

6-1-1993

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Paul von Nessen

John Telfer

Recommended Citation

Paul von Nessen and John Telfer, *Australia's Proposals for Taxation of Foreign Investment Funds: The Third Strike on Foreign Income*, 15 Loy. L.A. Int'l & Comp. L. Rev. 847 (1993).

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Australia's Proposals for Taxation of Foreign Investment Funds: The Third Strike on Foreign Income

PAUL VON NESSEN* AND JOHN TELFER**

I. INTRODUCTION

Since coming to power in 1982, the Labour government of Australia has systematically reformed the tax system. Many of the changes have directly affected domestic taxation. Principal changes include: (1) capital gains within the Income Tax Assessment Act ("ITAA");¹ (2) the introduction of a Fringe Benefits Tax;² and (3) the elimination of the classical corporate taxation system in favor of an imputation system.³

Although these innovations in domestic taxation created a significant impact and obtained substantial press exposure, similarly dramatic changes in foreign income taxation have occurred since 1985. In April 1992, the Federal Treasurer, John Dawkins, introduced a taxation on foreign investment funds which took effect January 1, 1993.⁴ This measure, which is similar to the Passive Foreign Investment Company Rules in the United States,⁵ is the third Australian foreign income tax reform since 1987. As a result of these reforms, the Australian taxation system has evolved from one of the simplest

* Associate Professor in Business Law, University of Melbourne, Melbourne, Victoria, Australia; B.A., Duke University, 1971; J.D., University of South Carolina, 1974; LL.M., Cambridge University, 1979; Barrister of the High Court of Australia.

** Senior Lecturer in Business Law, University of Melbourne, Melbourne, Victoria, Australia; B.A., LL.B., University of Melbourne, 1970; LL.M., University of London, 1972; Barrister of the High Court of Australia.

1. Income Tax Assessment Act 1936, 6 AUSTL. ACTS pt. IIIA (1901-1973) [hereinafter ITAA], amended by No. 52 of 1986, § 19.

2. Fringe Benefits Tax Assessment Act 1986 (Austl.).

3. ITAA, *supra* note 1, pt. IIIAA, amended by No. 58 of 1987. See Paul von Nessen, *Australian Taxation of Companies and Shareholders: Imputation Arrives Down Under*, 19 CASE W. RES. J. INT'L L. 73 (1987).

4. JOHN DAWKINS, TAXATION OF INTERESTS IN FOREIGN INVESTMENT FUNDS (1992). Subsequent to this release, the government accepted several modifications of sufficient significance to require the redrafting of the original Bill. In addition to substantive changes, implementation was delayed from July 1, 1992, to January 1, 1993.

5. I.R.C. § 1297.

and most ineffective systems to an advanced, complex, and perhaps overreaching taxation system for foreign income.

II. TAXATION OF FOREIGN INCOME IN AUSTRALIA PRIOR TO 1985

Like most other countries, Australia imposes a tax on international income based upon either residence of the taxpayer or source of the income.⁶ While Australian tax legislation always subjected Australian residents to taxation on all income whatever its geographic source,⁷ the government allowed concessions through international agreements and domestic legislation. Prior to 1985, the Australian domestic legislation on foreign income was quite simple. An Australian resident's foreign income was exempt from Australian taxation as long as it was subject to some foreign income tax at its source.⁸

Although the pre-1985 foreign income taxation rule is commendable for its simplicity, it obviously favored foreign investment and encouraged Australian residents to earn income abroad (or at least to structure transactions so that income would be characterized as foreign-sourced income).

Owing partially to the scope of tax minimization resulting from misuse of international transactions, in 1986, the Australian government repealed the exemption for foreign income taxed at its source, ITAA section 23(q).⁹ As a result, most foreign-sourced income of Australian residents became subject to Australian tax. Only income from specifically approved classes of overseas work¹⁰ (generally personal exertion work performed for a period greater than 90 days) remained subject to any exemption.

6. See ITAA, *supra* note 1, pt. III, § 25(1).

7. *Id.*

8. *Id.* § 23(q).

9. Taxation Laws Amendment (Foreign Tax Credits) Act 1986, No. 51 of 1986, AUSTRALIAN ACTS § 6. This took effect on July 1, 1987.

