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Australian property trusts to become more competitive

In early April, the Assistant Treasurer announced that changes would be made to the tax law in relation to Australian property trusts. The reason behind the proposed changes is to increase the international competitiveness of such property trusts by ensuring that they do not need to utilise stapled securities. Two changes were announced. The first was a proposed capital gains tax (CGT) roll-over when interposing a holding entity between entities with stapled securities and the unit holders. The second was to ensure that such restructures would not cause the interposed entity to breach the dreaded "Division 6C" provisions.

For those readers unaware of the term, Division 6C is a provision of the income tax law that treats "public trading trusts" as companies, for tax purposes. A public trading trust is, broadly, publicly owned and engaged in a business enterprise that wholly consists of "eligible investments" (broadly, passive investments). In order to minimise the impact of Division 6C, many trusts are set up as "stapled" arrangements, whereby the active business activities are put in one entity and the passive, eligible investments in a unit trust. The units in this unit trust are stapled to the shares or units in the business entity, so that holders of one security must own the second security, and they are traded together.

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This is not the only reason for stapling securities. Another reason, for instance, would be to merge the operations of two entities without doing a formal shifting of the assets (which could have significant stamp duty and legal fees) or the transferring of one entity to the other. However, where there are groups with a large number of entities with stapled units, the group can become unwieldy and difficult to manage. For instance, it still requires that every trust within the group issue a distribution statement with its distribution. This becomes even more pronounced in the current investment climate, where Australian property trusts are increasingly investing overseas. It is for this stated reason that the announced changes will be made. Once the changes are enacted, a holding entity can be interposed, and this entity can be used as the main vehicle to acquire Australian and offshore assets.

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BDO comment: The announced changes are very good news for the Australian property trust market. This market is the most sophisticated property trust market in the world and provides a useful way for investors to invest in large commercial property developments. While the stapling of units has been

a useful mechanism that allows flexibility and increases the ability to merge entities, the increasing number of large stapled groups is becoming difficult to manage. The announced changes will allow such groups to restructure in a tax-free manner, and thereby minimise their compliance and administrative costs.

Tax Office practice for captive insurance

In April the Tax Office issued Practice Statement Law Administration PS LA 2007/8, relating to the treatment of non-resident captive insurance arrangements. A captive insurance company is an insurance company that is primarily set up to insure the risks of its parent and affiliates (although it might also insure some third parties). Its parent is usually not an insurance entity and the captive insurance company is usually set up to spread the risks across the group.

The captive insurance company might retain the risks or it might pass them on elsewhere. Both situations have a commercial basis. In the case of retaining the risks, the commercial rationale is that, in some instance, it is more cost-effective to retain the risks within a fund set up for that purpose and spread it across the group, rather than paying an outside insurer. On the other hand, the captive insurance company might pass on the risk to a reinsurance provider. The commercial rationale for this is that it is in many cases cheaper to take out a single reinsurance policy than taking out a separate policy for each member of the group.

As many captive insurance companies are set up in low-tax jurisdictions, they are usually viewed with some degree of skepticism by tax authorities. This is particularly the case where a captive insurance company operates at a profit, either by retaining the risk (and therefore, appearing to merely be some kind of investment fund) or by earning a large profit on the difference between the insurance premiums earned and the reinsurance premiums paid. In these instances, the tax authorities in many cases consider the captive insurance company a scheme designed to transfer profits to the low-tax jurisdiction. This

skepticism is compounded by the fact that the captive insurance company's business is quite intangible, and it is not necessary to set up physical offices and operations.

The Practice Statement echoes with this skepticism. A number of factors are listed, all of which the Tax Office thinks should be considered by officers who review such structures. The factors are:

- whether the amount of deductions claimed is properly referable and proportionate to the actual insurance coverage provided, or whether the expense may be excessive;
- whether the transfer pricing rules will apply to reduce the amount of any deduction claimed;
- whether the captive insurance company is resident because its place of central management and control is in Australia;
- whether the income it receives is properly Australian-sourced income and assessable in Australia;
- whether special withholding rules apply to the premiums paid by the Australian residents to the non-resident captive insurance company;
- whether the captive insurance company is a controlled foreign company, and whether any of the Australian residents in the group are attributable taxpayers of that controlled foreign company; and
- whether the general anti-avoidance rules contained in Part IVA will apply.

BDO comment: Statements are prepared and issued to assist Tax Office personnel when they are conducting audits or other reviews. They are internal guidelines and are not issued to benefit taxpayers or their advisers. However, they are useful guides as to what the Tax Office would be looking at in various transactions. In this regard, any corporate group with a captive insurance company should review this arrangement, to ensure that the company is correctly administered offshore and to ensure that only a commercially justified premium is paid.

Tax Office practice for share buy-backs

In early May, the Tax Office issued Practice Statement Law Administration PS LA 2007/8, relating to share buy-backs. As many readers are aware, there is a special tax regime relating to share buy-backs, particularly off-market share buy-backs. Broadly, under this regime, part of the buy-back proceeds is treated as a dividend to the shareholder and not as a capital return.

Because of the specific regime and the ability to treat part as a dividend, the buy-back is a flexible tool and has been used in several arrangements. However, there are a number of anti-avoidance rules that can strike down the tax advantages of any buy-back arrangement. In particular, sections 45A and 45B strike down capital streaming arrangements and other arrangements that provide a capital benefit to the shareholder. It is for this reason that there are a number of administratively binding advices, private binding rulings and class rulings sought, to provide taxpayers with a degree of comfort in relation to their buy-back.

