2004-2005

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

NEW INTERNATIONAL TAX ARRANGEMENTS (FOREIGN-OWNED BRANCHES AND OTHER MEASURES) BILL 2005

EXPLANATORY MEMORANDUM

(Circulated by authority of the
Treasurer, the Hon Peter Costello MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
APRA	Australian Prudential Regulation Authority
ATO	Australian Taxation Office
Australian company	Australian resident company
Australian dividends	dividends paid by an Australian company
CGT	capital gains tax
Consultation Paper	the Treasury's consultation paper — *Review of International Taxation Arrangements*
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
MEC group	multiple entry consolidated group
NITA Act 2004	*New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004*
OECD	Organisation for Economic Co-operation and Development
the Board's Report	the Board of Taxation's report — *International Taxation — A Report to the Treasurer*

General outline and financial impact

Introduction

This Bill is a further instalment implementing the package of reforms which were announced following the Government's review of international taxation arrangements. Earlier instalments included a new treaty with the United Kingdom, the *New International Tax Arrangements Act 2004*, the *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004* and the New International Tax Arrangements (Managed Funds and Other Measures) Bill 2004.

Dividends received by foreign-owned branches

Schedule 1 to this Bill amends the taxation treatment of certain non-residents in respect of Australian branches by taxing dividends paid to the branches on a net assessment basis and providing tax offsets in relation to franked distributions received.

Date of effect: These amendments will apply to dividends, non-share dividends, non-unit dividends and distributions paid on or after the date of Royal Assent.

Proposal announced: This measure was announced in the Treasurer's Press Release No. 32 of 13 May 2003.

Financial impact: The financial impact of this measure is unquantifiable, but expected to be insignificant.

Compliance cost impact: The compliance costs will generally be comparable to current levels, although they may be reduced in relation to some taxpayers.

Changes to the controlled foreign companies rules

Schedule 2 to this Bill amends the income tax law to:

- prevent inappropriate taxation as a result of the definition of 'commencing day' in the controlled foreign companies rules when Australian residents gain a direct or indirect interest in a controlled foreign company,
  and
- remove inappropriate taxation where an 'unlisted country' controlled foreign company becomes a 'listed country' controlled foreign company due to its country of residence being listed.

This Schedule also corrects a deficiency in the law relating to 'adjusted distributable profits' when a controlled foreign company changes residence from an unlisted country to a listed country or Australia.

Date of effect: The new definition of commencing day will, for most purposes, apply to capital gains tax events occurring on or after the 1 July that next occurs after Royal Assent.

The removal of inappropriate consequences that follow listing of a country will apply from the day after Royal Assent.

The correction of the deficiency relating to adjusted distributable profits will apply for income years and statutory accounting periods starting on or after 1 July 2004.

Proposal announced: This measure was announced in the Treasurer's Press Release No. 32 of 13 May 2003.

Financial impact: The financial impact of the new definition of commencing day is unquantifiable. The financial impact of the amendments to remove inappropriate consequences that occur from the listing of a country is insignificant and has been rounded down to nil.

Compliance cost impact: This amendment will reduce compliance costs associated with acquisitions of overseas groups and restructuring of overseas operations. It allows Australian taxpayers who have acquired an interest in a foreign company, which has never before been controlled from Australia, to assume that Australian tax will not subsequently be payable on gains which have accrued prior to the time of acquisition by the Australian taxpayer.

There will be no compliance cost impact from the removal of inappropriate attribution when an unlisted country controlled foreign company becomes a listed country controlled foreign company due to its country of residence becoming listed pending listing of a country.

Australian branches of foreign financial entities

Schedule 3 to this Bill extends the existing separate entity treatment currently provided to Australian branches of foreign banks, to include Australian branches of foreign financial institutions. Separate entity treatment entails treating a branch as a separate legal entity from a parent company, as if it is a subsidiary. Australian branches of foreign banks are treated as entities separate from the head office of the foreign bank under Part IIIB of the *Income Tax Assessment Act 1936* (ITAA 1936) for thin capitalisation grouping purposes and under the transfer of loss provisions. Also extending separate entity treatment to Australian branches of foreign financial entities will improve competition within the financial services sector.

Date of effect: These amendments will generally apply to income years starting on or after the date of Royal Assent.

The amendments to the transfer of loss provisions will apply in relation to relevant losses for income years starting on or after the date of Royal Assent.

Proposal announced: This measure was announced in the Treasurer's Press Release No. 32 of 13 May 2003.

Financial impact: The financial impact of this measure is unquantifiable, but expected to be insignificant.

Compliance cost impact: There will be some additional compliance costs for taxpayers who are subject to this measure, however these costs are no more onerous then those imposed on foreign banks. These cost may be met by the systems taxpayers already have in place.

Cross-border employee shares and rights

Schedule 4 to this Bill amends the income tax law, to more closely align the taxation of shares or rights acquired under an employee share scheme with international norms developed by the Organisation for Economic Co-operation and Development. The amendments are relevant for individuals who work in more than one country or change their country of residence. They will help prevent double or nil taxation of employee shares or rights and provide greater certainty for individuals.

Additional rules clarify capital gains tax (CGT) interactions, and make other minor improvements.

Date of effect: The amendments relating to the acquisition of employee shares or rights by individuals or employee share trusts, and to individuals who first become employed in Australia holding employee shares or rights will generally apply from the date of Royal Assent.

The CGT amendments generally apply to CGT events occurring on or after Royal Assent.

Amendments to the fringe benefits tax and foreign investment fund rules apply from the relevant income year ending after Royal Assent.

Proposal announced: This measure was announced in the Treasurer's Press Release No. 32 of 13 May 2003.

Financial impact: The financial impact of this measure is unquantifiable, but expected to be insignificant.

Compliance cost impact: The clarification will provide greater certainty for taxpayers while its overall impact on compliance cost is unquantifiable.

Technical correction to application rule

Schedule 5 to this Bill amends the application rule in subitem 140(2) in Schedule 2 to the *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004* to ensure all the amendments made by Parts 2 and 3 in that Schedule operate as intended.

Date of effect: The change to the application rule is to take effect immediately after the commencement of the *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004*. That Act commenced on 29 June 2004.

Proposal announced: This measure has not previously been announced.

Financial impact: Nil.

Compliance cost impact: Nil.

Summary of regulation impact statement

Regulation impact on business

Impact: The measures in this Bill are part of a broader reform package that builds on Australia's position as an attractive place for business and investment. Two measures relate to the Australian branches of foreign entities and will provide a more neutral treatment of alternative corporate structures and improve competition in the financial services sector. The changes to the treatment of the employee shares or rights of individuals moving between countries will improve Australia's ability to attract highly skilled individuals and businesses that employ them by aligning more closely with international norms and reducing uncertainty. The changes to the controlled foreign companies rules have a number of objectives, including reducing compliance costs associated with the acquisitions of foreign companies and the restructuring of overseas operations.

Main points:

- Extending similar tax treatment to Australian branches of foreign financial entities, as currently provided to Australian branches of foreign banks, will foster competitive neutrality between these two types of financial service providers. It will provide similar tax outcomes for foreign financial entities (as well as banks) in choosing whether to operate in Australia through either branches or subsidiaries. There will be some compliance costs for taxpayers who are subject to this measure.

- The taxation of dividends received by Australian branches on an assessment basis will also improve tax neutrality between foreign-owned branches and subsidiaries in Australia. It removes an inconsistency between Australia's domestic income tax law and its tax treaty obligations, thereby providing

compliance cost savings for certain taxpayers as well as cash-flow benefits.

- The changes to the taxation of cross-border employee shares or rights aim to align Australia's tax rules more closely with international norms developed by the Organisation for Economic Co-operation and Development, and help prevent double or nil taxation where individuals move between countries. It will also address areas of uncertainty associated with the current law.

- Changes to the definition of 'commencing day' in the controlled foreign companies rules will ensure that only capital gains and capital losses that relate to the period of time during which a controlled foreign company was in the controlled foreign companies net are included in Australia's capital gains tax net.

Changes to the consequences that follow from the listing of a country as a listed country for the purposes of the controlled foreign companies rules will ensure that inappropriate consequences do not apply to attributable taxpayers with controlled foreign companies in such a country.

Chapter 1
Dividends received by foreign-owned branches

Outline of chapter

1.1 Schedule 1 to this Bill amends the taxation of certain non-residents in respect of Australian branches (permanent establishments) to:

- tax dividends paid to the branches on a net assessment basis, and
- provide tax offsets in relation to franked distributions (franked dividends) received.

1.2 Unless otherwise indicated, all legislative references are to the *Income Tax Assessment Act 1936*.

Context of amendments

1.3 These amendments are part of the Government's response to the Board of Taxation's report to the Treasurer on international taxation. The amendments will improve tax neutrality between the Australian branches and subsidiaries of non-residents. They are consistent with the general trend to treat branches as entities separate from the non-resident behind them.

1.4 Currently, dividends paid by an Australian resident company (Australian company) to a non-resident are subject to withholding tax. Such dividends are non-assessable non-exempt income in the hands of the non-resident. As the dividends are not included in the non-resident's assessable income, the non-resident is not entitled to deduct relevant expenses against that dividend income.

1.5 Where a non-resident is a resident of a tax treaty partner country, the treaty will generally require all income that is attributable to a branch, including dividends, to be taxed in Australia on a net profit basis. The

resulting mismatch with Australia's current domestic law, which applies a final withholding tax to gross dividends, increases compliance and administrative costs. These amendments will better align the domestic law with Australia's tax treaty obligations.

1.6 The main benefits to taxpayers affected by these amendments are:

- increased certainty in legal and administrative outcomes
- reduced compliance costs, and
- improved cash flows.

Summary of new law

1.7 Dividends paid by an Australian company to a non-resident company or individual that are attributable to an Australian branch of the non-resident will no longer be subject to dividend withholding tax. Rather, such dividends will be taxed in Australia on a net assessment basis. Where dividends are franked, the non-resident company or individual may be entitled to claim a tax offset. Consequential amendments provide other benefits consistent with taxation on a net assessment basis.

1.8 These amendments will apply to dividends and like amounts paid on or after the date of Royal Assent.

Comparison of key features of new law and current law

New law	*Current law*
Dividends paid by an Australian company to a non-resident company or individual that are attributable to an Australian branch of the non-resident will be taxed on a net assessment basis. Relevant expenses will be allowed as deductions against the non-resident's assessable income.	Dividends paid by an Australian company to a non-resident are subject to dividend withholding tax, even if they are attributable to a branch. Expenses incurred in deriving the dividends are not deductible. However, Australia's tax treaties require that relevant expenses be allowed as deductions against dividend income of an Australian branch of a non-resident.

New law	*Current law*
Non-resident companies and individuals in receipt of a franked distribution that is attributable to an Australian branch will be entitled to a franking tax offset.	Non-resident companies and individuals in receipt of a franked distribution are not entitled to a franking tax offset.

Detailed explanation of new law

1.9 Dividends paid by an Australian company (Australian dividends) to an Australian branch of a non-resident company or individual will be included in the assessable income of the non-resident. Further, where such dividends are franked, the non-resident company or individual may be entitled to claim a tax offset.

How are Australian dividends paid to Australian branches currently taxed?

1.10 Unfranked dividends paid by an Australian company to an Australian branch of a non-resident are taxed on a final withholding basis (section 128B). Those dividends are not assessable income and are not exempt income in the hands of the non-resident (section 128D).

1.11 Franked dividends are currently excluded from withholding tax (paragraph 128B(3)(ga)). However, dividends excluded from withholding tax by reason of being franked are still considered to be non-assessable non-exempt income of the non-resident (section 128D).

1.12 Non-residents are not entitled to deduct any expenses incurred in relation to deriving franked and unfranked dividends, as those dividends are not assessable income of the non-resident (section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997)). However, Australia's tax treaties require that relevant expenses be allowed as deductions against dividend income of a non-resident that is attributable to an Australian branch.

How will Australian dividends paid to an Australian branch be taxed?

1.13 Franked and unfranked dividends paid by an Australian company will be included in the assessable income of a non-resident company or individual where those dividends are attributable to a branch of the non-resident that is situated in Australia. Consequently, any expenses incurred in deriving that dividend income may be allowed as a deduction from that income when calculating the taxable income of the non-resident.

