Chapter 32

FOREIGN SOURCE INCOME OF RESIDENTS

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The challenge for taxation policy

Addressing the impact of entity taxation and problems with the current anti-tax-deferral rules

Impact of entity taxation

32.1 Residents are generally taxable on their worldwide income (that is, both Australian and foreign source income) as it is earned. This treatment ensures offshore investments are not favoured over domestic investments for taxation reasons.

32.2 Double taxation could arise if amounts of foreign source income were taxed both in Australia and in the country of source. Relief from double taxation is normally provided by allowing a credit for foreign tax paid on foreign source income. Relief is also provided by exempting foreign dividend and branch profit income derived by resident companies where it is likely that little or no Australian tax would be payable after a credit is provided for foreign tax. These exemptions help reduce compliance costs by removing the need to make a foreign tax credit calculation. Exemptions are also provided for distributions from amounts taxed previously under the anti-tax-deferral rules.

32.3 The new entity taxation proposals would impact on relief from taxation available for amounts of foreign source income derived through trusts. Currently trust beneficiaries generally have the same access to relief from double taxation as that available for direct investors, who receive relief for underlying and withholding taxes. Under entity taxation, however, relief from double taxation for trusts would be largely aligned with relief available for companies. This could mean that beneficiaries would generally cease to have access to credits for foreign tax paid on foreign source income derived through a resident trust. If unaddressed, this loss of credit flow-through could have a negative impact on resident collective investment vehicles structured as trusts.

Problems with the anti-tax-deferral rules

32.4 Anti-tax-deferral rules apply in some cases to tax Australian residents on their share of foreign source income accumulated in an offshore entity. In the absence of these rules, residents could accumulate foreign source income offshore and thereby defer Australian tax.

32.5 The anti-tax-deferral rules seek to claw back tax deferral benefits by taxing residents on their share of certain profits accumulated by a foreign company or foreign trust that would be taxable if the entity were a resident of Australia. The rules are reserved for situations where the risk of tax deferral is

greatest because of calculation difficulties and cash flow problems associated with taxing unrealised amounts.

32.6 Appendix A provides an outline of the current controlled foreign company (CFC), foreign investment fund (FIF), transferor trust and other related anti-tax-deferral rules.

32.7 The CFC measures were reviewed in 1997. Submissions were sought at that time on options for reducing compliance costs and a number of proposals were adopted. The CFC measures are nevertheless complex and a number of secondary policy issues need to be addressed. While the breadth of other business tax proposals precludes immediate legislative reform, comments are sought on policy issues of concern to business.

32.8 The FIF measures have not been the subject of a comprehensive review since their introduction in 1993. Problems have nevertheless been identified with the active business exemption because it is imprecise and may therefore provide little protection from tax deferral despite its compliance burden. The lack of precision is largely a consequence of the exemption being designed for use by minority investors who have access to limited information. The result is that the availability of the exemption does not properly reflect the risk of tax deferral associated with a particular FIF investment. Another problem is that the active business exemption for interests in closely held company FIFs that fall outside the CFC measures is markedly different to the exemption available for CFCs. This difference in the active income test was a design feature of the FIF measures, reflecting the fact that Australian residents and their associates do not control the foreign entity. However, given the problems that arise from this treatment, the design feature needs to be revisited.

32.9 A number of problems have also been identified in the anti-tax-deferral rules that apply to foreign trusts (that is, the transferor trust, FIF and related provisions). These rules are complex, involve unnecessary overlap and could be more effective.

A strategy for reform

Address the impact of entity taxation

32.10 Under the new entity taxation proposals, the treatment of foreign source income derived through trusts could be more closely aligned with the treatment for companies in accordance with the neutrality design principle in *A Strong Foundation*. Economic growth could also be enhanced by changes that would help ensure that resident collective investment vehicles remain

competitive with foreign counterparts under entity taxation. These changes would also achieve greater neutrality by providing closer treatment for offshore investments through entities relative to offshore investments held directly.

Improve the anti-tax-deferral rules

32.11 Changes could be made to improve the anti-tax-deferral rules in accordance with the neutrality, equity and simplification design principles in *A Strong Foundation*. In particular, the active business exemption in the FIF measures could be better designed to reduce the extent to which tax-deferral distorts investment decisions. Compliance and administrative costs could be reduced by avoiding overlap in the anti-tax-deferral rules for foreign trusts. The transferor trust measures could be made more effective by removing exemptions that have been or could be abused and by extending the time permitted for making adjustments under the measures. In addition, rules could be considered to deal with tax avoidance and evasion through the use of hidden trusts offshore.

Key policy issues associated with the impact of entity taxation

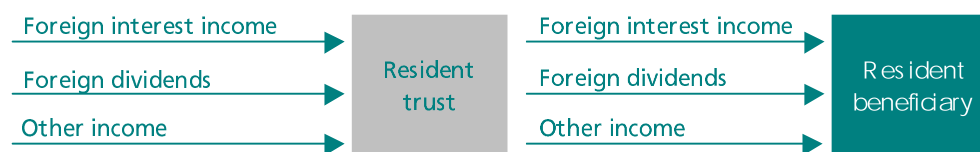
How would foreign source income derived through trusts be treated under entity taxation?

32.12 Changes are proposed to the taxation of foreign source income derived through trusts as a result of entity taxation. These changes would largely align the taxation treatment of amounts derived through trusts with the treatment of amounts derived through companies in accordance with the neutrality design principle in *A Strong Foundation*. This would improve equity and help ensure investment structures are driven by commercial rather than taxation considerations.

