance companies is modified taking into account the special regulatory and solvency requirements for insurance companies. The calculation of the active foreign business asset percentage for both life insurance and general insurance companies is modified in **proposed section 768-530**.

---

**Warning:**

This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments. This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
In the case of life insurance companies, the value of active foreign business assets is modified to include the value of non-active assets held to meet untainted insurance policy liabilities (proposed subsections 768-530(3) and (4)). Untainted insurance policies are insurance policies that do not give rise to tainted services income. The insurance policies that do give rise to tainted services income are those where the owner of the policy is an Australian resident.

For general insurance companies, the value of active foreign business assets is modified to include the value of non-active assets that relate to untainted outstanding claims of the company (proposed subsections 768-530(3) and (4)). Untainted outstanding claims are so much of the outstanding claims of the company at the end of the statutory accounting period that are referable to general insurance policies that do not give rise to tainted services income of the company of any statutory accounting period.

The reader is referred to paragraphs 1.178 to 1.213 of the Explanatory Memorandum for further details of the modifications for insurance companies.

**Modifications for foreign wholly owned groups to determine the foreign business asset percentage on a consolidated basis**

Where the determination of the active foreign business asset percentage involves a tier of foreign companies the calculation may be done on a consolidated basis for wholly-owned companies comprising or within that tier of companies. One calculation is performed for the top foreign company in the wholly-owned group that also covers all its 100% owned foreign subsidiary companies. Proposed subsection 768-535(2) gives the holding a choice to calculate the active foreign business asset percentage of the top foreign company on a consolidated basis. However, proposed paragraph 768-535(1)(b) provides that this choice cannot be made if the top foreign company of the wholly-owned group is:

- an AFI subsidiary
- a foreign life company; or
- a foreign general insurance company.

The use of consolidated accounts reflects the principle that within a wholly-owned group, internal transactions, and particularly internal debt and equity funding, should not affect the extent to which the foreign company being disposed of is considered to have an underlying active business.

**Warning:**

*This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.*

*This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.*
Application

The measures relating to the reduction in capital gains and losses arising of non-portfolio interests in active foreign companies apply to CGT events happening on or after 1 April 2004 (Schedule 1, item 1), the date of introduction of the bill.

Schedule 2 – Foreign branch income, non-portfolio dividends and listed countries

The measures in Schedule 2 expand the current exemptions for foreign branch profits and foreign non-portfolio dividends received by Australian companies. It also effects changes to the definition of ‘listed country’.

Foreign branch income exemption

Currently, resident companies do not include in assessable income certain foreign branch income and certain capital gains derived from a business carried on through a permanent establishment in a listed country. The amounts are not assessable and are not exempt income under section 23AH of the ITAA 1936. Non-assessable non-exempt income as defined in section 6-23 of the ITAA 1997 is not assessable income and is not taken into account in working out a taxpayer’s taxable income for an income year. As the amount is also not exempt income, it is not taken into account in working out a taxpayer’s tax loss for an income year or in working out how much of a prior year tax loss is deductible in an income year.

Further, a resident company may be a partner in a partnership or beneficiary of a trust that has a permanent establishment in a foreign country (there may also be several interposed partnerships and trusts between the resident company and the partnership or trust). In such circumstances, similar amounts of foreign branch income and capital gains, derived from a business carried on through the permanent establishment, are also not included in assessable income to the extent of the company’s indirect interest in that income or those gains.

Item 1 of Schedule 2 will repeal section 23AH and substitute proposed new section 23AH. The new section provides an exemption to a resident company for most foreign income and gains derived through a foreign permanent establishment in either a listed or unlisted country. The exemption will also continue to be available to resident companies that are partners in a partnership or beneficiaries of a trust (or where there are several interposed partnerships and trusts). The exemption applies to the extent of the company’s indirect interest in the amounts derived through the permanent establishment.

Warning:
This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.
This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
Foreign non-portfolio dividends

Non-portfolio dividends paid from a company resident in a listed country are currently not included in the assessable income of resident company recipients under section 23AJ of the ITAA 1936. Some dividends paid by a company resident in an unlisted country may also not be included where the dividend is paid out of profits that were taxed in a listed country. Division 6 of Part X of the ITAA 1936 (about exempting receipts, profits and profits percentage) provides a mechanism for this, particularly for dividends paid by companies resident in unlisted countries. Non-portfolio dividend as defined in section 317 of the ITAA 1936 means a dividend paid to a company where that company has a voting interest amounting to at least 10% of the voting power. It does not include a finance share dividend or a widely distributed finance share dividend.

The policy underlying section 23AJ and Division 6 of Part X was to exempt comparably taxed profits upon distribution to a resident company. The Treasurer’s announcement in Press Release No. 32 of 13 May 2003 removed the comparable tax requirement, thus allowing an exclusion from assessable income for all non-portfolio dividends. To give effect to this policy change Item 4 of Schedule 2 repeals section 23AJ and substitutes proposed new section 23AJ. Item 57 of Schedule 2 repeals Division 6 of Part X.