Further, a non-resident company or individual may be entitled to tax offsets under Division 207 of the ITAA 1997 in respect of franked dividends that are attributable to an Australian branch of the non-resident.

Exclusion from withholding tax

1.14 These amendments will ensure that Australian dividends paid to an Australian branch of a non-resident company or individual are excluded from withholding tax ***[Schedule 1, item 5, subsection 128B(1); item 6, subsection 128B(3E)]***. Consequently, the dividends will no longer be non-assessable non-exempt income of the non-resident pursuant to section 128D, even when the dividends are franked ***[Schedule 1, item 6, note to subsection 128B(3E)]***.

1.15 For franked dividends, section 128D will no longer apply, even though franked dividends are still potentially covered by paragraph 128B(3)(ga). Section 128D only includes franked dividends in the non-assessable non-exempt income of a non-resident where that income would have been subject to withholding tax *but for* paragraph 128B(3)(ga). However, new subsection 128B(3E) will ensure that relevant franked dividends will not otherwise be subject to withholding tax. Consequently, section 128D will not prevent those dividends from being included in assessable income.

Example 1.1

> NZ Co, a company resident in New Zealand, is paid a fully franked dividend by an Australian company. The dividend is attributable to NZ Co's Australian branch.
>
> New subsection 128B(3E) will exclude those dividends from withholding tax on the basis that the dividend is attributable to NZ Co's Australian branch. Consequently, section 128D will not apply to make that income non-assessable and non-exempt in the hands of NZ Co on the basis that withholding tax would not be payable on the dividends, even in the absence of paragraph 128B(3)(ga).

Attributable to an Australian branch

1.16 For the new exclusion from withholding tax to apply, the dividends must be attributable to an Australian branch of the non-resident company or individual ***[Schedule 1, item 6, paragraph 128B(3E)(b)]***. This ensures that only dividends paid to a non-resident through a branch situated in Australia will be included in the assessable income of the non-resident.

1.17 It is intended that the term 'attributable to' will adopt its ordinary meaning.

Example 1.2

> US Co, a company resident in the United States, which has a branch in Australia, is paid unfranked dividends by an Australian resident company, Aus Co. US Co's interest in Aus Co is held independently of US Co's Australian branch. Further, the dividends are paid into a bank account maintained in the United States by US Co.
>
> Although US Co carries on business through a branch in Australia, the unfranked dividends paid to it by Aus Co will be subject to withholding tax as they are not attributable to the branch (section 128B). Further, the dividends will be non-assessable non-exempt income of US Co (section 128D).

Definition of permanent establishment (branch)

1.18 A definition of 'permanent establishment' will be introduced specifically for the purpose of these amendments ***[Schedule 1, item 2, subsection 44(7); item 6, subsection 128B(3F); item 8, paragraph 115-280(1)(b) of the ITAA 1997; item 10, paragraph 207-75(2)(c) of the ITAA 1997]***. Under this definition, where a non-resident is subject to a tax treaty, the relevant treaty definition of permanent establishment will apply. Conversely, where there is no relevant tax treaty, the domestic law definition of permanent establishment will apply.

1.19 The primary reason for including this definition is to avoid a gap, and hence any unintended consequences, that may arise because of the differences in the definition of permanent establishment in Australia's domestic tax law and in Australia's various tax treaties.

Restriction to non-resident companies and individuals

Application to partnerships

1.20 A partnership is not a separate and distinct legal entity for either income tax or general law purposes. As a consequence, partners are taxed on their individual interest in the income of the partnership. Similarly, the existence of a partnership is ignored for the purpose of these amendments. Therefore, where dividends are paid by an Australian company to a partnership with a partner that is a non-resident company or individual, and the dividends are attributable to an Australian branch of the partnership, that partner will be exempt from withholding tax. The partner will instead

be taxed on its individual interest in those dividends on a net assessment basis.

Application to trusts

1.21 These amendments will not apply to dividends paid to Australian branches of non-resident trusts. ***[Schedule 1, item 6, paragraph 128B(3E)(c)]***

1.22 The current tax treatment of trusts is based primarily on the residence of the beneficiaries of those trusts. Non-resident beneficiaries deriving Australian dividend income through resident and non-resident trusts are therefore generally subject to the same tax. Not applying the amendments to non-resident trusts maintains this position.

1.23 For instance, a beneficiary that is presently entitled to an Australian dividend paid to a non-resident trust will be taken to have derived income consisting of that dividend at the time when the beneficiary became so entitled (subsection 128A(3)). A non-resident beneficiary will therefore be subject to withholding tax on that dividend (section 128B), and benefit from any relevant exclusions, regardless of whether the trust that derived the income is a resident of Australia or not.

1.24 However, the impact of tax treaties must be considered, especially in relation to the application of subsection 3(11) of the *International Tax Agreements Act 1953* and equivalent articles in subsequent tax treaties.

Inclusion in assessable income

1.25 Dividends paid to Australian branches of non-residents that are to be exempted from withholding tax will be included in the assessable income of those non-residents. ***[Schedule 1, item 1, paragraph 44(1)(c)]***

1.26 Inclusion in assessable income is achieved by expanding the scope of subsection 44(1). Paragraph 44(1)(b) will continue to apply to dividends paid to an Australian branch of a non-resident company or individual out of profits from an Australian source. The amendments will ensure that all other Australian dividends are included in the assessable income of a non-resident with an Australian branch by applying to Australian dividends paid out of a foreign source. ***[Schedule 1, item 1, paragraph 44(1)(c)]***

1.27 A consequence of including Australian dividends in the assessable income of a non-resident company or individual is that those dividends will be taxed on a net basis. This means that relevant expenses

will be allowed as deductions to reduce the taxable income of the non-resident.

Application to non-share and non-unit dividends

1.28 These amendments will also apply in relation to non-share dividends ***[Schedule 1, item 1, subparagraph 44(1)(c)(ii)].*** This is consistent with the current treatment of non-share dividends paid to a non-resident for withholding tax purposes. In particular, dividend withholding tax applies to a non-share dividend in the same way as it applies to a dividend (subsection 128AAA(1)).

1.29 A non-unit dividend that is paid out of corpus of a corporate unit trust will be taken to be derived from a source outside Australia to the extent to which it is attributable to a source outside Australia ***[Schedule 1, item 3, subsection 102L(21A)].*** Similarly, a non-unit dividend paid out of corpus of a public trading trust and that is attributable to a source outside Australia will, to that extent, be taken to be derived from a source outside Australia ***[Schedule 1, item 4, subsection 102T(22A)].*** These amendments reflect the general treatment of such trusts as companies.

Tax offsets available for franked dividends

1.30 Generally, if a corporate tax entity makes a franked distribution to a member, the assessable income of the member may include an amount equal to the franking credit on the distribution (Division 207 of the ITAA 1997). Further, the member is entitled to a tax offset equal to the amount of the franking credit on the distribution. That entitlement depends, among other conditions, on the member being an Australian resident at the time the distribution is made (section 207-75 of the ITAA 1997).

1.31 To provide access to franking tax offsets, a non-resident company or individual (foreign resident) will be treated as satisfying the residency requirement for franked dividends that are attributable to a branch they have in Australia ***[Schedule 1, item 9, subsection 207-75(1) of the ITAA 1997; item 10, subsection 207-75(2) of the ITAA 1997].*** If the non-resident receives a franked dividend that is not attributable to a branch in Australia, then they will not satisfy the residency requirement and so will not be entitled to a tax offset. However, such franked dividends will not constitute assessable income in any case (section 128D).

1.32 The non-resident company or individual will still be required to meet the other conditions apart from residency to benefit from the franking tax offset.

Excess franking tax offsets

Conversion into tax losses

1.33 Where a corporate tax entity has excess franking tax offsets that it is not able to use in a year of income, the entity may, subject to certain conditions, convert those excess franking tax offsets into tax losses (section 36-55 of the ITAA 1997). The tax losses may then be carried forward for consideration as a deduction in a later year of income.

1.34 The excess franking tax offset conversion provisions will apply to a non-resident company that is eligible for the franking tax offset. However, the non-resident company will still be subject to the normal rules governing the deduction of tax losses (Division 36 of the ITAA 1997).

Refundable tax offset rules

1.35 These amendments will ensure that a non-resident individual who has excess franking tax offsets cannot obtain a refund of those tax offsets under Division 67 of the ITAA 1997. ***[Schedule 1, item 7, subsection 67-25(1DA) of the ITAA 1997]***

1.36 In practice, denying a refund will have few consequences given the personal income tax rates applying to non-residents.

Application and transitional provisions

1.37 These amendments will commence on the date of Royal Assent ***[Clause 2]***. This means that the amendments will apply to dividends, non-share dividends, non-unit dividends and distributions paid on or after the date of Royal Assent.

Consequential amendments

Tax relief for shareholders in listed investment companies

1.38 These amendments will enable non-resident individuals to access the deduction provided under Subdivision 115-D of the ITAA 1997. ***[Schedule 1, item 8, paragraphs 115-280(1)(b) and (ba) of the ITAA 1997]***

1.39 An Australian resident individual may deduct an amount for a dividend paid to them by an Australian listed investment company where all or some part of the dividend is reasonably attributable to certain capital gains made by a listed investment company. The deduction effectively reduces the eligible capital gain component of a dividend by the capital gains tax discount.

1.40 Allowing a non-resident individual access to the deduction ensures consistent treatment with Australian resident individuals that are paid dividends from Australian listed investment companies.

Chapter 2
Changes to the controlled foreign companies rules

Outline of chapter

2.1 Schedule 2 to this Bill contains changes to:

- the definition of 'commencing day' as that term is used in the controlled foreign companies rules
- attribution of income under the controlled foreign companies rules when a country is listed as a 'listed country', and
- the definition of 'adjusted distributable profits' for the purpose of attribution under the controlled foreign companies rules when a controlled foreign company changes its residence from an 'unlisted country' to a listed country or Australia.

2.2 Unless otherwise stated, all legislative references are to the *Income Tax Assessment Act 1936*.

Context of amendments

Commencing day

2.3 The decision to change the definition of commencing day is part of the Government's response to the Board of Taxation's report to the Treasurer on international taxation.

2.4 The definition of commencing day determines the period of time over which capital gains and capital losses on assets without the necessary connection with Australia, that are owned by controlled foreign companies, are calculated.

2.5 The current definition means that, where an Australian taxpayer acquires an interest in a foreign company which has not been controlled from Australia, it cannot make the reasonable assumption that Australian tax will not subsequently be payable on gains which have accrued prior to the time of acquisition by the Australian taxpayer. The definition of commencing day will be changed so that this assumption can be made in these circumstances.

2.6 This amendment will reduce compliance costs associated with acquisitions of overseas groups and restructuring of overseas operations.

Consequences of changing an unlisted country to a listed country under the controlled foreign companies rules

2.7 The decision to change the consequences of a controlled foreign company's country of residence becoming a listed country also arises out of the Government's response to the Board of Taxation's report to the Treasurer on international taxation. This measure is a part of the Government's decision to consider further countries for addition to the listed country list, together with other changes to the law resulting from the Government's response to the Board of Taxation's report.

2.8 Currently, where a controlled foreign company's country of residence is listed as a listed country, attribution of income may occur as a result of that listing if the controlled foreign company was a resident of the country for less than three years prior to the time of residency change. This measure removes the three year requirement, as attribution in this case is no longer appropriate in light of the expansion of the income tax exemption under section 23AJ.

2.9 These amendments will enable further countries to be added to the listed country list without inappropriate consequences.

Adjusted distributable profits

2.10 The decision to change the definition of 'adjusted distributable profits' is intended to ensure that amendments made in the *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004* (NITA Act 2004) have their intended effect.

Summary of new law

Commencing day

2.11 The current definition of commencing day determines the commencing day largely by reference to the date that the eligible controlled foreign company becomes a controlled foreign company. The new definition will mean that the commencing day will instead be largely determined by reference to when there is an attributable taxpayer with a positive attribution percentage in relation to the controlled foreign company.