Foreign tax credit flow-through would cease to be available for resident trusts

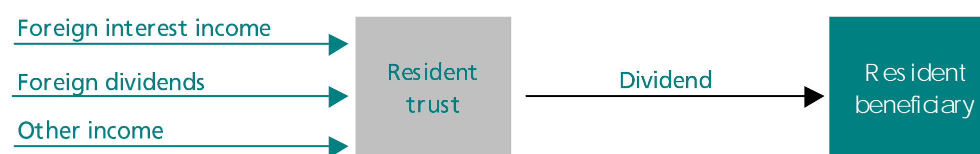
32.13 Currently amounts derived through a resident trust are taxed as if they were derived directly by a beneficiary. A credit can therefore be claimed by a beneficiary for foreign tax paid on foreign source income derived through a trust because the income retains its character as foreign source income in the hands of the beneficiary. The following figure shows how the current flow-through treatment operates for amounts derived through a resident trust.

Figure 32.1: Current flow-through treatment



32.14 The main impact of entity taxation is that trust distributions would be re-characterised as dividends. Amounts of foreign source income derived through a resident trust would therefore cease to be treated as foreign source income in the hands of a beneficiary. Accordingly, a beneficiary would not be able to claim a credit for foreign tax paid on a resident trust's foreign source income because on distribution the income would be treated as an Australian source dividend. The following figure shows how amounts derived by a resident trust would be re-characterised as dividends under entity taxation.

Figure 32.2: Entity taxation treatment



32.15 The loss of flow-through for foreign tax credits could have a negative impact on collective investment vehicles operating as trusts. In addition, offshore investments held directly could be treated more favourably than investments held through entities. These problems are discussed later in the chapter along with options for allowing limited credit flow-through for foreign taxes.

Foreign tax credit flow-through would also cease to be available for foreign trusts

32.16 Under entity taxation the tax treatment of distributions from foreign trusts would be aligned with that of distributions from foreign companies. Amounts distributed from a foreign trust could therefore be treated as a dividend rather than retaining the character of the income from which the distribution was made.

32.17 A consequence of taxing a trust distribution as a dividend separate from the income of a foreign trust is that a resident beneficiary would generally be unable to claim a credit for foreign tax paid on the income of the trust. Beneficiaries subject to entity taxation may, however, be able to claim a credit for this 'underlying tax'.

32.18 Countries that tax trusts as flow-through entities may only impose one level of tax on amounts derived by a trust. These countries normally tax the income of a trust as if the income were derived directly by beneficiaries. Accordingly, they normally do not tax trust distributions as a separate income stream.

32.19 Australian beneficiaries would generally be unable to claim a credit for foreign tax paid on amounts derived by trusts in these countries because the beneficiaries can only claim a credit for amounts taxable in Australia. In this regard, the only amount taxable in Australia is the trust distribution and this distribution has not been subject to foreign tax. A beneficiary who is a natural person, for instance, may be personally liable for interest withholding tax paid on interest income derived through a foreign trust. No credit would be available for the withholding tax, however, because the beneficiary would not be taxable on the interest income in Australia. The beneficiary is only taxable on the dividend arising from the trust distribution and can therefore only claim a credit for foreign tax paid on that income.

32.20 Figures showing how relief for foreign tax paid on amounts of foreign source income derived through a foreign trust could be aligned with the relief available for amounts derived through a foreign company are provided in Appendix B of this chapter.

Loans from foreign trusts

32.21 Deemed distribution rules may be required for loans from foreign trusts beyond those proposed for resident trusts. Less robust rules may be acceptable for loans made at commercial rates by resident trusts because these trusts would be taxed in Australia on the interest income. Interest income on a loan provided by a foreign trust is, however, unlikely to be subject to full rates of Australian tax unless the interest is taxed under the anti-tax-deferral rules. Interest withholding tax may also be payable but this is unlikely to discourage the arrangement. Particular attention will need to be given to loans from discretionary trusts because the anti-tax-deferral rules are least effective in dealing with these trusts.

How should relief from double taxation available for companies be extended to trusts under entity taxation?

32.22 Companies currently have access to relief from double taxation on foreign source income not available to other taxpayers. This relief could generally be extended to trusts taxed as entities to align the treatment of companies and trusts in accordance with the neutrality design principle in *A Strong Foundation*.

32.23 The types of relief from double taxation available only for companies are outlined below along with the merits of providing similar relief for amounts derived by resident trusts or for amounts derived from foreign trusts.

A credit for 'underlying tax' could be allowed for amounts derived from a foreign trust

32.24 A resident company that derives a dividend from a foreign company can currently claim a credit for foreign tax paid on the profits from which the dividend was paid (called 'underlying tax'). To qualify the resident company must, however, have a 10 per cent or greater voting interest in the foreign company. This relief allows companies to defer further tax on the foreign dividend income until the income is distributed to non corporate shareholders.

32.25 For consistency, resident trusts taxed as entities could have access to 'underlying tax' credit relief for dividends derived from foreign companies similar to that available for resident companies.

32.26 Similarly, resident companies and resident trusts could be allowed an 'underlying tax' credit for distributions derived from a non-portfolio interest in a foreign trust.

The exemption for dividends paid from comparably taxed profits could be extended to resident trusts

32.27 Resident companies are generally exempt on dividends derived from a foreign company if the dividends are paid from profits likely to have been taxed without concession in a listed comparable tax country. Again, to qualify the resident company must have a 10 per cent or greater voting interest in the foreign company. The exemption is provided on the basis that little or no Australian tax would be payable after a credit is provided for foreign underlying and withholding tax paid on the dividend. Compliance costs are reduced by exempting the dividend rather than requiring a foreign tax credit calculation.

32.28 Consistent with entity taxation, this exemption could be extended in a similar form to dividends derived by a resident trust.

32.29 It may not be appropriate, however, to allow the dividend exemption for distributions from foreign trusts. The exemption should only be available for dividends paid from profits that are likely to have been taxed in a listed comparable tax country. Trusts, however, are taxed as flow-through entities in many countries and may not be subject to a comparable level of tax. Foreign trusts could therefore be used to stream low-taxed third country

income to Australian beneficiaries without those amounts being subject to comparable tax in the trust's country of residence.

