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Tax Laws Amendment (Foreign Source Income Deferral) Bill (No. 1) 2010

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Law and Bills Digest Section

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Tax Laws Amendment (Foreign Source Income Deferral) Bill (No. 1) 2010

Date introduced: 13 May 2010

House: House of Representatives

Portfolio: Treasury

Commencement: **Sections 1–3**, and **Parts 1 and 3 of Schedule 1** commence on Royal Assent; **Part 2 of Schedule 1** commences retrospectively immediately after the commencement of Schedule 1 to the *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006*.[1]

Links: The links to the Bill, its Explanatory Memorandum and second reading speech can be found on the Bills page, which is at http://www.aph.gov.au/bills/. When Bills have been passed they can be found at ComLaw, which is at http://www.comlaw.gov.au/.

Purpose

The Bill repeals the foreign investment fund provisions and the deemed present entitlement rules in the *Income Tax Assessment Act 1936* (ITAA 1936) as part of a general review of the accruals taxation system.[2] The rules will be replaced with a more narrowly defined anti-avoidance rule that targets Australian residents' foreign source income while also encouraging Australian investment in foreign investment funds.

Background

There are three main types of rules in the accruals taxation system: the foreign investment fund (FIF) measures; the transferor trust measures; and the controlled foreign company (CFC) rules. As the Bill only deals with the FIF measures (and the related 'deemed present entitlement' (DPE) rules for foreign trusts), the discussion in this Digest will be confined to those rules.

1. Schedule 1 to the *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006* commenced on 14 September 2006.

2. The accruals taxation system is designed to 'tax Australian residents on an accruals basis on their share of income derived by foreign entities which has not been comparably taxed offshore': *Australian Master Tax Guide*, 46th edition, 2010, ¶21–105. The latest consolidation of the ITAA 1936 is available electronically at http://www.austlii.edu.au/au/legis/cth/consol_act/itaa1936240/, viewed 26 May 2010.

Foreign investment fund (FIF) measures

A FIF is a foreign company or a foreign trust. The FIF provisions are contained in Part XI of the ITAA 1936 (sections 469 to 624), which deals solely with 'foreign investment funds and foreign life assurance policies'. The FIF provisions are designed to reduce tax avoidance opportunities and apply to Australian residents who accumulate passive income in offshore investment funds over which they have no control (often in low tax or tax-free countries). The FIF provisions are intended to reduce the opportunity for Australian resident investors to minimise or defer the payment of Australian taxation on those foreign source earnings (particularly if the taxpayer is able to convert the income into capital gains).[3]

The FIF measures apply to a taxpayer who was an Australian resident at any time in a particular income year and had an interest in either a FIF at the end of the income year (or at any time during the income year) or an interest in a foreign life assurance policy (FLP) at any time during that income year. However, instead of the usual income year period, a taxpayer may elect to use the period covered by the FIF's annual accounts as a notional accounting period (noting that the financial or income years of many countries do not commence on 1 July and therefore do not issue the necessary financial statements on 30 June each year).[4] If the taxpayer was an Australian resident for the whole of the income year (or the notional accounting period), the taxpayer's assessable income (for Australian income tax purposes) must include the whole of the FIF income which accrued to the taxpayer during that period. If the taxpayer is an Australian resident for only part of the income year (or notional accounting period), only a proportion of the taxpayer's FIF income is included in the taxpayer's assessable income.[5]

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3. *Australian Master Tax Guide*, op. cit., ¶21–360 and ¶21–370. See also Treasury, *Review of International Taxation Arrangements*, Treasury website, 6 September 2006, viewed 26 May 2010, http://www.treasury.gov.au/content/int_tax_review.asp?ContentID=760&titl=Review%20of%20International%20Taxtion%20Arrangements and http://www.treasury.gov.au/documents/881/PDF/RITA_Glossary.pdf. Note that there are a number of exemptions from the FIF measures, such as where a taxpayer acquires an interest in an employee share scheme and the interest is in a FIF (section 503A of the ITAA 1936); where the foreign company is principally engages in eligible activities (sections 495 to 501 of the ITAA 1936); and where the taxpayer has an interest in a publicly listed company that is principally engaged in authorised banking business (section 503 of the ITAA 1936).

4. Alternatively the taxpayer may elect to use the period which coincides with the end of the month for which the cash surrender value of the interests in a FLP is available on an annual basis. See sections 486 and 487 of the ITAA 1936.

