

Tax Brief

4 August 2009

Reforming the Taxation of Offshore Income

As part of the May 2009 Budget, the Government released the final report of the Board of Taxation's project on reforming Australia's "anti-tax-deferral" measures – that is, principally the rules concerning controlled foreign companies, foreign investment funds and transferor trusts. The Government also announced that it was accepting all but one of the Board's recommendations. On 12 May, Treasury released a Discussion Paper seeking submissions on various options for implementing the Board's recommendations. This Tax Brief examines the Board of Taxation's proposals, the Budget announcement and Treasury's first steps in what will be a major overhaul of one of the most significant elements in Australia's foreign source income regime. We also examine some of the preliminary reactions from industry in the months since the release of Treasury's paper.

It is a mistake to consider these developments as limited to tinkering with the "anti-tax-deferral" measures – these are major changes to Australia's international tax landscape. Moreover, many of the proposals now being actively developed were raised by the Board of Taxation in its 2003 report on improvements to Australia's international tax framework. It now seems the mood of Government has changed and the time is ripe for dusting-off that report and giving effect to its recommendations.

1. Background

In October 2006, the former Government requested the Board of Taxation to review Australia's anti-tax-deferral regimes – the controlled foreign company rules ("CFC"), the foreign investment fund regime ("FIF"), the transferor trust regime ("TTR"), and the deemed present entitlement rules which form part of the general trust provisions of the Act. The Board consulted widely, releasing a Discussion Paper in May 2007, a more considered Position Paper in March 2008 and a further five Issues Papers in May 2008. We have chronicled these developments in various Tax Briefs: on the Board's Discussion Paper [http://www.gf.com.au/477_556.htm], Position Paper [http://www.gf.com.au/477_628.htm] and Issues Papers [http://www.gf.com.au/477_649.htm].

The Board's Final Report on this project was submitted to the Government in September 2008 and was released for public scrutiny in May 2009 as part of the Budget papers

[\[http://www.taxboard.gov.au/content/anti_tax_deferral/index.asp\]](http://www.taxboard.gov.au/content/anti_tax_deferral/index.asp).

2. Budget announcement

The announcement accompanying the May 2009 Budget proposed a number of reforms:

- The CFC provisions would be retained and made the principal rules to prevent the deferral of Australian tax on foreign passive income. It is proposed that some foreign trusts and other entities will also be treated as CFCs.
- Various amendments would be made to the scope and operation of the CFC rules. In particular, there would be changes to the classification of various types of income as active or passive, and to eliminate the automatic attribution of base company income – that is, income derived by a CFC from certain dealings in goods and services with Australian residents.
- The range of exemptions from attribution under the revised CFC rules would be extended, to include a specific exemption for complying superannuation entities.
- The calculation of the amount of attributable income from a CFC would be made more flexible – taxpayers could choose whether to undertake the full re-calculation of the CFC's income using Australian tax law, or to use the additional methodologies currently available under the FIF rules – that is, either by measuring changes in the market value of interests in the foreign entity or by assuming a deemed rate of return on the amount invested in the foreign entity.
- The FIF provisions would be repealed and possibly be replaced with “a specific, narrowly defined anti avoidance rule that applies to offshore accumulation or roll up funds.” However, this new rule would be “carefully monitored.”
- The deemed present entitlement rules in the trust regime would be repealed, but the TTR rules would be retained, albeit with amendments limiting their scope.

All of these proposals are welcome improvements to the current collection of overlapping and over-engineered regimes. One disappointment, however, was that the Government did not accept the Board's recommendation that listed public companies be exempted from the CFC measures altogether. The Assistant Treasurer cited “the revenue implications of the proposed reforms [and] pressing needs within the Australian budget.”

