The Senate

Economics Legislation Committee

New International Tax Arrangements Bill 2003

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CHAPTER 1

INTRODUCTION

Background

1.1 The New International Tax Arrangements Bill 2003 was introduced into the House of Representatives on 4 December 2003 by the Hon Ross Cameron MP, Parliamentary Secretary to the Treasurer. It was passed by the House of Representatives on 4 March 2004, and was introduced into the Senate on 8 March 2004.

Purpose of the bill

1.2 According to Mr Cameron's Second Reading Speech, the purpose of the bill is to 'reduce unnecessary tax compliance burdens for the superannuation and managed funds industries.'[1] The bill is the first of a series of proposed laws to emerge from the measures announced in Budget 2003 in response to the Board of Taxation review of international tax arrangements.

Reference of the bill

1.3 On 10 March 2004, the Senate adopted the Selection of Bills Committee Report No. 3 of 2004 and referred the provisions of the bill to the Senate Economics Legislation Committee for consideration and report by 12 May 2004.

Submissions

1.4 The Committee advertised its inquiry into the New International Tax Arrangements Bill 2003 on the internet and in *The Australian* newspaper. In addition the Committee contacted a number of organisations alerting them to the inquiry and inviting them to make a submission. A list of submissions appears at **Appendix 1**.

Hearings and evidence

1.5 The Committee held one public hearing at Parliament House, Canberra, on Thursday, 1 April 2004. Witnesses who appeared before the Committee at that hearing are listed in **Appendix 2**.

1.6 Copies of the Hansard transcript are tabled for the information of the Senate. They are also available through the internet at http://aph.gov.au/hansard.

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1 House of Representatives, *Hansard*, the Hon Ross Cameron MP, 4 December 2003, p. 23768.

Acknowledgment

1.7 The Committee wishes to thank all those who assisted with this inquiry.

CHAPTER 2

THE BILL

Background to the bill

2.1 The New International Tax Arrangements Bill 2003 is the first bill to be introduced into the parliament in response to the Board of Taxation inquiry into international taxation, whose report was presented to the Treasurer in February 2003. A Government response to the report was released in March 2003, proposing three tranches of implementing legislation, and the proposals were described further in the 2003 budget. This chapter traces that process as background to the current bill.

Board of Taxation inquiry into international taxation

2.2 In May 2002, the Treasurer issued a press release announcing a review by the Board of Taxation ('the Board') of four areas of international taxation arrangements. Those four areas were:

- the dividend imputation system's treatment of foreign source income;
- the foreign source income rules (comprising principally the controlled foreign corporation[sic] (CFC), foreign investment fund (FIF) and foreign tax credit/exemption rules);
- the overall treatment of 'conduit income'; and
- high level aspects of Double Tax Agreement (DTA) policy and processes.[1]

2.3 In the Board's report,[2] an additional term of reference (namely 'the taxation treatment of foreign expatriates') was also cited. It is not clear from the report how this term of reference was derived.

2.4 The Board reported on 28 February 2003. It made 41 recommendations, which it grouped informally into four categories:

- recommendations which ensure that Australia's dividend imputation system does not impede the ability of Australian companies to attract capital for offshore expansion;

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1 Press Release, *Review of International Tax Arrangements*, Hon Peter Costello MP, Treasurer, 2 May 2002.

2 *International Taxation – A Report to the Treasurer*, Volume 1 'The Board of Taxation's Recommendations', p. xi (hereafter 'The Board of Taxation Report').

- Recommendations which remove impediments to Australia's attractiveness as a location for internationally-focused companies to operate global and regional business;

- Recommendations which remove impediments to Australia as a global financial services centre; and

- Recommendations which improve Australia's tax treatment of foreign expatriates to enhance Australia's attractiveness to overseas talent.

Government response to the Board of Taxation recommendations

2.5 The Treasurer announced the Government's response to the Board's review on 13 May 2003. The Government proposed a series of reforms including:

- simplifying the application of the CFC rules for Australian companies operating in countries where tax arrangements are comparable to Australia's and easing these rules for certain services provided in international markets;

- moving towards a more residence-based treaty policy, consistent with the direction set in the US Protocol[3], where the overall treaty package is in Australia's national interests;

- exempting Australian companies (and their CFCs) from capital gains tax (CGT) for the sale of certain non-portfolio interests in foreign companies and extending the existing tax exemption for foreign non-portfolio dividends (and certain branch profits);

- proceeding with the previously announced foreign income account measure;

- better targeting the foreign investment fund (FIF) rules to reduce compliance costs for Australian managed funds and superannuation entities investing offshore by increasing the balanced portfolio exemption from 5 to 10 per cent for all taxpayers along with exempting complying superannuation funds from the FIF rules;

- revising certain aspects of the cross-border taxation of resident trusts to improve the international competitiveness of Australian managed funds;

- proceeding with the simplified treatment of foreign trusts and the tightening of the transferor trust rules, both previously announced;

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3 This refers to the protocol amending aspects of the Australia-US double taxation treaty. The protocol entered force on 13 May 2003.