5. See section 529 of the ITAA 1936, which sets out when/how FIF is to be included in a taxpayer's assessable income.

The taxpayer's FIF income is calculated by one of three methods:[6] the market value method;[7] the deemed rate of return method;[8] or the calculation method.[9] The taxpayer's FIF amount must be converted into Australian currency before being included in the taxpayer's assessable income.[10]

Deemed present entitlement (DPE) rules

Other legislative measures apply to prevent the deferral of Australian tax on trust income accumulated in a non-resident trust for the benefit of an Australian resident beneficiary. If an Australian resident taxpayer has a beneficial interest in a non-resident trust, the

6. Section 469 of the ITAA 1936.

7. The *market value method* uses the quoted market value for the interest from an approved stock exchange. If there is more than one quoted market value (for example, where the stock is quoted on more than one approved stock exchange), the taxpayer may choose which stock exchange quotation is to be used. The taxpayer must continue to use that exchange for as long as practicable. If no quoted market value is available, the taxpayer must use either the deemed rate of return method or the calculation method. See section 539 of the ITAA 1936, which sets out how market value is ascertained.

8. The *deemed rate of return method* is more complicated than the market value method. It depends on whether the taxpayer holds only one interest in the FIF (in which case the interest forms a group), or whether the taxpayer holds more than one interest (in which case one must first determine if the interests are similar in character and can be grouped for calculation purposes). The deemed rate of return method is then applied to each group of interest separately. The taxpayer's FIF amount is calculated using the formula: opening value × deemed rate of return ÷ number of days held (divided by 365). The 'deemed rate of return' is basically the General Interest Charge (GIC) determined under section 8AAD of the *Taxation Administration Act 1953* less three percentage points. See sections 543 to 557 of the ITAA 1936 (being Subdivision C of Division 18 of Part XI of the ITAA 1936).

9. The *calculation method* is only used if the taxpayer elects to use it. Only interests held by the taxpayer at the end of the notional accounting period are taken into account. The calculation method involves determining (from the FIF's notional income, including gross income and capital profits/gains) if the FIF has made a net profit or loss. Where there is a calculated loss, the taxpayer's share may be carried forward to later notional accounting periods. The method is based on the formula: calculated profit × attribution percentage (which is the greatest of the taxpayer's rights to receive income or capital (as opposed, for example, to voting rights) or to participate in the company's decision making) × number of days the taxpayer has held the interest (divided by the total number of days in the notional accounting period). See sections 557A to 583 of the ITAA 1936 (being Subdivision D of Division 18 of Part XI of the ITAA 1936).

10. The rate of exchange to be used is the rate that applied on the last day of the notional accounting period—unless the taxpayer has elected to calculate the individual components of FIF income in Australian currency. See sections 533A, 538, 542, 556, 559, 593 and 600 of the ITAA 1936, all of which require FIF amounts and income to be expressed in Australian currency.

'deemed present entitlement' rules apply. The taxpayer is deemed to be presently entitled to any income of the trust which can be legally available for distribution to the taxpayer (under the trust deed and relevant law), even though the trustee may not actually be able to distribute the income at the relevant time.[11] The taxpayer is assessed to pay tax on his or her share of the net income of the trust.[12]

Basis of policy commitment

The Government announced its intention to reform the foreign source income anti-tax-deferral (attribution) rules in the 2009–10 Budget.[13] The announcement follows a lengthy review by the Board of Taxation (the Board) of the foreign source anti-tax-deferral regimes. The review was initiated by the Howard Government on 10 October 2006 and involved targeted consultations and a discussion paper that was released on 25 May 2007. The Board also released a position paper and several issues papers too. Finally, in September 2008, the Board released its report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs.[14]

In relation to the FIF provisions, the Board recommended that the FIF provisions be repealed and replaced with 'specific anti-roll-up fund measures targeting accumulation funds that reinvest interest-like returns'.[15] It also recommended that closely held fixed

11. The beneficiary may also be deemed to be presently entitled to the income even though under the terms of the trust, the beneficiary is actually only entitled to have money applied for his or her benefit (rather than having the money paid directly to him or her): See *Australian Master Tax Guide*, op. cit., ¶6–100, and *Sacks v Gridiger* (1990) 90 ATC 4299; (1990) 22 NSWLR 502 (available electronically at http://law.ato.gov.au/atolaw/view.htm?dbwidetocone=05%3ALRP%3ASupreme%20Court%3A1990%3ASacks%20v.%20Gridiger%20-%20(1%20January%201990)%3A%23001%23Judgment%20by%20McLelland%20J.%26c%3B, viewed 27 May 2010).