3. Treasury Discussion Paper

At the same time as the Budget announcement, Treasury released a Discussion Paper on implementing these proposals and seeking submissions on various design options. The Discussion Paper can be found at –

[http://www.treasury.gov.au/documents/1526/PDF/income_anti_tax_deferral_attribution_rules.pdf]

The Paper sets out a general operative principle which, it says, should form the basis for the design of the new CFC regime:

An Australian resident which holds a substantial ownership interest in a controlled foreign entity in an income year, includes in its assessable income its share of the passive income derived by the foreign entity.

The rest of the Paper elaborates the various terms used in this statement. Treasury has received a number of submissions which it has published on its website (reference is made in this Tax Brief to some issues made in these submissions where relevant).

3.1 Attributable taxpayers - residents

The first set of issues examined in the Paper deals with identifying the range of Australian resident taxpayers who should be immune from potential attribution.

In other words, it seems to be assumed that every resident holding a sufficient interest in a controlled foreign entity (“CFC”) – that is, a foreign company or foreign trust – will be potentially subject to attribution, unless an exception applies. The residence criterion will be satisfied under the usual tests for individuals and companies, and, for partnerships and trusts, where the partnership has a single resident partner or the trustee is a resident. Where interests in the CFC are held by companies, partnerships and trusts it seems, again more by implication than by express formulation, that the current law will remain so that the CFC rules are applied at the level of the company, partnership or trust, and not directly to the shareholders, partners or beneficiaries.

Superannuation entities. Currently, the FIF rules contain an exemption for complying superannuation funds – no amounts are attributed to them under the FIF rules, presumably on the basis that the tax benefit of deferral for them is so modest that it is unlikely to influence their choice of investments. The Board recommended that this exemption be replicated in the revised CFC regime and it will likely be expanded to approved deposit funds, pooled superannuation trusts and providers of retirement savings accounts. Industry submissions have sought also to include in the exception assets held by life insurance companies that are segregated exempt assets or complying superannuation / FHSA assets.

The Paper considers whether and how such an exemption might be extended to superannuation entities that hold their interests indirectly – that is, via an on-shore partnership or trust. This kind of structure is a problem under the current FIF rules as the relevant exemption does not apply if

complying superannuation funds choose to invest in foreign entities via a resident trust. The options under consideration seem to be either a complete exemption from the revised CFC rules for the onshore trust if it is sufficiently owned by superannuation entities, and/or permitting the revised CFC rules to operate on the trust but then excluding in the hands of the superannuation entity the amount that was added to the trust's net income.

Dual residents and temporary residents. The Paper proposes to continue exempting two other sets of resident taxpayers from attribution under a revised CFC regime: dual resident entities that are treated as non-residents for the purposes of Australia's tax treaties because of the operation of a treaty "tie-breaker" rule and temporary residents. The discussion in the Paper ponders whether it might be appropriate to extend the Board of Taxation's proposal – first made in 2003 – that "a non-resident for treaty purposes should be treated as a non-resident *for all purposes* of income tax law ..." to all taxpayers, not just to companies.

Small investors. The Paper examines the position of small investors – who currently enjoy an exemption under the FIF rules – and considers how their situation should be addressed under a revised CFC regime. The Paper seems to imply that their position is largely solved by a more narrowly drawn definition of the kinds of income to be attributed to Australian residents – in the presence of such a rule, there is no need for a *de minimis* exemption. The Board of Taxation had, however, previously intimated (in its January 2008 Position Paper) that small investors should be exempt from attribution under the revised CFC regime if the value of their (total) foreign investments was less than \$200,000 (although this is not contained in the Board's final September 2008 Report).

Industry submissions have recommended that the small investor exemption should be extended to all types of investor, not simply individuals as is the case under current FIF law.

Listed companies. As noted above, the Government did not accept the Board's recommendation that listed public companies be exempted from the CFC measures.

3.2 Relevant types of interest

The Paper then examines a collection of issues related to identifying the kind and size of interests in foreign entities that will render their resident owners subject to potential attribution.