10. See ITAA, *supra* note 1, §§ 23AF-AG. The exemption for income earned in foreign employment was broadened as of July 1, 1990, bringing most expatriate Australian individuals within its ambit. This exemption, unlike the former exemption under ITAA § 23(q), applies only if the income is not exempted from payment of tax in the source country, either under its laws generally or under an international agreement, such as a double tax agreement. This provision eliminates the tax-free sabbatical originally enjoyed by Australian academics visiting and earning income in the United States. These individuals were exempt from United States federal income tax by virtue of the United States-Australia Tax Treaty (which provided that Australia should impose tax on such income); however, by allowing themselves to pay individual state income taxes (with marginal rates often well below 10%), their United States earnings were subject to the ITAA § 23(q) exemption in Australia.

Upon the repeal of the foreign income exemption, the Australian government implemented a tax credit system.¹¹ After this change, Australian residents reported their foreign income as a gross figure. Hence, the foreign income assessable in Australia was the total foreign income before imposition of foreign tax. The tax credit system credited foreign tax paid against the Australian tax imposed upon the taxpayer's foreign income.¹² As might be expected, the government limited the credit by reference to the amount of the Australian tax liability attributable to such income. In conjunction with the adoption of this credit system, the Australian government strengthened enforcement provisions to assure that credits were applied properly.¹³

There are numerous advantages to changing the foreign tax system from an exemption system to a credit system. Despite the increased complexity, this system assures that Australian residents are mostly subject to the same total incidence of tax on income derived from foreign countries as income derived domestically. This eliminated the benefit of diverting all forms of income to low tax rate countries. Unfortunately, the initial legislation did not address resident shareholders' ability to structure their foreign investments so as to prevent immediate derivation of foreign income.

III. FOREIGN-SOURCED INCOME SYSTEM

By 1990, the ability of Australian residents to defer repatriation of foreign income through the use of foreign entities, and in particular company subsidiaries, was considered sufficiently important to warrant rectification. In 1990, the Australian government introduced a foreign-sourced income system, attributing to resident taxpayers certain types of income derived by either a Controlled Foreign Company ("CFC")¹⁴ or a non-resident transferee trust.¹⁵ The taxation system attributes to Australian residents income derived by foreign corporations under the control of Australian residents and by non-resident trusts to which Australian residents transferred property or services. This occurs regardless of whether the foreign subsidiary has declared

11. See Taxation Laws Amendment (Foreign Tax Credits) Act 1986, No. 51 of 1986, *supra* note 9, §§ 3, 19.

12. *Id.*

13. *Id.* § 19.

14. Taxation Laws Amendment (Foreign Income) Act 1990, No. 5 of 1991, AUSTL. ACTS. This Act was announced on April 12, 1989, and took effect July 1, 1990.

15. *Id.*

dividends¹⁶ or whether the resident beneficiaries are presently entitled to trust income.¹⁷

A. Controlled Foreign Companies

The 1990 Australian CFC legislation is similar to United States provisions concerning controlled foreign corporations,¹⁸ passive foreign investment companies,¹⁹ and foreign personal holding companies.²⁰ Furthermore, there are even greater similarities between the Australian CFC legislation and Canadian provisions relating to passive investment income of controlled foreign affiliates.²¹ Despite these similarities, the Australian legislation contains a number of unique features.

The Australian CFC legislation applies only where an Australian taxpayer has a minimum control interest²² in a foreign company classified as a CFC. A company will qualify as a CFC if it is a foreign resident company and satisfies any of the following three control tests at the end of the appropriate tax year:

1. Five or fewer Australian residents (each with at least a 1% control interest) have or are entitled to acquire at least a 50% control interest in the company;²³
2. A single Australian entity has at least a 40% control interest in the company (unless the shareholder can demonstrate that the company is controlled by another unassociated entity); or
3. A group of five or fewer Australian entities has actual control of the company (either alone or together with associates).

The CFC legislation divides non-resident companies into two categories: (1) companies that are residents of countries with a com-

16. ITAA, *supra* note 1, pt. III, § 44 (normally requires dividend declaration).

17. This is the usual Australian test for determining whether a beneficiary must include income from a trust. See ITAA, *supra* note 1, § 97; Federal Comm'r of Taxation v. Whiting, 68 C.L.R. 199 (1943).