The Practice Statement provides details to Tax Office personnel who are proposing to issue such rulings or any administratively binding private advice. It details how the share buy-back rules apply in principle. It also discusses the operation of other rules such as the 45 day waiting period rule, which requires shareholders to hold shares “at risk” for 45 days before being entitled to franking credits. In this regard, the Tax Office advises its personnel to ensure that a buy-back announcement will not result in a materially diminished risk or loss of opportunities—to overcome this, the Practice Statement says that the buy-back timetable should limit trading on the shares after announcement and before record date to three days (although it can be extended to up to seven days if there are strong commercial reasons).

The Practice Statement has a long discussion on the anti-avoidance rules, not only sections 45A and 45B, but also the general anti-avoidance rules contained in Part IVA. As mentioned in the previous article, Practice Statements are designed as guidelines for Tax Office personnel. Therefore, the discussions are more designed to make Tax Office personnel aware that these anti-avoidance rules may apply to share buy-backs, rather than providing guidance on which arrangements are acceptable.

BDO comment: A share buy-back arrangement is a flexible mechanism to return value to shareholders and to buy out shareholders. Because of this, it is used for a number of different types of transactions. Consequently, there has been an increase in the applications before the Tax Office and the Tax Office has started to look at such arrangements with suspicion. It is unsurprising that this Practice Statement (which is just guidance to Tax Officers) has been issued. For taxpayers seeking a private ruling, class ruling or administratively binding advice, the Practice Statement has a clear message—make sure that the buy-back has a commercial purpose and is not designed to avoid tax.



BDO Kendalls national tax seminars

BDO Kendalls conducts a series of bi-monthly seminars around the country, focusing on issues topical within the tax world. July's seminar is titled “Taxation of financial arrangements – How the rules affect you”. The seminars will be held in the third and fourth weeks of July. If you would like to attend or would like more information about upcoming seminars in the series, please contact your local BDO Kendalls office.

Partnership interests are not business assets

Last month, the Commissioner issued draft Taxation Determination TD 2007/D6, which discussed whether an interest in a partnership was an “active foreign business asset” for the purposes of the capital gains tax (CGT) participation exemption. The draft Determination answers the question emphatically as “no”, due to a specific exclusion for interests in partnerships and trusts.

BDO comment: The participation exemption is an exemption from Australian CGT for shares to the extent that the shares represent active assets, that is, business assets rather than passive investments. One of the reasons behind this exemption was to make Australia more attractive as an international holding company location. Unfortunately, interests in partnerships and trusts are considered to be more like investments. Readers with offshore operations should ensure that they are structured correctly, in order for them to take advantage of this participation exemption.



US tax debt not enforceable in Australia

In recent decision of *Jamieson v Commissioner for Internal Revenue* [2007] NSWSC 324, the Supreme Court of NSW upheld a motion by the executrix of a deceased estate, allowing her to distribute the assets of the estate without taking into account a claim for unpaid US tax brought by the US Internal Revenue Service (IRS). The deceased in that case was an Australian citizen and domicile, but was resident in the USA. The majority of his assets were in NSW. The executrix was his daughter. The IRS sought to enforce an unpaid tax debt relating to “deficiencies in tax”.

The Court held that a tax debt was not enforceable in Australia. This is a long-standing rule in common law countries, which prevents foreign public laws from being enforceable locally. There is even a specific exclusion for tax debts from the *Foreign Judgments Act 1991* (Cth), the law that allows the

enforcement of judgments of foreign courts. This rule has been abrogated by some double tax treaties such as the treaties with France and Norway, but it has not been abrogated by the treaty with the USA. Therefore, it was a simple matter for the Court to hold that the US tax debt was not enforceable in Australia.

BDO comment: The principle that a foreign tax law cannot be enforceable in Australia is long standing and, therefore, the Court’s ultimate decision is not surprising. However, it is important to note that, as mentioned above, this rule has been abrogated in some cases, notably under the French and the Norwegian double tax agreements. With the growing globalisation of the world economy, the increase in cooperation amongst tax authorities and the clamping down of international tax evasion, it is likely that, in future, it will become less and less possible to rely on this rule.

Interest subject to withholding tax

A recent case before the Federal Court demonstrates the technical difficulties that can arise when non-residents invest in resident trusts. In the case, *GE Capital Finance Pty Ltd v Commissioner of Taxation* [2007] FCA 558, a resident trust earned interest income to which a US beneficiary was entitled. There are two possible withholding tax mechanisms to deal with this interest. First, under the ordinary withholding tax rules, interest paid to a non-resident is subject to tax at the rate of 10%. Additionally, under the trust rules, a trustee is required to pay tax at the corporate rate on Australian sourced income to which a non-resident is entitled.

The ordinary withholding tax rules apply first in most cases. However, the Commissioner ran a very technical argument to say that the withholding tax rules did not apply and, therefore, the higher "trust withholding" provisions would apply. His argument was based on a provision in the *International Tax Agreements Act 1953*, which deems a beneficiary in an Australian trust to have a permanent establishment in Australia under certain circumstances.

To put the Court's judgment simplistically, one of those circumstances was that the trust itself earning business income, which was not the circumstances of the present case. Therefore, the 10% interest withholding, rather than the 30% trust withholding rate, applied.



BDO comment: It would have been a sad day for the Australia investment trust market if the Commissioner had won this case. The Australian investment trust market is one of the most advanced in the world and one of the reasons that investments trusts are so popular is due to their flow-through tax treatment. However, this flow-through tax treatment is not a general rule, and income does actually change its nature and source when it is earned by a trust and distributed to a beneficiary. In order to achieve the advantageous flow-through treatment, there are a large number of technical rules that deal specifically with withholding taxes, capital gains and foreign sourced trust income.

The Commissioner thought that there was a "glitch" in the rules that would have changed the nature of that income. If he were correct, a huge number of investment trusts would have grossly underpaid their withholding rate taxes. Luckily, the Court held that this glitch did not exist, either in the words or intention of the law.

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