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Further International Tax Reforms

One of the more welcome announcements in the May 2005 Budget was the decision to remove the rules which limit the utilisation of foreign losses and which require the allocation of foreign tax credits against separate classes of income. The tax community has waited with growing impatience to see this announcement turned into legislative form. After more than 2 years delay, the Government introduced a Bill (“**the Bill**”) to give effect to this announcement on 21 June, the last sitting day of the Winter session. The tax community will have to wait a little longer for the new rules to commence – the new measures will not start until 1 July 2008 at the earliest.

1. Background

Under current law, taxpayers are not able to apply foreign losses against domestic source income. Further, taxpayers are required to subdivide quarantined foreign losses into 4 separate classes; a foreign loss in each class can be carried forward and utilised in future years only against foreign income of the same class. The implication of the Budget announcement was that, in future, the only relevant question would be the capital / revenue character of a loss, and the further dimensions – whether the loss is foreign or domestically sourced, and what class of foreign loss was it – would cease to be relevant.

It is also necessary at present for taxpayers to calculate foreign tax credits (“**FTCs**”) separately for the various classes of foreign income. The ability of taxpayers to use FTCs in excess of the Australian tax payable on the foreign income of each particular class is restricted. The implication of the Budget announcement was that, in future, the only relevant question would be the total amount of foreign income and foreign tax, with the potential impact of allowing a faster rate of utilisation of FTCs for certain taxpayers.

The Bill introduced into Parliament delivers these proposals. It –

- repeals the existing law which quarantines foreign losses;
- replaces the foreign tax credit system with a re-written and re-named “foreign income tax offset” regime; and
- enacts some further international proposals.

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2. Foreign losses

2.1 New rules

For resident taxpayers, the Bill repeals the existing law which quarantines foreign losses and divides them into 4 classes. As a consequence of this change, the existing election which allows taxpayers to apply domestic losses to reduce foreign income will also be repealed.

Another corollary of this change is that the requirement to ascribe a source to various kinds of deductions will arise less often. It will still be necessary to ascribe a source to deductions that contribute to earning foreign income that is exempt, such as foreign branch income, and some kinds of non-assessable non-exempt income, but not if the income is assessable. Further, even though the need to allocate deductions to ascertain whether there is a loss may arise less often, it will still be necessary to allocate deductions for the purposes of calculating the cap on the amount of tax offset available for foreign income tax.

The Bill also slightly modifies the operation of the loss rules for controlled foreign companies (“CFCs”). Losses incurred by CFCs will still be held offshore in the CFC – that is, the CFC’s loss cannot be used directly to reduce the taxable income of its resident shareholders. But the calculation of the attributable income of a CFC will be changed by these rules:

- CFCs will not have to classify their losses into 4 classes; and
- CFCs will be able to apply a revenue loss against a capital gain. (CFCs, like other taxpayers, will continue not to be able to apply a capital loss to reduce revenue gains.)

2.2 Commencement and transition

The new regime commences for the income year that starts on or after 1 July after the Bill receives Royal Assent. So, assuming the Bill is passed by Parliament in the Spring session this year, and receives Royal Assent shortly thereafter, the new regime will commence for determining the taxable income or tax loss for most taxpayers for the 2008-09 income year.

The next question is, what happens to existing quarantined foreign losses at that date? Unhappily, these losses are not “un-quarantined” on 1 July 2008. Instead, the transition from the old system involves a highly complex transitional calculation. In general terms, this regime accumulates quarantined foreign losses at the commencement of the new regime and allows them to be recovered at the rate of up to 20% per year over the next 5 years, assuming the taxpayer has sufficient income in each year to absorb 1/5th of the loss. If the taxpayer has insufficient income in any year to absorb the available 20%, the deficiency is added to the 20% that can be deducted in a later year. If all quarantined losses have not been recovered after 5 years, the balance is then “un-quarantined.”