12. Sections 96B and 96C of the ITAA 1936. For further explanation, see *Australian Master Tax Guide*, op. cit., ¶6–155.

13. Australian Government, *Budget measures: budget paper no. 2: 2009-10*, Commonwealth of Australia, Canberra, 12 May 2009, p. 23, viewed 25 May 2010, http://www.budget.gov.au/2009-10/content/bp2/download/bp2_Consolidated.pdf

14. Board of Taxation, *Review of the Anti-Tax-Deferral Regimes*, website, viewed 26 May 2010, http://www.taxboard.gov.au/content/anti_tax_deferral.asp and Board of Taxation, *Review of the Foreign Source Income Anti-Tax-Deferral Regimes: Report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs*, September 2008, viewed 26 May 2010, http://www.taxboard.gov.au/content/anti_tax_deferral/downloads/anti_tax_deferral_report_to_minister.pdf

15. Board of Taxation, *Review of the Foreign Source Income Anti-Tax-Deferral Regimes: Report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs*, op. cit., p. 2 (Recommendation 1).

trusts should be brought into the controlled foreign company (CFC) rules and that the deemed present entitlement rules should be repealed.[16]

The Board's recommendations demonstrate a desire to increase Australia's attractiveness as a financial services hub (by enhancing Australia's offshore investment and encouraging Australian businesses to be more productive and competitive) and reduce compliance costs for the managed funds industry and other investors. In this regard, the Board commented:

> The reforms proposed by the Board will ensure Australia has a world-class attribution regime and that the reformed rules keep abreast of changes occurring in the global business environment. The proposals will provide significant scope to reduce red-tape and compliance costs while maintaining the integrity of Australia's tax base. In particular:
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> - The recommendations will have a positive impact on Australia's offshore investment performance and enhance the productivity of Australian businesses and improve their international competitiveness.
> - The managed funds industry and other investors affected by the FIF rules will achieve significant reductions in compliance costs. This is consistent with the Government's commitment to develop Australia as a financial services hub and to cut red-tape.
> - The modernisation of the active/passive definitions will benefit Australian businesses operating offshore by reducing their compliance costs and improving their competitiveness and productivity in global markets.
> - The repeal of the FIF rules in conjunction with the relocation of the CFC rules into the [*Income Tax Assessment Act 1997*] will provide scope to both simplify the tax law and take a significant step towards consolidating the two income tax Acts.[17]

On 18 December 2009, Senator Nick Sherry (Assistant Treasurer) released exposure draft legislation for public consultation.[18] The Treasury received eight written submissions but

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16. Ibid.

17. Ibid., pp. 15–16. Although they were also announced in the 2009–10 Budget, the reform of the CFC rules (and also the transferor trust rules) recommended by the Board are yet to occur. See Australian Government, *Budget measures: budget paper no. 2: 2009-10*, op. cit., p. 23. In mid-May 2010, the Treasury said that 'these measures will be introduced into Parliament as soon as practicable together with a specific anti-roll-up fund rule that was also announced by the Government as part of these reforms'. See Treasury, *Tax Laws Amendment (Foreign Source Income Deferral) Bill (No.1) 2010: Summary Of Consultation Process*, Treasury website, mid-May 2010, p. 1, viewed 25 May 2010, http://www.treasury.gov.au/documents/1699/PDF/Consultation_Summary.pdf and Senator N Sherry (Assistant Treasurer), *Bill to Repeal Foreign Investment Fund and Deemed Present Entitlement Rules to Slash Compliance Costs*, media release, no. 106, 13 May 2010, viewed 28 May 2010, http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/106.htm&pageID=003&min=njsa&Year=&DocType= As at the date of writing, such legislation is yet to be introduced.

also conducted consultations and discussions with key stakeholders and interested parties, most of whom support the repeal of the FIF provisions.[19]

Committee consideration

On 13 May 2010, the Senate Selection of Bills Committee resolved to recommend that the Bill not be referred to a committee.[20]

Financial implications

The Government estimates that the financial impact of the repeal of the FIF measures is 'unquantifiable but not significant'.[21] It also estimates that there will be 'overall medium' compliance cost savings to affected taxpayers compared with compliance costs under the current rules. In this regard, the Government estimates that there will be a start-up cost impact of between $40 million and $80 million, offset by a decrease in ongoing compliance costs of between $40 million and $80 million per annum.[22]

Main provisions

Item 7 repeals existing section 23AK of the ITAA 1936 and substitutes **proposed section 23AK** in its place. Both provisions are intended to prevent double taxation in relation to amounts paid out of attributed FIF income. Such amounts are exempt from taxation to the extent of any attribution surplus in the relevant FIF attribution account. The revision to section 23AK is consequential upon the repeal of the FIF rules. **Proposed section 23AK** will ensure that amounts previously taxed under the FIF rules will continue to be exempt from further taxation if it is further distributed.