- extending aspects of the 'separate entity' treatment given to foreign bank permanent establishments to branches of other financial entities. Further, unfranked dividends received by foreign-owned branches generally will be taxed on assessment, instead of being subject to non-resident withholding tax; and
- addressing the double taxation of employee share options. [4]

Provisions of the 2003 budget

2.6 Funding for the reform measures was announced in the 2003-2004 budget, which anticipated a $270 million decrease in revenue over four years arising from implementation of the *Review of International Taxation Arrangements* reforms, as follows:

Year	Net Effect on Revenue ($m)
2003-04	-60.0
2004-05	-165.0
2005-06	-10.0
2006-07	-35.0

2.7 The total of $270 million is a net figure, which includes the impact of the Government's agreement with the Board's recommendation that a previously-announced franking credit for foreign dividend withholding tax measure should not proceed. The budget paper states that 'Funding for this proposal was included in the forward estimates and the savings from not proceeding are reflected in the overall net cost of this measure'.[5]

2.8 The costs to revenue for the measures contained in this bill are stated in the Explanatory Memorandum, and can be summarised as follows (figures in $m):

Measure	2004-05	2005-06	2006-07
Foreign investment funds	15.0	20.0	20.0
Interest withholding tax exemption for unit trusts	3.0	3.0	3.0
Attributable income of controlled foreign companies	Negligible		

4 Press Release, *Review of International Taxation Arrangements*, Hon Peter Costello MP, Treasurer, 13 May 2003.

5 2003-04 Budget Paper No. 2, p.29.

Preventing double taxation of royalties subject to withholding tax	1.0	1.0	1.0
Annual Totals	**19.0**	**24.0**	**24.0**

Provisions of the bill

2.9 The substantive provisions of this bill are set out in four schedules, which are enacted by section 3. Each of those schedules gives effect to a separate measure, and this section of the report will outline the impact of each schedule. The measures do not overlap in any significant sense. In its submission, the Department of the Treasury outlined the purpose of the measures contained in the bill as follows:

> The measures in the Bill are designed to:
>
> - reduce unnecessary tax compliance burdens for the superannuation and managed funds industries by amending the foreign investment fund ('FIF') rules to:
>   - increase the balanced portfolio FIF exemption;
>   - exempt complying superannuation entities from the FIF rules; and
>   - remove 'management of funds' from the FIF blacklist of non-eligible activities, so that investment in a company principally engaged in funds management should no longer constitute a 'black-listed' FIF activity.
> - the managed fund industry will also benefit from a proposed exemption for public unit trusts from interest withholding tax on interest paid on widely offered debentures issued to non-residents.
> - in addition the Bill amends the controlled foreign company ('CFC') rules by allowing for the making of regulations in the CFC rules to pare back the types of attributable income of CFCs in comparably taxed jurisdictions (known as 'broad exemption listed countries', or 'BELCs');
> - finally, the Bill also implements a change recommended by the Review of Business Tax to prevent double taxation of royalties in transfer pricing situations.[6]

Schedule 1 – Foreign investment funds

2.10 Schedule 1 relates to the foreign investment funds (FIF) rules contained in Part XI of the *Income Tax Assessment Act 1936*. These measures were introduced by the *Income Tax Assessment Amendment (Foreign Investment) Act 1992* and have been

6 Submission 5, Department of the Treasury, p. 9.

effective since 1993. The FIF rules aim to 'reduce the extent to which Australian residents can defer Australian tax where they hold interests in foreign entities,'[7] where those foreign entities accumulate wealth rather than providing the investor with a present entitlement to income. In the absence of FIF rules, investors could invest in offshore entities, with a view to strategically managing the point in time at which they derive the income (and thereby incur an Australian taxation obligation).

2.11 The Department of the Treasury stated in its submission:

> The [FIF] rules seek to prevent residents from deferring taxation by accumulating passive income (such as portfolio dividends and interest) at low or zero rates of tax in foreign entities. The rules apply to portfolio investments and are directed at companies and taxpayers on high marginal tax rates, where the benefits from deferral are greatest.[8]

2.12 Presently, the FIF rules contain a range of exemptions directed towards 'offshore interests where tax-motivated accumulation is unlikely,'[9] such as:[10]

- an exemption for interests in foreign companies which are principally engaged in certain active businesses;[11]
- an exemption for an interest in a foreign bank;[12]
- an exemption for an interest in a foreign life insurance company;[13] and
- an exemption for an interest of $A50,000 or less.[14]

2.13 The current bill proposes three separate amendments to Part XI of the *Income Tax Assessment Act 1936*:

- removal of complying superannuation entities, and other eligible entities, from the FIF rules;

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7 Australian Taxation Office, *Foreign Investment Funds Guide* p. 1.