Foreign tax credits

A foreign tax credit is generally available under Division 18 of Part 111 of the ITAA 1936 where a resident entity includes foreign income in its assessable income and foreign tax was paid on its foreign income. The foreign tax credit was intended to avoid double taxation. As all non-portfolio dividends will be excluded from assessable income under the proposed measures there will be no double taxation of such income and foreign tax credits for underlying foreign company tax now available under section 160AFC of the ITAA 1936 will no longer be required. Item 37 of Schedule 2 repeals section 160AFC.

The repeal of section 160AFC will have impacts on several other provisions which are discussed together with the consequential amendments in paragraphs 2.72 to 2.93 of the Explanatory Memorandum to the bill.

Listed countries

The current provisions relating to the exemption of foreign branch income require that it must be subject to tax in a listed country. Income taxed in a listed country generally means that the foreign income is considered to have been comparably taxed to income derived in Australia. Currently, listed countries as defined in subsection 320 of the ITAA 1936 fall into two classes: broad-exemption listed countries and limited-exemption listed countries. Broad-exemption listed countries are countries with very similar income tax systems to Australia while limited-exemption listed countries are countries with broadly comparable income tax systems to Australia. Items 85 and 86 of Schedule 2 repeal the definitions of

Warning:
This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.
This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
broad-exemption listed country and limited-emption listed country in subsection 320(1) of the ITAA 1936. Item 87 repeals the definition of listed country and substitutes a new definition in subsection 320(1) of the ITAA 1936. Under the proposed definition a listed country means a foreign country, or a part of a foreign country, that is declared by the regulations to be a listed country for the purposes of Part X of the ITAA 1936 dealing with controlled foreign countries.

Comparison of key features of new law proposed by Schedule 2 and current law

<table>
<thead>
<tr>
<th>Current law</th>
<th>New law</th>
</tr>
</thead>
<tbody>
<tr>
<td>A foreign non-portfolio dividend paid to a resident company out of comparably taxed profits is not assessable income.</td>
<td>All foreign non-portfolio dividends paid to Australian companies are not assessable income.</td>
</tr>
<tr>
<td>Some non-portfolio dividends paid to a controlled foreign company may be attributed to an Australian shareholder.</td>
<td>Non-portfolio dividends paid to a controlled foreign company are no longer attributed to Australian shareholders.</td>
</tr>
<tr>
<td>Foreign branch profits derived by a resident company from a comparably taxing country are generally exempt from Australian tax. There is no active income test for branches in broad-exemption listed countries and no income earned in branches in unlisted countries is exempt.</td>
<td>Active foreign branch income derived by a resident company in any foreign country will be non-assessable income. Only tainted income will ever be assessable and that will depend on the branch failing an active income test in all cases.</td>
</tr>
<tr>
<td>Foreign tax credits are available for foreign underlying company tax deemed to be paid by a resident company that receives an assessable foreign dividend from a related foreign company.</td>
<td>There will be no foreign tax credit for underlying tax paid on profits from which dividends are paid.</td>
</tr>
</tbody>
</table>

Warning:
This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.
This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
<table>
<thead>
<tr>
<th>Current law</th>
<th>New law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 458 directly includes in the assessable income of an attributable taxpayer a non-portfolio dividend paid from a controlled foreign company in an unlisted country to another controlled foreign company in a listed country which doesn’t tax the dividend. It also applies to certain other dividends.</td>
<td>Section 458 is repealed.</td>
</tr>
<tr>
<td>Section 459 directly attributes deemed dividends paid directly or indirectly between some controlled foreign companies to their Australian shareholders.</td>
<td>Section 459 is repealed but in some cases the deemed dividend may be counted as part of the attributable income of a controlled foreign company.</td>
</tr>
</tbody>
</table>
| An attributable taxpayer’s assessable income includes:  
  - unrealised gains accumulated on all assets; and  
  - all distributable profits, where a controlled foreign company changes residence from an unlisted to a listed country. | An attributable taxpayer’s assessable income will include only:  
  - unrealised gains accumulated on tainted assets; and  
  - adjusted tainted income other than non-portfolio dividends, where a controlled foreign company changes residence from an unlisted to a listed country. |
| The controlled foreign companies rules, dividend rules and branch profits rules apply differently depending on the country concerned. Countries are classified as either broad-exemption listed countries, limited-exemption listed countries or unlisted countries. | Countries are either listed or unlisted. The unlisted category includes countries previously classed as limited-exemption listed countries. The listed class consists of those previously called broad-exemption listed countries. The previous limited-exemption listed country list is used for one provision only. |

Source: Explanatory Memorandum at the end of paragraph 2.12

**Warning:**
This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.

This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
Application

- The expanded exemption for foreign branch profits applies to income years commencing on or after 1 July 2004 (Schedule 2, item 140(1)).

- The expanded exemption for non-portfolio dividends apply to dividends paid after 30 June 2004 (Schedule 2, item 140(2)).

- The changes to the classification of countries and the definition of a listed country apply to income years and statutory accounting periods commencing on or after 1 July 2004 (Schedule 2, item 140(3)).