The branch profit exemption could be available for offshore branches of resident trusts

32.30 Resident companies are generally exempt from Australian tax on foreign source income derived through a branch in a listed comparable tax country if the income is taxed without concession in a listed country. Similar to the exemption for dividends, the exemption is provided to reduce compliance costs. The branch profits exemption could also be available on a similar basis for amounts derived through a branch of a resident trust.

Should foreign tax credits flow through entities to resident taxpayers?

Flow-through for resident entities

32.31 The loss of foreign tax credit flow-through for trusts under entity taxation could place resident collective investment vehicles at a competitive disadvantage with some foreign counterparts offshore. Foreign investments through entities could also be treated less favourably than investments held directly. These outcomes would be inconsistent with the neutrality design principle in *A Strong Foundation*.

32.32 The loss of credit flow-through for foreign trusts would help ensure collective investment vehicles operating as offshore trusts are not treated more favourably than resident trust vehicles. There are, however, other vehicles used for collective investment offshore that would not be affected by entity taxation. Some funds, for instance, operate through companies that are largely exempt from tax if they satisfy a distribution requirement (for example, United States regulated investment companies). Amounts derived through these companies by Australian residents are generally only subject to dividend withholding tax and these vehicles could therefore have an advantage over other vehicles because the foreign withholding tax paid on the offshore investments would be fully creditable in Australia.

32.33 To achieve more equal treatment, it may be necessary to preserve certain foreign tax credit benefits for amounts derived through resident trusts.

Option 1: Exclude collective investment vehicles from the general entities regime

32.34 One option would be to exclude collective investment vehicles from the general entities regime as discussed in Chapter 16. This would allow foreign source income passing through those vehicles to be taxed only in the hands of investors.

Option 2: Allow an imputation credit for withholding tax paid on foreign dividends

32.35 Another option would be to allow an imputation credit for withholding tax paid on foreign dividends derived by a resident trust. For consistency, imputation credits for foreign dividend withholding tax could also be allowed for amounts derived through resident companies.

32.36 Another benefit of providing credit flow-through is that it could help ensure investments in foreign companies are not treated more favourably than investments in Australian based multinationals. More favourable treatment currently applies for investments in foreign companies because Australian residents can claim a credit for dividend withholding tax paid on dividends derived directly from a foreign company. In contrast, Australian based multinationals cannot pass onto shareholders a credit for foreign dividend withholding tax paid on dividends derived from a foreign subsidiary. This is perceived as discouraging multinationals from repatriating profits to Australia. This issue will increase in significance as Australian operations continue to expand offshore.

32.37 In addition, credit flow-through could result in more equal treatment of foreign source income under the imputation system which currently favours domestic investment over foreign investment where the underlying rates of return are the same.

Imputation credits for foreign dividend withholding tax

32.38 An imputation credit could be available for foreign dividend withholding tax paid in accordance with a double taxation agreement (subject to the normal rules for claiming foreign tax credits). A benefit of this option is that these treaties would cap the foreign tax payable to around 15 per cent of the gross dividend. Accordingly, some revenue is likely to be collected in Australia on the dividend. A limited imputation credit could also be considered for dividend withholding tax paid in a non-treaty country (for example, the credit could be capped at 15 per cent of the gross dividend). The following table illustrates the net effect of this treatment.

Table 32.1: Impact of allowing imputation credits for foreign dividend withholding tax

	Current trust treatment ($)	Taxing trusts as companies ($)	Allowing an imputation credit for foreign dividend withholding tax ($)
Foreign dividend	100	100	100
Foreign DWT	-15	-15	-15
Net dividend paid to Australia	85	85	85
Australian entity tax	0	-21	-21
Distribution to resident investor	85	64	64
Impact of personal tax at 17% (after credits allowed)	-2	6.5 (Refund)	19 (Refund)
Return to investor	83	70.5	83

32.39 Refunds of excess imputation credits could be allowed although this could increase the risk to the revenue of schemes designed to generate foreign tax credits. A separate account could be used to track imputation credits for foreign taxes if the credits were to be non-refundable. The maintenance of separate accounts would increase complexity and compliance costs.

32.40 The provision of imputation credits for foreign dividend withholding tax should provide an outcome consistent with that of an individual resident investing directly. Other foreign source income derived by collective investment vehicles includes interest income and capital gains from the disposal of foreign portfolio shareholdings. These amounts, however, tend to be generally exempt from foreign tax because they are highly mobile and there are practical difficulties associated with taxing gains from the disposal of portfolio shareholdings.

32.41 An imputation credit could also be provided for dividend withholding tax paid on exempt foreign dividends. This would provide similar access to foreign tax credit flow-through for these dividends to that available for other dividends.

Flow-through for foreign trusts

32.42 Resident collective investment vehicles could be advantaged relative to foreign vehicles operating through trusts if credit flow-through were limited to resident entities.

32.43 One way of achieving consistent treatment of foreign collective investment vehicles operating through trusts could be to allow equivalent flow-through of foreign tax credits for foreign trusts to that provided for

resident entities. If, for instance, an imputation credit were available to resident entities for foreign dividend withholding tax, a foreign tax credit could be available for withholding tax paid on dividends derived through a foreign trust.

Key policy issues associated with improving the anti-tax-deferral rules

How could problems with the active business exemption be addressed?

32.44 The active business exemption in the FIF measures could be redesigned to improve the anti-tax-deferral purpose of the measures. Below are some options for addressing problems with the active business exemption.

Option 1: Remove the active business exemption

32.45 One option would be to remove the active business exemption from the FIF measures and thereby largely tax all FIF investments on a current basis. This option would be most effective in clawing back the benefits of tax deferral but would greatly increase compliance costs and may create a bias in favour of domestic investment.

Option 2: Replace the active business exemption

32.46 Another option would be to replace the active business exemption with one or more exemptions designed to deal with cases where the tax deferral advantage might be significant. One approach would involve differentiating between non-portfolio and portfolio investments. This would allow the exemptions to be better tailored to a taxpayer’s ability to obtain information and to the risk of tax deferral for a FIF investment. Broadly a non-portfolio investment is where a taxpayer has 10 per cent or greater voting interest in a foreign company whereas a portfolio investment is where a taxpayer's voting interest is less than 10 per cent.