8 Submission 5, Department of the Treasury, p. 10.

9 Submission 5, Department of the Treasury, p. 12.

10 This list is illustrative rather than exhaustive.

11 *Income Tax Assessment Act 1936* s. 497

12 *Income Tax Assessment Act 1936* s. 503

13 *Income Tax Assessment Act 1936* s. 507

14 *Income Tax Assessment Act 1936* s. 515

- increase of the balanced portfolio exemption threshold under ss.524 and 525(1)(c) from 5% to 10%; and
- removal of 'management of funds' from the list of FIF non-eligible business activities contained in Schedule 4 of the *Income Tax Assessment Act 1936*.

Removal of complying superannuation entities, and other eligible entities, from the FIF rules

2.14 Recommendation 4.4 of the Board of Taxation Report was as follows:

> The Board recommends that complying superannuation entities should be exempted from the foreign investment fund rules.[15]

2.15 Schedule 1, Item 8 of the bill proposes to implement this recommendation by inserting into the Act a new Division (11A) which would exempt superannuation entities, and life insurance investments or fixed trust investments (where the life insurance investment or fixed trust investment is in favour of a complying superannuation entity) from the FIF rules. The Explanatory Memorandum provides the following rationale:

> The tax benefits of investing in FIFs are much lower for complying superannuation entities that are generally taxed at a flat rate of 15% and can only access a one-third discount on eligible capital gains.[16]

Increase of the balanced portfolio exemption threshold under ss.524 and 525(1)(c) from 5% to 10%

2.16 The *Income Tax Assessment Act 1936* contains an exemption from the FIF rules for investors who have 5 per cent or less of their FIF holdings subject to the FIF rules. That is, investors who have exemptions relating to at least 95 per cent of their FIF investments will be able to obtain exemptions for the final 5 per cent. The rationale for this exemption was explained by the Minister in the second reading speech for the Income Tax Assessment Amendment (Foreign Investment) Bill 1992:

> In cases where only 5 per cent or less of a taxpayer's aggregate interests in foreign investment funds would give rise to taxation under these measures, because the other 95 per cent or more of the taxpayer's interests are exempt under another of the exemptions, then the entire interests in foreign investment funds will not be subject to [the FIF] measures. This exemption recognises the need for balanced investment portfolios. […] The inclusion of an exemption for those taxpayers with balanced investment portfolios in foreign investment funds … has

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15 *International Taxation – A Report to the Treasurer*, Volume 1 'The Board of Taxation's Recommendations,' p.122.

16 Explanatory Memorandum, p. 8.

> targeted more closely the foreign investment fund measures at offshore investment that provides tax minimisation and deferral.[17]

2.17 The relevant provisions are contained in Division 14 of Part XI of the *Income Tax Assessment Act 1936*. Section 524 sets out the object of the Division in the following terms:

> **524.** The object of this Division is to exempt a taxpayer from taxation in respect of foreign investment fund income that would otherwise be taken to accrue from FIFs if the total value of the taxpayer's interests in those FIFs does not exceed 5% of the total value of all the taxpayer's interests in FIFs.

2.18 Section 525 is the substantive section giving legal effect to this object.

2.19 Recommendation 4.2 of the Board of Taxation Report was as follows:

> The Board recommends that the 5 per cent balanced portfolio exemption threshold in the foreign investment fund rules should be increased for Australian managed funds that do not carry on a trading business as defined in Division 6C of the [*Income Tax Assessment Act 1936*], to 10 per cent of the overall cost of the assets of the trust.

2.20 The Board indicated the difficulties with the current portfolio exemption threshold:

> The desired portfolio mix of many fund managers in Australia has higher proportions of FIF interests with attributable incomes under the FIF regime than the balanced portfolio exemption permits. This is often a reflection of the FIF regime's over-broad coverage […]
>
> Most fund managers (including superannuation entities) adjust foreign investment portfolios significantly just before relevant year-ends to meet the balanced portfolio exemption, and reverse the transactions shortly thereafter. This incurs significant transaction costs and so lowers returns for investors. The tax and other costs of doing this are substantial, but they are less than complying with a massive records-keeping burden which the application of the FIF regime would impose on funds.[18]

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17 House of Representatives, *Hansard*, The Hon. Peter Baldwin MP, Minister Assisting the Treasurer, 3 November 1992, p. 2437.

18 *International Taxation – A Report to the Treasurer*, Volume 1 'The Board of Taxation's Recommendations,' pp.114 and 115.