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18. Senator N Sherry (Assistant Treasurer), *Release of Draft Legislation to Repeal Foreign Investment Fund Rules*, media release, no. 117, 18 December 2009, viewed 25 May 2010, http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/117.htm&pageID=003&min=njsa&Year=&DocType=

19. Treasury, *Tax Laws Amendment (Foreign Source Income Deferral) Bill (No.1) 2010: Summary Of Consultation Process*, op. cit. All eight submissions are available on the Treasury's website at http://www.treasury.gov.au/contentitem.asp?ContentID=1732&NavID=066, viewed 25 May 2010.

20. Selection of Bills Committee, *Report No. 7 of 2010*, 13 May 2010, viewed 28 May 2010, http://www.aph.gov.au/Senate/committee/selectionbills_ctte/reports/2010/report0710.pdf

21. Explanatory Memorandum, Tax Laws Amendment (Foreign Source Income Deferral) Bill (No.1) 2010, p. 3.

22. Ibid.

Similarly, **item 7** also inserts **proposed section 23B** which deals with the situation where the income of the FIF has been attributed but not distributed before the disposal of the taxpayer's interest in the FIF. It largely replicates current section 613 of the ITAA, which ensures that proceeds from a capital gain are reduced where the taxpayer has an attribution surplus in relation to the particular FIF.[23]

Item 9 repeals current sections 96A, 96B and 96C of the ITAA 1936. Section 96A is intended to avoid double Australian taxation in relation to foreign source income derived under a FIF. It specifically excludes from the assessable income of a presently entitled Australian resident beneficiary of a non-resident trust, the beneficiary's share of net income of a trust which is otherwise attributable under the (current) FIF measures. As mentioned earlier in this Digest, sections 96B and 96C set out the deemed present entitlement rules.

Item 37 repeals Part XI of the ITAA 1936 in its entirety.

The balance of the items in **Schedule 1** to the Bill makes consequential amendments to the ITAA 1936, the *Income Tax Assessment Act 1997* and the *Superannuation Industry (Supervision) Act 1993*. Some of these provisions warrant some discussion here.

Item 49 amends Division 230 of the ITAA 1997, which deals with the taxation of financial arrangements (unless specific exceptions apply). Currently, Division 230 does not apply to interests in FIFs (including CFC interests) and foreign life assurance policies. However, following the proposed repeal of the FIF rules, Division 230 needs to be amended so interests in FIFs are no longer exempt from its operation. The 'direct participation interests' of an attributable taxpayer in a CFC will continue to be exempt from the operation of Division 230.

Under current section 559A of the ITAA 1936, a taxpayer may (provided certain conditions are met) elect to have his or her FIF income calculated by using the CFC provisions in Part X of the ITAA 1936.[24] Following the repeal of section 559A (as part of the general repeal of Part XI of the ITAA 1936), **item 62** amends existing section 768 of the ITAA 1997 to ensure that taxpayers can continue to take advantage of the election.[25]

23. Section 613 of the ITAA 1936 is available electronically at http://www.austlii.edu.au/au/legis/cth/consol_act/itaa1936240/s613.html, viewed 28 May 2010.

24. The text of section 559A is available electronically at http://www.austlii.edu.au/cgi-bin/sinodisp/au/legis/cth/consol_act/itaa1936240/s559a.html, viewed 28 May 2010.

25. The text of section 768-553 is available electronically at http://www.austlii.edu.au/au/legis/cth/consol_act/itaa1997240/s768.533.html, viewed 28 May 2010.

Items 75–78 amend sections 830-10 and 830-15 of the ITAA 1997. These provisions treat certain partnerships and companies as foreign hybrids, with the result they are taxed like partnerships. The amendments are required following the repeal of section 485AA of the ITAA 1936, which deals with the right of taxpayer to elect to exclude interests in foreign hybrids from the operation Part XI of the ITAA 1936.[26] The Explanatory Memorandum provides two useful examples of the operation of the revised provisions.[27]

26. See **item 37** of **Schedule 1** to the current Bill (which repeals Part XI of the ITAA 1936). The text of current section 485AA of the ITAA 1936 is available electronically at http://www.austlii.edu.au/au/legis/cth/consol_act/itaa1936240/s485aa.html, viewed 28 May 2010. See also **item 96** of **Schedule 1** to the current Bill, which provides that despite the repeal of current subsection 485AA(1) of the ITAA 1936, elections made under that provision continue to have effect as if the repeal had not happened.

27. Explanatory Memorandum, op. cit. p. 14.