



AUSTRALIA

In November 2007 a new Government was elected in Australia. With months of campaigning by both major parties, the focus of legislative reform diverted from implementing significant changes to the tax landscape in Australia to promises that aimed to secure votes.

The election process impacted the status of significant tax reforms, particularly in the later half of 2007. Most notably, the Bill to give effect to the final tranche of the Taxation of Financial Arrangements legislation lapsed in October 2007 and proposed amendments to the thin capitalisation provisions were delayed. Despite these distractions, controversial changes to the tax consolidation regime were proposed for scrip for scrip transactions, legislation governing foreign tax offset rules and asset-based financing transactions was passed (pre-election), while a new double tax treaty with Japan was signed.

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

NEW TAXATION OF FINANCIAL ARRANGEMENTS REGIME

The Tax Laws Amendments (Taxation of Financial Arrangements) Bill 2007 (TOFA Bill) was introduced into Parliament on 20 September 2007. This was the final tranche of extensive reform of the taxation of financial arrangements in Australia and the rules have been anticipated for a number of years.

Broadly, the measures contained within the TOFA Bill focused on aligning the tax and accounting treatment of the recognition of gains and losses from financial arrangements. For these purposes, financial arrangements have been widely defined as legal or equitable rights or obligations to receive or provide a financial benefit that can be settled in cash.

Prima facie gains will be included in assessable income, and losses will be an allowable deduction to the extent that they are incurred in carrying on a business. For tax purposes, the timing of the recognition of gains and losses

from financial arrangements will be determined by one of six tax timing rules contained within the provisions. Each of these methods has its own requirements that must be satisfied before it can be adopted.

Although the draft measures are based on the accounting treatment applied to financial instruments, there will continue to be some instances where the tax and accounting treatment differ. This may arise as a result of the tax characteristics of the taxpayer, the nature of the arrangement and the tax recognition method adopted.

With the election of a new Government in November 2007, the Bill has now lapsed. However, it is expected that the TOFA Bill is a legislative priority for the new Government and is not politically sensitive. Accordingly, it is anticipated that the TOFA Bill will be reintroduced into Parliament in the first half of 2008.

TAX CONSOLIDATIONS: PROPOSED AMENDMENTS SURROUNDING CAPITAL GAINS TAX ROLL-OVERS

On 12 October 2007, the previous Government announced by press release a proposal to amend the consolidation rules where an entity joins a consolidated group following a Capital Gains Tax (CGT) roll-over affecting the shares of the joining entity (i.e., a transaction which defers the capital gain of shareholders). The proposed amendments seek to remove the ability of an entity to uplift the tax cost base of an entity's assets to market value. These elements are discussed in more detail below.

Broadly, the CGT roll-over provisions operate to defer a capital gain that would otherwise be derived on the disposal of shares. For example, under a CGT scrip for scrip transaction, shareholders will dispose of their shares in a company (Coy A) in exchange for shares in the acquiring company (Coy B). From a tax perspective, the cost base of the shareholders' interests in Coy B will be the same as the cost base of the shares they held in Coy A. However, provided that Coy B is widely held (generally this requirement will be satisfied where the company has at least 300 shareholders and no one owns a 30% stake) the tax cost base of Coy B's shares in Coy A will equal to the market value of the shares it issues in itself to the former shareholders.

Ordinarily, when an entity joins the consolidated group, the underlying tax base of all its assets are "reset" for tax purposes (including depreciable assets). While this can be a very complex exercise, at the simplest level it broadly involves allocating the acquisition cost to the underlying assets in proportion to their market value. For example, if the shares of an entity were acquired for market value consideration of A\$100 (i.e., the issue of shares worth A\$100), this amount would be "spread" across the

underlying assets of the acquired entity in proportion to the market value of the assets. This will often result if the assets of an entity receive an “uplift” in their tax cost base. If an asset were sold immediately after acquisition, no capital gain should be realised.