Ownership interests. The first issue is the kinds of interests which confer ownership of an offshore entity – that is, distinguishing equity-like interests from other kinds of interests in an offshore entity. The Paper proposes using "equity interest" as defined under the existing debt-equity rules for this purpose. This would have the effect of including some kinds of non-share interests – call options, incomplete contracts and certain participating and convertible notes, for example – and excluding others that are shares in form – redeemable preference shares and other financing shares.

Industry submissions have not generally been supportive of this change. Several submissions note that including non-share-based interests as

equity is likely to give rise to serious fluctuations and difficulties in applying the CFC methods, as the amount of debt varies from year to year. Moreover, the tests for a CFC regime should be directed to finding indicia of control; the debt-equity tests are directed to finding certainty of repayment which seems an odd test to use in this context.

The Paper does not, however, deal in any detail with another aspect of this problem – that is, how to classify for the Australian tests the kinds of unusual interests that are sometimes created by the laws of foreign countries. It simply asks, what can be done to secure “the flexibility to deal with the variety of ownership interests encountered throughout the world?” Industry submissions have noted that finding the ownership interests in many curious foreign entities is likely to be very problematic, which may well be a sufficient reason for limiting the new regime’s focus just to share-based interests.

Level of ownership. The next issue it considers is to set the level of ownership. The issue is to determine whether the residents have a sufficient interest in a foreign entity to justify tax by attribution, or whether the resident can be taxed (or exempt from tax) simply on receipt. Because the FIF rules will disappear, the Paper proposes maintaining the level at which attribution can be invoked at an associate-inclusive holding of at least 10%. In other words, residents holding 8% of a foreign entity (directly or indirectly, together with associates) will not be exposed to attribution; residents holding 11% of a foreign entity will be potentially exposed to attribution (assuming always that the foreign entity is actually controlled from Australia – for example, that the only other shareholder in the foreign entity is another resident taxpayer). The Paper notes that keeping the requisite level of ownership at 10% accords with an Australian corporate shareholder’s entitlement to claim an exemption from tax on dividends received from the foreign entity – susceptibility to attribution and immunity from tax on dividends would be formally aligned.

The Paper then considers two situations where aggregating multiple interests should apply for determining the 10% threshold – where interests are held by associates, and where interests are held through offshore intermediaries. Industry submissions have focussed on some problems with the current definition of “associates”, especially the difficulties that arise where another shareholder in the foreign company is an independent non-resident, but happens to be related to an Australian resident (eg. the non-resident shareholder happens to have an Australian subsidiary company). With regard to tracing through offshore intermediaries, the Paper proposes continuing the current practice of only counting interests that are held by a controlled foreign entity and interests held by a transferor trust.

3.3 Controlled foreign entities

Control. Current law is triggered where a foreign company is controlled by Australian residents. Under current law, “control” was typically identified by finding that 5 or fewer Australian residents held at least 50% of the foreign company (or 40% if held by a single Australian resident, together with its associates). While a “control” test will remain, the Paper proposes that

control could now be determined by examining the facts and circumstances – “a broad economic notion of control” – rather than a share-based computation. Not surprisingly, industry submissions have noted the added uncertainty that adopting such a position – and excluding more evident (“bright-line”) criteria for testing control – will induce. These submissions have tended to support continuing to apply the current tests – residents holding 50% of the issued shares, or 40% where there is no other single controller.

The Paper does not address one of the flaws in the “concentration” aspect of the current control test. At present, a company will be a CFC if a group of 5 or fewer Australian residents hold sufficient shares in the company. There are obvious difficulties with this test – unrelated parties can happen to find themselves members of a “group” even though they are unaware that other residents are investors. Submissions have recommended changing this position such that the test would require that, for a resident taxpayer to be subject to attribution, the taxpayer would have to be a member of “the controlling group” of the CFE. Taxpayers outside this group – even those with a 10% interest – should not be subject to attribution.