2.21 The Board further noted that 'The location of offshore funds in tax havens or in jurisdictions with favourable regimes does not of itself indicate a growth in tax avoidance.'[19]

2.22 The Board proposed raising the threshold to 10%, but did so as 'the simplest short term solution' to the problems faced by fund managers currently dealing with the lower 5% threshold.

2.23 The Treasury submission summarises the Government's view in response:

> When the FIF rules were developed in the late 1980s and early 1990s it was considered that a diversified portfolio would generally have less than 5 per cent of interests in non-exempt FIF activities. Since then it has been argued that financial assets which broadly constitute non-exempt FIF investments now comprise a greater proportion of global investment. Consequently, a diversified portfolio is now likely to have a higher proportion of non-exempt FIF investments.
>
> With many managed funds having more than 5 percent of non-exempt assets, the balanced portfolio exemption is not adequately exempting diversified funds from FIF attribution. Industry advises that up to 7 per cent of assets may not be exempt in a managed fund with a diversified asset portfolio. Consequently, consistent with the Board's recommendations, it is proposed to increase the balanced portfolio threshold from 5 to 10 per cent.[20]

2.24 Schedule 1, Items 10 and 11 of the current bill implement the change in this threshold by substituting '10%' for '5%' in the Act. No other aspects of the relevant sections are changed. Item 13 of the current bill states that the new threshold will apply to the income year commencing 1 July 2003.

Removal of 'management of funds' from the list of FIF non-eligible business activities contained in Schedule 4 of the *Income Tax Assessment Act 1936*.

2.25 One of the most important distinctions in the application of the FIF rules is the distinction between 'passive' and 'active' income and assets. Broadly speaking, investment in companies overseas which derive active income or possess active assets will not attract taxation under the FIF rules, as the purpose of such investments is not to avoid taxation by accumulating wealth overseas without deriving a present income from that wealth. On the other hand, investment in companies overseas which derive passive income or possess passive assets will attract taxation under the FIF rules.

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19 *International Taxation – A Report to the Treasurer*, Volume 1 'The Board of Taxation's Recommendations,' p.117.

20 Submission 5, Department of the Treasury, p. 13.

2.26 The distinction between passive and active assets and income is drawn in section 496 of the *Income Tax Assessment Act 1936*, which in turn calls up Schedule 4 of the Act. Passive incomes are derived from the activities listed in Schedule 4, namely:

(a) Banking and the provision of finance

(b) Financial intermediation services

(c) Investment in tainted assets, or tainted commodity investments, within the meaning of s.317

(d) Life insurance business

(e) General insurance business

(f) Management of funds

(g) Activities in connection with real property, other than in connection with construction.

2.27 Active incomes are defined by exception – that is, any activity not covered by s.496 is regarded as active.

2.28 The Board of Taxation considered Schedule 4 and noted that:

> When the FIF regime was introduced ten years ago, it was less common for funds management companies to be a separately available investment for portfolio investors. A number of such companies are now listed and should enjoy the same treatment as other financial institutions.[21]

2.29 The Board's recommendation 4.5 was as follows:

> The Board recommends that the foreign investment fund rules should be amended to allow fund management services to be an eligible activity for the purposes of the foreign investment fund rules.

2.30 The Government accepted this recommendation on the basis that:

> the activity of managing funds for others is not of itself an activity that involves deriving passive income or holding passive assets (other than on behalf of investors in the funds). Fund managers derive fees for services such as holding and managing assets for others. This should be considered an 'active', rather than 'passive' income-earning activity.[22]

2.31 Schedule 1, Item 12 of the bill implements this recommendation by removing Item (f) from Schedule 4 of the *Income Tax Assessment Act 1936*.

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21 *International Taxation – A Report to the Treasurer*, Volume 1 'The Board of Taxation's Recommendations,' p.122.

22 Explanatory Memorandum, p. 12.

Schedule 2 – Interest withholding tax exemption for certain unit trusts

2.32 When an entity obtains finance overseas, and must pay interest on that finance, the entity is required under Division 11A of the *Income Tax Assessment Act 1936* to withhold a portion of that interest, and to pay it as tax (interest withholding tax).

2.33 Section 128F allows companies to be exempt from paying interest withholding tax with respect to debentures provided that the debentures were 'issued with a view to public subscription or purchase or other wide distribution among investors.'[23]

2.34 Companies are the only entities currently able to obtain access to this exemption. Other entities, such as unit trusts, are not able to obtain access to the exemption. According to the Explanatory Memorandum, this has led some unit trusts to 'effectively obtain the exemption by having an interposed company undertake the borrowing and [pay] the interest'.[24]

2.35 The Board of Taxation considered this issue and stated:

> The widely-held debenture exemption should be extended to Australian managed funds, to remove the current discrimination between managed funds and companies and to give equivalent treatment to many overseas funds. Property trusts in particular are expected by the markets to borrow to partly fund their investments; but they are effectively limited to borrowing in Australia, because of the lack of the withholding tax exemption for widely issued debentures of companies.[25]

2.36 The Board's recommendation 4.8C was as follows:

> The Board recommends that exemption from interest withholding tax be available to widely held Australian unit trusts that are subject to Division 6 of the 1936 Act for widely distributed debentures issued to non-residents.

