Email: economics.sen@aph.gov.au

21 August 2003

The Secretary
Senate Economics Legislation Committee
Room SG.64
Parliament House
CANBERRA ACT 2600

Dear Dr Bachelard

**Inquiry into Taxation Laws Amendment Bill (No 7) 2003**

## 1. Introduction

We refer to a letter from the Committee Secretary dated 15 August 2003 inviting the Taxation Institute of Australia to make a submission to the Committee in its inquiry into three aspects of the Taxation Laws Amendment Bill (No 7) 2003 (TLAB7). Thank you for this opportunity to provide comments.

By way of background the Taxation Institute was established in 1943 and has a membership of 11,000 tax practitioners throughout Australia. Our members range from senior members of the bar specialising in tax, and senior tax advisors in the accounting and legal profession to small rural and suburban accountants.

## 2. Foreign Losses and Consolidation (Schedule 5)

The revenue risks associated with transitional rules to allow certain entities with foreign losses to be excluded from a consolidated group were listed as the first issue of concern for the Committee.

The Taxation Institute believes that the proposed amendments in Schedule 5 of the TLAB7 are essential to avoid major problems and inequities that would otherwise arise for groups that have previously incurred foreign losses in the expectation that these losses could be utilised against the resulting foreign income when subsequently derived.



**Taxation Institute of Australia**
Level 9 64 Castlereagh Street Sydney NSW 2000 **Tel** (02) 8223 0000 **Fax** (02) 8223 0077
**Email** tia@taxinstitute.com.au **Website** www.taxinstitute.com.au ABN 45 008 392 372

Although we are not able to speak directly on the revenue impacts of the measures the Taxation Institute believes that they should not have a revenue cost because of the strict limitations imposed on the scope of the measures, and the fact that these measures at most, only replicate the pre-existing tax position. In some quarters it is argued that they arguably could be revenue positive (see submission to this committee by Shaddick and Spence).

The specific limitations are that these provisions have a very targeted/restricted application, in that they apply to wholly owned subsidiaries at 1 July 2002 (provided these subsidiaries themselves do not own shares in Australian group companies) and where a group elects to consolidate during the transitional period ending on 30 June 2004. This restriction is supplemented by a further three year limitation on the ability of the foreign loss entity to remain outside a consolidated group and where an election is made for a foreign loss entity to remain outside a consolidated group, all consolidation regime transitional concessions and grouping facilities will not be available during that period.

**3. Imputation and Life Companies (Schedule 7)**

The second issue of concern requiring comment was the adequacy of imputation rules for life companies.

The Taxation Institute supports the amendments contained in TLAB7 in relation to the imputation rules for life insurance companies. They represent a significant simplification of the old rules in terms of the style of drafting, although they substantially replicate the existing provisions.

Importantly, they overcome certain anomalies that existed in relation to recognising the franking account credits applicable to the shareholder portion of tax paid by life insurance companies. The anomaly arose as life insurance companies pay tax on behalf of policyholders for whom no franking account credit is available and on behalf of the shareholders for whom franking account credit is available.

The Taxation Institute also notes that there is the issue of the franking deficit tax offset problem, in as much as s.205-70(2) step 2 could provide a problem for any taxpayer with a franking deficit at year end where their income year straddles 30 June 2002 (i.e. introduction of the new simplified imputation system rules). It is possible, even where a taxpayer may have underfranked a dividend (and therefore suffered s.160APX debit), to be in deficit at year end and subject to franking deficit tax, whereas the offset for the franking deficit tax would only be as to 70% even though there has been, in fact, no overfranking. This represents effectively a double penalty. However this is only a transitional issue and could be adjusted by some transitional provision inserted into the amending bill. The Institute would be loath to see the whole thing delayed unless such an amended provision could be easily inserted.

The Taxation Institute notes that the amendments in TLAB7 represent another step in the re-writing of the imputation rules into the 1997 Income Tax Assessment Act. There is obviously further work to be done in completing that re-write and there are further technical issues that will need to be addressed in the ongoing programme of work. However, this should not be a cause for concern or a reason for delay of the passing of the redrafted provisions contained in TLAB7.