Company. The Paper examines how to classify different kinds of entities that are created under the laws of foreign countries, and whether the Australian classification, especially of foreign limited partnerships is satisfactory. It asks whether there are other classes of foreign entities that should or should not be viewed as CFEs.

Trusts. It was noted above that the new CFC regime is proposed to be possibly expanded to encompass interests in foreign trusts as well as companies. The Paper refers to “closely-held trusts” which is presumably meant to indicate the same notion as achieved by the control test for companies. Industry submissions have focussed on some of the difficulties with current rules that use a similar idea, and sought to have bare trusts and nominee situations disregarded.

Time. Under current law, the status of an entity as a CFC is effectively determined once, on the last day of the foreign entity’s income year; the holding of a FIF interest is effectively determined on each day of the year and on the last day of the income year. The Paper asks whether a point-in-time test or a day-by-day test is more appropriate for determining whether a CFE is controlled by Australian residents.

Industry submissions have supported the continued use of the “once only” testing time for CFEs. In other words, in order for any amount to be attributed, the resident should hold its interest on the last day of the CFE’s income year and on that day, the foreign entity should be a CFE. However, submissions have also sought to take this timing dimension further by arguing that income derived during the year, but before the taxpayer’s interest was acquired, should be disregarded. At present, only capital gains are thus disregarded.

3.4 Kinds of income to be attributed

Much of the dissatisfaction with the CFC and FIF regimes has concerned the over-reaching definition of attributable income – the kinds of income that can be subject to attribution. The Paper proposes that the income subject to potential attribution should consist of two broad groups of income:

- a redefined idea of “passive income” (although even passive income would not be subject to attribution where the active income test is satisfied); and
- “other amounts derived by the foreign entity through its participation in trusts and partnerships.” In relation to trusts, these amounts are presently subject to attribution even if the active income test is satisfied by the CFC.

With regard to restricting attributable income to just passive income, the Paper notes that this kind of income can be isolated only if the taxpayer is calculating attributable income under the “branch equivalent” method. The Board had recommended that taxpayers be given the option of calculating the attributable income under the “branch equivalent” method or under one of the FIF methods – either a deemed rate of return or movements in market value – and the Paper notes that if one of these other FIF equivalent options is chosen, the ability to restrict accrual taxation just to certain kinds of income will be lost. (This is discussed in more detail below.)

Base company income. It is worth noting that implicit in this description of the target is a decision to accept the Board’s recommendation that so-called “base company income” – income derived by a foreign company from certain trading transactions involving Australian residents, or performing services for Australian residents – should not be subject to attribution. Instead, any concerns about these transactions should be dealt with using the transfer pricing rules. This recommendation had already been floated by the Board in 2003, but the government now intends to act upon it more broadly.

Passive income. The notion of passive income is clearly critical to a CFC regime. The Board had recommended, and the Paper accepts, that some list of types of passive income should remain, but that its scope should be “modernised.” The current list in the legislation treats as passive income certain kinds of:

- dividends and trust distributions;
- interest, annuities and currency gains;
- rent and royalties; and
- income and gains from sales of certain kinds of assets.

The Paper advances a few targeted changes to the list:

- there might be a general exclusion for income (even passive income) that is directly related to an active trade or business conducted through a permanent establishment. The Paper notes that such an exception would cover interest earned in the course of a business of lending

money and that “rent from the leasing of moveable property will generally be treated as active income;”

- the Paper notes the Board's recommendation that, at least in relation to the application of the active income test, related party income should not be viewed as passive income. The Paper suggests that this could be limited just to transactions between related parties in the same jurisdiction, but that would provide significantly less relief than the Board's accepted recommendation;
- the Paper accepts that non-portfolio dividends should be regarded as active participation income, and not be subject to attribution except perhaps if they were Australian-sourced dividends and unfranked. Portfolio dividends would, however, remain passive income.

Not surprisingly, submissions have focussed on a much more thorough reconstruction of the notion of passive income, and especially the need for a more complete exemption of income from financial intermediary business and the management of real property.