18. I.R.C. subpt. F.

19. *Id.* § 1297.

20. *Id.* § 552.

21. Income Tax Act, R.S.C. (1952), amended by 1970-71-72 ch. 63, § 95 (re-enacted S.C. 1974-75-76 ch. 26, § 57) (Can.).

22. This will occur if an Australian resident has either:

1. a minimum 10% controlling interest in the controlled foreign company; or
2. a minimum 1% controlling interest in the controlled foreign company and is one of five or fewer entities that control the controlled foreign company.

23. The appropriate tax year is that of the prospective CFC or the tax year of any foreign company higher up in the ownership chain.

parable tax system to Australia;²⁴ and (2) companies that are residents of those countries without comparable tax systems (commonly known as tax havens and referred to as "unlisted" in the Australian scheme). Companies that are not Australian residents (as defined in the ITAA or by treaty agreements) are considered residents of the listed countries if the listed countries' tax laws recognize them as residents. If a company is neither an Australian resident nor a resident of a listed country,²⁵ it is a resident of an unlisted country. The government assigns the CFC to a particular unlisted country by reference to several clear criteria.²⁶

Under the Australian CFC legislation, Australian residents are taxed on certain types of CFC income notwithstanding that they may not have received distributions of such income. A percentage of certain types of CFC income (calculated by reference to the Australian associate's direct and indirect interest in the CFC) is attributed to the Australian resident at the end of the CFC's statutory tax year.²⁷ Taxation on an accrual basis is inappropriate and not required where an Australian resident's interest in the CFC is through an entity residing in any of the listed countries where taxation is on an accrual basis under similar circumstances.²⁸

The types of income attributed to the Australian resident associates of the CFC depend upon two factors: (1) whether the CFC is resident in a listed country or an unlisted country; and (2) the extent to which the CFC derives active, rather than passive,²⁹ income.

Any passive income,³⁰ income from transactions with Australian residents, and income from transactions between certain related par-

24. See Income Tax Regulations 152J, Schedule 10 (Austl.).

25. Where a company is resident in both a listed and an unlisted country, it is considered as a resident of the listed country.

26. If a company is, under the normal tests of residency, a resident in only one unlisted country, it is a resident of that country for CFC purposes. If a company is a resident in more than one unlisted country, it is a resident of the country of incorporation. If a company does not qualify as a resident of any particular unlisted country, it is considered a resident of the unlisted country (if any) in which its management and control is solely or principally located. Finally, if a company is not treated as a resident of any particular unlisted country and does not have its management and control in an unlisted country, it is a resident of the country of its incorporation.

27. ITAA, *supra* note 1, pt. X, Division 7.

28. The United States, Canada, the United Kingdom, New Zealand, Japan, Germany, and France are listed countries.

29. ITAA, *supra* note 1, § 160AEA (defines passive income). Under this definition, passive income comprises dividends, interest, royalties, annuities, and capital gains.

30. *Id.*

ties is subject to attribution unless a CFC with residence in an unlisted country earns more than 95% active income.³¹ Attribution also applies to income from a non-resident trust that has received property or services from an Australian resident.

A CFC residing in a listed country is subject to attribution only on that part of its income which is taxed at concessional rates in other listed countries. However, such attribution will not occur for a CFC residing in a listed country if it earns more than 95% active income.

After this scheme came into force, several consequential changes were made. When dividends are distributed from income already attributed to an Australian resident, new tax laws prevent double taxation.³² The government made changes to enable attribution of any credit for foreign taxes paid, to clarify the treatment of foreign losses, and to reconcile the treatment of branch profits with the treatment of CFC profits.

B. *Transferee Non-resident Trusts*

In conjunction with adopting an accrual based system for attribution of foreign-sourced income from CFCs, particular foreign trusts are also subject to a similar system. The trust provisions³³ target the most abusive foreign-sourced income deferrals. Attribution of non-resident trust income³⁴ may occur under this provision where an entity³⁵ has transferred property or services³⁶ to that non-resident trust.