2.12 In addition the amendments will ensure that, for the purposes of determining the commencing day, an attributable taxpayer can ignore time before the most recent period during which there was no attributable taxpayer with a positive attribution interest in relation to the controlled foreign company.

Consequences of changing an unlisted country to a listed country under the controlled foreign companies rules

2.13 Items 1 to 4 and 9 of Schedule 2 ensure that attribution no longer occurs solely because an unlisted country controlled foreign company becomes a listed country controlled foreign company due to its country of residence being listed.

Adjusted distributable profits

2.14 The change to the definition of adjusted distributable profits will ensure that adjusted distributable profits of previous statutory accounting periods are ignored. This is consistent with the intent underlying the NITA Act 2004.

Comparison of key features of new law and current law

New law	*Current law*
Capital gains and capital losses on assets without the necessary connection with Australia, that are owned by controlled foreign companies, enter Australia's capital gains tax (CGT) net from the date (the commencing day) that an eligible controlled foreign company has an attributable taxpayer with a positive attribution percentage or 30 June 1990, whichever is later.	The commencing day is the date that an eligible controlled foreign company becomes a controlled foreign company or 30 June 1990, whichever is later.
In determining the commencing day, all periods of time before the most recent period during which there was no attributable taxpayer with a positive attribution percentage are ignored.	In determining the commencing day, all periods of time after 30 June 1990 are considered.
There is no attribution under section 457 solely because a controlled foreign company's country of residence becomes a listed country.	Where a controlled foreign company's country of residence goes from being an unlisted country to a listed country, section 457 only operates to attribute income if the controlled foreign company was a resident of that unlisted country for less than three years prior to the time of residency change.
Paragraphs 384(2)(e) and 385(2)(e) will be repealed.	Under paragraphs 384(2)(e) and 385(2)(e), unrealised gains on tainted assets are taxed when the assets are subsequently sold.
Section 457 will not attribute adjusted distributable profits of past statutory accounting periods.	The definition of adjusted distributable profits in section 457 does not ignore previous statutory accounting periods.

Detailed explanation of new law

Commencing day

2.15 Division 7, Subdivision C of Part X contains modifications to Australia's CGT rules. Amongst other things, these aim to exclude any capital gain or capital loss on assets without the necessary connection with Australia that accrued before either the commencement of the controlled foreign companies rules (30 June 1990), or the date that the company became a controlled foreign company (whichever is later). This date is known as the commencing day. These gains or losses should not be attributed because they either relate to a time that the controlled foreign companies rules did not exist (pre-30 June 1990) or when the company was not in Australia's tax net (which a company supposedly is when it is a controlled foreign company).

2.16 To achieve this, Subdivision C treats a controlled foreign company that owned assets at the end of the commencing day, as having acquired those assets on that day for market value. Further, under section 408A capital losses that arose from CGT events before the end of the commencing day cannot be carried forward.

2.17 There are times, however, when a company becomes a controlled foreign company but the company is not in Australia's tax net. This can arise when Australian residents have foreign associates through which they are taken to be able to exert control upon a foreign company, but do not have any direct or indirect interest in the foreign company.

Example 2.1

> ForCo Ltd, a non-resident company wholly-owned by non-residents, has two subsidiaries – AusCo Pty Ltd, an Australian resident company, and CFC Ltd, a non-resident company. Because ForCo Ltd is an associate of AusCo Pty Ltd, CFC Ltd is a controlled foreign company because AusCo Pty Ltd is taken to be able to control it through its relationship with ForCo Ltd. This is despite AusCo Pty Ltd (or any other Australian resident) having no attribution percentage in relation to CFC Ltd, and therefore no possibility of any income being attributable in respect of CFC Ltd's activities.

2.18 This causes a problem where some time after the foreign entity becomes a controlled foreign company, an Australian resident obtains a direct or indirect interest in the foreign entity. If the foreign entity then derives a capital gain or capital loss from selling a relevant asset, the asset's cost base is not its market value at the time the Australian resident

obtained the direct or indirect interest in the foreign entity (being the time the controlled foreign company has substantively entered into the Australian tax net). Instead, the cost base is that at the time the foreign entity originally became a controlled foreign company. This inappropriately leads to a capital gain or capital loss being included in attributable income that may have accrued during a time when there was no Australian resident with a direct or indirect interest in the controlled foreign company.

2.19 Further, there are situations where a company that was a controlled foreign company, is no longer a controlled foreign company. Where a subsequent Australian resident obtains control of the company (and the company again becomes a controlled foreign company), taxation of gains that accrued while the company was not in the CGT net can arise. This gives rise to problems when Australians conduct due diligence processes whilst acquiring a foreign company — the due diligence process has to discover whether, in the history of the company since 30 June 1990, there was technically any Australian control of the company. This can be an onerous process.

2.20 Item 5 of Schedule 2 to this Bill will change the meaning of commencing day in section 406 of Part X so that:

- instead of the time an eligible controlled foreign company became a controlled foreign company being used to identify the commencing day, the time that there was no attributable taxpayer with a positive attribution percentage in relation to the controlled foreign company will be used, and

- periods of time before the most recent time during which there was not an attributable taxpayer with a positive attribution percentage in relation to the controlled foreign company will be ignored in determining the commencing day.

Example 2.2

Robert purchased all of the shares in Graz Inc at 3.00 pm on 20 October 2004. At the time of purchase there were no other attributable taxpayers. Upon purchase of the shares, Graz Inc becomes a controlled foreign company. From 30 June to 1 April 2002, Graz Inc was a controlled foreign company.

The 'last day of the most recent period during which there was not an attributable taxpayer with an attribution percentage (greater than nil)' is 20 October 2004. This is because up to 3.00 pm on that day, there

was no such attributable taxpayer in relation to Graz Inc. Because this is later than 30 June 1990, the commencing day is 20 October 2004.

The period of time from 30 June to 1 April 2002 is not relevant in determining the commencing day, because it is before the 'most recent period during which there was not an attributable taxpayer with an attribution percentage (greater than nil)'.

2.21 Section 408A will continue to, in effect, appropriately deny the carry-forward of capital losses that relate to CGT events that occurred prior to the commencing day.

Consequences of changing an unlisted country to a listed country under the controlled foreign companies rules

2.22 Where a controlled foreign company's country of residence goes from being an unlisted country to being a listed country, section 457 only operates to attribute income if the controlled foreign company was a resident of that unlisted country for less than three years prior to the time of residency change (subsection 457(3)). The income attributed in that case is not intended to include all adjusted distributable profits as unrealised gains on tainted assets are intended to be excluded and then taxed subsequently under paragraphs 385(2)(e) and 384(2)(e).

2.23 The NITA Act 2004 has resulted in the three categories of countries (broad-exemption listed countries, limited-exemption listed countries, and unlisted countries) being narrowed to two (unlisted and listed countries). Broad-exemption listed countries are now known as listed countries (a term that previously included limited-exemption listed countries in its meaning) while unlisted countries and limited-exemption listed countries are now unlisted countries. As a consequence, section 384, which was important in determining the assessable income of an unlisted country or limited exemption listed country controlled foreign company now only applies to unlisted country controlled foreign companies; and section 385 which applied to broad-exemption listed country controlled foreign companies now applies to listed country controlled foreign companies.

2.24 Paragraph 384(2)(e) therefore now only has application to a controlled foreign company that was resident of an unlisted country that became a limited-exemption listed country (eg Argentina in 2000). Following the NITA Act 2004, this paragraph prima facie covers cases where an unlisted country becomes an unlisted country — it therefore no longer has any apparent use. Therefore the use of paragraph 384(2)(e) is

only relevant for past cases where the relevant change occurred when the limited-exemption listed country term still applied. In such cases, paragraph 384(2)(e) has the consequence that where a relevant controlled foreign company sells an untainted asset (tainted assets would be subject to attribution under paragraph 384(2)(a)) that it held at residence change time, then any gain is attributable. The underlying rationale for such an outcome would be in respect of maintaining the quarantining of section 23AJ to only limited-exemption listed countries or broad-exemption listed countries.

2.25 Previously, when a controlled foreign company in a listed country sold an untainted asset and paid a non-portfolio dividend to the parent in Australia, section 23AJ would exempt the payment from tax as it exempted non-portfolio dividends from listed countries (at the time, broad-exemption listed countries and limited-exemption listed countries). As a result of the NITA Act 2004, the exemption has been extended to *all* non-portfolio dividends whether they come from an unlisted country or a listed country. As a result, when a controlled foreign company from *any* country sells an untainted asset and pays non-portfolio dividends to its parent in Australia, section 23AJ will exempt these. Paragraph 384(2)(e)'s attribution of any gains from selling an untainted asset is therefore no longer justified.

2.26 In contrast to paragraph 384(2)(e), paragraph 385(2)(e) has an ongoing role in respect of future listed country additions (putting aside the technical error in paragraph 457(3)(d) that currently renders it redundant). However, controlled foreign companies located in listed countries are generally only attributed on the tainted income that is eligible designated concession income. Eligible designated concession income is income that is specified in regulations as having received concessional tax treatment in the listed country. However in paragraph 385(2)(e) cases, attribution will occur in respect of realised gains on tainted assets, even when they are not eligible designated concession income. It is difficult to see the rationale for this outcome. If gains on such assets are taxed concessionally, they should be eligible designated concession income. If not, then the intention of listed country status is to reduce compliance costs for taxpayers in respect of sufficiently comparably-taxed amounts by removing them from attribution.

2.27 The current operation of section 457 in these circumstances is no longer justified given the extension of section 23AJ (as discussed above) to all countries, listed or unlisted.

Removing attribution when a country is listed

2.28 This measure provides an exemption from section 457 where an unlisted country controlled foreign company becomes a listed country controlled foreign company due to its country of residence being listed, without a three year prior-residence requirement. Also, there is no attribution under paragraphs 385(2)(e) and 384(2)(e) as these have been repealed.

2.29 In a general sense, the changes ensure:

- that under the controlled foreign companies rules, no inappropriate consequences to taxpayers (under sections 384, 385, and 457) arise from a country becoming, or having become, a listed country,
  and

- that there is consistency with the policy behind the expansion of section 23AJ.

Adjusted distributable profits

2.30 Section 457 is currently intended to attribute tainted income that relates to the period from the end of the most recent statutory accounting period to the time the company changed residence. Also, any unrealised gain on 'tainted assets' (assets whose gains and losses are potentially subject to attribution) is also generally attributed by section 457 at that time.

2.31 The definition of adjusted distributable profits substituted by the NITA Act 2004, however, did not ignore previous statutory accounting periods. Hence, adjusted tainted income from previous periods (that will have already been attributed to taxpayers under section 456) is arguably part of adjusted distributable profits, and so attributable again under section 457.

2.32 Items 6 to 8 and 10 of Schedule 2 change the definition of adjusted distributable profits to ignore previous statutory accounting periods. However, in calculating the unrealised gains on tainted assets held by the controlled foreign company at the time it changed residence, previous statutory accounting periods remain relevant.

2.33 For tainted income that consists of the proceeds of the disposal of an asset, it is intended that the cost of the asset is included in the profit calculation by virtue of clauses such as (a)(iii) and (b)(ii).

Application and transitional provisions

Commencing day

2.34 The new definition of commencing day will, for most purposes, apply to CGT events occurring on or after the 1 July that next occurs after Royal Assent. For the purposes of determining whether carried forward losses relating to CGT events or disposals occurring before a commencing day as determined under this new definition are available, the new definition will apply to statutory accounting periods starting on or after Royal Assent.

2.35 The above application date is intended to ensure that section 408A applies appropriately, that is, to not allow net capital losses that arose before the commencing day as determined under the proposed definition of commencing day. However, the application date is not intended to require taxpayers to recalculate net capital losses or net capital gains that arise as a result of a different commencing day as determined under the proposed definition.

Consequences of changing an unlisted country to a listed country under the controlled foreign companies rules

2.36 The removal of inappropriate consequences that follow listing of a country will apply from the day after this Bill receives Royal Assent.

Adjusted distributable profits

2.37 The correction of the deficiency relating to the attribution of prior statutory accounting periods' adjusted distributable profits is to apply for income years and statutory accounting periods starting on or after 1 July 2004.