32.47 Exemptions that could be considered as alternatives to the active business exemption are outlined below. Appendix C provides further detail on these exemptions.

Exemption for non-portfolio investments

32.48 The active income test in the CFC measures could be the basis of an exemption for non-portfolio holdings in FIFs. This would result in greater symmetry in the exemptions available under the CFC and FIF measures for non-portfolio holdings. If the test is failed, the FIF measures could apply to tax the FIF investment. This option could involve difficulties for some taxpayers because of problems in obtaining the necessary financial information to determine if the FIF passes the active income test.

Exemption for portfolio investments

32.49 It is difficult to use statutory tests based on limited information to appropriately differentiate between portfolio FIF investments that offer significant tax deferral opportunities and FIF investments that should be exempt from the anti-tax-deferral rules.

32.50 One approach would be to replace the active business exemption with a jurisdictional exemption. A jurisdictional exemption could apply, for instance, to interests in company FIFs that are taxed on a worldwide basis in a listed comparable tax country (this list could be limited to countries with effective anti-tax-deferral regimes). An exemption could be justified for these FIF interests because tax deferral opportunities are likely to be low if the worldwide income of a company FIF is taxed in a comparable tax country.

32.51 A problem with this approach is that it could be difficult for portfolio investors to determine whether a company FIF is taxed in a listed country on a worldwide basis. If it is impractical for investors to obtain this information, consideration could be given to allowing the exemption where a company FIF is listed on an approved stock exchange and carries on business in a listed country. This alternative would, however, be considerably less robust.

Exemption for portfolio interests in certain foreign trusts

32.52 There may be scope for an exemption from the FIF measures to be provided for portfolio interests in foreign trusts that, for example, offer investment portfolios that track a share market index. This type of exemption could be justified on the basis that there is likely to be a low risk of tax deferral where an investment portfolio is diversified. Some flexibility could be provided to allow modest variations from a share market index. Safeguards could be required, however, to ensure these funds do not offer tax deferral benefits by accumulating low taxed profits offshore. Views are sought on how this type of exemption could be formulated.

How could the anti-tax-deferral rules for foreign trusts be improved?

32.53 Overlap in the anti-tax-deferral rules for foreign trusts could be reduced. This would help reduce compliance and administrative costs in accordance with the simplification design principle in *A Strong Foundation*. Some changes may also be required as a result of entity taxation for trusts.

The deemed present entitlement rules could be removed

32.54 Interests in fixed trusts that are exempt from the FIF measures may currently be subject to the deemed present entitlement rules in the general trust provisions. See Appendix A for an explanation of these rules. To avoid this overlap the deemed present entitlement rules could be removed and the FIF measures used as the sole anti-tax-deferral regime for taxing fixed interests in foreign trusts.

Widely held fixed trusts could be treated in the same way as companies

32.55 Greater neutrality could be achieved in accordance with the objectives of consistent entity taxation if the treatment of trusts under the anti-tax-deferral rules were more closely aligned with that for companies. In this regard, interests in widely held fixed trusts are clearly identifiable and could be treated in the same way as interests in companies. Interests in these trusts could therefore continue to be subject to the FIF measures but also qualify for the active business exemption which is currently only available for interests in company FIFs. If, however, the active business exemption is replaced with a jurisdictional exemption for portfolio FIF investments as discussed previously, it may not be appropriate to extend the jurisdictional exemption to widely held fixed trusts. This is because trusts are often taxed as flow-through entities in other countries and there is a significant risk that third country income derived by a trust in a listed country will not be taxed in that country.

Anti-tax-deferral rules for other fixed trusts

32.56 The risk that a foreign trust could be used to defer tax is increased if Australian residents can exercise significant influence over the trust. Indications that this influence may exist include circumstances where interests in a foreign trust are closely held by Australian beneficiaries or if an Australian resident has settled property on the trust.

Closely held fixed trusts

32.57 More robust anti-tax-deferral rules may therefore be warranted for closely held fixed trusts. A trust is currently treated as closely held if five or fewer Australian beneficiaries have 50 per cent or greater interest in the income or property of the trust. Interests in closely held fixed trusts are currently exempt from the FIF measures (being treated as interests in controlled foreign trusts) but are subject to the deemed present entitlement rules in the general trust provisions.

32.58 As mentioned above, the deemed present entitlement rules could be removed to rationalise the anti-tax-deferral rules for trusts. Accordingly, the FIF rules could be extended to apply to interests in closely held fixed trusts and the calculation method tightened to require a net income calculation for those interests. This should not increase the compliance burden for beneficiaries of closely held fixed trusts because they are currently required to make the more precise net income calculation of a trust's profits under the deemed present entitlement rules in the general trust provisions.

Fixed trusts that are neither widely nor closely held

32.59 Fixed trusts that do not meet the tests for being either widely or closely held could continue to be subject to the FIF measures. The effectiveness of the FIF rules could be improved, however, if the market value method for determining FIF income were only available for interests in widely held fixed trusts. This method is susceptible to manipulation of unit redemption values which is more likely to occur for trusts that are not widely held. A less punitive interest rate could apply to interests in these trusts under the deemed rate of return method for calculating FIF income because this is likely to become one of the primary methods for determining their FIF income.

32.60 It is not proposed to extend the active business exemption to trusts other than widely held fixed trusts because trusts have a history of being used for tax avoidance purposes owing partly to lower regulatory requirements and their flexibility of operation.

32.61 Other issues relating to the anti-tax-deferral rules for fixed trusts are examined in Appendix D.

Anti-tax-deferral rules for discretionary trusts

32.62 Special rules may be required to deal with foreign discretionary trusts. These trusts present particular difficulties for anti-tax-deferral rules because often it is not possible to establish an interest held by an Australian beneficiary in profits accumulating in a foreign trust.