Under the foreign trust income attribution scheme, if the recipient trust is a discretionary trust, the transfer of property or services by an Australian resident to the non-resident trust, which is essential to the provision's operation, may have occurred at any time.³⁷ Where the recipient trust is non-discretionary, the transfer must have occurred after April 12, 1989, without consideration or with inadequate consideration.³⁸ Trust income attribution is comparable to CFC in-

31. *Id.*

32. *Id.* (now ITAA § 23AJ). This relief applies to non-portfolio investments. Similarly, relief provisions apply to CFC residents in non-listed countries when a dividend distribution emanates from income subject to a comparable tax in a listed country (for example where it is sourced in a listed country).

33. *Id.* (now ITAA pt. III, Division 6AAA, amended by No. 5 of 1991).

34. *Id.* (now ITAA § 102AAB).

35. An entity is defined as a company, partnership, trustee or other person. *Id.*

36. *Id.* (now ITAA § 102AAK). Transfers also include the initial transfers which establish the trust.

37. *Id.* (now ITAA § 102AAB).

38. *Id.* (now ITAA § 102AAT).

come attribution, with the Australian resident taxed on an accrual basis where the trust income has not already been taxed by a country with a comparable tax system.

To alleviate the retrospective effect of the foreign discretionary trust legislation, the commissioner of taxation may determine that attribution does not apply to transfers to discretionary trusts made prior to April 12, 1989, where the transferor was in no position to control the trust after that date.³⁹ Family trusts, including trusts created after the breakdown of marriage and trusts created to provide for family relief where all beneficiaries are non-resident, are also exempted.⁴⁰ Finally, the foreign trust attribution regime applies to trusts in listed countries only when attributable income exceeds specified minimum amounts.⁴¹

IV. DEFICIENCIES IN THE PRE-1992 POSITION

Despite the changes made in 1990 to the foreign-sourced income tax laws that prevented, to a large extent, any deferral of foreign-sourced income for resident taxpayers who controlled foreign subsidiaries or transferred assets to foreign trusts, the Australian government continued to perceive these tax laws as imperfect. On August 20, 1991, the Australian government announced that it intended to broaden the foreign income attribution system to a larger group of taxpayers.⁴² This announcement identified three areas that the former legislative changes had not redressed:

1. Resident taxpayers who owned interests in companies which were not Australian controlled were not covered by the CFC provisions;
2. The CFC provision did not apply where the level of ownership in a CFC was small; and
3. Australian taxpayers continued to defer foreign income using trusts. Resident beneficiaries continued to benefit from income deferral when trusts were established or funded by non-residents.

In light of these deficiencies, the Australian government indicated its continuing concern with the deferral of foreign-sourced income generally. In particular, it was concerned with the ability to use

39. *Id.* (now ITAA § 102AAG).

40. *See id.* (now ITAA § 102AAH).

41. It only applies if the transferor's aggregate attributable income does not exceed \$20,000, or 10% of the aggregate net incomes of all applicable trusts, whichever is less.

42. John Kerin, Budget Statement of the Treasurer (1991).

this deferral to convert foreign-sourced income into capital gains that benefit from exclusion of an inflation component. Additionally, it identified as a continuing problem the diversion of passive investment income to countries with low tax rates.

The Australian government initially intended to make attribution of foreign-sourced income apply almost universally. However, some investors would face great difficulty in ascertaining the attributable foreign income or realized gains, particularly where investments are within a tiered structure. As a consequence, the initial proposal provided for fairly precise attribution of the foreign income from foreign entities in which Australian residents directly invested. For attribution of income or realized gains of subsidiaries within a tiered structure (for which the Australian investors are unable to provide information), an estimation based upon market value was considered appropriate.⁴³

In response to the August 1991 announcement, the government received several submissions that identified problems with the original proposal. The principal difficulty addressed by these submissions and Treasurer John Dawkins' Information Paper⁴⁴ was the valuation of income and realized gains in multi-tiered structures. The government rejected one proposal that required the Australian Tax Office to certify that each foreign investment had a maximum number of tiers. Instead, the government preferred to rely on several market-based valuation alternatives to overcome this problem. Similarly, the government also rejected submissions that required it to establish a tax avoidance motive before foreign income attribution applied.

However, the government accepted several suggestions for amendments to the original government proposal. For example, it accepted exclusions for minimal deferrals and for short term investments. On the basis of the original 1991 proposal and suggested changes, the government released the Foreign Investment Funds Bill on June 25, 1992.