Amount of passive income. Once the CFE has attributable income, the Paper notes that a CFE is required to calculate the amount of the attributable income under Australian tax law as if it were a resident. The Paper proposes that certain domestic rules which are switched off in calculating the amount of attributable income – notably the debt-equity rules, the taxation of financial arrangements (“**TOFA**”) rules and the thin capitalisation rules – be re-instated and made to apply to CFEs. The Paper implies that the reinstatement of these rules is the trade-off for a narrower definition of passive income. However, it recognises that any thin capitalisation rules would require a simpler computation than that which applies to real Australian residents.

The Paper notes that no change is proposed to the current rules which almost always exempt from attribution income that has been taxed in one of the 7 countries that Australia regards as having a comparable tax system.

Income from interests in offshore trusts, partnerships and companies. The Paper notes that the inclusion in attributable income of amounts arising where a CFE holds interests in other offshore trusts and partnerships is to give effect to the principle, “there should be no difference in what is assessable or deductible from what occurs if the Australian resident attributable taxpayer held those interests directly” instead of through a CFE. The Paper therefore proposes that the income of a CFE will include all income derived by the CFE via a trust or partnership. This would be the case irrespective of the nature of the income, whether the CFE passes the active income test and whether the income is subject to tax in the foreign jurisdiction. This would extend the type of income derived by a CFE via trusts and partnerships that can be presently attributed under the CFC measures. Understandably, industry submissions are resisting this proposal.

The proposal to include offshore trusts in a revised CFE regime could, however, cause a problem at this point. The problem arises where one

offshore trust holds an interest in another trust, and both are fixed trusts. The problem is that a share of the net income of the second offshore trust will flow through the intermediary to the onshore entity under current trust law, and will also be included in the attributable income of the intermediate trust and attributed to the onshore entity under the CFC rules. The Paper says simply that, “some way to prevent double counting of the attributable income component of net income will have to be developed in consultation.”

Active income test. The Paper discusses the operation of the active income test in this context. Under current law, the active income test and the definition of attributable income are not fully co-ordinated, even though they are directed to identifying the same kinds of income. Hence the Paper proposes a more co-ordinated approach.

The Paper also proposes a few changes to the scope and operation of the active income test:

- it proposes that active income would be defined ignoring income from related party transactions between associates in the same jurisdiction; and
- it also considers how to apply the active income test to a CFE that holds interests in partnerships or trusts. One option raised in the Paper is that the active income test should be applied to the sum of the CFE’s own income plus its share of the income of the partnership and trust (under current law, this occurs in relation to partnerships but not trusts). If the active income test was passed by the CFE on this calculation, then the CFE may not be attributed on any amount (although the Paper is a bit confusing in this respect as it seems to imply that, even if the CFE passes the active income test, income derived via the trust and partnership could still be attributed in a manner similar to current rules).

Industry submissions have sought to broaden the active income test – to make it a general gateway for exposure to a CFC regime. In other words, passing the active income test would mean that no amounts would be attributable, not even income derived *via* subordinate trusts. Secondly, the computation under active income test should be applied on an accounting consolidated group basis (irrespective of whether the CFEs are located in the same jurisdiction). Submissions have noted that the Board’s recommendation (as accepted by the Government) was not restricted to “same jurisdiction” groups; so, the origin of that notion is unclear.

3.5 Methods of computing the amount to be attributed

It is clear from the Board of Taxation’s earlier reports that it had begun the consultation process with a clear view that taxpayers subject to a revamped CFC regime should be able to compute the amount of attributable income using either a full “branch equivalent” calculation as under the current CFC rules, or using the FIF methods – applying a deemed rate of return to the amount invested or including movements in the market value of the interest. By the time the Board’s final report was issued, this enthusiasm had clearly waned, in part because of the tension between restricting the attributable

income of a CFE to just its passive income and the way that a deemed rate of return or market value system operates.