If the interests in an entity joining an income tax consolidated group had previously been subject to a CGT roll-over transaction, this would mean no capital gain would have been derived on the disposal of the shares by shareholders and no capital gain would be derived on any disposal of assets immediately after acquisition. With this in mind, the proposed rules are aimed at addressing Treasury’s concern that transactions which are structured to minimise the amount of tax payable will erode the tax revenue base.

Although brief, the announcement caused a disruption to Australian capital markets and, in particular, has caused substantial uncertainty for scrip for scrip transactions. However, with a new Government in power, the Assistant Treasurer has initiated a consultation process which will focus on ensuring “non-contrived commercial takeovers involving an exchange of scrip” are not affected by the changes. However, at the moment the precise form of the proposed changes is unknown.

TAX PREFERRED ENTITIES AND ASSET FINANCING

On 21 June 2007, Royal Assent was granted to the Bill to give effect to the long-awaited measures dealing with the taxation of asset based financing transactions between taxpayers and “tax-preferred” entities (typically government bodies and non-residents). Effective for transactions entered into on or after 1 July 2007, the new measures will replace the existing provisions which have hampered leasing (and other) transactions involving tax exempt entities for many years.

Originally foreshadowed by the Government in May 2002 and introduced into Parliament in September 2005, the new rules will apply to a taxpayer if a tax-preferred end-user directly or indirectly uses, or effectively controls an asset by way of lease or other use. There are various elements which have been defined which will be crucial to determining the scope of the new provisions and the impact on taxpayers.

Broadly, the new measures will operate to deny the taxpayer depreciation deductions on assets leased to a tax exempt entity and will treat certain arrangements as a deemed loan thereby making it assessable as a financial arrangement on a compounding accruals basis. It is important to note that there are exclusions to these rules, most notably for small business taxpayers and short-term or low value transactions.

NEW DOUBLE TAXATION AGREEMENT WITH JAPAN

Australia and Japan signed a new tax treaty on 1 February 2008 to replace the existing treaty which was signed in 1969. It is expected that the new treaty will be “in force” with effect from 1 January 2009, once both countries have ratified the treaty.

The key changes implemented by the new treaty focus on reducing withholding tax rates, broadening the definition of “permanent establishment”, the introduction of a limitation of benefits article and the introduction of an alienation of property article.

Dividend, interest and royalty withholding tax is currently levied at a rate of 15%, 10% and 10%, respectively. Dividends will be subject to withholding tax at a maximum rate of 10%. However, this will be reduced to 5% where the interest held in the company is between 10% and 80% and may be further reduced to 0% where the shareholding is 80% or above. Royalty payments will only be subject to a 5% rate of withholding tax, while interest payments will continue to be subject to a 10% withholding tax. However, this may be reduced to 0% for qualifying government and financial institutions (e.g., banks).

The new treaty also contains a comprehensive alienation of property provision which seeks to align the tax treatment of capital gains with the Organisation for Economic Cooperation and Development’s practice, while preserving Australia’s taxing rights over Australian assets such as Australian real property (i.e., land or land related assets).

A comprehensive limitation of benefits article has been introduced into the new treaty to ensure that only qualified persons can enjoy the benefits afforded by the treaty. Broadly, a qualified person includes individuals, listed companies, certain government entities, listed trusts, certain tax exempt organisations, certain unlisted trusts and pension funds. Similar to the current tax treaty between the U.S. and Australia, this article is intended to prevent taxpayers from “treaty shopping”.

It is envisaged that the new treaty will enhance trade and investment flows between Australia and Japan whilst reflecting the current tax treaty policies of both countries.

NEW FOREIGN INCOME TAX OFFSET RULES

Australia’s foreign income tax offset (or foreign tax credit) rules underwent significant reform in 2007, with measures introduced to remove complexities in the law that were no longer justified. In line with extensive reforms in relation to the taxation of international arrangements, the new measures were introduced to simplify the existing foreign tax credit and foreign loss provisions.

