



AUSTRALIA

KEY TAX PROPOSALS AND DEVELOPMENTS IN THE PAST TWELVE MONTHS

There have been significant changes and developments in the Australian tax system in the last twelve months. Now entering its second year, and against the back drop of the global credit crisis, the Federal Government has released a range of new tax proposals and developments that will affect taxpayers operating in or through Australia.

The key highlights over the last twelve months have been the release of a discussion paper by the Australian Tax Office (ATO) outlining its opinion on the interaction between Australia's transfer pricing and thin capitalisation rules; the announcement of a major review of Australia's tax system; and most recently, the announcement of a proposed investment allowance.

Furthermore, a number of tax reforms announced prior to the change in Government in late 2007 have finally been introduced to Parliament. These include the long-awaited Taxation of Financial Arrangements Bill, and the draft legislation that gives effect to the Government's announcement on the proposed amendments to capital gains tax (CGT) rollovers where an entity joins a consolidated group in a scrip-based takeover.

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

Australian Federal Government announces comprehensive review of the Australian tax system

In May 2008, the Federal Government appointed Australia's Future Tax System (AFTS) Review Panel, chaired by Dr Ken Henry, to undertake a comprehensive examination of the current Australian tax system at both the Federal and State level (excluding GST). The AFTS or 'Henry Review' is focused on building a tax system in Australia which is internationally competitive, streamlined, simplified and harmonised. The review, which is not due to report until December 2009, will make recommendations to position the Australian tax system to be globally competitive and to deal with the demographic, social, economic and environmental challenges of the 21st century.

The review is being promoted by the Federal Government as the most comprehensive examination of Australia's tax system in over 50 years.

PricewaterhouseCoopers Australia is actively engaging with the Federal Government and the key stakeholders in the business community, and will be involved throughout the consultation phases of the review.

Board of Taxation review of anti-tax deferral regimes

The Australian Board of Taxation, a non-statutory advisory body that reports to the Federal Government, is undertaking a review of Australia's foreign source income anti-tax deferral regimes. The review is focused on regimes which operate to attribute (and thereby assess) the foreign source income of non-resident entities to Australian entities

on an accrual basis (e.g. controlled foreign companies and foreign investment funds). The objective is to reduce the complexity and compliance costs associated with the rules and to ensure the regimes do not inhibit Australia's competitiveness in the global economy.

The Board will conduct targeted consultation with industry stakeholders to assist in developing detailed recommendations in line with its own position papers. These recommendations will form the basis of a report to the Government in the second half of 2009.

Amendments to Australia's thin capitalisation provisions

Broadly, Australia's thin capitalisation provisions operate to limit the amount of debt deductions claimable in Australia to 75% of an entity's equity where that entity is foreign owned or has foreign subsidiaries. The provisions aim at ensuring that Australia does not bear an unreasonable level of the overall group's debt. An entity is required to calculate its thin capitalisation position (which is based on the value of its assets, liabilities and equity) using accounts prepared in accordance with the relevant accounting standards.

The adoption of the Australian equivalent of the International Financial Reporting Standards (AIFRS) in 2005 had a negative impact on the thin capitalisation position for a number of entities, particularly those with significant intangible assets on the balance sheet. Under AIFRS, intangible assets can only be carried at market value if an active market exists. If no active market exists, companies can only value intangible assets at cost, less any accumulated amortisation and impairment. This impediment led to a number of companies electing to continue to use the Australian Generally Accepted Accounting Principles under a transitional rule which ceased to have effect on 31 December 2008.

After considerable lobbying from industry groups and professional bodies, including PricewaterhouseCoopers Australia, the Federal Government introduced and recently passed legislation aimed at solving this problem. The rules now allow entities a limited departure from AIFRS for thin capitalisation purposes when valuing intangible assets, by providing them with an option to independently value these assets, thereby effectively removing the active market requirement. This change provides opportunities for taxpayers who have a significant value of intangible assets that are not recorded on their balance sheet.

New approach to transfer pricing and intra-group finance guarantees

On 3 June 2008, the ATO released a discussion paper outlining its view on the interaction between transfer pricing and cross-border loans and credit guarantees. The paper may have considerable implications for merger and acquisition transactions, capital raisings and group restructures.