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A separate, and similarly complicated regime, is created for unconsolidated entities with foreign quarantined losses that join a consolidated group, and bring quarantined foreign loss with them. This regime attempts to marry the 20% system to the available fraction regime for transferred losses. (Entities that leave one consolidated group and join another will leave their foreign losses with the former group.) No special rules are provided for consolidated groups with quarantined foreign losses at the start of the new system – they are simply dealt with under the standard regime.

A *de minimis* concession allows a taxpayer to deduct a quarantined foreign loss without restriction if it is less than \$10,000, or if the taxpayer elects to deduct only \$10,000 and abandon the remainder.

3. Foreign income tax offset

3.1 Foreign income tax offset

The Bill re-enacts the FTC system, now named the “foreign income tax offset.” The foreign income tax offset removes the former FTC classes as expected.

In an unexpected move, the drafter has taken the opportunity to re-write this legislation in its entirety. The re-write addresses some of the existing problems in the FTC system, but it can be safely predicted that the changes in terminology will introduce some new and unintended issues. In addition to the unintended changes, several aspects of the FTC system policy have been deliberately changed in the re-written provisions. The Bill also formalises many of the current “administrative fixes” that the Australian Taxation Office has adopted over the years in a multitude of tax rulings to make the FTC system work properly.

Many of the basic elements of the foreign income tax offset system are the same as the existing FTC system:

- The tax offset is available for foreign tax on amounts included in Australian assessable income.
- A tax offset is only available for foreign income taxes. Some taxes will not qualify as income taxes, and the Bill retains the current exclusion for a credit absorption tax or unitary tax. The Explanatory Memorandum (“EM”) to the Bill states that a tax offset is available for national income taxes, sub-national income taxes, and even supra-national income taxes – it gives the example of income taxes paid to the EU. The Bill also continues the existing reversal of the offset if the foreign tax is subsequently refunded or is otherwise reimbursed to the taxpayer.
- The amount of tax offset is limited to the greater of the amount for foreign tax paid or the Australian tax payable.

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- The foreign tax must be one which the taxpayer has paid or, in some cases, borne. Current law expresses this requirement in a rule that the tax must be one for which the taxpayer was “personally liable.” According to the EM, the Bill removes this additional requirement because it is unnecessary – a simpler formula will achieve what is required, namely, that a person who pays tax in a representative capacity is not entitled to the tax offset. Other provisions in the Bill provide that a person who has borne the cost of tax imposed by law on, and paid by, another, or paid by another under an arrangement, will be entitled to the tax offset.

There are, however, a series of express changes to the former system. For the most part, these changes either relax current rules which limit access to the FTC or formalise existing administrative concessions by expressing them in the legislation. There are, however, some important changes to current policy buried in the text of the new provisions:

- It is no longer a requirement that the amount included in the assessable income of a taxpayer has a foreign source. It is sufficient that the taxpayer has paid a foreign income tax in respect of an amount included in their (Australian) assessable income. Removing this requirement will eliminate border disputes, where Australia and another country both claim that the amount is sourced in their country.
- The requirement of a foreign source created a further problem for capital gains – it was not always obvious what the location of a net capital gain would be, given that it could be the result of aggregating many individual gains and losses. The Bill eliminates the need to find the location of a net capital gain.
- The current legislation gives a tax offset for foreign taxes paid on “foreign income,” a term which received statutory modification in some cases where the taxpayer was deriving something that was assessable but not ordinary income. One statutory modification dealt with a taxpayer who was deriving a capital gain rather than “income” but other, more exotic, amounts added into assessable income were not specifically addressed. The Bill now addresses this issue directly by extending the tax offset to foreign taxes paid on any amount included in assessable income.
- The new regime will extend to amounts that are included in the assessable income of non-resident taxpayers. (Under current law, only a resident taxpayer can claim a FTC.) This extension will not often come into play but it will be important in those cases where both Australia and a foreign country claim that the amount is sourced in their country – Australia will give the non-resident a credit for foreign tax imposed on income that Australia also claims is assessable.
- However, this extension to non-residents is reversed if the foreign income tax is levied on income from sources outside that country because the foreign country treats the person as a resident and levies tax on a worldwide basis. In other words, Australia will allow a credit to

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foreigners for tax levied on their income on the basis of source, but not foreign taxes levied on the basis of residence.