32.63 Discretionary trusts could be subject to the transferor trust measures if a resident transferor can be identified. If this is not possible, an interest charge could apply to distributions of low taxed profits from these trusts. Broadly, the charge could apply to the amount of Australian tax that would have been paid if the profits had been distributed and would accrue from the time the tax would have been paid.

32.64 In cases where beneficiaries have some fixed interests in a discretionary trust (that is, it is a 'hybrid trust'), the beneficiaries could be subject to the FIF measures on those interests. The transferor trust rules could then apply on a residual basis. Finally, an interest charge could apply to claw back tax deferral benefits for distributions from these trusts.

Should the transferor trust measures be the sole anti-tax-deferral regime for discretionary trusts?

32.65 Overlap in the anti-tax-deferral rules could be reduced if an exemption from the FIF measures were provided for fixed interests in a discretionary trust where the trust is subject to the transferor trust measures. Additional complexity created by this overlap may be justified, however, to avoid taxing a transferor on amounts that would benefit a resident beneficiary.

How could the transferor trust measures be improved?

Some exemptions could be removed and amendment powers extended

32.66 The transferor trust measures could be made more effective by removing exemptions for:

- transfers made prior to the operation of the measures;
- transfers made by a taxpayer prior to becoming a resident of Australia; and
- transfers made under the terms of a deceased estate.

32.67 The Commissioner of Taxation has advised that these exemptions have been or are likely to be abused. The removal or extension of the time limit for making adjustments under the transferor trust measures could also be considered because in practice it is difficult to establish within the allowed time whether the measures should apply.

32.68 The changes would improve the integrity and overall equity of the tax system by ensuring residents pay tax on income accumulating for their benefit offshore.

32.69 There are, however, other equity considerations. The removal of the exemption for transfers made prior to the operation of the transferor trust measures and for transfers made by a taxpayer prior to becoming a resident of Australia may be seen as unfair. This is because a taxpayer may not have been aware at the time of the transfer that a tax obligation could arise. The removal of the exemption for transfers made under the terms of a deceased estate could also be seen as unfair. This is because linkages made to justify the taxation of beneficiaries of a deceased estate on income accumulating offshore may not mean that the beneficiaries would ultimately benefit from the income. The removal or extension of the time limit for making adjustments under the transferor trust measures may be seen as unfair because the potential for prior year tax assessments to be adjusted reduces financial certainty for taxpayers.

Rules for dealing with hidden trusts

32.70 Rules could also be considered for dealing with tax avoidance and evasion through the use of hidden trusts. The rules are relatively extreme and could be seen as unfair because a tax liability could arise where there is no conclusive evidence of tax avoidance or evasion. There may, however, be few options for dealing with fraud through the use of hidden trusts and rules of this kind may be required if hidden trusts become a serious threat to the tax system.

32.71 Practical issues associated with the above options are discussed in Appendix E.

Appendix **A**

The current framework of the anti-tax-deferral rules

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CFC measures

A.1 The CFC measures apply to shareholdings in foreign companies that are controlled by Australian residents. To prevent tax deferral, the measures tax resident shareholders on their pro rata share of a CFC's tainted income as it is earned unless the income is comparably taxed offshore or the CFC satisfies an active income test. Broadly, tainted income arises from investments and arrangements that are likely to be significantly influenced by taxation considerations. Examples of tainted income include interest, royalties, dividends and amounts arising from certain related party transactions.

A.2 The CFC measures focus on tainted income because it is the most mobile form of income and is thus readily diverted for tax planning purposes to avoid or defer Australian tax. Active income (that is, income other than tainted income) is generally exempt from the CFC measures to allow Australian based multinationals to compete effectively offshore. Generally, investments that produce active income cannot easily be relocated to defer Australian tax. The risk of tax deferral is therefore relatively low.

Transferor trust measures

A.3 The transferor trust measures apply to Australian residents who have directly or indirectly transferred value to a foreign trust. These transferors are treated as controllers and are generally taxed on the undistributed profits of a trust even if they cannot benefit from the trust. An exemption is provided for amounts that have been comparably taxed offshore.

A.4 An interest charge also applies to distributions to residents from a foreign trust to the extent the distribution is made from low taxed profits accumulated offshore. The charge operates to claw back tax deferral benefits obtained from holding the profits offshore.

FIF measures

A.5 The FIF measures apply to resident taxpayers that have an interest in a non-controlled foreign company or trust. The measures also apply to residents who hold foreign life policies.

A.6 Broadly, the FIF measures operate to approximate a resident taxpayer's share of the undistributed profits of a FIF and to assess the taxpayer on those profits. An active business exemption is provided for interests in company FIFs engaged in a wide range of activities. A balanced portfolio exemption is also provided to allow small holdings of non-exempt FIFs for diversification purposes. Broadly, the exemption is available for non-exempt FIF investments where their aggregate value is less than 5 per cent of the total value of FIF investments.

A.7 There are three methods for determining the amount to be taxed under the FIF measures. The market value method relies on the change in value of a FIF interest over a period and therefore can reflect unrealised gains that have accrued to a FIF. Unrealised gains are also effectively taxed under the deemed rate of return method which imputes a rate of return based on the amount invested in a FIF. The advantage of these methods is that they can be applied using only limited information. If more information can be obtained, taxation of unrealised gains can be avoided by using the more precise calculation method.

A.8 The FIF measures are not effective in preventing tax deferral for interests in discretionary trusts because the methods for determining FIF income can only be applied where it is possible to determine a taxpayer's interest in a FIF. The transferor trust measures are the only rules effective in dealing with interests in these trusts.