Broadly, the ATO argues that even if a taxpayer's debt to equity ratio is within the thin capitalisation limit, it could still use Australia's transfer pricing provisions to adjust the pricing of intra-group financial transactions if it concludes that a taxpayer's debt is priced inappropriately (e.g. exceeds an "arm's length" amount).

The paper also states that because the ATO views guarantees as constituting a service, it is necessary to examine the provision of a credit guarantee from both the perspectives of the provider and the recipient. Therefore, where credit guarantees are, in substance, a substitute for equity, they should not be deductible for tax purposes. Additionally, the purpose and objective of the arrangement need to be examined where the guarantor lacks the financial capacity to meet its obligations were it required to do so.

Although the ATO discussion paper does not have the force of law in Australia, it does reflect the ATO's position in some recent tax audits. This has resulted in confusion and uncertainty as to the application of the law particularly in light of the decline in asset values due to the global credit crisis.

Changes to the managed investment trusts withholding tax regime

With effect from 1 July 2008, amendments have been introduced to reduce the rate of withholding tax (WHT) applying to distributions of Australian sourced net income to foreign investors of Australian managed investment trusts, and to reduce compliance burdens for non-resident investors.

The new rules to be phased in over three years, will reduce the rate of WHT on eligible distributions by Australian managed investment trusts from 30% to 7.5% for foreign residents from countries with which Australia has an effective exchange of information (EOI) on tax matters. Broadly, countries having effective EOI on tax matters with Australia include countries that have a bilateral tax information exchange agreement with Australia.

The new WHT regime only applies to Australian source income, excluding the distribution of dividends, interest and royalties which remain subject to the existing WHT rules that cover these types of income. In addition, the new rules will deem the WHT to be a final tax liability, thereby removing the requirement for non-resident investors to lodge an Australian income tax return.

New investment allowance for the acquisition of eligible assets

On 12 December 2008, the Federal Government announced the introduction of a temporary investment allowance to stimulate business investment in Australia. The investment allowance grants taxpayers a once-off deduction of up to 30% of the acquisition cost of certain eligible assets. This is in addition to the normal tax depreciation deductions which will continue to be available over the life of the assets. The scope of this allowance was significantly extended as part of an Australian economic stimulus package announced by the Government on 3 February 2009.

For an asset to be considered eligible for the investment allowance, it must:

1. be a new tangible fixed asset (including motor vehicles);
2. be eligible for tax depreciation;
3. have a cost of A\$10,000 or more (or A\$1,000 or more for small businesses);
4. be used in Australia; and
5. be acquired, or held under contract within a certain time period (see below).

To take advantage of the 30% bonus deduction of the cost of an eligible asset, acquisition of the asset must take place or construction of the asset must commence between 13 December 2008 and 30 June 2009 and the asset must be installed ready for use by 30 June 2010.

Alternatively, a 10% bonus deduction of the cost of an eligible asset is available for those assets that are acquired, or start to be held under a contract entered into between 1 July 2009 and 31 December 2009 and installed ready for use by the end of December 2010.

Some assets have been excluded from the investment allowance e.g. trading stock or improvements to land, assets which have previously been used or held for use and intangibles such as software, patents and copyright.

New Western Australia stamp duty regime

The Western Australian State Government has enacted changes to the Western Australian stamp duty regime with effect from 1 July 2008. The amendments see a reduction in the stamp duty rates with the maximum rate being reduced from 5.4% to 5.15% for acquisitions that occur after 30 June 2008.

Broadly, the new stamp duty applies to acquisitions of interests in companies and unit trusts (referred to as “landholders”) that are directly or indirectly entitled to an interest in land located in Western Australia with a market value of A\$2 million or more. The stamp duty will be payable if an entity and its related parties acquire an interest of 50% or more in an unlisted landholder (or 90% or more in a listed landholder). The creation or transfer of some interests in dutiable property will also be subject to the stamp duty.

Finally, changes have also been made to the stamp duty applicable on the transfer of interests in joint ventures and partnerships, including the introduction of some new exemptions and concessions.

Investors holding or acquiring interests in Western Australian projects should take note of the potential impact of the reforms.

Australia's right to tax gains under Australia's CGT measures may be limited in certain circumstances

There has been significant doubt in Australia as to whether capital gains are covered by Australia's double tax agreements (DTAs) where they came into effect prior to the introduction of Australia's CGT provisions, as they do not specifically allocate the right to tax capital gains.