2.38 The new definition is intended to align with the changes made to section 457 by the NITA Act 2004. These latter changes were meant to apply for income years and statutory accounting periods on or after 1 July 2004.

Chapter 3
Australian branches of foreign financial entities

Outline of chapter

3.1 Schedule 3 to this Bill extends the existing separate entity treatment under the taxation law, provided to Australian branches (permanent establishments) of foreign banks, to Australian branches of foreign financial institutions (entities). Separate entity treatment entails treating a branch as a separate legal entity from a parent company, as if it is a subsidiary. Extending separate entity treatment to Australian branches of foreign financial entities will improve competition within the financial services sector.

3.2 Unless otherwise stated, all legislative references are to the *Income Tax Assessment Act 1997*.

Context of amendments

3.3 The amendments are part of the Government's response to the Board of Taxation's report to the Treasurer on international taxation. They will foster competitive neutrality between Australian branches of foreign banks and financial entities (which often provide similar services) by providing a similar tax treatment. This measure, along with taxing dividends received by branches in Australia on an assessment basis (Chapter 1), are further steps in treating Australian branches and subsidiaries on a like basis.

3.4 As a general principle, a branch and its head office are part of the one legal person. Under the law generally, a legal person cannot enter into transactions with themself. This is known as the single entity approach. For income tax law purposes the trend in Australia, and internationally, is to treat branches as separate entities like subsidiaries. Australian branches of foreign banks are already treated as entities separate from the head office of the foreign bank under Part IIIB of the *Income Tax Assessment Act 1936* (ITAA 1936), for thin capitalisation grouping purposes and under the transfer of loss provisions.

3.5 The separate entity treatment that is currently available to the branches of foreign banks will be extended to Australian branches of foreign financial entities. The amendments will provide a more consistent income tax treatment of Australian branches of foreign banks and foreign financial entities.

Summary of new law

3.6 This measure will amend the income tax law to provide limited separate entity treatment to Australian branches of foreign financial entities. Transactions between a branch and the relevant foreign financial entity will be recognised, a branch will be able to group with Australian subsidiaries of the foreign financial entity (or foreign bank within a wholly-owned group) and also transfer losses. Financial entities accessing separate entity treatment will be required to keep records by which they can separately account for money used in the activities of their branches in Australia. A similar condition is currently imposed on foreign banks with Australian branches.

3.7 The amendments to Part IIIB of the ITAA 1936 and the thin capitalisation grouping provisions will apply to income years starting on or after the date of Royal Assent. The transfer of loss provisions will apply in relation to losses of Australian branches of foreign financial entities, and of other relevant companies, for income years starting on or after the date of Royal Assent.

Comparison of key features of new law and current law

New law	*Current law*
Limited separate entity treatment is provided to Australian branches of foreign financial entities, as well as to Australian branches of foreign banks.	Limited separate entity treatment is provided to Australian branches of foreign banks under Part IIIB of the ITAA 1936, thin capitalisation grouping and transfer of loss provisions.

Detailed explanation of new law

Separate entity treatment for Australian branches of foreign banks

3.8 Presently, Australian branches of foreign banks receive limited separate entity treatment under Part IIIB of the ITAA 1936, which contains provisions assisting the calculation of taxable income derived by a foreign bank through an Australian branch. These provisions essentially recognise intra-bank transactions between the Australian branch of the foreign bank and the foreign bank itself.

3.9 Furthermore, Australian branches of foreign banks are also able to:

- transfer losses to and from Australian companies of the same wholly-owned group (Division 170), and
- group for thin capitalisation purposes with certain other Australian resident companies of the same wholly-owned group (Subdivision 820-FB).

Extending separate entity treatment to Australian branches of foreign financial entities

3.10 Branches of foreign financial entities, which will be able to access the limited separate entity treatment, are identified in the amendments as branches in Australia of foreign entities that are financial entities. The terms 'foreign entity' and 'financial entity' are defined by section 995-1. ***[Schedule 3, item 2, section 160ZZZK; item 7, note to subsection 170-5(2A); item 9, note to subsection 170-105(2A); item 17, subparagraphs 820-597(1)(c)(ii) and 820-599(1)(c)(ii)]***

3.11 A foreign entity is an entity that is not an 'Australian entity'. An 'Australian entity' is, in effect, an Australian partnership or trust, or a resident company or individual (but not dual-residents). While an individual may be a foreign entity, they cannot be a financial entity as defined, and so cannot access this measure.

3.12 A financial entity encompasses entities operating within the financial services sector. To fall within this definition, Australian branches of foreign entities would need to provide financial services in Australia. This (implicit) requirement matches the requirement for Australian branches of foreign banks to fall within Part IIIB of the ITAA 1936 (see definition of 'Australian branch' in section 160ZZV of the ITAA 1936).

Extending Part IIIB to branches of foreign financial entities

3.13 The amendments will provide Australian branches of foreign financial entities separate entity treatment under Part IIIB of the ITAA 1936 on a similar basis as for Australian branches of foreign banks. ***[Schedule 3, item 1, note to subsection 160ZZVA(1); item 2, subsection 160ZZZK(3)]***

3.14 Similarly, foreign financial entities will be treated in the same way as foreign banks ***[Schedule 3, item 1, note to subsection 160ZZVA(1); item 2, subsection 160ZZZK(2)]***. For example, certain foreign banks have the option to opt out of Part IIIB for a year of income where the foreign bank is resident of a country with which Australia has a tax treaty (subsection 160ZZVB(2) of the ITAA 1936). This option will also be available to foreign financial entities.

Extending the transfer of loss provisions to branches of foreign financial entities

3.15 The transfer of loss provisions allow the losses of unprofitable company group members to be offset against the income of profitable group members. Since the inception of the consolidation regime (which generally achieves the same outcome by a different mechanism), these rules only apply in relation to Australian branches of foreign banks, as they cannot consolidate.

3.16 Loss transfers are allowed between the Australian branch of a foreign bank and:

- the head company of a consolidated group or a multiple entry consolidated group (MEC group), or
- a company which is not eligible to be a member of a consolidated group.

Both tax losses (Subdivision 170-A) and net capital losses (Subdivision 170-B) can be transferred.

3.17 The amendments will allow Australian branches of foreign financial entities, meeting the same conditions and requirements as for Australian branches of foreign banks, to transfer tax losses and net capital losses to and from relevant members of the same wholly-owned company groups. ***[Schedule 3, item 7, note to subsection 170-5(2A); item 8, section 170-75; item 9, note to subsection 170-105(2A); item 10, section 170-174]***

3.18 Transfer of tax losses and net capital losses will also be possible between Australian branches (of foreign financial entities and foreign banks) within a wholly-owned company group. Two Australian branches have the potential to satisfy the conditions for the transfer, under the transfer of loss provisions, since one of the branches can qualify as either an Australian branch of a foreign bank, or a foreign financial entity, and the other cannot be a member of a consolidatable group. ***[Schedule 3, item 7, note to subsection 170-5(2A); item 9, note to subsection 170-105(2A)]***

3.19 Under Division 170, losses are technically only transferable between resident companies of the same wholly-owned group. However, Part IIIB of the ITAA 1936 treats Australian branches of foreign banks as Australian residents for the purposes of Division 170 (sections 160ZZZG and 160ZZZH of the ITAA 1936). Hence, the amendments to Part IIIB (described above) are also needed to allow Division 170 to operate with respect to Australian branches of foreign financial entities.

Extending grouping for thin capitalisation purposes to Australian branches of foreign financial entities

Background

3.20 The thin capitalisation rules compare the level of debt and equity funding used to finance an entity's Australian operations. Where there is a relatively high level of debt funding of the Australian operations deductions in respect of debt are limited.

3.21 The thin capitalisation rules apply differently depending on whether an entity is:

- an inward investing entity or an outward investing entity
- a general entity or a financial entity,
  or
- an authorised deposit-taking institution.

3.22 Where an entity is both an inward and outward investing entity, the general classification scheme operates to give priority to the outward investor rules. Where a group consists of a combination of general, financial and authorised deposit-taking institution entities, the authorised deposit-taking institution rules take precedence. Authorised deposit-taking institutions are essentially banks. If the group consists of general and financial entities, but no authorised deposit-taking institution entities, then the financial entity rules apply.

Grouping of Australian branches of foreign banks

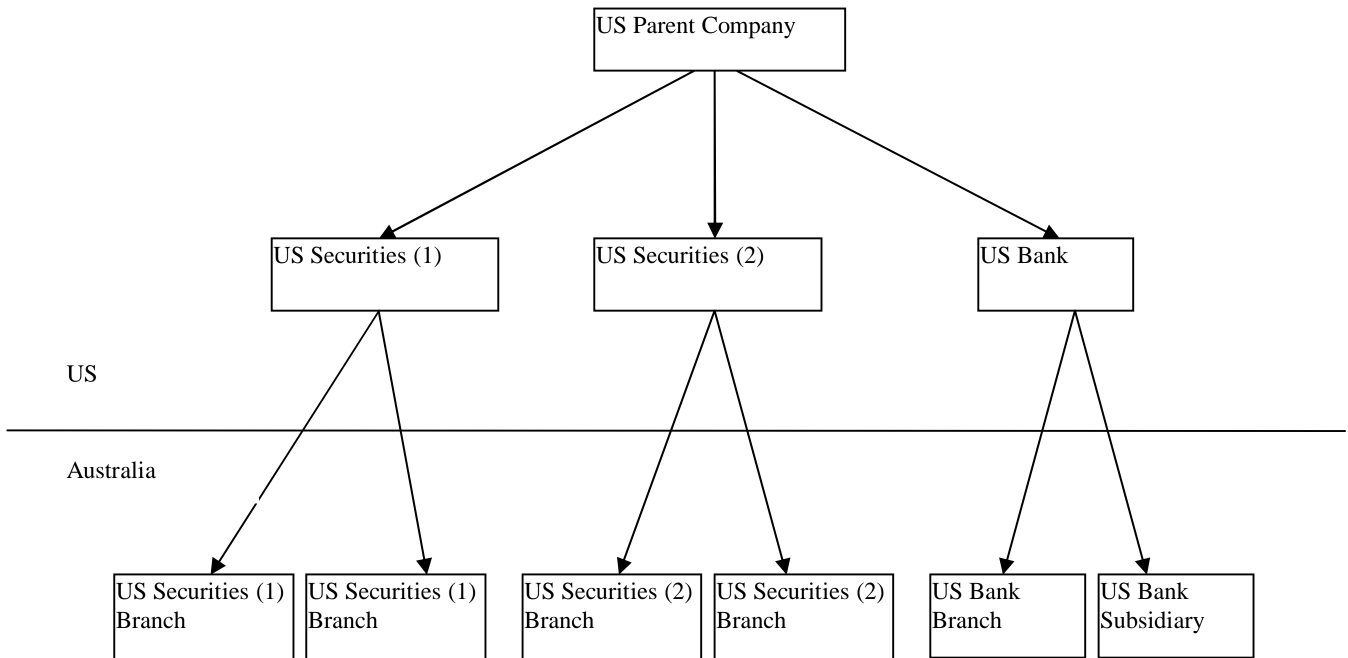
3.23 The head company of a consolidated group or MEC group may make a choice to treat an Australian branch of a foreign bank as part of itself for purposes of the application of the thin capitalisation rules, subject to certain conditions (section 820-597). A single company that is an Australian entity, and not part of a consolidated group, consolidatable group or a MEC group, may make a similar choice (section 820-599). Hence, Australian branches of foreign banks can be grouped with wholly-owned Australian subsidiaries of the same foreign bank group when determining the thin capitalisation positions of both the branches and the subsidiaries.