2.37 Schedule 2 of the current bill implements this recommendation for eligible unit trusts. Eligible unit trusts are defined in such a way as to ensure that 'eligible unit trusts are directly or indirectly widely held.'[26] Subsection 128FA(6) applies the conditions imposed on companies in s.128F to unit trusts.

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23 *Income Tax Assessment Act 1936*, s.128F(3)(a)

24 Explanatory Memorandum, p. 15.

25 *International Taxation – A Report to the Treasurer*. Volume 1 'The Board of Taxation's Recommendations' p.129.

26 Explanatory Memorandum, p. 17.

Schedule 3 – Attributable income of CFCs

2.38 Controlled Foreign Companies (CFCs) are essentially companies which are resident overseas, but which are controlled by Australian entities.[27] Part X of the *Income Tax Assessment Act 1936* provides a scheme whereby income and dividends from a CFC can be attributed for taxation purposes to the Australian entities which own the CFC. The purpose of these sections is to ensure that Australian entities are not able to shift income to non-resident companies in order to take advantage of lower rates of taxation overseas.

2.39 Section 320 of the Act provides for a distinction betwee *listed* and *unlisted* countries. The rules for CFCs differ between these categories. Listed countries, as explained in the Explanatory Memorandum, 'have comparable income tax regimes to Australia, which significantly reduces the scope to avoid tax.'[28]

2.40 The listed countries are outlined under Regulation 152J of the Income Tax Assessment Regulations 1936, which in turn calls on Schedule 10 of the regulations. This schedule further divides listed countries into *Broad Exemption Listed Countries* and *Limited Exemption Listed Countries.*[29] This further division was made because 'there are many countries on the [previous list of 'listed' countries] that do not consistently levy tax on a basis closely comparable to Australia.'[30] Consequently, 'CFCs in the limited-exemption countries will in certain respects be given similar treatment to CFCs resident in unlisted countries.' [31]

2.41 The current bill relates primarily to the Broad Exemption Listed Countries, which are:

- Canada;
- France;
- Germany;
- Japan;
- New Zealand;
- the United Kingdom;
- the United States of America.

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27 The full definition can be found in the *Income Tax Assessment Act 1936*, s.340

28 Explanatory Memorandum, p. 21.

29 These categories were inserted into the Act by the *Taxation Laws Amendment (Foreign Income Measures) Act 1997*.

30 Lehmann & Coleman, *Taxation Law In Australia*, Australian Tax Practice, 1998, p. 1215 (quoting the Explanatory Memorandum to the Taxation Laws Amendment (Foreign Income Measures) Bill 1997).

31 Lehmann & Coleman, *Taxation Law In Australia*, Australian Tax Practice, 1998, p. 1215

2.42 The Board of Taxation Report reviewed the CFC rules and made a number of recommendations. Recommendation 3, the key recommendation in relation to CFCs, was:

> The Board recommends that where an attributable taxpayer holds an interest in a controlled foreign company that is resident in a broad-exemption listed country, the following income should not be attributed to the Australian resident:
>
> (a) the income of the controlled foreign company (which would include its subsidiaries) that is sourced in that broad-exemption listed country or another broad-exemption listed country or is otherwise included in the tax base of a broad exemption listed country;
>
> (b) the income of any subsidiaries of the broad-exemption listed country controlled foreign company where the subsidiaries are not resident in a broad-exemption listed country provided the broad-exemption listed country has a broadly comparable controlled foreign company regime to Australia's controlled foreign company regime.[32]

2.43 The Government's response endorsed the Board's recommendations in relation to CFCs:

> The CFC reforms will streamline the application of the CFC rules, reducing the informational requirements and compliance costs of those rules and improving the flexibility of Australian companies with operations offshore, without significantly increasing risks to integrity. These changes will help improve the efficiency and competitiveness of outwardly oriented Australian business. They will also make Australia a more attractive place for regional headquarter operations.[33]

2.44 The current bill addresses a specific situation, where a CFC in a broad exemption listed country invests outside that broad exemption listed country. Treasury notes that 'in practice, little income of this sort is attributable.'[34] As a result, it cannot be said that this form of income constitutes a threat to the revenue. In response to the Board of Taxation Review, the government indicated that 'only types of income that give rise to significant integrity risks would remain'[35] under the CFC rules.

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32 *International Taxation – A Report to the Treasurer*, Volume 1 'The Board of Taxation's Recommendations,' p.82.