Two high-profile cases recently decided by the Australian courts, *Virgin Holdings v Deputy Commissioner of Tax* (Virgin Holdings) and *Undershaft (No 1) Limited v Commissioner of Taxation* (Undershaft), considered whether Australia's right to tax capital gains is limited by the operation of DTAs entered into prior to the introduction of the Australian CGT provisions.

In *Virgin Holdings*, the Australian Federal Court held that the DTA between Australia and Switzerland operated to deny Australia the right to tax a capital gain made by a Swiss resident company on the sale of shares in an Australian company. In reaching this conclusion, the court rejected the Commissioners arguments that Australia's CGT provisions are not a tax covered by “pre-CGT DTAs” and references

to the right to tax “income” in the DTA did not extend to capital gains. Accordingly, the court concluded that capital gains are covered by pre-CGT treaties. The ATO has decided not to appeal against this decision.

In *Undershaft*, the Australian Federal Court confirmed the decision in *Virgin Holdings* that relief was available for Australian capital gains made under a pre-CGT DTA by virtue of the operation of the business profits article.

Taxation of financial arrangements regime

The final tranche of extensive reform to the taxation of financial arrangements, the *Tax Laws Amendments (Taxation of Financial Arrangements) Bill 2007* (TOFA Bill), was initially introduced into Parliament in September 2007, but then lapsed with the election of the new Federal Government in November 2007. However, a revised version has recently been reintroduced into Parliament and is expected to be enacted later this year.

The final tranche of the TOFA reform aims at aligning the tax and accounting treatment on the recognition of gains and losses from financial arrangements. The definition of financial arrangements has been widely defined to include legal or equitable rights, or obligations to receive or provide a financial benefit that can be settled in cash. For tax purposes, the timing of recognition of gains and losses will be determined by one of six different timing rules as specified in the legislation.

Once enacted, the proposed measures will apply to all financial arrangements entered into on or after 1 July 2010, with an option of electing for the measures to apply from 1 July 2009.

Proposed scrip for scrip CGT rollovers amendments

The Federal Government had previously announced its intention to modify Australia’s CGT provisions in relation to CGT rollovers for corporate restructures. The proposed amendments (which are expected to be enacted shortly) are aimed at preventing an entity from undertaking a ‘contrived restructure’ with the intent of receiving an ‘inappropriate uplift’ in the tax cost base of the entity’s assets.

Broadly, these provisions may apply where a widely held company (Coy A) purchases the shares in another company (Coy B) and issues shares in itself as consideration for the acquisition. Here, the CGT roll-over provisions will operate to defer the capital gain that would otherwise be derived by Coy B’s shareholders on disposal of their interests, while increasing the tax cost base of the shares acquired by Coy A to “market value”.

When Coy B becomes a member of Coy A’s income tax consolidated group, the tax cost base of its shares will, in broad terms, be pushed down and spread across its underlying assets in proportion to their market value. This will often result in certain assets receiving an ‘uplift’ in their tax cost base. Accordingly, if an underlying asset of Coy B is immediately sold after acquisition, no capital gain would arise.

The government was concerned that this may result in entities undertaking contrived restructures to dispose of assets without tax leakage.

The new provisions currently being considered should only apply where the arrangement is taken to be a ‘restructure’ (rather than a merger or takeover). Broadly, a restructure will be taken to occur if the market value of the acquiring entity’s net assets immediately before the acquisition is less than 20% of the market value of its net assets immediately after the completion of the acquisition (i.e. including Coy B’s net assets). If this occurs, the tax cost base of the shares acquired will not be uplifted and this will affect the reset of the target’s assets for tax purposes.

New Australia-Japan double taxation agreement in force

The new Australia-Japan double tax agreement came into force on 3 December 2008. The new agreement reduces the rate of WHT on dividends to a maximum rate of 10%, with further reductions to 5% or even 0% depending on the ownership interest in the entity. Royalty payments will now only be subject to WHT at a rate of 5%, while interest payments will continue to be subject to 10% WHT. However, the WHT on interest payments may be reduced to 0% for qualifying government and financial institutions.

The agreement also broadens the definition of permanent establishment and introduces a limitation of benefits article and an alienation of profits article.

