BTR/Section23 -

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23

IMPROVING AUSTRALIA'S INTERNATIONAL TAX REGIME

Identifying some important issues to be reviewed

Recommendation

23.1 Review of foreign source income rules

That there be a comprehensive review of the foreign source income rules.

Against the Review's timeframe, the breadth of other business tax proposals has precluded a detailed examination of the foreign source income rules (although the Review has proposed certain changes it considers have the necessary priority). These rules comprise the controlled foreign company (CFC), transferor trust, foreign investment fund (FIF) and related measures. They are complex and require further review before comprehensive recommendations can be made. A summary of the foreign source income rules is provided on pages 680-682 of *A Platform for Consultation*.

A number of submissions raised policy issues relating to the CFC measures. For example, more liberal capital gains rollover relief was sought for corporate reorganisations involving CFCs. Such policy issues could be examined as part of the recommended review.

A number of submissions sought a review of the underlying objectives of the FIF measures and questioned whether the measures are achieving those objectives. The review could consider:

- problems with the active business exemption in the FIF measures discussed in *A Platform for Consultation* (pages 666 and 674-675), and related issues raised in submissions;
- taxing interests in closely held fixed trusts under the CFC measures (page 688); and
- allowing the active business exemption in the FIF measures for interests in widely held fixed trusts (page 676) and limiting the availability of the market value method for trust FIFs (page 677).

The review could also consider changes to the rules in the transferor trust measures for dealing with deceased estates (pages 678-679 and 691-692) and for further rules to deal with hidden trusts (pages 679 and 692-693).

Some changes relating to foreign trusts have been recommended elsewhere in advance of a comprehensive review as a consequence of the entity tax regime, to reduce compliance costs and complexity in the law, and to minimise tax avoidance through the use of foreign trusts.

Recommendation

23.2 Further review of Australia's international tax regime

That the following aspects of Australia's international tax regime be reviewed subject to the indicated objectives.

Record keeping

(a) To encourage compliance in relation to international transactions:

(i) record keeping requirements in the law be consolidated and streamlined; and

(ii) penalty levels reflect a business's efforts to keep appropriate documentation to verify income and deductions.

Payments to tax havens

(b) Deductions be disallowed for, or withholding tax be levied on, payments made to tax havens where the purpose of the payments cannot be verified because of the unavailability of all relevant information.

Source rules

(c) Existing source rules be consolidated in the tax law, subject to:

(i) a general source principle providing that income is to be sourced in Australia to the extent such income derives from:

- **functions performed in Australia,**
- **assets located or used in Australia, or**
- **risks assumed in Australia;**

(ii) the place where a contract is concluded being disregarded for source purposes; and

(iii) a specific source rule providing that, where a non-resident carries on business in Australia through a permanent establishment:

- **the foreign source income attributable to that permanent establishment be subject to assessment in Australia; but**
- **this rule not apply to collective investment vehicles (CIVs).**

Foreign funds management entities

(d) The treatment of distributions from foreign funds management entities be developed consistent with Australia's objectives for international taxation of portfolio investment and with the flow-through treatment of domestic CIVs (see Recommendations 16.1 to 16.3).

The Review has made firm recommendations in a significant number of international tax areas. These provide the basis for a more internationally competitive tax system. However, business has cautioned against proceeding too quickly on some aspects of the international tax issues raised in *A Platform for Consultation*.

Furthermore, there are a number of topics currently being debated and developed in the OECD that will not be finalised for some time. Business is concerned about the potential for double taxation to arise and also does not want Australia to pre-empt developments in areas such as taxation of new technologies (for example, electronic commerce) and the application of separate entity treatment to branches.

Record keeping

Record keeping requirements were discussed in *A Platform for Consultation* (pages 709-710). It proposed that Australia attempt to co-ordinate record keeping requirements with those of our major trading partners, particularly the United States. Consultation and submissions noted that the US rules were quite onerous and should not be used as a basis for record keeping purposes in Australia. The objective is to ensure that appropriate records are kept and that the ATO can access them without imposing undue costs on business.

Payments to tax havens

In the case of many tax havens, bank secrecy and other laws prevent revenue authorities from verifying that payments made to tax havens for expenditure purported to be incurred in the haven are in fact for the claimed purpose (for example, services rendered) and are not returned to the person making the payment or to an associate of that person.