The Australian government delayed passage of the Bill in order to provide interested parties with an opportunity to examine the proposed legislation and further consult with the government regarding the provisions. Professor Brian Arnold of the University of Western Ontario submitted a report with suggested changes, and a number of these changes were incorporated into the Bill. The original Bill was

43. John Dawkins, Information Paper (April 2, 1992).

44. *Id.*

withdrawn and the modified Bill was reintroduced on November 3, 1992, taking effect on January 1, 1993. This modified Bill represented the third and final part of Australia's foreign income tax.⁴⁵

V. THE FOREIGN INVESTMENT FUND BILL

The Foreign Investment Fund ("FIF") Bill,⁴⁶ enacted on December 15, 1992, and given Royal assent on December 18, 1992, introduced a new Part into the ITAA⁴⁷ and made certain consequential amendments.⁴⁸ This law operates from January 1, 1993. Although the law now contains many exceptions, it still retains the general impact of the original proposals.

The legislation applies to foreign investment funds ("FIFs")⁴⁹ held by foreign companies and foreign trusts.⁵⁰ The FIF Bill defines foreign companies as companies not residing in Australia.⁵¹ Unlike the CFC provisions discussed above, the usual Australian domestic rules governing company residency apply. Hence, a company is a resident of Australia if it is incorporated in Australia or if its central management and control are in Australia.⁵² However, these rules, as always, may be overridden by a double tax agreement.⁵³

The FIF Bill's definition of a foreign trust excludes: (1) a trust resulting from will or intestacy; (2) a resident Part IX entity; and (3) an Australian resident trust.⁵⁴ A resident Part IX entity is a superannuation⁵⁵ or similar fund that is a resident of Australia. Residence for this purpose occurs if the Part IX entity was established in Australia

45. John Dawkins, *Foreign Investment Fund (FIF) Legislation: Government Response to Consultant's Report* (Oct. 9, 1992).

46. Formally the *Income Tax Assessment Amendment (Foreign Investment) Bill 1992*. The Bill was introduced on November 3, 1992, and replaced the Bill introduced on June 25, 1992. The earlier Bill was withdrawn pursuant to the Treasurer's announcement of October 9, following the government's receipt of a review of the legislation by Professor Brian Arnold of the Faculty of Law, University of Western Ontario. The Bill received Royal assent on December 18, 1992.

47. The new addition, Part XI of the ITAA, consists of §§ 469-624. *Income Tax Assessment Amendment (Foreign Investment) Bill 1992 cl. 27 (Austl.)* [hereinafter FIF Bill].

48. In particular, amendments are made to § 6AB and Divisions 6 and 6AA, and a new § 23AK is inserted.

49. FIF Bill, *supra* note 47, cl. 27 (proposed ITAA § 469).

50. *Id.* (proposed ITAA § 481).

51. *Id.* (proposed ITAA §§ 470, 481).

52. There is considerable Australian case law on central management and control. *See, e.g., Esquire Nominees Ltd. v. Federal Comm'r of Taxation*, 129 C.L.R. 177 (1973).

53. FIF Bill, *supra* note 47, cl. 27 (proposed ITAA § 470).

54. *Id.* (proposed ITAA § 481(3)).

55. A superannuation fund is a retirement fund.

or its central management and control were in Australia at any time during the previous twelve months.⁵⁶

A trust is a resident of Australia if either the trustee resides in Australia within the prior twelve months or the central management and control of the trust is in Australia.⁵⁷ These are largely factual questions. An alternative residency test applies to corporate unit trusts or public trading trusts (both of which are treated under Australian tax law as companies).⁵⁸ These commercial trusts are considered Australian resident trusts if they qualify under a residency test analogous to the foreign company residency test, noted above.

The FIF Bill also applies to certain interests in life insurance policies issued by foreign entities, referred to as foreign life policies.⁵⁹ Given the limited interest of foreign life policies in the general context of the foreign income taxation, this Article does not address the specific provisions dealing with them.