33 Press Release, *Review of International Taxation Arrangements*, Hon Peter Costello MP, Treasurer, 13 May 2003.

34 Submission 5, Department of the Treasury, p. 18.

35 Submission 5, Department of the Treasury, p. 18.

2.45 The purpose of this bill is effectively to remove this form of income from the CFC rules. However, instead of repealing the relevant provisions outright, the bill makes the application of those provisions dependent on the content of regulations. Treasury has then indicated that no regulations are planned. The net effect of this is that income earned by a CFC in a broad exemption listed country from investment outside that country will no longer be attributable under the CFC rules.

2.46 Treasury explained the rationale for this approach as follows:

> As no relevant regulations in this regard are currently intended, the practical outcome is likely to be similar to a repeal. But the ability to specify relevant attributable amounts in regulations is a useful safeguard in case integrity risks open up in the future.[36]

Schedule 4 – Preventing double taxation of royalties subject to withholding tax

2.47 Part III, Division 13 of the *Income Tax Assessment Act 1936* contains provisions dealing with 'transfer pricing'. Transfer pricing is the practice of 'pricing arrangements that shift profits from high to low tax countries'[37] in order to minimise taxation. Broadly, the division contains provisions which enable the income from such transactions to be assessed as though the parties to such a transaction were 'between independent parties dealing at arm's length with each other.'[38]

2.48 Under s.136AF of the Act, the Commissioner is able to allow deductions to the payer in order to prevents double-taxation of the payment. Section 136AF(3) deals, in particular, with withholding tax on interest, where the Commissioner has determined that a deduction should *not* be allowed on the interest payment. The Explanatory Memorandum explains its effect as follows:

> Subsection 136AF(3) of the ITAA 1936 operates to remove … double taxation for interest payments. It enables the Commissioner to determine that withholding tax should not have been paid by the (non-resident) recipient, to the extent that the interest amount has been disallowed as a deduction to the Australian payer.[39]

2.49 In the absence of such a provision, the interest payment would be taxed twice: once in the hands of the Australian payer (who is effectively taxed, in that their deduction is denied) and once in the hands of the non-resident recipient (as a result of the withholding tax).

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36 Submission 5, Department of the Treasury, p. 19.

37 Lehmann & Coleman, *Taxation Law In Australia*, Australian Tax Practice, 1998, p. 1156.

38 *Income Tax Assessment Act 1936*, s. 136AA(3)(d)

39 Explanatory Memorandum, p. 25.

2.50 The report *A Tax System Redesigned* drew attention to the fact that while these provisions cover interest, they do not affect royalties:

> Currently consequential adjustments can [be] and are made where an amount has been included in a taxpayer's assessible income or where a deduction has been adjusted to take account of dealings carried out on an arm's length basis.
>
> However there is no legislative support to adjust, for example, royalty withholding tax where a royalty deduction has been reduced.
>
> Australia's tax treaties impose an obligation on both tax treaty partners to relieve double taxation where a transfer pricing adjustment has been made by the other country in accordance with the treaty. There is currently uncertainty in the way these provisions achieve their aim and in some cases inadequate relief may result (for example where one of the parties is in a loss situation, or in the royalty case referred to above). Legislation is needed to ensure that the relief from double taxation matches what would have been the outcome had the dealings been undertaken on an arm's-length basis in the first place.[40]

2.51 Schedule 4 of the current bill gives effect to this proposal simply by inserting the words 'or royalties' into s. 136AF(3)(b) of the *Income Tax Assessment Act 1936*. The result would be that royalties would be treated in the same manner as interest for purposes of providing relief from double-taxation under transfer pricing arrangements.

2.52 The Treasury submission explained the proposed amendment as follows:

> When a royalty is paid from Australia it will generally be deductible to the payer and subject to withholding tax (generally at 10%). Presently, the compensating adjustment provisions do not apply in circumstances where royalty withholding tax was previously paid on the amount that was disallowed under the transfer pricing rules. This means that the amount is effectively taxed once in the hands of the Australian payer, by reason of a disallowance of the deduction, and again by way of withholding tax in the hands of the non-resident recipient.
>
> The amendment will enable the Commissioner to determine that royalty withholding tax is not payable by a non-resident taxpayer to the extent that the transfer pricing rules have disallowed a deduction to the payer of the royalty. This will prevent double taxation of this amount. It is left to the Commissioner to determine how this is done.[41]

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40 *A Tax System Redesigned*, July 1999 pp. 671-672.

41 Submission 5, Department of the Treasury, p. 20.

CHAPTER 3

ISSUES AND RECOMMENDATION

3.1 Two issues were raised by the Selection of Bills Committee with respect to the current bill. One issue related to the impact on revenue of the balanced portfolio exemption under the FIF rules, and the other related to the overall cost of measures implemented in response to the Board of Taxation report. No further issues were raised by any submissions or evidence before the Committee, and no evidence opposed to the bill was received.