The objective is to ensure that records are available to support the claimed purpose of payments to tax havens. Legislation could provide for the disallowance of a deduction or the imposition of withholding tax in circumstances where all the records are not available to support the economic purpose of the payment to the tax haven or where the dealings between Australia and the tax haven entity are not transparent.

The United States provides for the Secretary of the Treasury to treat certain interest payments as subject to the United States' higher levels of withholding

tax where the interest is paid to a person in a foreign country that the Secretary determines in writing has inadequate exchange of information arrangements with the United States.

Determining whether a country is a tax haven for this purpose could rely on the criteria that the OECD is to use in listing tax havens for the purpose of its Harmful Tax Competition project.

Statutory source rules

Two options were proposed in *A Platform for Consultation* (pages 698-700) for providing clearer rules to determine the source of income. Option 1 was a general rule taking into account particular factors. Option 2 involved specific rules for particular situations. Submissions generally considered that an approach combining Options 1 and 2 was preferable. Submissions expressed concern that source rules should not involve added complexity or be developed independently of an international consensus on such rules (developed through an organisation such as the OECD).

The objective of the general source principle is to ensure that Australia gets a fair share of tax that reflects its commercial and economic contribution, in terms of value added in Australia, to an entity's profits. It will provide greater certainty than the current inconsistent common law rules primarily by specifying that the source of income should not be based on the place where a contract is made. Specific rules may still be required for particular situations to increase certainty.

Establishing a specific rule relating to the foreign source income of permanent establishments is consistent with the approach taken for business profits in Double Tax Agreements. Such a rule would have the effect of overriding paragraph 23(r) of the *Income Tax Assessment Act 1936*. This subsection provides that the income of a non-resident from sources outside Australia is not subject to Australian tax. The provision has already been specifically overridden by the current Foreign Bank Branch measures and the rule would clarify the interaction between the Source Article in our Double Tax Agreements and paragraph 23(r).

As a result, income derived from sources outside Australia, but reflecting the economic contribution made by the branch in Australia to the entity's foreign source income, will be taxed in Australia. An example would be if a US entity has a permanent establishment in Australia and employees of that establishment secure loans or sell goods in a third country without setting up a permanent establishment in that third country. As the income reflects the activities of the employees of the Australian permanent establishment, Australia should tax that income.

This approach is taken in the OECD Model Tax Convention, Australia's tax treaties, and the US. In many countries the income would not be assessed because it reflects the activities of the permanent establishment in Australia, rather than a permanent establishment in the source country. However, if the income was taxed at source, a mechanism to relieve double tax will be provided. Currently the Foreign Bank Branch measures allow for foreign taxes to be deducted from the assessable income of the branch in such situations.

The rule will not apply to CIVs as the activities undertaken by these investment vehicles are highly mobile and do not give rise to a sufficient connection with Australia to warrant Australia having a taxing right over this income.

Foreign fund management entities

Providing comparable treatment for foreign funds management vehicles was raised in *A Platform for Consultation* (pages 673-674).

Recommended flow-through taxation arrangements for resident collective investment vehicles will allow Australian investors to continue to claim credits for foreign tax paid on amounts derived through these vehicles. Credits would, however, cease to be available under entity taxation for foreign underlying tax paid on amounts derived by Australian portfolio investors through foreign funds managers operating through trusts.

This outcome reflects that it is possible to provide flow-through treatment for certain resident vehicles based on them meeting strict requirements, including that they are widely held (see Recommendations 16.1 and 16.2). However, it is not possible to impose the same requirements on foreign vehicles. If foreign funds management trusts were exempted from the entity regime, they could operate at an advantage over resident CIVs because they would not be subject to the same regulatory requirements. Furthermore, there would be a substantial risk to the integrity of the entity regime if 'closely held' foreign trusts inadvertently qualified for flow-through taxation due to the difficulty in ensuring that only funds management vehicles qualified for flow-through taxation.

Recommendation

23.3 Rewrite and redesign of international tax legislation

That other areas of the international tax legislation be rewritten and redesigned:

(i) in accordance with the integrated design process recommended by the Review; and

(ii) as part of the forward work program for business taxation, as also recommended by the Review.

Substantial redrafting and redesign of the international tax legislation is required as part of the simplification strategy. Such redrafting and redesign is necessary as the relevant provisions were not dealt with by the Tax Law Improvement Project. This strategy should be cognisant of the Review's international tax recommendations, and the recommended comprehensive review of the foreign source income rules. It should also be conducted in consultation with affected parties.