Deemed present entitlement rules in the general trust provisions

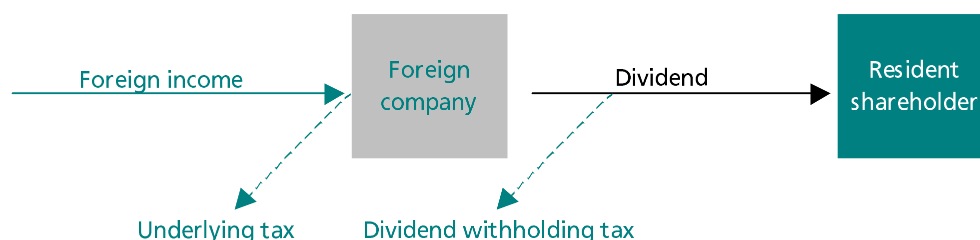
A.9 The deemed present entitlement rules in the general trust provisions apply to interests in controlled foreign trusts and other interests in foreign trusts that are exempt from the FIF measures. These rules prevent tax deferral by deeming beneficiaries to be presently entitled to a share of profits accumulated in a foreign trust based on their rights to receive distributions from the trust in the future. Once again, the rules have limited effect in preventing tax deferral through the use of discretionary trusts because it is not possible to determine a beneficiary's future entitlement to profits accumulated in the trust.

Relief for foreign tax paid on amounts derived through foreign trusts

B.1 The figures in this appendix show how relief for foreign tax paid on amounts of foreign source income derived through a foreign trust would be aligned with relief available for amounts derived through a foreign company.

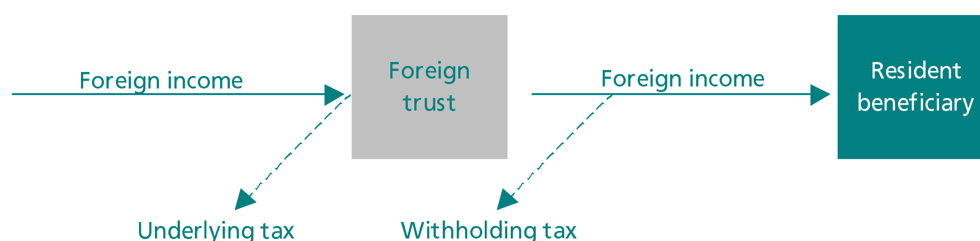
B.2 The first figure shows relief currently available for amounts derived through a foreign company. The second figure contrasts this treatment with the relief currently available for amounts derived through a foreign trust. The third figure shows the relief that would be available under entity taxation for amounts derived through a foreign trust.

Figure B.1: Foreign tax credit relief for amounts derived through a foreign company



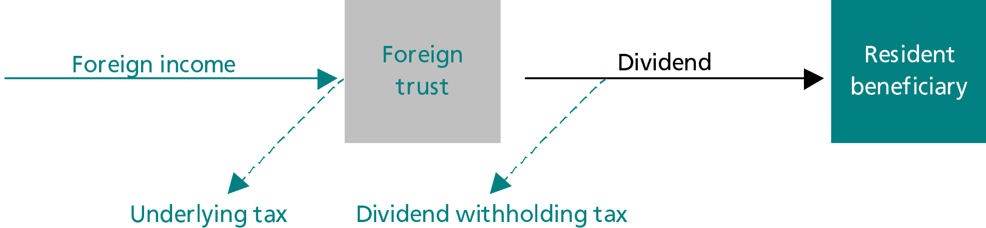
Currently resident portfolio shareholders in a foreign company can generally only claim a credit for dividend withholding tax paid on amounts of foreign source income derived through the foreign company. Non-portfolio shareholders that are companies may also be allowed a credit for 'underlying tax' paid by a foreign company.

Figure B.2: Foreign tax credit relief currently available for amounts derived through a foreign trust



Currently resident beneficiaries can claim a credit for foreign tax paid by the trustee and for foreign withholding tax paid on amounts of foreign source income derived through a foreign trust. This treatment is more favourable than that for amounts derived through companies because a credit is available for the total foreign tax paid rather than only the withholding tax.

Figure B.3: Foreign tax credit relief available under entity taxation for amounts derived through a foreign trust



Under entity taxation, foreign source income of a foreign trust would be treated as a dividend when derived by a resident beneficiary. Consequently, the beneficiary would generally only be able to claim a credit for foreign tax paid on the distribution. A non-portfolio beneficiary subject to entity taxation could, however, claim an underlying tax credit for tax paid on profits from which the distribution was made. This is consistent with relief available for foreign tax paid on amounts derived through a foreign company.

Appendix **C**

Possible alternatives to the active business exemption

Exemption for non-portfolio investments 685

Exemption for portfolio investments 686

Option 1: Exemption for company FIFs taxed in a listed comparable tax country 686

Option 2: Exemption for company FIFs carrying on business in a listed country 687

Implications for the balanced portfolio exemption 687

C.1 This appendix provides further details on exemptions from the FIF measures for portfolio and non-portfolio FIF investments that could replace the active business exemption.

Exemption for non-portfolio investments

C.2 The active income test in the CFC measures could be the basis of an exemption for non-portfolio holdings in FIFs. This would result in greater symmetry in the exemptions available under the CFC and FIF measures for non-portfolio holdings. If the test is failed, the FIF measures could apply to tax the FIF investment.

C.3 Some adjustments would be required to the active income test before it could be applied to non-portfolio holdings in FIFs. This is because the active income test currently applies separately to each company in a chain of foreign companies. The FIF measures, however, apply only to a first tier entity. Accordingly, the active income test would need to be adapted for the purposes of the FIF measures to take account of income derived through lower tier entities when determining the test for a first tier company.

C.4 One approach for taking income derived by lower tier entities into account would be to include a share of income derived by those entities when determining the active income test for a first tier company. This share could be based on the direct or indirect interest held by the first tier company in each of the lower tier entities. In cases where it is not practical to obtain

information from a lower tier entity, one of the methods for determining FIF income could be applied and a share of the FIF income treated as tainted income for the purposes of the test. The FIF income would be treated as tainted in this case because failure to obtain more detailed information indicates the investment is passive.

C.5 An exemption based on the active income test would be less arbitrary and more robust but could increase compliance costs. These costs are considered manageable because non-portfolio investors should be able to obtain information necessary to comply with the requirements of the active income test.