Schedule 3 – Tainted services income

The controlled foreign companies rules include in the taxable income of an Australian taxpayer, the taxpayer’s share of the specified income (known as attributable income) of a non-resident company in which they have a controlling interest. The income targeted for attribution is income that can readily be shifted offshore by taxpayers to non-resident companies that they own or control, to take advantage of any lower tax rates offshore.

One category of attributable income is called tainted services income. Tainted services income is, in general, income from services provided by a company to an Australian resident or to an associate of the company (including non-resident associates). It also includes income from services provided to a non-resident in connection with a business carried on by the non-resident through a permanent establishment in Australia.

The measures in Schedule 3 reduce the scope of tainted services income without altering the tainted services concept. The amendments in item 1 of Schedule 3 repeal existing paragraph 448(1)(a) and substitutes proposed new paragraph 448(1)(a) which generally removes from the scope of tainted services income, the income a company derives from providing services to non-resident associates.

The removal of services provided to non-resident associates from tainted services income is applied consistently to the treatment of insurance premium income and relevant Australian financial institution subsidiary income by amendments proposed by items 3, 4, 7, 8 and 9 of Schedule 3.

Application

The amendments apply to statutory accounting periods of companies beginning on or after 1 July 2004 (Schedule 3, item 10).

Warning:

This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments. This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
Concluding Comments

Economic benefits of the measures in the Bill

The economic benefits resulting from implementing the measures in the Bill are set out in paragraphs 4.22 to 4.26 of the Regulation Impact Statement which is Chapter 4 of the Explanatory Memorandum to the Bill. These are set out below for ease of reference.

CGT relief for disposal of a non-portfolio interest in a foreign company with an active business – Schedule 1 amendments

This measure will align more closely the tax treatment of selling an interest in a foreign company (that has an active business) with the tax outcome that would result if the foreign company disposed of its active foreign business assets and distributed those profits to its shareholders. In other words, there will be no liability to Australian tax if an Australian company (or its controlled foreign company) sells a non-portfolio interest in a foreign company or if the Australian company (or its controlled foreign company) procures the foreign company to sell its active assets and distribute those profits as a dividend.

This will increase flexibility in corporate restructuring decisions, and will provide an exemption to Australian companies similar to what is currently available in many European countries. This will ensure that Australian companies are not at a competitive disadvantage when they seek to invest offshore, and will encourage foreign groups to establish a regional headquarters in Australia.

Extension of the exemption for non-portfolio dividends and certain foreign branch profits to all countries – Schedule 2 amendments

The measure will assist Australian companies investing in foreign countries to be more competitive with foreign counterparts, as they will not be required to pay additional Australian tax on foreign active business income. It will also remove income tax impediments for companies who distribute profits from countries not currently eligible for an exemption, but who will benefit from the extended exemption.

The substantial compliance cost savings for companies will also provide economic benefits.

Modified application of the tainted services income rules – Schedule 3 amendments

The measure will allow Australian multinationals to better compete internationally, with negligible risk to the tax base. It will also provide a more neutral treatment of services provided to group companies by offshore group service centres. Achieving these outcomes will increase Australia’s ability to retain and attract multinationals and regional headquarter operations.

Warning:
This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.
This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
Financial impact of the measures in the Bill

The costs to revenue of the measures contained in the Bill are summarised from information provided in the Explanatory Memorandum, as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. CGT relief for disposal of a non-portfolio interest in a foreign company with an active business – Schedule 1 amendments</td>
<td>The financial impact of this measure is not quantifiable</td>
<td>The financial impact of this measure is not quantifiable</td>
<td>The financial impact of this measure is not quantifiable</td>
<td>The financial impact of this measure is not quantifiable</td>
</tr>
<tr>
<td>2. Extend exemption for non-portfolio dividends and certain branch profits to all countries – Schedule 2 amendments</td>
<td>Nil (a)</td>
<td>Nil (a)</td>
<td>-$30 million (a)</td>
<td>-$55 million (a)</td>
</tr>
<tr>
<td>3. Modified application of the tainted services income rules Schedule 3 amendments</td>
<td>Nil (b)</td>
<td>Nil (b)</td>
<td>-$10 million (b)</td>
<td>-$10 million (b)</td>
</tr>
</tbody>
</table>

However, the Regulation Impact Statement (RIS) in Table 4.3 titled - Taxpayers affected by measures in the bill - refers to the lack of complete data relating to taxpayers affected by measures in the bill. This would appear to cast doubts on the accuracy of the estimates in rows 2 and 3 of the above table. The reservations in the RIS are set out in paragraphs (a) and (b) below:

(a) Extending the exemptions for non-portfolio dividends and certain foreign branch profits to all countries will potentially impact on all companies considering substantial investments offshore. It is not known how many companies will be affected.

*Warning:* This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments. This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.
(b) The modified application of the tainted service income rules will primarily benefit Australian resident taxpayers with controlled foreign companies or overseas branches that provide services to non-resident associates. A reliable estimate of the number of overseas permanent establishments of Australian companies is not available given current data holdings.

Endnotes

5 Explanatory Memorandum to the New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004, p. 3.