A. *Interests in FIFs and Taxation of Attributed Income*

Once the government establishes that a particular entity is an FIF, attribution of income to Australian residents occurs if the Australian resident has an "interest" in the FIF. An "interest" in a foreign company is a share in the company or an entitlement to acquire such a share. An interest in a foreign trust is an interest in the corpus or income, or an instrument entitling a taxpayer to acquire such an interest.⁶⁰

When an Australian resident has an interest in an FIF, a portion of the income accumulated in the FIF is accrued and attributed to the Australian taxpayer notwithstanding a lack of actual distributions from the FIF.⁶¹ Subject to the exceptions noted below, a taxpayer with an interest in an FIF is assessed on a portion of the undistributed FIF income. This portion is determined based upon a notional accounting period, usually the taxpayer's income year.⁶² A taxpayer may elect, however, to use some other accounting period, for exam-

56. FIF Bill, *supra* note 47, cl. 27 (proposed ITAA § 477).

57. *Id.*

58. ITAA §§ 102L, 102M.

59. FIF Bill, *supra* note 47, cl. 27 (proposed ITAA § 481). Foreign life insurance policies do not have a special segment in pt. XI. Throughout, they are treated in tandem with FIFs.

60. *Id.* (proposed ITAA § 483).

61. *Id.* (proposed ITAA § 529).

62. July 1 to June 30 is the fiscal year for most Australian taxpayers.

ple, the calendar year.⁶³

The FIF Bill provides three methods to calculate the amount included in a taxpayer's income: the calculation method, the market value method, and the deemed rate of return method. The three methods enable the taxpayer to attribute income based on the exact income derived by the FIF, the increase in market value of the FIF interest over the tax year, or the deemed rate of return on the initial value of the FIF interest at the beginning of the tax year.

The calculation method allows taxpayers to determine their attributable income by reference to the income the FIF actually earned. This method involves the use of extensive financial information about the FIF because it requires the calculation of both the FIF's gross income and its deductible expenses.⁶⁴ However, most taxpayers probably do not have enough financial data about their FIFs to use this method. If the data is available, and the taxpayer elects to use this method, the taxpayer's share of profit is determined by applying the following formula:⁶⁵

$$(\text{Calculated profit}) \times (\text{Attribution \%}) \times (\text{Days held/Total days})$$

When a taxpayer chooses not to use the calculation method, the market value method can be used if it is practical to do so. The market value method estimates the income of the FIF by comparing the market value of the taxpayer's interest in the FIF at the year's beginning with the value at the year's end to ascertain whether there has been an increase in value during the period.⁶⁶ The tax legislation provides allowances for any distributions during the period, for disposals of part of the taxpayer's interest, and any acquisitions of interests during the period.⁶⁷

When a taxpayer elects not to apply the calculation method and when the market value method is impractical, the deemed rate of return method applies. The deemed rate of return method employs the following formula to ascertain the taxpayer's share of income:⁶⁸

$$(\text{Opening value}) \times (\text{Deemed rate of return} + 4\%) \times (\text{Days Held/Total days})$$

63. FIF Bill, *supra* note 47, cl. 27 (proposed ITAA § 486).

64. *Id.* (now ITAA §§ 560, 570).

65. *Id.* (now ITAA §§ 558-583).

66. *Id.* (now ITAA §§ 537-542).

67. *Id.* cls. 5, 27 (now ITAA §§ 23AK, 538). The method of adjustment under the market value method is specifically detailed in this latter section.

68. *Id.* cl. 27 (now ITAA § 555).

The deemed rate of return is the interest paid by the Australian Taxation Office on overpayments of tax.⁶⁹ This method attributes a relatively high income to taxpayers.

If the FIF makes distributions during the year, these distributions form part of a taxpayer's income and are not counted twice under the attribution regime.⁷⁰ Similarly, distributions from income previously taxed pursuant to the FIF measures are subject to exemption mechanisms.⁷¹ If the calculation of the FIF's income under the market value method produces a negative result, then the taxpayer can deduct its portion of that loss from other income. However, the taxpayer's previously attributable income from that FIF limits the taxpayer's loss deductions. The taxpayer must quarantine any excess losses to use them in later years as an offset against future positive income of that FIF.⁷²

B. FIF Exceptions and Exemptions

In the original FIF proposals, there were only four specified exemptions or exclusions. The most important excluded active business investments from the attribution provision. The remainder of the original exemptions covered short term visitors, small investors, and employer-sponsored foreign superannuation. Three further exclusions were added prior to the introduction of the original FIF Bill that prevented FIF income attribution on investments in countries with restrictions on direct foreign investment, investments in foreign bank shares, and investments to which other attribution provisions (e.g., CFCs) already applied.