C.6 If an active income test were adopted, consideration could be given to reducing FIF income arising from a first tier company FIF to the extent the company is treated as having derived active income for the purposes of the test. This treatment would further align the treatment of non-portfolio holdings under the CFC and FIF measures. In this regard, active income is generally exempt from the CFC measures.

Exemption for portfolio investments

C.7 It is difficult to use statutory tests based on limited information to adequately differentiate between FIF investments that offer significant tax deferral opportunities and FIF investments that should be exempt from the anti-tax-deferral rules.

Option 1: Exemption for company FIFs taxed in a listed comparable tax country

C.8 One option for dealing with portfolio investments in company FIFs would be to replace the active business exemption with a jurisdictional exemption. A jurisdictional exemption could apply, for instance, for interests in company FIFs that are taxed on a worldwide basis in a listed comparable tax country. An exemption could be justified for these FIF interests because tax deferral opportunities are likely to be low if the worldwide income of a FIF is taxed in a comparable tax country.

C.9 The risk of tax deferral could be further reduced if only comparable tax countries with effective anti-tax-deferral regimes were listed. The operation of these regimes would help reduce the risk that tax deferral benefits could arise for third country investments held directly by a listed country FIF or held indirectly through other entities resident in the listed country.

Option 2: Exemption for company FIFs carrying on business in a listed country

C.10 A problem with option 1 is that it could be difficult for portfolio investors to determine whether a company FIF is taxed in a listed country on a worldwide basis. If it is impractical for investors to obtain this information, consideration could be given to allowing the exemption where a company FIF is listed on an approved stock exchange, and carries on business, in a listed country. This alternative would be less robust, however, because the exemption could apply to company FIFs that carry on business in a listed country and are otherwise treated as non-residents of that country. Tax deferral opportunities could therefore arise because amounts derived by a non-resident from a third country investment would not normally be taxable in a listed country unless the investment is connected with a branch in the listed country.

Implications for the balanced portfolio exemption

C.11 Portfolio investments in non-exempt company FIFs could continue to be held without being subject to the FIF measures if the balanced portfolio exemption is satisfied. This would allow some portfolio investments in unlisted countries to be exempt from the FIF measures. Consideration could be given to increasing the percentage of non-exempt FIFs permitted under the exemption, particularly if only comparable tax countries with effective FIF regimes are listed for the purposes of the jurisdictional exemption.

Appendix **D**

Possible changes to the anti-tax-deferral rules for fixed trusts

D.1 This appendix examines further issues relating to the anti-tax-deferral rules for fixed trusts.

Should interests in closely held fixed trusts be subject to the CFC measures rather than the FIF measures?

D.2 Greater equivalence in treatment of companies and trusts could be achieved if closely held fixed trusts were subject to the CFC measures rather than the FIF measures. While this would be conceptually attractive, differences in the treatment of companies and trusts in other countries may necessitate a departure from the objective of achieving equivalence.

D.3 It may not be appropriate, for instance, to provide trusts with an exemption for amounts taxed in a listed comparable tax country. In this regard, the exemption should only be available for income that has been taxed in a listed country. This condition usually would not be satisfied, however, if a listed country treats trusts as flow-through entities. In this case, the listed country is unlikely to tax third country income derived by Australian beneficiaries via a trust in that country. Moreover, certain types of income sourced in that country may be taxed at lower rates on a withholding basis because the income would be treated as if it were derived directly by the Australian beneficiaries.

D.4 More robust anti-tax-deferral rules may also be justified for trusts because trusts have a history of being used for tax avoidance purposes owing partly to lower regulatory requirements and their greater flexibility relative to companies.

Should fixed trusts be subject solely to either the transferor trust or FIF measures?

D.5 There is potential for overlap in the anti-tax-deferral rules for fixed trusts that could be avoided if fixed trusts were subject solely to either the transferor trust or FIF measures. In this regard, beneficiaries can currently be

subject to the deemed present entitlement rules in the general trust provisions on an interest in a fixed trust in addition to a transferor being subject to the transferor trust measures. This overlap could continue if the anti-tax-deferral rules in the general trust provisions were removed and the FIF measures were extended to apply to interests in all fixed trusts as discussed previously.

D.6 Overlap of the anti-tax-deferral rules could be avoided by exempting fixed trusts from the transferor trust measures and relying solely on the FIF measures to address tax deferral opportunities for these trusts. The removal of potential overlap would help reduce complexity in the law and might not greatly increase the risk of tax deferral. In this regard, it may be sufficient to rely on the FIF measures to deal with deferral opportunities because it should be possible to identify interests that beneficiaries have in the accumulated profits of a fixed trust.

D.7 The existence of a transferor may, however, indicate that a guiding hand could be using a trust to avoid tax. A trust could, for instance, be only one component of a broader scheme which involves distributing trust profits to non-resident beneficiaries who then provide gifts or other benefits to the transferor or associates of the transferor. The application of the more robust transferor trust measures may therefore be justified where a resident transferor can be identified.

D.8 An alternative approach for reducing overlap would be to provide an exemption from the FIF measures for trusts subject to the transferor trust measures. A downside of applying only the transferor trust measures is that a transferor may be taxed on amounts that can be shown to be accumulating for the benefit of a resident beneficiary. It may be fairer in this case to tax the beneficiary on the amounts under the FIF measures. This would involve applying both the transferor trust and FIF measures and reducing the amount to be taxed under the transferor trust measures by an amount based on the interest taxed under the FIF measures.

Appendix **E**

Options for improving the transferor trust measures and for dealing with hidden trusts

Should the exemption for transfers made prior to the operation of the measures be removed?	690
Should the exemption for transfers made prior to a taxpayer becoming a resident of Australia be removed?	691
Should the exemption for transfers made under the terms of a deceased estate be removed?	691
Should the time restriction for making adjustments under the measures be removed?	692
Are rules required to prevent evasion of the transferor trust rules through the use of hidden trusts?	692

E.1 This appendix examines options that would improve the effectiveness of the transferor trust measures and an option that could help reduce tax evasion through the use of hidden trusts.