- The new regime does not contain a parallel to the current requirement that taxpayers mitigate the amount of foreign tax they suffer if they enjoy an election to pay tax on a net basis. (Current law requires a taxpayer who has been assessed by the foreign country on their gross income, but who could file a tax return and be assessed on their net income, to do so.)
- The new regime addresses some of the timing difficulties in this area more succinctly. It is not uncommon to see amounts included in the assessable income of a taxpayer in one (Australian) income year and for the relevant foreign tax to be paid in a different (Australian) income year. The new regime makes it clear that no entitlement to a tax offset arises unless and until the amount of foreign tax has been paid, but once the foreign tax has been paid, the tax offset is to be enjoyed in the year in which the amount was included in assessable income. If that is a prior year, that year's return can be amended without restriction. So, the tax offset cannot be anticipated, but the past can be cured. (Of course, for widely-held trusts, this theoretical possibility of reversing the past is subject to the practical reality that, because the offset is not enjoyed by the trustee but rather flows through to unit-holders, it is these thousands of unit-holders who would have to file amended returns.)
- The treatment of surplus foreign tax credits has also been changed. Under current law, a taxpayer with surplus foreign tax credits can carry forward the surplus for up to 5 years. The new foreign income tax offset system has no carry forward system, so that surplus tax offsets will now be lost. This is presumably part of the price to be paid for the Government's decision to eliminate the quarantining of foreign tax credits against individual classes of income. This was not part of the original announcement, nor the subsequent consultations.
- A de minimis concession provides that the limit on foreign income tax offset does not have to be calculated if the foreign income tax is less than \$1,000.

3.2 Operation of the foreign income tax offset for foreign companies and trusts and their Australian shareholders and beneficiaries

The FTC system forms part of the set of rules which must be applied in determining the attributable amounts from foreign companies and trusts – that is, the amount which might be attributed to the Australian resident investors of foreign entities. The issue in this situation is how the income tax imposed on the foreign entity (so-called, underlying tax) affects the calculation of the amount to be attributed, and taxed, to the Australian investors.

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In addition, the FTC system is relevant when a dividend or distribution is paid to the Australian resident investors. The issue in this situation is typically how the foreign withholding tax affects the amounts of tax to be paid by Australian investors on the distribution they have received.

The Bill re-writes the existing rules:

- So far as the foreign underlying tax is concerned, the Bill provides that an Australian shareholder which is attributed with income from holding an interest in a controlled foreign company (“CFC”) or foreign investment fund (“FIF”) is entitled to a tax offset for the underlying tax that the CFC or FIF has paid. The Australian shareholder must be a company and must have at least a 10% interest in the foreign company. Where the foreign company is a FIF, the Australian resident must be using the calculation method rather than one of the other computation methods.
- So far as the foreign withholding tax is concerned, the Bill retains the rule that an Australian shareholder who receives a dividend paid by a CFC or FIF out of attributed income is entitled to a tax offset. The shareholder needs the benefit of a special rule because a dividend paid in these circumstances is not included in assessable income – tax was collected in the prior year when the income was attributed to the resident shareholder, and so the subsequent distribution of that amount is not taxed again, and not being assessable, would not carry a tax offset.

The Bill also removes some of the current record-keeping rules for Australian residents imposed under the CFC and FIF rules in order to track foreign tax paid by offshore companies.

3.3 Commencement and transition

Like the foreign loss changes, the new foreign income tax offset regime commences for the income year that starts on or after 1 July after the Bill receives Royal Assent – for most taxpayers, the 2008-09 income year.

The next question is, what happens to existing surplus foreign tax credits at that date, given that there is no carry forward under the new system?

The Bill will allow a taxpayer with existing surplus foreign tax credits at the date of commencement of the new regime to continue to carry forward those credits. The rules to accomplish this are highly complex. In general terms, the taxpayer will consolidate all existing surplus foreign tax credits at the start of the new regime. The taxpayer will then be able to use pre-commencement credits (after using any current year foreign income tax offset) to reduce the Australian tax on any class of foreign income without restriction by class. However, the surplus pre-commencement foreign tax credits can still only be used up to the foreign tax credit ceiling, and any pre-commencement foreign tax credits will still retain their 5-year life.