Grouping of Australian branches of foreign financial entities

3.24 Grouping for thin capitalisation purposes will be extended to Australian branches of foreign financial entities. Sections 820-597 and 820-599 are rewritten to apply to foreign financial entities as well as foreign banks within a wholly-owned group that operates in Australia using branches and subsidiaries. Therefore, a relevant head company of a consolidated group or MEC group, or a relevant single company which cannot consolidate, will be able to treat an Australian branch of a foreign bank, or a foreign financial entity, as part of itself for thin capitalisation purposes. This will allow Australian branches of foreign banks, and foreign financial entities, to be grouped with wholly-owned Australian subsidiaries of the foreign parent in determining the thin capitalisation positions of both the branches and subsidiaries. ***[Schedule 3, item 17, sections 820-597 and 820-599]***

3.25 As part of rewriting sections 820-597 and 820-599, the term 'establishment entity' refers to the foreign bank or the foreign financial entity that established an Australian branch or branches ***[Schedule 3, item 17, paragraphs 820-597(1)(c) and 820-599(1)(c)]***. A head company or single company will not be required to group all of the Australian branches within a wholly-owned group ***[Schedule 3, item 17, subsections 820-597(3) and 820-599(3)]***. However, if a head company or single company makes a choice to treat one of the Australian branches, of an establishment entity, as part of itself for the grouping period, it must also make that choice in respect of all of the Australian branches of that establishment entity ***[Schedule 3, item 17, subsections 820-597(2) and 820-599(2)]***. See Example 3.1.

Example 3.1



US Securities (1), US Securities (2) and US Bank, and their respective branches and subsidiaries, are part of the same wholly-owned group. US Bank Subsidiary is a single Australian resident company which cannot consolidate. Under the new section 820-599, US Bank Subsidiary could make a choice to group with:

(a) both the US Securities (1) Branches

(b) both the US Securities (2) Branches

(c) US Bank Branch,
or

(d) any or all of (a) to (c).

US Bank Subsidiary does not have to make a choice to treat all the Australian branches (of US Bank, US Securities (1) and US Securities (2)) as part of itself for the grouping period.

Once US Bank Subsidiary makes a choice to treat one of the Australian branches of an establishment entity as part of itself for the grouping period, it must choose to group all of the branches of that establishment entity. That is, once US Bank Subsidiary makes a choice to group one of the US Securities (2) Branches, it must choose to group all of US Securities (2) Branches. If US Bank Subsidiary does not choose to group any of US Securities (2) Branches, but one of the US Securities (1) Branches, it must choose to group all of US Securities (1) Branches.

Consequences of grouping

3.26 The consequences of making a choice to group under sections 820-597 and 820-599 are set out in sections 820-601 to 820-617. The rules which follow from the making of the choice will be extended to Australian branches of foreign financial entities. ***[Schedule 3, items 18 to 21 and 23 to 26]***

3.27 The rules set out the effect of making a choice to group Australian branches, of foreign financial entities or foreign banks, on the classification of the head company or single company (section 820-609). The appropriate thin capitalisation rules that will apply to the head company or single resident company depend upon the classification given to the head company or single company based on the general classification scheme described in paragraphs 3.21 and 3.22.

3.28 If a single company prior to grouping with an Australian branch, of a foreign financial entity or foreign bank, was both an inward investment vehicle (general or financial) and an outward investor (financial or general), then the outward investing entity rules will apply. ***[Schedule 3, item 27, paragraph 820-609(4)(a) and subsection 820-609(6)]***

Thin capitalisation classifications — authorised deposit-taking institution

3.29 The amendments will retain the current classifications in cases involving banks only. Where an Australian branch of a foreign financial entity is grouped with an authorised deposit-taking institution group, the authorised deposit-taking institution rules will take precedence.

3.30 If the head company or single company, prior to the inclusion of an Australian branch of a foreign financial entity or foreign bank, was an outward investing entity (authorised deposit-taking institution), the head company or single company will remain an outward investing entity (authorised deposit-taking institution) ***[Schedule 3, item 27, paragraph 820-609(1)(a)]***. An inward investing entity (authorised deposit-taking institution) is a foreign bank that carries on banking business in Australia through a branch. Under Subdivision 820-FB, an Australian branch can only be grouped with a company. Therefore, the classification scheme does not cater for grouping of Australian branches without the presence of an Australian company.

3.31 Where an Australian branch of a foreign bank is grouped with a financial entity group, the authorised deposit-taking institution rules will take precedence. If the head company or single company, prior to the inclusion of an Australian branch of a foreign bank, was an outward

investing entity (non-authorised deposit-taking institution) and an outward investor (general or financial), the head company or single company will be an outward investing entity (authorised deposit-taking institution). ***[Schedule 3, item 27, paragraph 820-609(1)(b)]***

3.32 If the head company or single company, prior to the inclusion of an Australian branch of a foreign bank, was an inward investment vehicle (general or financial), the head company or single company will be an inward investing entity (authorised deposit-taking institution). ***[Schedule 3, item 27, subsection 820-609(4)]***

3.33 If the single company was a foreign controlled Australian authorised deposit-taking institution exempt from the thin capitalisation regime prior to the inclusion of an Australian branch of a foreign financial entity or foreign bank, the single company will apply the outward investing entity (authorised deposit-taking institution) rules following the inclusion of the Australian branch ***[Schedule 3, item 27, subsection 820-609(3)]***. Similarly, if a head company was exempt from the thin capitalisation regime prior to the inclusion of an Australian branch of a foreign financial entity or foreign bank, the head company will apply the outward investing entity (authorised deposit-taking institution) rules following the inclusion of an Australian branch ***[Schedule 3, item 27, subsection 820-609(2)]***. That is, a foreign controlled Australian authorised deposit-taking institution will no longer be exempt from the thin capitalisation regime when it groups with an Australian branch of a foreign financial entity or foreign bank, which are not supervised by the Australian Prudential Regulation Authority (APRA).

Thin capitalisation classifications — non-authorised deposit-taking institution

3.34 Where the authorised deposit-taking institution rules do not apply, and where a head company or single company makes the choice to include an Australian branch of a foreign financial entity as part of itself, the head company or single company will be classified as either:

- an outward investing entity (non-authorised deposit-taking institution) and outward investor (financial),
  or

- an inward investing entity (non-authorised deposit-taking institution) and inward investment vehicle (financial).

[Schedule 3, item 27, subsections 820-609(5) and (6)]

3.35 If the head company or single company, prior to the inclusion of the Australian branch of a foreign financial entity, was an outward investing entity (non-authorised deposit-taking institution) and an outward investor (general or financial), the head company or single company will remain an outward investing entity (non-authorised deposit-taking institution). Further, as the group consists of a financial entity, the outward investor (financial) rules apply (Subdivision 820-B). ***[Schedule 3, item 27, subsection 820-609(5)]***

3.36 If the head company or single company, prior to the inclusion of an Australian branch of a foreign financial entity, was an inward investing entity (non-authorised deposit-taking institution) and an inward investment vehicle (general or financial), the head company or single company will remain an inward investing entity (non-authorised deposit-taking institution). Further, as the group consists of a financial entity, the inward investment vehicle (financial) rules apply (Subdivision 820-C). ***[Schedule 3, item 27, subsection 820-609(6)]***

3.37 The calculations under Subdivisions 820-D and 820-E are based on the APRA rules and need to be modified where an authorised deposit-taking institution group contains entities which are not supervised by APRA (sections 820-613 and 820-615). The same concern does not exist for financial entities applying Subdivisions 820-B and 820-C. Consequently, the calculations for financial entities can apply without modification. Modified subsections 820-603(3) and (4), in conjunction with Subdivisions 820-B and 820-C, will produce the appropriate outcome since the head company or single company (treated like a head company) will be taken to include the Australian branch of a financial entity.

Financial entities that choose to be treated as authorised deposit-taking institutions

3.38 Under the current rules, certain financial entities, which are not authorised deposit-taking institutions, can choose to apply the thin capitalisation rules as authorised deposit-taking institutions (Subdivision 820-EA). Where a group consists of an Australian branch of a foreign financial entity (but no authorised deposit-taking institutions or Australian branches of foreign banks), not only can that entity access the grouping provisions, it will also be able to choose (subject to meeting the relevant conditions) to apply the authorised deposit-taking institution rules. Consequently, a head company or a single company that chooses to group and that is classified as an outward investor (financial) or inward investment vehicle (financial) may, if it satisfies the existing conditions in Subdivision 820-EA, choose to be treated as an outward investing entity (authorised deposit-taking institution). Further, it can also use the modified

calculations under section 820-613. ***[Schedule 3, item 27, note to subsection 820-609(7); item 29, note to subsection 820-613(1); item 30, subsections 820-613(3) and (4)]***

Application and transitional provisions

3.39 The amendments to Part IIIB of the ITAA 1936 and the thin capitalisation grouping provisions will apply to income years starting on or after the date of Royal Assent. ***[Clause 2; Schedule 3, items 4 and 39]***

3.40 The transfer of loss provisions will apply in relation to losses of Australian branches of foreign financial entities, and of other relevant companies, for income years starting on or after the date of Royal Assent. ***[Clause 2; Schedule 3, item 11]***

Consequential amendments

Requirement to keep records

3.41 A taxpayer carrying on a business is required to keep records that record and explain all transactions and other acts engaged in by the taxpayer that are relevant for any purpose of the ITAA 1936 (section 262A of the ITAA 1936).

3.42 Under Part IIIB of the ITAA 1936, certain transactions between foreign banks and their Australian branches, which would otherwise not be recognised for taxation purposes, are recognised. Accordingly, foreign banks are also required to keep accounting records in respect of any branches in Australia through which they carry on banking business (subsection 262A(1B) of the ITAA 1936). The accounting records provide a means by which the foreign bank can separately account for money used in the activities of a branch in Australia. A similar condition will be imposed on foreign financial entities which have Australian branches. ***[Schedule 3, item 3, subsection 262A(1BA)]***

Updated references, headings and checklists

3.43 Section 12-5 contains a checklist of the specific types of deduction which are affected by statutory provisions. Each entry in the checklist is cross-referenced to the relevant statutory provisions. The checklist will be updated to include references to deduction provisions affecting foreign financial entities' branches. ***[Schedule 3, item 5; item 6]***

3.44 These amendments also update various cross-references within the tax legislation, legislative notes and headings to correspond with the substantive changes to the taxation provisions. ***[Schedule 3, items 12 to 16, 22, 28 and 31 to 38]***

3.45 Subsection 820-445(4) of Subdivision 820-EA is repealed as it is redundant because of subsection 820-609(7). ***[Schedule 3, item 13, subsection 820-445(4); item 27, subsection 820-609(7)]***

Chapter 4
Cross-border employee shares or rights

Outline of chapter

4.1 Schedule 4 to this Bill more closely aligns the taxation of shares or rights acquired under an employee share scheme (employee shares or rights) with international norms developed by the Organisation for Economic Co-operation and Development (OECD). These amendments will be relevant where an individual works in more than one country or changes country of residence.

4.2 These amendments will help prevent double or nil taxation of employee shares or rights and provide greater certainty for individuals. This is achieved primarily by allowing employee shares or rights to benefit from existing mechanisms to prevent double taxation, and clarifying the treatment of individuals with employee shares or rights who subsequently become employed in Australia. Additional rules clarify capital gains tax (CGT) interactions, and make other improvements.

4.3 Unless otherwise indicated, all legislative references are to the *Income Tax Assessment Act 1936*.

Context of amendments

4.4 These amendments are part of the Government's response to the Board of Taxation's report to the Treasurer on international taxation. They will reduce the potential for double or nil taxation of income from employee shares or rights in the international context. Providing a more internationally consistent treatment of employee shares or rights will ensure a fairer and more certain outcome for relevant individuals. It will also assist Australian businesses in attracting skilled workers.

4.5 Employee shares or rights provided at a discount can be seen as a substitute for employment income. The discount may relate to employment over a long period. Hence problems can arise in respect of individuals who acquire such shares or rights and who subsequently change their country of residence, work in more than one country, or work in one country while resident of another. Many of these problems arise as countries tax

employee shares or rights in many different ways. To help address these problems, the OECD recently approved revisions to the Commentary to its *Model Tax Convention on Income and on Capital* clarifying the tax treaty treatment of employee rights.

4.6 The OECD commentary on the articles of the model tax convention is relevant in interpreting Australia's tax treaties. The revised commentary treats the benefit accruing up to the exercise of a right as an employment benefit to which Article 15 (*Income from Employment*) of the model tax convention applies. The commentary recognises that the facts and circumstances of the particular case will determine the period of employment to which the right relates. The number of days worked in a treaty country during this employment period then determines the extent of that country's source taxing rights.