Should the exemption for transfers made prior to the operation of the measures be removed?

E.2 The exemption from the transferor trust measures for transfers to foreign trusts made before 12 April 1989 (that is, before the introduction of the measures) could be removed. These transfers are currently exempt unless it can be conclusively demonstrated that the transferor or an associate is in a position to control the trust. This exemption extends beyond the normal scope of provisions intended to provide transitional relief because it exempts income that continues to accrue and, given the anti-avoidance rationale for the original measures, may not be appropriate. Also, it has been found in practice

to be very difficult, if not impossible, to establish that control has existed in relation to certain foreign trusts.

Should the exemption for transfers made prior to a taxpayer becoming a resident of Australia be removed?

E.3 The exemption from the transferor trust measures for pre-residency transfers could be largely removed. This exemption currently allows prospective residents to transfer legal ownership of assets to foreign trusts immediately before changing residence and thereby defer or avoid Australian tax unless it can be shown that the trust is controlled.

E.4 The exemption could be limited to temporary visitors to Australia whose stay is no longer than four years. The exemption would therefore be aligned with the temporary visitor exemption in the FIF measures. Consistent with the removal of the exemption for transfers made prior to the introduction of the transferor trust measures, pre-residence change transfers could be taken into account on a prospective basis for the purposes of the transferor trust measures even if made prior to the removal of the exemption.

Should the exemption for transfers made under the terms of a deceased estate be removed?

E.5 The exemption from the transferor trust measures for transfers made under the terms of a deceased estate could be removed. This exemption currently allows beneficiaries of a deceased estate to obtain a tax-deferral benefit if they can benefit from amounts accumulating in the estate or in trusts created under the terms of the estate.

E.6 Succession rules could be introduced to apply to transfers to foreign trusts created under the terms of a deceased estate and to bequests to existing foreign trusts. These rules would initially treat a deceased estate as a transferor where the deceased estate has a resident executor. The beneficiaries of the estate would then be treated as transferors once probate is settled and the estate is distributed. The undistributed income of the foreign trust would be attributed in proportion to each beneficiary's share of the estate. A special 'look-through' rule could apply to immediately treat beneficiaries as transferors in cases where the executor is not a resident. Again the income of a foreign trust would be attributed to beneficiaries of the estate in the proportion that they benefit under the deceased estate. Consideration could be given to also removing the exemption in the FIF measures for interests in a foreign trust arising under a deceased estate.

E.7 Transfers made by deceased estates prior to the introduction of the above rules could be taken into account for the purposes of determining whether there is a transferor. This treatment would be consistent with the removal of the exemptions for transfers made prior to the introduction of the transferor trust measures and for pre-residency transfers.

Should the time restriction for making adjustments under the measures be removed?

E.8 The Commissioner of Taxation's power to amend a tax assessment for the purposes of applying the transferor trust measures could be extended to apply for a longer period. The Commissioner's power is currently limited to amending assessments for the last four income years unless it can be established that a transferor was in a position to control a foreign trust.

E.9 Wider amendment powers could be considered because in practice it is difficult to establish within a four year period whether a foreign trust is controlled. Often it is not apparent that Australian residents have a connection with a foreign trust until they benefit from the trust. Once alerted, an investigation of the connection may show that the trust is controlled by a resident transferor and action can be taken to apply the transferor trust measures. This action is currently limited to adjusting assessments for the past four years unless there is evidence of evasion. A windfall tax deferral benefit could therefore arise for amounts accumulated in the foreign trust in earlier years.

Are rules required to prevent evasion of the transferor trust rules through the use of hidden trusts?

E.10 Even if the transferor trust rules are tightened as discussed above, the rules would not be effective when dealing with hidden trusts (that is, trusts created offshore where it is not possible to show that a trust relationship exists). There is a risk that these trusts are being used to avoid or evade Australian tax because of the ease with which they can be hidden by 'under the table' dealings and difficulties associated with proving their existence (particularly where only limited information is available under the laws of another country).

E.11 One option for dealing with hidden trusts would be to apply a penalty tax on non-arm's length asset transfers offshore by Australian residents to reflect the tax that would have been paid on income from those assets if it were possible to show that a trust was created. The charge could be imposed on the difference between the arm's length value of a transfer and the actual consideration received.

E.12 To limit the measure to transfers that present the greatest risk, an exclusion could be available for transfers not exceeding a specified value during a year of income and for gifts to charitable organisations. An exclusion could also be available if the assets transferred are:

(i) applied for the benefit of a natural person;

(ii) there is a relationship between the person and the transferor to justify the non-arm's length terms of the transfer; and

(iii) the person has an indefeasible interest in the asset.

E.13 The penalty tax could be applied without restriction to transfers to foreign accounts protected by secrecy rules. These accounts can be used to evade Australian tax because they break the paper trail necessary to determine how the transferred amounts have been used.

E.14 Another issue relating to hidden trusts is that distributions from existing foreign trusts can be characterised as tax exempt gifts. One option for dealing with this issue would be to treat certain gifts as income. These rules could apply to non-arm's length transfers made directly or indirectly by non-residents to residents of Australia unless there is a relationship between the recipient and the non-resident to justify the non-arm's length terms of the transfer. Under this approach, the difference between the arm's length value of the transfer and the actual consideration given could be treated as income of the recipient.

E.15 The above measures are relatively extreme and could be seen as unfair because a tax liability could arise where there is no conclusive evidence of tax avoidance or evasion. The measures would also increase compliance costs, are likely to be difficult to target and could impede legitimate property transfers if they are not well targeted. Measures of this kind may be required, however, if the use of hidden trusts becomes a serious threat to the tax system.

E.16 Views are sought on how the measures could be formulated to ensure legitimate transfers would not be caught and on other measures that should be considered.