The Treasury Paper is also sceptical about the benefit of offering three choices. It doubts that there will be compliance savings if attributable taxpayers have a choice between three methods – it is assumed that they will feel compelled to perform all three calculations to see which results in the least tax cost – and there may need to be anti-avoidance rules to control switching between methods, as well as complex transitional rules for those cases where switching is permitted.

The Paper solicits views about whether the choice should be offered and whether changes are needed to the deemed rate of return methodology or the market value computation currently seen in the FIF rules for these options to be workable in practice.

3.6 Other exceptions

It is worth noting at this point that, even with these modifications, the new CFE regime has the potential to be quite wide-ranging. In particular, it lacks many of the special exceptions currently contained in the FIF rules.

Industry submissions have recommended exceptions from attribution under the revised CFC regime where:

- the amount of passive income of the CFE is not sufficiently large;
- the taxpayer passes a test similar to the “90% Australian asset” exception contained in the thin cap rules ; and
- the taxpayer passes a balanced portfolio exception, similar to that contained in the FIF rules.

4. Distributions from foreign entities

4.1 Dividends

The Paper proposes a few changes to the current treatment of distributions from foreign companies. If implemented, the changes could generally expand the situations where non-portfolio dividends from CFCs will be exempt from further tax in Australia.

Non-portfolio dividends paid to resident companies by foreign companies will remain exempt from Australian tax. However, the Paper proposes making the exemption depend upon the nature of the resident’s interest, classified using the demarcation in the Australia’s debt-equity rules. Hence:

- dividends on shares that are re-classified as debt interests would no longer enjoy the benefit of the exemption; but
- distributions on equity interests that are not shares (eg, some types of participating notes) might become entitled to the exemption.

The Paper notes that the exemption for non-portfolio dividends is limited to situations where a resident company directly holds shares in the foreign company. It is said not to be available for example if:

- the shares are held by a resident company indirectly through its interest in a trust or partnership (whether resident or non-resident); or
- the shares are held by another kind of entity that is not a company but is taxed like a company, such as a corporate unit trust or a corporate limited partnership.

The Paper asks whether the exemption should be expanded to include both of these situations (although as regards the first situation in relation to interposed trusts, only to the extent the interposed trust is an Australian resident). The industry submissions have focussed on the disqualification of a resident company holding its interest via a trust or partnership (particularly where the trustee is a nominee or bare trust only) as a major defect in the current law that requires rectification.

Dividends out of previously attributed income. The Paper also examines the exemption from Australian tax where the dividend paid by the foreign company represents the distribution of profits that have previously been attributed to residents. It considers possible changes to these rules:

- repealing the exemption (an unwelcome change for taxpayers) on the basis that it adds to complexity and may be relevant only rarely if the kinds of income subject to attribution are to be drawn much more narrowly than under current law; and
- changing the point at which the benefit of the exemption is enjoyed where the shares in a foreign entity are held by a resident partnership or trust. Under current law, the exemption occurs in computing the assessable income of a partner or beneficiary. The Paper asks whether the benefit of the exemption should be delivered in computing the net income of the partnership or trust (probably a welcome change for taxpayers).

4.2 Trust distributions

Because the revamped CFC regime is proposed to extend to foreign trusts, the Paper also considers how to deal with trust distributions. In an interesting development, the Paper contemplates, “a similar exemption for distributions paid directly by [foreign trusts] on non-portfolio equity interests so that there is neutrality in the tax treatment of different business vehicles.” In other words, the Paper appears to be contemplating a regime under which resident corporate investors in foreign trusts would:

- be subjected to tax on the basis of cash payments received rather than having a present entitlement to receive a share of income; and
- be entitled to an exemption from Australian tax where the distribution is paid by a foreign trust in which they hold a non-portfolio interest which satisfies an equity-like test.