4.7 These amendments do not seek to incorporate the OECD approach into Australian domestic law. Rather, the amendments align the domestic law more closely with the OECD approach by emphasising the employment income nature of employee shares or rights, clarifying residence and source country taxing arrangements, and improving the interaction of the employee share scheme and CGT provisions.

Summary of new law

4.8 Individuals acquiring employee shares or rights will have access to existing offshore employment income exemptions. Similarly, the foreign tax credit and foreign loss provisions will apply to employee share scheme income in the same way as other assessable employment income.

4.9 The amendments make clear that the employee share scheme provisions also apply to individuals who become employed in Australia (Australian employees) after acquiring employee shares or rights relating to that employment. The concessional treatment available for qualifying shares or rights will extend to such cases. Further, amounts that relate to employment offshore while not a resident will not be assessable income.

4.10 The amendments also rectify existing problems for employee share trusts in respect of employment offshore, better address overlaps with the foreign investment fund rules, and improve interactions with the CGT provisions for both residents who become non-residents and non-residents who become residents.

4.11 The amendments relating to the acquisition of employee shares or rights by individuals, and individuals who first become Australian

employees holding employee shares or rights, will generally apply from the date of Royal Assent.

4.12 The amendments for shares or rights acquired under an employee share trust apply to shares or rights to which a beneficiary becomes absolutely entitled on or after Royal Assent. The remaining CGT amendments apply to CGT events occurring on or after Royal Assent. Amendments to the fringe benefits tax and foreign investment fund rules apply from the relevant income year ending after Royal Assent.

Comparison of key features of new law and current law

New law	*Current law*
Income assessed under the employee share scheme provisions, like other employment income, is able to qualify for existing exemptions for offshore employment, and be treated as employment income for foreign tax credit and loss purposes.	Income assessed under the employee share income provisions does not benefit from existing exemptions for offshore employment (sections 23AF and 23AG) and is not treated as employment income for foreign tax credit and loss purposes (Division 18 of Part III)
For relevant shares or rights acquired when employed offshore, the employee share scheme provisions apply at the time of first becoming an Australian employee. Income attributable to employment subsequently performed in Australia will be taxable. Such income may benefit from the more favourable rules applying to qualifying shares or rights.	For employee shares or rights acquired when employed offshore, income attributable to employment subsequently performed in Australia may not be taxed.
Amounts are not assessable under the employee share scheme provisions to the extent that the share or right acquired relates to relevant employment offshore while not an Australian resident.	Application of the general principle that non-residents are not taxable on foreign source income is uncertain for employee shares or rights.

New law	*Current law*
The CGT cost base for inbound residents holding employee shares or rights is generally the market value of those shares or rights at the time of becoming a resident. For certain qualifying shares or rights, the cost base may be market value as determined at a later time.	For CGT purposes, the cost bases of employee shares or rights acquired by an employee while not an Australian resident, and who subsequently becomes a resident, are subject to two sets of rules. The priority between those rules is unclear.

Detailed explanation of new law

Overview of current employee share scheme provisions (Division 13A of Part III)

4.13 The employee share scheme provisions apply to shares or rights acquired by an individual (or an associate) in respect of the individual's employment (or service). Where the share or right is acquired for a price less than market value — that is, at a discount — the discount is part of the individual's assessable income. How and when a discount is included in assessable income depends in part on whether it is qualifying or not-qualifying.

Treatment of not-qualifying shares or rights

4.14 The discount on not-qualifying shares or rights is included in the individual's assessable income in the year the share or right is acquired (subsection 139B(2)). Where an individual acquires an employee share or right offshore, it may be unclear how the provisions apply. Further, as a practical matter, an individual who acquires an employee share or right while offshore will probably not be aware of the potential application of the employee share scheme provisions.

Treatment of qualifying shares or rights

4.15 Individuals receiving qualifying shares or rights can benefit from either:

- the first $1,000 of the discount on the shares or rights not being taxable (exemption benefit), subject to meeting additional conditions,
  or

- a deferral of the year of assessment, until a further event known as a 'cessation time' occurs (for a deferral period of a maximum of ten years). Assessable income is then determined by the value of the discount as calculated at the cessation time, not in the year of acquisition.

4.16 To obtain the exemption benefit, an individual must elect to be taxed in the year in which the share or right is acquired before lodging a tax return for that year (section 139E). If an election is not made, the second concession applies (subsection 139B(3)).

Conditions to be a qualifying share or right

4.17 There are a number of conditions for a share or right to be a qualifying share or right (section 139CD). One condition is that the shares or rights offered are in a company which is the employer or holding company of the employer (subsection 139CD(3)).

4.18 An ***employer*** is defined as a person who is required to pay work and income support related withholding payments and benefits (section 139GA, subsection 221A(1)). Employers are generally required to withhold from payments to employees in Australia. However, employers of individuals offshore will generally fall outside this definition (see paragraph 4.27). Employee shares or rights acquired by an individual employed offshore will therefore generally not be a qualifying share or right, and not eligible for concessional treatment under Division 13A.

Treating employee share scheme income as employment income

4.19 International double taxation problems may arise where Australian tax is paid by a resident individual on an employee share or right under the employee share scheme provisions, and the individual also pays tax overseas as some of the relevant service took place offshore.

4.20 Domestic relief from such double taxation on the income earned offshore by Australian residents can be achieved by providing either an exemption for the offshore income or providing a foreign tax credit. For offshore employment income in general, exemptions are currently provided for:

- the foreign earnings of an Australian resident individual, where the foreign service is conducted overseas for a continuous period of 91 days or more and subject to certain conditions (section 23AG),
  and

- eligible foreign remuneration of an Australian resident individual performing qualifying services on an approved overseas development project for a continuous period of 91 days or more and subject to certain conditions (section 23AF).

4.21 As the discounts taxed under the employee share scheme provisions are a substitute for employment or services income, the amendments will allow them to benefit from the exemptions where all relevant conditions are satisfied. This is done by modifying the definitions in the relevant provisions of the type of income that can benefit to include amounts otherwise included in assessable income under the employee share provisions. ***[Schedule 4, item 2, subsection 23AF(18), paragraph (a) of the definition of 'eligible foreign remuneration'; item 3, subsection 23AF(18), paragraph (b) of the definition of 'eligible foreign remuneration'; item 4, subsection 23AG(7), definition of 'foreign earnings']***

4.22 Where an exemption is not available, a credit for foreign tax paid on foreign income may be available (Division 18 of Part III). The foreign tax credit provisions divide foreign income into baskets, limiting the credits available to Australian tax payable on the income in each basket. Employment income generally falls within the 'other' income basket, but current taxpayer practice is that employee share or right income may fall within 'passive income' as passive income includes profits of a capital nature.

4.23 Employee share or right income will be specifically excluded from the passive income basket ***[Schedule 4, item 24, paragraph 160AEA(1)(q)]***. Such income will therefore clearly fall within the other income basket along with employment income. Doing so will prevent foreign tax credit mismatches between alternative forms of employment remuneration. This amendment will also flow through to the definition of 'modified passive income' in the foreign loss provisions (subsection 160AEA(2)).

Inbound individuals with employee shares or rights relating to Australian employment

4.24 An individual employed offshore who acquires an employee share or right may subsequently be employed in Australia for a period of time that relates to the share or right. Part of the income (discount) earned by the individual therefore relates to employment in Australia, but currently none of it may be taxed in Australia. The amendments will address this potential case of nil taxation.

Meaning of 'foreign service', 'employee' and 'employer'

4.25 A key concept that will be introduced into Division 13A by the amendments is ***foreign service***. It will be defined as service in a foreign country as the holder of an office or in the capacity of an employee. ***[Schedule 4, item 22, section 139GBA; item 23, section 139GH]***

4.26 Currently, the definitions of 'employee' and 'employer' only include individuals who are entitled to receive work and income support related withholding payments and benefits, and the employers of these individuals (sections 139GA and 221A).

4.27 Employers are not required to withhold tax under section 12-1 of Schedule 4 to the *Taxation Administration Act 1953* where the salary of the taxpayer is exempt income. In the case of an individual employed offshore, the income will generally be exempt:

- for non-residents, if it is not Australian sourced (paragraph 23(r)), and

- for residents employed offshore, if an exemption for salary or wage income applies (section 23AF or 23AG).

4.28 The new concept of foreign service will add to the current, limited definitions of employee and employer in the employee share scheme provisions, by including (adding) offshore employees and employers ***[Schedule 4, item 20, section 139GA]***. This will clarify, rather than extend, the operation of the employee share scheme provisions.

4.29 The broader definition of employee will have two components: Australian employees and employees engaged in foreign service. This allows for clarification of where the employee share scheme provisions apply to Australian employment, and where they apply to both Australian and foreign service. The first outcome is achieved by excluding foreign service from the meaning of employee for the purposes of some provisions. ***[Schedule 4, item 20, paragraph 139GA(2)(b)]***

4.30 In this explanatory memorandum, individuals employed in Australia (satisfying the section 221A definition) are referred to as 'Australian employees'. The term used for the new broad case including both Australian and foreign service employees is 'employee'.

Treatment of individuals who become Australian employees (inbound individuals)

4.31 These amendments have the effect that individuals who acquire employee shares or rights while offshore, and then later become Australian employees while still engaged in employment or service that is relevant to the acquisition of the shares or rights, will apply the employee share scheme provisions at the point of becoming an Australian employee ***[Schedule 4, item 6, subsection 139B(2); item 7, subsection 139B(2A)].*** Where an individual acquires an employee share or right in relation to the employment of an associate, the employee share scheme provisions will apply at the time that associate first engages in employment or service in Australia in relation to the acquisition of the share or right. ***[Schedule 4, item 14, paragraph 139D(1)(c); item 15, subsection 139D(2); item 16, subsection 139D(3)]***

4.32 Individuals will need to examine their circumstances and specific employee share plan to determine whether the period after becoming an Australian employee is relevant to the acquisition of the employee share or right The period of employment after becoming an Australian employee will generally not be relevant if no forfeiture conditions remain at the time an individual becomes an Australian employee. If the employee share or right may be forfeited unless the individual undertakes further employment or services at the time employment commences in Australia, a portion of the discount will generally be assessable in Australia.

Example 4.1

> Under the terms of his employee share plan Arnold is required to complete five years of service before obtaining an unforfeitable right to an employee right. Arnold becomes an Australian employee when only four years of service have been completed. One year as an Australian employee will be relevant to the acquisition of Arnold's right.

4.33 For such inbound individuals, they will either be assessed in the year they become a relevant employee for the first time or at a cessation time for qualifying shares or rights where the relevant election is not made (see paragraph 4.35). If assessed in the year of income in which they become an employee in Australia, the discount will still be valued as at acquisition. ***[Schedule 4, item 7, subsection 139B(2A); item 9, subsection 139CC(2)]***

4.34 However, for inbound individuals the portion of the discount that relates to foreign service when a non-resident will not be included in assessable income. This exclusion may also apply in other cases, such as

where a taxpayer ceases to be a resident before the end of the relevant period of employment (see paragraph 4.43). ***[Schedule 4, item 5, subsection 139B(1A)]***

4.35 Individuals with qualifying shares or rights can currently elect in the year of income of acquisition to be assessed in that year. To cater for the new treatment of inbound individuals, an equivalent election is provided. Inbound individuals will be able to elect in the year of first becoming an Australian employee to be assessed in that year on all employee shares or rights acquired in an income year prior to becoming an Australian employee. Shares or rights acquired prior to becoming an Australian employee, but in the same income year, are covered by the current, and separate, election (subsection 139E(1)). ***[Schedule 4, item 7, subsection 139B(2A); item 8, subsection 139B(3); item 18, subsection 139E(2); item 19, subsections 139E(3) and (4)]***

4.36 These amendments allow inbound individuals to access the favourable treatment available to qualifying shares or rights, subject to a further condition. Access will be achieved by the extension of the definition of employer to include the employer of a person engaged in foreign service ***[Schedule 4, item 20, subsection 139GA(3)].*** This will allow an employee share or right granted offshore to be a qualifying share or right, as one condition that needs to be met to qualify involves having an employer as defined (subsection 139CD(3)).