The existing foreign tax credit rules operated to eliminate double taxation by allowing a credit against Australian tax liabilities for foreign tax paid on assessable income generated offshore. The credit available was equal to the lesser of the foreign tax paid or the amount of Australian tax payable in respect of the foreign income.

Previously, foreign income derived by an Australian resident taxpayer had to be separated into four classes of income and foreign tax credits could only be utilised against foreign income of the same class. The taxpayer also had the option of carrying forward any excess credit for a period of five years. With effect from income tax years beginning on or after 1 July 2008, the requirement to quarantine foreign tax credits into separate classes will be removed. However, as foreign tax credits can be used to offset any type of foreign income, taxpayers will no longer be able to carry forward excess credits for utilisation in future years.

In addition, legislative amendments have been introduced which remove the requirement to quarantine foreign losses from domestic income. A foreign loss will arise where foreign deductions exceed foreign taxable income. Previously, foreign losses were quarantined into four separate classes and could only be utilised against foreign income of the same class. However, the amendments provide taxpayers with the ability to offset foreign losses against domestic assessable income, subject to existing loss utilisation tests for domestic tax losses being satisfied.

Transitional rules will apply to foreign tax credits and foreign losses existing at the date of commencement of the new provisions. Broadly, these rules will provide a mechanism for a taxpayer to carry forward the existing excess amounts for a period of up to five years, subject to some limitations and exceptions.

AMENDMENTS TO AUSTRALIA'S THIN CAPITALISATION PROVISIONS

The thin capitalisation provisions require an entity to calculate their thin capitalisation position using accounts prepared in accordance with relevant accounting standards. The Australian equivalent to International Financial Reporting Standards (AIFRS) was adopted by Australia on 1 January 2005. As a transitional measure, thin capitalisation reporting entities had the option of continuing to use accounts prepared in accordance with Australian Generally Accepted Accounting Standards (AGAAP) for a period of three years. With the transitional period ending on 31 December 2008, the adverse impact that the adoption of AIFRS may have on the thin capitalisation position of some entities has been highlighted.

Specifically, the application of AIFRS will impact groups with intangible assets of significant value on their balance sheet for which there is no "active market". The value of an intangible asset with no "active market" may only be carried at its cost less any accumulated amortisation and impairment costs. Consequently it is likely that the "safe harbor" for a number of entities will be adversely impacted by the changes. These include major players who have significant value placed on certain intangible assets.

On 12 September 2007, the Treasurer announced the Government's intention to amend the thin capitalisation rules to address certain adverse impacts arising as a result of the adoption of the AIFRS. Broadly, the rules propose to allow entities a limited departure from AIFRS amounts for thin capitalisation purposes, and instead provide an option to make an election to independently value intangible assets. Although the scope of the proposed amendments is unclear, it is likely that this will address the adverse impact that AIFRS will have on the thin capitalisation position of some entities.

The change of Government has delayed the drafting of any legislation to give effect to the proposed changes. Rather, it is likely that further approval will be required before the amendments are introduced into Parliament.

RULES GOVERNING DISTRIBUTIONS TO SHAREHOLDERS OF A PRIVATE COMPANY RELAXED

The Australian tax legislation contains an integrity provision aimed at preventing private companies from making tax-free distributions of profits to shareholders or their associates. Where certain conditions are satisfied, advances, loans and other payments to shareholders or their associates are treated as assessable dividends to the extent that there are profits in the company. Where a deemed dividend arises, the private company's franking account is debited and the shareholder pays tax on the deemed dividend at their marginal tax rate.

These deemed dividend provisions were amended in 2007 to reduce the circumstances in which taxpayers can inadvertently trigger a deemed dividend as well as to reduce the penalties associated with deemed dividends. Specifically, the new rules remove the automatic debiting of the private company's franking account when a deemed dividend arises, and grants the Commissioner a discretion to disregard deemed dividends where they have been triggered by an honest mistake or inadvertent omission.