The Australian government withdrew the original FIF Bill in October 1992, because the government accepted a number of suggestions for improvement through its consultative process. One significant change was the government's total reconstruction of the active business investment exemption. As initially proposed, the government based the active income exemption upon the investment of FIFs in specified active businesses (a "white list"). The FIF Bill now adopts a "black list" approach, excluding specified businesses from

69. Taxation (Interest on Overpayments) Act 1983, No. 12 of 1983 (Austl.). The interest rate was 14.026% per annum prior to July 1, 1992. It was reduced to 10% per annum from that date. *Id.*

70. FIF Bill, *supra* note 47, cl. 27 (proposed ITAA § 530).

71. *Id.* (now ITAA §§ 601-606).

72. *Id.* (now ITAA §§ 531, 541-542).

characterization as active businesses,⁷³ thus prohibiting certain FIFs involved in those activities from qualifying for active business exemptions.

Despite the modifications made to the active business exemption, the basic thrust of the FIF Bill remains. Passive investments rather than active investments are the Bill's principal targets for attribution of income. Consequently, taxpayers receive a specific income exemption for investments in companies principally engaged in active businesses. This exemption does not completely encompass investments in foreign trusts. However, the exemption will apply to a foreign trust's own investments in companies principally engaged in active businesses.⁷⁴ Hence, a foreign company's direct investment in active businesses is outside the scope of the FIF legislation.⁷⁵

There are two tests to determine whether a company is an active business. The first test requires the listing of the company on an eligible stock exchange⁷⁶ or inclusion in an approved international classification⁷⁷ that designates the company in an eligible activity for active status.⁷⁸ The second test requires the company to use 50% or more of the gross value of its assets for eligible activities.⁷⁹ If at least 50% of a fund's assets are used in an active business, the fund investments fall within the exclusion.⁸⁰

As a consequence of the broad exclusion of suspect business activities utilized in the FIF Bill, specific provisions address companies involved in several "blacklisted" activities upon a showing that the company was generally run as an active business. These specific provisions help to characterize life insurance companies,⁸¹ general insur-

73. FIF Bill, *supra* note 47, Schedule 4. Currently this list includes:

- (a) Banking and the provision of finance;
- (b) Financial intermediation services;
- (c) Investment in tainted assets or tainted commodity investments;
- (d) Life insurance business;
- (e) General insurance business;
- (f) Management of funds; and
- (g) Activities in connection with real property.

74. ITAA, *supra* note 1, § 95(1).

75. FIF Bill, *supra* note 47, cl. 27 (proposed ITAA pt. XI, Division 3).

76. *Id.* sched. 3.

77. *Id.* sched. 5; for example, Standard and Poor's Composite Index is an approved international classification.

78. *Id.* cl. 27 (now ITAA § 499).

79. *Id.* (now ITAA § 500). Investments in subsidiaries are apportioned to the parent based upon the activities in which the subsidiaries assets are used.

80. *Id.* cl. 25 (now ITAA § 498).

81. *Id.* cl. 27 (now ITAA pt. XI, Division 5).

ance companies,⁸² and real estate companies⁸³ as active businesses, as long as the shares that form the basis of the investment in the companies are widely held and actively traded. The Bill retains similar exemption requirements for investments in foreign banks.⁸⁴ Additionally, the exemption for active businesses may apply to multi-industry foreign companies⁸⁵ and to balanced investment portfolios⁸⁶ in approved analogous circumstances.