4.37 However, employee shares or rights acquired in foreign service will not be qualifying shares or rights if a cessation time is reached prior to when the individual first becomes an employee in Australia in respect of employment related to the share or right. This is necessary because the deferral concession cannot be meaningfully applied to these shares or rights. ***[Schedule 4, item 10, paragraphs 139CD(1)(a) and (b); item 11, note 1 to subsection 139CD(1); item 12, note 2 to subsection 139CD(1); item 13, section 139CDA]***

4.38 Employee shares must already satisfy one additional condition for qualifying status. Seventy-five per cent of permanent employees must be eligible to acquire shares in the scheme. The definition of 'permanent employees' excludes employees who are exempt visitors, are not resident, or are not physically present in Australia (subsection 139GB(3)). To preserve this outcome, the current limited definition of employee (excluding foreign service) is retained for the purpose of defining permanent employee. ***[Schedule 4, item 20, paragraph 139GA(2)(b); item 21, subsection 139GB(1)]***

4.39 The definition of permanent employee also has relevance for the additional conditions that apply for a qualifying share or right to be eligible for the $1,000 discount (section 139CE). The employee share scheme must be operated on a non-discriminatory basis, and this is only satisfied if 75 per cent of permanent employees are eligible to participate in the scheme (subsection 139CE(4)). Again, offshore employee share plans will not satisfy this in many cases, and this will remain unchanged. However, an eligible offshore employee will receive the full $1,000 discount (regardless of any exemption for foreign service).

The extent to which employee share scheme income relates to relevant service offshore

4.40 The amendments extend existing exemptions related to offshore employment (sections 23AF and 23AG) to employee shares or rights, and will introduce a specific exclusion related to foreign service.

- The exemption in section 23AG relates to foreign earnings (which will include the discount on employee shares or rights) derived from the relevant foreign service (as defined in that section) (subsection 23AG(1)).

- The exemption in section 23AF relates to any eligible foreign remuneration (which will include the discount on employee shares or rights) that is attributable to relevant qualifying service (subsection 23AF(1)).

- The new exclusion will apply to the amount of the discount to the extent that the share or right acquired is in respect of the taxpayer's engagement in foreign service while not a resident of Australia (see paragraph 4.34).

4.41 How, for these provisions, the amount of the otherwise assessable discount will be assigned to the relevant foreign or qualifying service will depend on the facts and circumstances of each case. This is essentially the approach adopted by the OECD in respect of rights, and therefore also of relevance in interpreting the relevant articles of Australia's tax treaties.

4.42 The revised OECD commentary does, however, set out a number of principles that offer guidance as to what outcome the facts and circumstances would typically point to. Those principles suggest that a generally reasonable approach would look at the time worked in the relevant foreign or qualifying service as a proportion of the total period of employment to which the right relates.

4.43 Sections 23AF and 23AG cannot easily be applied prospectively, as it will generally not be clear in advance that all conditions in these sections are satisfied. New subsection 139B(1A) raises similar issues. As a result, the most reasonable approach would in general be to assume that the status quo at assessment time will prevail. For example, an individual becoming an Australian employee in relation to the previous acquisition of shares or rights would generally include the entire discount in assessable income, except for the portion that relates to past foreign service, on the basis that having become an Australian employee they will remain so.

4.44 Although this is a general presumption, there may be facts and circumstances where an individual could rebut this. For example, a contract for employment may make it clear that an individual will only be engaged in relevant employment in Australia for a certain period. An individual is expected to take a reasonable approach given all the facts and circumstances. If in the event the actual circumstances differ from those assumed at the original assessment time, adjustments can be made.

Extended time for the amendment of assessments

4.45 As discussed, an individual may, after a taxing point under the employee share scheme provisions, engage in foreign service that relates to the acquisition of an employee share or right and which benefits from an exemption or exclusion. While assessments can be amended, in some cases the general four year period for amendment may have ended. For example, an amount may be included in assessable income when a share or right is acquired, but the relevant period of employment or services may only end 10 years later.

4.46 To address this problem, the amendments will allow assessments to be amended:

- for a period of four years beginning at the end of the income year when the relevant period of employment ends, and
- but only where section 23AF or 23AG (for residents) or new subsection 139B(1A) (for foreign service while a non-resident) apply.

[Schedule 4, item 17, section 139DG]

Example 4.2

Barbara acquired an employee right in year 1. At the time of acquisition, Barbara was employed in the United Kingdom where she was also resident. Under the conditions of the scheme, Barbara was required to work for six years to be able to exercise the right. Barbara was transferred to Australia in year 3, when two years of the relevant employment had been completed, and became a resident here.

Though Barbara satisfied the conditions for a 'qualifying right' she elected to be taxed in the year of income she first became employed in Australia. She includes two-thirds of the total discount (as calculated at acquisition) in assessable income, as one-third clearly relates to the previous period of employment in the United Kingdom while a non-resident, and it is presumed that the rest of her employment will be in Australia.

While based in Australia, Barbara worked in the Hong Kong office for three uninterrupted periods of four months. Barbara returned to work in the United Kingdom at the beginning of year 6, becoming resident there again, and completing the remaining year of employment.

At the end of the relevant six years of service, Barbara realises that only one-third, rather than two-thirds, of the discount related to relevant service in Australia. For one-sixth of the period, while a resident but working in Hong Kong, she was eligible for exemptions under section 23AG. For a further one-sixth of the period, in addition to the original one-third, she was a non-resident while working in foreign service and new subsection 139B(1A) applies. Barbara amends her assessment for the relevant year to include only one-third of the value of the discount at acquisition.

Clarification of capital gains tax cost base rules

4.47 All legislative references in paragraphs 4.48 to 4.55 are to the *Income Tax Assessment Act 1997*.

4.48 The CGT provisions contain special cost base rules for employee shares or rights (Subdivision 130-D). There are also general cost base rules for assets, without the necessary connection with Australia, owned by non-residents who become residents (Subdivision 136-B). Where such inbound residents hold employee shares or rights it may be unclear which rules apply.

4.49 These amendments clarify which rules apply in particular situations, where an employee share or right does not have the necessary connection with Australia. (Where a share or right has the necessary

connection with Australia, for example is in an Australian private company, only the employee share or right cost base rules (Subdivision 130-D) can apply and so no clarification is needed.) The amendments follow a general rule that the CGT provisions are only intended to have application to gains (or losses) on employee shares or rights that arise after the discount taxed under the employee share scheme provisions was valued.

4.50 Therefore, where an inbound resident owns a qualifying share or right for which the cessation time is yet to happen, the cost base of the share or right will be its market value at the subsequent cessation time, as determined by the employee share or right cost base rules (Subdivision 130-D) ***[Schedule 4, item 31, paragraph 130-83(1)(b); item 33, subsection 130-83(4); item 36, subsection 136-40(4)].*** This treatment reflects the fact that at the time an individual changes residence, changes in value for these shares or rights are still subject to assessment under the employee share scheme provisions.

4.51 In all other cases, the employee share or right owned by the inbound resident will be taxable under the employee share scheme provisions only by reference to the discount valued at acquisition. In these cases, the cost base will be determined by the market value at residence change time (Subdivision 136-B). This treatment reflects the fact that gains (or losses) in respect of these shares or rights following acquisition but before becoming a resident are not intended to be within Australia's tax base. ***[Schedule 4, item 30, subsection 130-80(4); item 34, subsection 130-85(4)]***

Removal of potential double taxation for outbound residents

4.52 Lack of clarity in the interaction between the employee share scheme and CGT provisions may also create potential double taxation for outbound residents. CGT event I1 may create a CGT liability when an individual stops being a resident of Australia.

4.53 However, an individual with a qualifying employee share or right may not have reached a cessation time before becoming non-resident. Consequently, the individual may be taxed at a later time on the same gain or discount already taxed under the CGT provisions.

4.54 These amendments will provide that a capital gain or loss in respect of CGT event I1 is disregarded if a share or right is qualifying, not covered by an election (to be assessed in the year of income of acquisition or of becoming an Australian employee), and has not yet reached a cessation time. ***[Schedule 4, item 28, subsection 104-160(5); item 29, subsection 104-160(6)]***

4.55 These amendments will also clarify the link between CGT event I1 and the Subdivision 130-D rules. Subsection 130-83(2) provides that where certain CGT events happen at the same time as a cessation time, or within 30 days, any capital gain or loss is disregarded. This is because the change in value to cessation time has been accounted for, and it is not necessary for the CGT rules to have any application. An amendment adds CGT event I1 to the list of relevant CGT events in that subsection. ***[Schedule 4, item 32, subsection 130-83(2)]***

Other amendments

4.56 Some additional amendments are necessary to provisions outside Division 13A to ensure that employee shares and rights are taxed appropriately in the international context.

Employee share trusts

4.57 Two amendments relate to incorporating the new definition of foreign service in rules relating to employee share trusts.

4.58 Currently, a trustee of an employee share trust may disregard a capital gain or loss made when a beneficiary becomes absolutely entitled to a share or right. The capital gain is only disregarded if the beneficiary (or associate) is an Australian employee. This can leave an unwarranted liability for a trustee where a beneficiary (or associate) is engaged in foreign service.

4.59 These amendments will resolve this problem by including an individual (or associate) who is engaged in foreign service in the list of relevant beneficiaries. ***[Schedule 4, item 35, paragraph 130-90(1A)(c)]***

4.60 A similar problem arises under the fringe benefits tax provisions. Benefits arising in respect of the provision of money or shares to an employee share trust are excluded from the definition of 'fringe benefit' where the activities of the trust are limited to obtaining shares, or rights to acquire shares, in a company, or the holding company of the company and providing those shares to employees. These amendments will extend this exclusion to employee share trusts that also provide shares, or rights to acquire shares to employees and individuals engaged in foreign service. ***[Schedule 4, item 1, subsection 136(1), paragraph (hb) of the definition of 'fringe benefit']***

Foreign investment funds

4.61 The foreign investment fund rules may include an amount in the assessable income of taxpayers with interests in certain offshore companies. Where an employee share or right relates to an offshore company, there is the potential for the employee share scheme and foreign investment fund rules to overlap.

4.62 The foreign investment fund rules currently seek to prevent double taxation where an interest in a foreign investment fund is a qualifying share or right and assessment under the employee share scheme provisions has been deferred to a cessation time. This is done by providing an exemption equivalent to the increase in market value (as calculated by the employee share scheme rules) of an employee share or right during a relevant foreign investment fund period.

4.63 However, the market value as calculated by the employee share scheme rules may be different to the amount of deemed assessable income calculated under the foreign investment fund rules. In these cases, there may still be foreign investment fund income in relation to the employee share or right.

4.64 These amendments will provide a more straight-forward relief from double taxation by reducing the foreign investment fund income to zero where, for the whole of the relevant period, the individual holds a qualifying employee share or right and is deferring taxation to a cessation time which is still to occur. ***[Schedule 4, item 25, subsection 530A(1A)]***

4.65 Where an employee share or right is held for only part of a notional accounting period (eg reaches a cessation time during a relevant period), a method of dividing assessable amounts between the foreign investment fund and employee share scheme rules is still necessary. The current approach will be retained for these purposes. ***[Schedule 4, item 26, paragraph 530A(1)(a); item 27, paragraph 530A(1)(b)]***

Application and transitional provisions

4.66 The amendments to the employment income provisions, and to the general application of Division 13A including to inbound individuals, apply to employee shares or rights acquired on or after the date of Royal Assent. ***[Schedule 4, subitems 38(1) and (2)]***

4.67 However, these amendments will also apply to employee shares or rights acquired before Royal Assent if:

- the individual holding the shares or rights was not an Australian employee immediately before Royal Assent, and
- becomes an Australian employee, in relation to acquisition of these employee shares or rights, on or after Royal Assent.

[Schedule 4, subitems 38(3) to (5)]

4.68 This application to individuals who become Australian employees reflects the fact that the relevant Australian employment in respect of which the discount on the employee shares or rights becomes assessable arises after Royal Assent, even if the shares or rights were acquired before.