Balanced portfolio exemption

3.2 The Selection of Bills Committee Report[1] asked the Committee to 'examine the proposed increase in the foreign investment fund rules balanced portfolio exemption from 5 to 10 per cent.' The Committee drew this issue to the attention of stakeholders in its advertisements for the current inquiry.

3.3 As noted in chapter 2, the bill proposes to increase the balanced portfolio exemption threshold contained in sections 524 and 525(1)(c) of the *Income Tax Assessment Act 1936* from 5 per cent to 10 per cent. All relevant evidence and submissions before the Committee supported this proposal.

3.4 The Business Coalition for Tax Reform, for instance, stated that:

> … increasing the threshold will have beneficial impact on the administrative costs imposed on funds, and ultimately on Australian investors saving for their retirement. Because far fewer funds are expected to be in breach of the proposed 10% threshold, many will be able to avoid the administrative costs associated with disposing of some of the offending investments before year end (known as 'bed and breakfast' transactions), or the detailed work required in maintaining attribution accounts. As far as they go, the proposed measures are therefore most welcome and we would urge Senators to support this part of the Bill.[2]

3.5 The Investment and Financial Services Association stated:

> IFSA supports the measure to increase the balanced portfolio exemption from 5 to 10%. For the vast majority of properly constructed foreign portfolios this will eliminate the need to conduct a year end sell down and repurchase. The experience of our industry is that for most global portfolios 5% is not quite enough to eliminate year end problems with total non

1 Selection of Bills Committee Report No. 3 of 2004.

2 Submission 2, Business Coalition for Tax Reform, p. 2.

> exempt investments of 6 to 7% quite common and higher levels not unusual.[3]

3.6 The Business Council of Australia set out its reasons for supporting the bill in similar terms:

> Some of the benefits of increasing the FIF balanced portfolio exemption threshold from 5% to 10% are lower compliance costs for fund managers and other taxpayers who will not have to:
>
> - determine attributed income or maintain attribution accounts; or in order to avoid attribution
> - undertake the practice of 'selling down' non-exempt FIF assets at the end of the income year in order to meet the balanced portfolio exemption threshold.[4]

3.7 Other submissions supporting this arrangement included those from the Association of Superannuation Funds of Australia and the Taxation Institute of Australia.

3.8 The Committee concludes from this evidence that the measure should be supported.

Cost of measures

3.9 The Selection of Bills Committee Report asked the Committee to 'examine the reconciliation of the cost to revenue of the measures in this Bill and the reforms to International Tax announced in the 2003-04 Budget and those included in the International Tax Arrangements Bill 2003.' This issue took up much of the Committee's time in its hearing on 1 April 2004.

3.10 As noted in chapter 2, the entire package of international tax measures announced in the budget is projected to cost $270 million net in the period to 2006-07. This figure includes an offset from the previously-announced franking credit for foreign dividend withholding tax measure, which will now not proceed.

3.11 The cost of the measures implemented in this bill amount to $67 million in the period to 2006-07.

3.12 A previously implemented measure, which this Committee reported on in its report into the *Provisions of the International Tax Agreements Amendment Bill 2003* relating to a double-taxation treaty with the UK, will cost $280 million.

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3 Submission 3, Investment and Financial Services Association, p. 2.

4 Submission 7, Business Council of Australia, pp. 3-4.

3.13 Finally, on 1 April 2004, the Government introduced the *New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004*, which contains measures forecast to cost $105 million.

3.14 Consequently, measures with a total cost of $452 million have been announced to date. To reconcile this figure with the budget prediction of $270 million, offsets of $182 million (plus the cost of any further measures) must be found.

3.15 During the Committee's hearing into this reference, Treasury officials were asked to identify these offsets. Officers identified the franking credit for foreign dividend withholding tax measure identified above.[5] This measure was identified in the report *A Tax System Redesigned* ('the Ralph Report').

3.16 The Ralph Report forecast that the franking credit for foreign dividend withholding tax measure would cost a total of $830 million in the period from 2000-01 through 2004-05. The cost in 2004-05 was to be $200 million[6]. The removal of this $200 million cost from the budget more than offsets the shortfall between currently-announced international taxation measures spending and the budget forecast of $270 million.

3.17 On the basis of these figures, the Committee observes that there is no reason to doubt that the budget forecast of $270 million can be reconciled with the costs announced in the current bill, the costs of the *International Tax Agreements Amendment Act 2003* and the forecast costs of the New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004.

Recommendation

The Committee recommends that the Senate pass the bill.

Senator George Brandis
Chair

5 *Transcript of Evidence*, Motteram, 1 April 2004, p. 11.