The government recognized that it should not discourage or disadvantage Australian investors' investment opportunities. Thus, the government excluded indirect investments in certain countries from FIF attribution. This exclusion applies to approved funds, listed in free-market countries, which invest in stocks or shares of corporations located in countries that prevent direct investment.⁸⁷ Currently, Australians must invest indirectly through such funds in the emerging markets of India, Taiwan, and the Republic of Korea. Similarly, the tax legislation excludes interests in non-resident employer-sponsored superannuation funds if the taxpayer is or was an employee of the relevant employer or its associate.⁸⁸

Of the remaining exclusions and exemptions allowed in the current FIF legislation, those dealing with short term visitors and small investors are straightforward concessions justified by administrative simplicity. The FIF legislation does not apply to short-term visitors to Australia.⁸⁹ Similarly, if the total value of any individual taxpayer's interests in all FIFs does not exceed \$50,000, then no income is attributed.⁹⁰

The final significant FIF exclusions are tax design features. The first prevents application of the FIF attribution system where another attribution system already applies. If the CFC measures or the transferee trust measures apply to income, then these provisions take pre-

82. *Id.* (now ITAA Division 6).

83. *Id.* (now ITAA Division 7).

84. *Id.* (now ITAA §§ 503-504). This particular exemption formed part of the original government proposal.

85. *Id.* (now ITAA § 523).

86. *Id.* (now ITAA § 525).

87. *Id.* (now ITAA § 513).

88. *Id.* (now ITAA § 519).

89. *Id.* (now ITAA § 517). Short-term visitors include those holding temporary entry permits and those present in Australia for less than four years. The provision does not apply to persons who are present in Australia under a temporary entry permit awaiting the outcome of an application for a permanent entry permit.

90. *Id.* (now ITAA § 515). In the original Bill, the limit was set at the relatively low figure of \$20,000.

cedence over the FIF legislation.⁹¹ The second design change⁹² exempts interests in FIFs from attribution where such interests are trading stock and where any appreciation of value in the FIFs is already included in income through the trading stock provisions.⁹³

VI. CONCLUSION

The extent to which the government of the taxpayer's residency should tax foreign income presents a spectrum of responses. Singapore, for example, taxes only income received in Singapore by Singapore residents.⁹⁴ The United States and Canada, like many advanced countries, fall at the other end of this spectrum, taxing undistributed income or capital gains in certain circumstances.

Since 1987, Australia has moved quickly from one end of the international taxation spectrum to the extreme limits of the other. Originally, income derived abroad by Australian residents was subject to Australian tax only when received by the Australian residents without tax imposed at the source. Through the introduction of a tax credit system and accrual attribution for controlled foreign entities, Australia's international taxation system now shows the same sophistication of many other industrialized nations' taxation systems.

With the introduction of the FIF proposals, Australia will now tax undistributed income and capital gains as a general rule.⁹⁵ These changes thrust Australia into the leading edge of international taxation, perhaps leading where angels (an unquestionably inappropriate metaphor in taxation law) would fear to tread.

The Australian taxation system cushions resident individuals from the effects of these changes by a *de minimis* exemption in the FIF Bill. However, Australian resident superannuation funds with foreign passive investments in entities without a policy of regularly distributing income are significantly affected by the new regime. The Australian funds will quite naturally be keen to enjoy capital growth,

91. *Id.* cls. 26, 27 (now ITAA §§ 431A-B, 493-494).

92. *Id.* cl. 27 (now ITAA § 521).

93. ITAA, *supra* note 1, § 31.

94. This is the interpretation placed on § 10(1)(a) of the Singapore Income Tax Act by the Singapore Inland Revenue Department. It derives from Indian case law on analogous provisions.

95. New Zealand has announced that it will introduce a FIF regime somewhat similar to Australia's. The original New Zealand FIF regime has effectively been abandoned. A new regime will apply from April 1, 1993. However, it will apply to interests acquired in FIFs after July 2, 1992.

because their needs for income are often not immediate. In most cases,⁹⁶ however, they are taxed⁹⁷ on this undistributed capital growth.

The usual justifications for measures like the CFC and transferee foreign trust provisions are that taxpayers resident in the tax jurisdiction can control the foreign entity. Their control of the remittal of income or capital gains to themselves presumably justifies taxation on an accrual attribution basis. However, investors in FIFs cannot control what is done. Given the limited exceptions to the Australian FIF Bill provisions, it effectively penalizes genuine arm's length investments. In our view, this approach stretches the spectrum of foreign income taxation into an area where it should not go.

96. Employer sponsored schemes, which are the smaller segment of the Australian superannuation scheme market, are to be exempted from FIF application. FIF Bill, *supra* note 47, cl. 27 (now ITAA § 519).

97. However, most Australian superannuation funds currently pay tax at the concessional rate of 15%.