Finally, the Taxation Institute understands that the industry was consulted in relation to the drafting of these provisions and that they have that industry support.

**4. Tax treatment of investments in foreign hybrids (Schedule 10)**

The final issue of concern requiring comment was the tax treatment of investments in foreign hybrids. The Taxation Institute believes that the proposed legislative changes adhere to the policy of the CFC provisions (ie tax deferred income, but not to impose double taxation), whilst providing:

- Clarity;
- Certainty; and
- Eliminate the impediments (significant compliance costs and the need to plan for the alternative scenarios which could arise from the legislative uncertainty) to investing via these vehicles.

In order to provide support for these views, it is necessary to first explain the commercial use of such structures and then to outline the legislative uncertainty and double taxation the legislation seeks to overcome.

(a) Commercial purpose

The use of Limited Partnerships, Limited Liability Partnerships and Limited Liability Companies (collectively "Foreign Hybrids") for investing in foreign jurisdictions is common and widespread, particularly in the US and UK. This is the result of various foreign Governments' policies that aim to facilitate joint investment activities between tax-exempt or concessionally taxed entities and taxable entities, whereby the tax-exempt entities do not lose the benefit of their favourable tax status. This objective is achieved by the foreign jurisdiction treating Foreign Hybrids as "transparent" for tax purposes.

Such entities targeted for special treatment include Government agencies, pension funds, life companies and other concessionally taxed entities. These entities represent a substantial portion of the US and UK economies (and hence the world economy). The elimination of Australian out-bound investors from co-venturing with these organizations would represent a substantial distortion to the efficient flow of capital.

(b) The legislative uncertainty and double taxation.

Uncertainty as to the application of the Australian Controlled Foreign Company ("CFC") provisions to these types of investment has existed since 1991. In particular, the concept of "residency" which is critical for CFC purposes is to be determined under foreign tax law. However the concept of "residency" for these types of entities is largely irrelevant in many instances.

This uncertainty was exacerbated when the ATO made public their intended approach to determining residency for these entities in late 2001 in TD 2001/D14. Generally, the consequences of the view adopted in TD 2001/D14 included:

- No relief is available from the active income test, thus increasing compliance costs where small operations exist;
- All adjusted tainted income will be attributable, regardless of the fact that comparable taxation may have been imposed offshore; and
- Distributions to partners resident in Australia or listed jurisdictions will be taxable under Sections 44 and 458 to the extent that they do not represent previously attributable income. That is, active income will be taxable.

In addition, significant uncertainty exists in relation to the availability and timing of foreign tax credits ("FTCs") in relation to the foreign tax paid. Thus resulting in double taxation of all income.

During extensive consultation with Treasury, very few examples were found where taxpayers had adopted the same position as the ATO, as explained in TD 2001/D14 (the possible exception being where excess FTCs could be generated). The positions adopted in practice included:

- Adopting a different technical interpretation on the residency issue by:
  - Extensive and expensive analysis of the foreign tax regime; or
  - Taking a pragmatic approach to the application of the uncertain legislation; and
- Treatment in accordance with the ATO position but with a technical argument around the existence of a foreign permanent establishment.

These options alleviated the double tax problem but involved significant compliance costs, technical difficulty and great uncertainty. In addition, the requirement of the CFC rules to individually identify and analyse all Foreign Hybrids was unworkable as these entities (by their very nature) are ignored in the foreign jurisdiction and hence no “stand alone” information exists.

In conclusion, the Taxation Institute believes that proposed legislative changes adhere to the policy of the CFC provisions (ie tax deferred income, but not to impose double taxation), whilst providing clarity, certainty, and eliminates significant compliance costs associated in investing via these vehicles.

**5. Conclusion**

I hope the above comments are of assistance in the Committee’s review. If you would like to discuss any of the matters in this submission in more detail, please do not hesitate to contact the Tax Director, Michael Dirkis, on 02 8223 0011.

Yours sincerely

Gil Levy
**President**