6 *A Tax System Redesigned,* July 1999 p. 715, table 24.4.

SENATE ECONOMICS LEGISLATION COMMITTEE
LABOR SENATOR'S MINORITY REPORT
INTERNATIONAL TAX ARRANGEMENTS AMENDMENT BILL 2003

The International Tax Arrangements Amendment Bill 2003 is part of a package of measures announced in the 2003 Budget arising out of the Review of International Tax Arrangements (RITA).

The description in the budget papers of those international tax measures was ambiguous.

It appeared to refer to an unspecified set of Review of International Taxation Arrangements measures and the component of those costs that would be associated with the two new Double Tax Agreements (DTA) for the UK and Mexico.

It was also equally capable of being read as referring to the total cost of the two international tax agreements and the total cost of the Government's proposed RITA measures.

It was not until the two DTA's were being ratified by parliament that it was clarified that the budget measure referred to an unspecified set of RITA measures and the UK DTA only.

The budget estimate of the cost of those international tax measures was $270 million over the budget year (2003-04) and the three forward estimate years.

This raised concerns about the budget estimate because the direct cost of the UK DAT was $280 million over the four years.

The cost over those four years of this Bill (the International Tax Arrangements Amendment Bill 2003) was a further $62.5 million.

The Government then introduced another tranche of RITA measures (the International Tax Arrangements Amendment Bill 2004) which had a cost of $62.5 million over the four years.

The total direct cost of the original $270 million RITA budget measures had reached $447.5 million and the Government had advised that there was another tranche of the measures to come.

The purpose of Labor Senators referring this Bill to the committee was to obtain a full reconciliation with the original budget estimate of the measures.

If there was something wrong with that budget estimate the Government hadn't bother to clarify it, as it could have when it produced the Mid-Year Economic and Fiscal Outlook.

Repeated requests to the Minister's office for clarification were to no avail.

The only explanation for this absence of information was that the cost of the further measures may change before they are introduced into parliament.

It is not unreasonable that the cost might change but it is also not unreasonable for the parliament to be told about it, particularly when the cost of the original budget measures appeared to have blown out by 65%.

As a result of the hearing on this Bill the following further information has been obtained from Treasury.

The cost of the remaining RITA 2003 Budget measures will not exceed $50 million over the four years, taking the total direct cost to $497.5 million.

The costing of the original RITA budget measure also included an offset, which was the Government's decision to defer implementation of an earlier decision to provide franking credits for foreign dividend withholding tax.

At the time the original decision to provide franking credits for foreign dividend withholding tax was made in November 1999, the estimates of its cost were $340 million in 2002-03, $190 million in 2003-04 and $200 million in 2004-05.

While these numbers do not coincide with the whole of the current budget year and forward estimates period, they do indicate a very substantial offset within that period - for 2003-04 and 2004-05 totalling $390 million.

While the likely cost of that measure may have changed, it is safe to conclude on the basis of the information provided by Treasury that the total direct cost of the RITA measures in the 2003 Budget will be less than the $270 million estimate contained in the 2003 budget.

It should also be noted that Treasury provided estimates in the explanatory memorandum for the International Tax Agreements Amendment Bill 2003 of the extra revenue from increased economic activity resulting from the UK DTA of a further $70 million a year. Treasury's modelling shows this activity building up rapidly in the second year of the new UK DTA and continuing at a relatively steady state thereafter.

The total effect on revenue of the full package of RITA measures announced in the 2003 Budget is small.

Senator Ursula Stephens
Deputy Chair

Appendix 1

SUBMISSIONS RECEIVED

Submission Number	Submittor
1	Binns Consulting Pty Ltd
2	Business Coalition for Tax Reform
3	IFSA
4	Association of Superannuation Funds of Australia (ASFA)
4a	Association of Superannuation Funds of Australia (ASFA)
5	The Treasury
6	Taxation Institute of Australia
7	Business Council of Australia
8	Australian Bankers' Association

Appendix 2

PUBLIC HEARING AND WITNESSES

THURSDAY, 1 APRIL 2004 – CANBERRA

BARLIN, Mr Philip Charles, Representative
Investment and Financial Services Association Ltd

DRENTH, Mr Frank, Executive Director
Corporate Tax Association of Australia Inc

LE, Mr Alexander Hoa The, Analyst
International Tax and Treaties Division, Department of the Treasury

MARSDEN, Ms Freya Verity, Director, Policy
Business Council of Australia

MOTTERAM, Mr Neil Francis
Acting General Manager, International Tax and Treaties Division
Department of the Treasury

PARTINGTON, Mr Allan John, Senior Adviser, Tax Analysis Division
Department of the Treasury

SALISBURY, Mr Kim, Manager, International Tax and Treaties Division
Department of the Treasury