



AUSTRALIA

Australia's focus on tax reform has continued during the past twelve months. The 2005/06 Federal Budget proposed a number of changes aimed at improving Australia's status as an attractive place for business and investment. Further changes are also expected to flow from the current Treasury benchmarking exercise of the Australian tax system.

Capitalising on the opportunities and managing the risks that arise from these developments presents a challenge for many corporate taxpayers given the volume of change.

The key changes introduced since the last edition of Asia Pacific Tax Notes are outlined below.

INTERNATIONAL TAX REFORMS

Further legislative changes have been introduced or announced as part of a co-ordinated suite of reforms arising from the Review of International Taxation Arrangements (RITA) conducted by the Board of Taxation.

Major Reforms Proposed in 2005/06 Federal Budget

On 10 May 2005, the Treasurer announced three major reforms to Australia's international tax system as part of the 2005/06 Federal Budget.

1. Capital gains tax concession for foreign residents

It was announced that the range of assets on which foreign residents would be subject to capital gains tax (CGT) would be significantly narrowed. Broadly, it is proposed that foreign residents should only be subject to CGT where there is a substantial interest in Australian real property or in respect of business assets of Australian branches.

The definition of "real property" is expected to be consistent with Australia's treaty practice. While draft legislation has not yet been released in relation to these announced changes, proposed legislation is expected to be released by July 2006.

2. Removal of foreign loss and foreign tax credit quarantining

The Treasurer announced that the current requirement for taxpayers to quarantine foreign losses as they arise from domestic income would be removed. It was further proposed to remove the requirement for taxpayers to quarantine their foreign losses and foreign tax credits into separate classes.

The changes are expected to apply to foreign losses and foreign tax credits arising after the date of enactment of the relevant legislation.

3. Foreign source income exemption for temporary residents

The Government has introduced draft legislation to re-introduce a four-year exemption for temporary residents on most foreign-sourced income. The proposal also includes a four-year freeze on interest withholding tax obligations of temporary residents.

New Conduit Foreign Income regime

The new Conduit Foreign Income (CFI) rules came into effect on 14 December 2005. These rules replaced the previous Foreign Dividend Account (FDA) rules, and are of particular interest to Australian companies that are predominantly foreign-owned and derive foreign income.

The CFI regime is designed to enhance Australia's position as a regional holding company location by ensuring that a broader range of foreign sourced profits can be "flowed" through Australian corporate entities to ultimate foreign resident recipients free of income tax and withholding tax.

Items of CFI include:

- Foreign sourced non-portfolio dividends.
- Foreign sourced branch income and certain capital gains.
- Australian capital gains on the disposal of shares in a foreign company with an underlying active business.
- Foreign sourced income and gains which have been offset by foreign tax credits.

These rules apply to distributions made after 14 December 2005.

Benchmarking Study of Australia's Tax System

The Australian Federal Government announced on 26 February 2006 that it had commissioned an international benchmarking study of Australia's tax system.

The study will make comparisons with all the various Organisation for Economic Co-Operation and Development (OECD) countries and focus on the overall level of taxes, the tax revenue mix, and the base and rates within each type of tax. The report is due for submission to the Federal Treasurer on 3 April 2006.

Proposed New Tax-timing Rules

Draft legislation in relation to tax-timing rules for financial arrangements was released for public comment on 16 December 2005.

The proposed rules are designed to minimise tax-timing mismatches by specifying five tax-timing methods, including tax-timing hedging rules. Any gain or loss from a financial arrangement is to be taxed on revenue account.

Individuals and entities which have a turnover of less than \$20 million per year are not subject to the proposed new rules, unless the arrangement defers a significant gain or loss.



Foreign Currency Translation Elections

Australian companies and consolidated groups can choose to use a functional currency (that is, a currency other than Australian dollars) to prepare income tax returns.

This choice is available where the taxpayer has an obligation to prepare financial and directors' reports under Australian Corporations law and the sole or predominant currency of the taxpayer's business is a currency other than Australian dollars.

The Australian Taxation Office (ATO) has confirmed in a published ruling that the repayment of a foreign currency denominated borrowing will not give rise to a foreign exchange gain or loss if the borrowing had already been subject to a functional currency election and is repaid in the functional currency.

OTHER TAX DEVELOPMENTS

ATO compliance programme for 2005/06

There are a range of issues on the ATO's compliance radar for the 2005/06 income tax year.

New areas of focus include:

- Intra-group transactions involving intangibles, cross-border financing and management services.
- Compliance with new international tax rules and IFRS.
- Share buybacks and capital management issues.

Thin Capitalisation Compliance

There is now a number of ATO reviews where questions are emerging around the deductibility of interest following a “debt pushdown” transaction of one kind or another.

This seems to indicate that some ATO officials are interested in the potential application of Australia’s broad general anti-avoidance provisions to deny interest deductions on debt funding, even where debt falls within the bounds of thin capitalisation limits. This raises some doubt as to whether the “safe harbour” limit prescribed by the thin capitalisation rules are really “safe”.

Interest Deductibility Uncertainty

The ATO has expressed its view in Draft Tax Determination TD 2005/D29 that the funding costs incurred by an Australian company to acquire shares in an existing Australian company, where both companies are part of the same income tax consolidated group, will not be deductible.

The ATO’s view presents a real difficulty for some transactions in a post-income tax consolidation environment and more broadly, for Australian corporate groups seeking to undertake reorganisations.

A number of professional bodies have lodged formal submissions with the ATO in relation to the draft Tax Determination. A re-drafted version of the Tax Determination is expected later this year.

The McDermott Industries Case

The Full Federal Court in the McDermott Industries case decided that the use of substantial equipment in Australia created an Australian Permanent Establishment (PE) under the Australia/Singapore double tax agreement (DTA). The case involved an Australian company which chartered vessels from a Singaporean company for use in Australia. Based on the finding that an Australian PE existed, the Court held that no royalty withholding tax was payable on the charter payments.

The decision has wide ranging implications on the taxation of lessors and lessees in an international context. Specifically, non-resident lessors could be unexpectedly subject to 30% income tax on profits attributable to an Australian PE and have withholding tax obligations. This would be of particular concern for non-resident lessors who may have incorrectly assumed that their Australian tax exposure was limited to withholding tax.

The Court’s comments on the PE issue in the McDermott Industries case are particularly pertinent in light of the revised US and UK DTAs. The US and UK DTAs are quite different from the DTA considered in McDermott Industries and arguably place greater emphasis on the business profits article in the context of cross-border leasing transactions, have a reduced scope of the definition of “royalties” and specifically preclude hire-purchase arrangement from creating a PE. ATO guidance is expected to be released on this matter this year.