A separate procedure is created for unconsolidated entities with surplus pre-commencement foreign tax credits that join a consolidated group.

4. Income and loss adjustments arising from transfer pricing disputes

The Bill also modifies the procedure for dealing with the double tax problems that can arise from transfer pricing disputes. A transfer pricing dispute can often involve revenue authorities in two countries each claiming that the same profit belongs in the taxable income of the taxpayer located in their country. The Bill addresses the impact on an Australian taxpayer of a transfer pricing adjustment made by a foreign revenue authority to the profits of a foreign entity associated with the Australian taxpayer. This is the so-called “correlative adjustment” – the adjustment that should be made to an Australian taxpayer in light of a transfer pricing assessment that the foreign authorities have issued to a related foreign taxpayer.

The Bill proposes inserting a new rule in the *International Tax Agreements Act 1953* (Cth) allowing the Commissioner to adjust the taxable income or tax loss of a taxpayer to the amount that the Commissioner considers appropriate. The power to make such a determination is unlimited by time – the Commissioner can amend the tax position of any year.

While the Bill is cast as permissive – “the Commissioner may determine ...” – Australia’s tax treaties will typically require a correlative adjustment to be made by the Australian authorities, though there can be practical difficulties in getting the Australian authorities to agree that an adjustment made by foreign authorities should be accepted. Current law deals with this matter by way of tax credit rather than an income or loss adjustment; the new provision changes the income or loss of the relevant year.

Putting this power in the *International Tax Agreements Act 1953* makes it apparent that the power is available only in situations where the transfer pricing dispute arises with a country with which Australia has a tax treaty. However, a taxpayer with a transfer pricing dispute involving a non-treaty country would still have rights under existing objection procedures to challenge the assessment of its taxable income or tax loss.

5. Calculation of FIF income

The Bill proposes one modification to the rules which determine how much income should be accrued by Australian residents under the FIF system. This issue – how many calculation methods should be prescribed and which ones – is a major part of the Board of Taxation’s discussion paper, *Review Of The Foreign Source Income Anti-Tax-Deferral Regimes*, released in May 2007. The Bill anticipates some of that discussion by modifying the FIF calculation regime.

Current law requires a resident taxpayer holding an interest in a FIF – a foreign company or trust – to pay Australian tax in the current year on an amount which is deemed to accrue to the resident. The amount included in the resident’s income is calculated using one of three methods – the change in market value of the interest in the FIF over the year, a deemed rate of return on the funds invested in the FIF, or a calculation of a share of the profit earned by the FIF (the “**FIF calculation method**”). For the most

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part, taxpayers can choose which method they wish to use, although not all taxpayers will be entitled to access all methods.

As a result of the Bill, the amount included in the resident's income will now be calculated using one of four methods. The three existing methods will remain in place, but the Bill proposes allowing some Australian residents to calculate the amount arising from their interest in a FIF using the rules of the calculation method (the "**CFC calculation method**") set out in the controlled foreign company system. This option will be available to residents holding at least 10% of the FIF and the foreign entity must be a company. The option to use the CFC calculation will be revocable, but once revoked, the taxpayer will not be able to resume using it.

The obvious significance of this change lies in the differences between the rules of the FIF calculation method and the CFC calculation method. While these differences are many, the most important difference is likely to be in the treatment of dividends from second tier foreign companies. Resident investors with a minority interest in an offshore FIF which itself has an interest in a further offshore FIF are likely to want to make the election to use the CFC calculation method. One other consequence of using the CFC calculation method for FIF interests is that this will invoke other rules involved in the CFC calculation such as the CFC active income test and the exemptions in the CFC calculation. However, the CFC calculation (which requires, in general terms, the construction of the CFC's taxable income as if Australian income tax law applied to it) is a much more complex calculation to perform and requires access to more detailed information than the FIF calculation (which is derived principally from the accounting profit shown in the accounts of the FIF).

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