Under such a system, presumably the current trust tax regime could simply be switched off for corporate shareholders. However, it is fair to assume that the decision to include closely-held foreign trusts in the revamped CFC regime (and consequently the extension of the dividend exemption to distributions by such trusts) will be subject to further review.

5. Disposals of interests in CFEs

Sales of shares in companies The Paper proposes no first order changes to the current treatment of gains and losses made from transactions with interests in foreign companies – principally, the CGT participation exemption for capital gains and losses made by resident companies on transactions with shares in foreign companies, and the adjustment for sales of interests in CFCs with retained attributed profits – although some of the proposed changes elsewhere would have second order effects (see section 7 below).

The one significant change that the Paper considers is how to deal with gains or losses made on interests where the interest in the foreign entity is held indirectly – that is, typically held by a resident trust with a corporate beneficiary. Under current law the CGT participation exemption would not be available.

Sales of interests in foreign trusts. The Paper does not contemplate the other important expansion to the current regime – expanding the CGT participation exemption to the situation where the resident corporate taxpayer holds a sufficient interest in a foreign trust that is conducting an active business.

6. Relief of double taxation

The Paper examines two situations where double tax relief may be appropriate and the method of delivering that relief.

The first situation is where the amounts to be attributed to Australian company taxpayers have already been subject to foreign tax. The Paper raises the possibility of a major change in this area: replacing the current foreign tax credit with a deduction for any foreign tax imposed on the CFC. Industry submissions have noted that this was not recommended by the Board of Taxation, and has not been subject to prior consultation. Nor has it been announced by the government as a prospective change.

The second situation arises where there is double accrual taxation – that is, Australia's CFC rules attribute some of the income of the CFC to an Australian resident taxpayer, and the CFC rules of some third country attribute income from the same CFC to taxpayers resident in that country. Under current law, the amount of income of a CFC attributed to taxpayers resident in Australia is reduced by any amount that will be subject to attribution for a CFC in a third country, provided it is a listed country. The Paper considers whether this situation might not be better handled by simply treating the accrual tax imposed by the third country as if it were another tax imposed on the CFE in the source country.

Neither of these possible changes has received much support in submissions.

7. Other aspects

There are two other points about the Paper that deserve some mention.

Co-ordinating concepts. One recurrent theme to the Paper is the possibility of using the same concept in Australia's international tax rules and removing the legacy of incrementally added labels. Examples cited in the Paper include using the same concept for:

- ownership interests, whether the concept is being used to describe the kinds of interests that will expose the taxpayer to attribution under the CFE measures, entitle the taxpayer to a distribution exemption, or entitle the taxpayer to an exemption from CGT under the CGT participation exemption; and
- active and passive income, whether the concept is being used in the active income tests, in the definition of passive income or in the classification of foreign business assets.

Industry submissions have suggested that these alignments can be taken even further to eliminate inconsistencies – for example, when the positions of associates are added (or excluded); and when the fact that shares carry or lack votes is significant (or ignored).

Expanding TOFA. The Paper also considers what adjustments should be made to recently-enacted TOFA rules. Under current law, every share is a financial arrangement and so the TOFA rules *potentially* apply as an overlay to the CFC rules. At present, a special exception exists so that TOFA does not apply to an interest in a CFC or FIF. The Paper proposes amendments to the TOFA regime to remove this wholesale exception and replace it with these rules:

- TOFA would not apply to gains and losses made on sales of non-portfolio interests in foreign companies and trusts;
- TOFA would also not apply to gains and losses made on interests in foreign companies and trusts held by resident superannuation entities; and
- TOFA would apply to gains and losses made on portfolio interests in CFCs (assuming other exemptions were not available).

8. Next steps

Submissions on the Treasury Paper were lodged in early June and consultation between Treasury, private sector representatives and various professional bodies is now well underway. We have attempted at various points to indicate the kinds of areas where we expect to see some movement from Treasury based on those submissions and the consultation. It remains to be seen just how much movement there will be to improve the scope and delivery of the proposals contained in the Paper.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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