4.69 The amendments to clarify the cost base for inbound residents, and to remove potential double taxation for outbound residents apply to CGT events happening on or after the day of Royal Assent. ***[Schedule 4, item 40]***

4.70 The amendment to the CGT rules for an employee share trust applies to shares or rights to which a beneficiary becomes absolutely entitled on or after the day of Royal Assent. ***[Schedule 4, item 41]***

4.71 The amendments to clarify the interaction of the employee share scheme provisions and foreign investment fund rules apply to years of income ending after Royal Assent ***[Schedule 4, item 39]***. The amendment to the definition of 'exempt fringe benefit' applies to fringe benefit tax years ending after Royal Assent ***[Schedule 4, item 37]***. As the amendments to the foreign investment fund and fringe benefit tax rules are beneficial to taxpayers, the changes apply for the first prospective assessment.

Chapter 5
Technical correction to application rule

Outline of chapter

5.1 Schedule 5 to this Bill amends subitem 140(2) of the *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004* (NITA Act 2004) which deals with the application rule for Parts 2 and 3 of Schedule 2 to that Act. This chapter explains how the new application rule will affect the amendments contained in Parts 2 and 3.

5.2 Unless otherwise stated, all legislative references are to the *Income Tax Assessment Act 1936*.

Context of amendments

5.3 The technical amendment in this Schedule amends an application rule to ensure that the changes made by the NITA Act 2004 operate as originally intended. The original application rule resulted in ambiguity and did not clearly express the Government's policy.

Summary of new law

5.4 Schedule 5 amends the application rule in subitem 140(2) in Schedule 2 to the NITA Act 2004 to ensure all the amendments made by Parts 2 and 3 in that Schedule operate as intended.

Comparison of key features of new law and current law

New law	*Current law*
The application rule ensures most amendments contained in Parts 2 and 3 of Schedule 2 to the NITA Act 2004 apply when a thing happens after 30 June 2004. A further application rule applies specifically to items 7, 58 and 59 of those Parts to ensure those amendments apply to a statutory	The application rule provides that all amendments contained in Parts 2 and 3 of Schedule 2 to the NITA Act 2004 apply when a dividend is paid after 30 June 2004.

accounting period that starts on or after 1 July 2004.	

Detailed explanation of new law

5.5 Schedule 5 to this Bill clarifies the application rule contained in Part 6 of Schedule 2 to the NITA Act 2004. The application provisions in Part 6 provide rules to ensure amendments made by Parts 1 to 5 in Schedule 2 to the NITA Act 2004 operate from the intended time.

5.6 The new application rule changes the specific rule in Part 6 dealing with the application of amendments made by items 4 to 84 in Schedule 2 to the NITA Act 2004. The new rule applies so that most of the amendments made by those items will come into effect when a thing happens after 30 June 2004. The rule is drafted in a principle-based way to cover many sorts of things such as the payment of a dividend, the sale of an asset or the change of residence of a foreign company. The effect of the new rule on the amendments made by items 4 to 84 in Schedule 2 to the NITA Act 2004 is explained in paragraphs 5.7 to 5.16.

5.7 Amendments made by items 4 to 6 and 8 in Part 2 of Schedule 2 to the NITA Act 2004 will apply when a dividend is paid after 30 June 2004. The new subitem 140(2) of Schedule 2 to the NITA Act 2004 ensures the amendments take effect at the time a thing happens where it happens after 30 June 2004. A dividend paid is the relevant thing happening. ***[Schedule 5, item 1, subitem 140(2) in Schedule 2 to the NITA Act 2004]***

5.8 Items 5 and 6 amend provisions dealing with the calculation of attributable income. Item 8 repeals provisions that were used to calculate attributable income in specific situations. The calculation of attributable income is not a 'thing that happens' for the purposes of the new subitem 140(2). The amendments made by items 5, 6 and 8 are only important in calculating attributable income where a controlled foreign company receives a dividend. This means that the changes made by those items will take effect where a dividend is paid after 30 June 2004. ***[Schedule 5, item 1, subitem 140(2) in Schedule 2 to the NITA Act 2004]***

5.9 Item 7 in Schedule 2 to the NITA Act 2004 amends section 403. The old section 403 provided a rule that applied where an unlisted country controlled foreign company derived certain branch profits and non-portfolio dividends. The rule allowed those amounts to be treated as notional exempt income in the calculation of attributable income. The

calculation of attributable income of a controlled foreign company is made at the end of a statutory accounting period.

5.10 The amended section 403 is reduced to only apply to certain branch profits of an unlisted country controlled foreign company. Those amounts are treated as notional exempt income. There is no event or thing that happens that would trigger the operation of the amendment which means the new subitem 140(2) would not be effective. Instead, the application rule in new subitem 140(2A) ensures the amendment takes effect where a statutory accounting period of a controlled foreign company starts on or after 1 July 2004 ***[Schedule 5, item 1, subitem 140(2A) in Schedule 2 to the NITA Act 2004].*** Other rules ensure the proper treatment of non-portfolio dividends received by a controlled foreign company after 30 June 2004 but before the start of the first statutory accounting period after 1 July 2004.

5.11 Items 9 to 37 and items 39 to 57 of Part 3 in Schedule 2 to the NITA Act 2004 amend provisions that are relevant when an Australian company or a controlled foreign company receives a dividend. The amendments made by those items will take effect where a dividend is paid after 30 June 2004. The payment of a dividend is the relevant thing happening. ***[Schedule 5, item 1, subitem 140(2) in Schedule 2 to the NITA Act 2004]***

5.12 Item 38 of Schedule 2 to the NITA Act 2004 amends section 160AFCB. This provision applies where there is a calculation of attributable income under section 457. Attributable income is calculated under section 457 where a controlled foreign company changes its residence from an unlisted country to a listed country or to Australia. The amendment made by item 38 is effective from the time a company changes its residence after 30 June 2004. A change of residence is the relevant thing happening. ***[Schedule 5, item 1, subitem 140(2) in Schedule 2 to the NITA Act 2004]***

5.13 Items 58 and 59 in Schedule 2 to the NITA Act 2004 repeal two provisions in section 384. Section 384 provided additional assumptions for calculating the attributable income of a controlled foreign company resident in a non-broad-exemption listed country. Paragraph 384(2)(aa) and subparagraph 384(2)(d)(ia) provided rules where the controlled foreign company was resident in a limited-exemption listed country. Where a statutory accounting period starts on or after 1 July 2004, section 384 will only apply to companies resident in unlisted countries. The list of limited-exemption countries will no longer be used in calculating the attributable income of a controlled foreign company.

5.14 There is no event or thing happening that would trigger the repeal of paragraph 384(2)(aa) and subparagraph 384(2)(d)(ia), which means the new subitem 140(2) would not be effective. Instead, the application rule in new subitem 140(2A) ensures the repeals take effect where a statutory accounting period starts on or after 1 July 2004 ***[Schedule 5, item 1, subitem 140(2A) in Schedule 2 to the NITA Act 2004]***. The repeals will take effect at the same time the list of limited-exemption countries is no longer used.

5.15 Items 60 and 71 to 73 of Schedule 2 to the NITA Act 2004 amend sections affected by the calculation of attributable income under section 457. Attributable income is calculated under section 457 where a controlled foreign company changes its residence from an unlisted country to a listed country or to Australia. The amendments made by those items are effective from the time a company changes its residence after 30 June 2004. A change of residence is the relevant thing happening. ***[Schedule 5, item 1, subitem 140(2) in Schedule 2 to the NITA Act 2004]***

5.16 Items 61 to 70 and 74 to 84 of Schedule 2 to the NITA Act 2004 amend provisions that are relevant when an Australian company or a controlled foreign company receives a dividend. The amendments made by those items will take effect where a dividend is paid after 30 June 2004. The payment of a dividend is the relevant thing happening. ***[Schedule 5, item 1, subitem 140(2) in Schedule 2 to the NITA Act 2004]***

Application and transitional provisions

5.17 The amendments made by Schedule 5 to this Bill commence immediately after the commencement of the NITA Act 2004. That Act commenced on 29 June 2004. These amendments are retrospective to ensure that it is clear when the amendments in the NITA Act 2004 take effect.

Chapter 6 Regulation impact statement

Policy objective

6.1 This Bill is a further instalment of reforms announced by the Government following the review of international taxation arrangements. The overall purpose of the reforms is to build on Australia's position as an attractive place for business and investment.

The objectives of the measures in this Bill

6.2 Two of the reforms in this Bill aim to align the taxation treatment of branches in Australia of foreign entities more closely with that of foreign-owned subsidiaries. Doing so is intended to provide for a more neutral tax treatment of alternative corporate structures, reduce compliance costs overall, and improve competition in the financial services sector in particular.

6.3 Reforms to the controlled foreign companies rules have a number of objectives. They aim to provide an improved legislative basis for listing further countries as benefiting from a reduced application of the rules, thereby reducing compliance costs. Compliance costs associated with acquisitions of foreign companies and the restructuring of overseas operations are intended to be reduced. A technical deficiency in the rules is also corrected.

6.4 Reforms are also to be made to the treatment of the employee shares or rights of individuals who change their country of residence or work in more than one country. The changes aim to align Australia's taxation rules more closely with the developing international norms, and help prevent double or nil taxation of such cross-border employee shares or rights. By doing so, the changes will improve Australia's ability to attract highly skilled individuals and businesses that employ them.

Implementation options

6.5 The measures addressed in this regulation impact statement arise directly from recommendations made by the Board of Taxation as part of

the review of international taxation arrangements. The implementation options for these measures can be found in the Board of Taxation's report, *International Taxation – A Report to the Treasurer* (the Board's Report) and the Treasury's consultation paper, *Review of International Taxation Arrangements* (Consultation Paper).

6.6 Table 6.1 shows where the measures, and principles underlying them, are discussed in the Board's Report and the Consultation Paper.

Table 6.1: Options for implementing measures in this Bill arising directly from the Board's Report and the Consultation Paper

Measure	*The Board's Report*	*Consultation Paper*
Extend to Australian branches of foreign financial entities the treatment given to Australian branches of foreign banks under various income tax law provisions.	Recommendation 4.11(1), pages 131 to 134	Option 4.11, page 70
Tax dividends received by Australian branches of foreign entities under the assessment system instead of the withholding tax system.	Recommendation 4.11(2), pages 131 to 134	Option 4.11, page 70
Remove inappropriate consequences that follow from the listing of a country and make amendments to the definition of 'commencing day'.	Recommendations 3.4(c) and (d), pages 87 to 89 and Attachments 1 and 2; Recommendation 3.3, page 87	
Amendments to the taxation of cross-border employee shares or rights.	Recommendation 5.2, pages 138 to 141	Option 5.2, pages 78 and 79

6.7 The second last item in Table 6.1 relates to a register of controlled foreign companies rules policy and technical issues. The register is at Attachment 2 to the Board's Report. Following consultative processes established to implement the outcomes of the review of international taxation arrangements, it was considered that the following issues should be dealt with as a priority.

6.8 The definition of commencing day in section 406 of the *Income Tax Assessment Act 1936* (ITAA 1936) relates to issue 1.1.14 of Attachment 2 to the Board's Report.

6.9 The Government also agreed to Recommendation 3.3 of the Board's Report to consider further countries for 'listing' (which is done by amendments to the relevant regulations). However, section 457 (and related provisions in sections 384 and 385) of the ITAA 1936 could mean that listing has inappropriate and negative consequences for taxpayers. These problems need to be addressed before any additional countries are listed.

Table 6.2: Implementation options for details not explicitly addressed in the Board's Report or the Consultation Paper, and options endorsed by the Board of Taxation that were not adopted by the Government in this Bill

Measure	*Implementation options*
Tax dividends received by Australian branches of foreign entities under the assessment system instead of the withholding tax system.	In this Bill, the exemption from withholding tax is limited to dividends paid to Australian branches of non-resident companies and individuals. The Board's Report did not specify a limitation to any particular type of entity carrying on business in Australia at or through a branch. This limitation ensures that non-resident partnerships and trusts continue to receive consistent treatment with Australian partnerships and trusts. Franked distributions received by Australian branches of foreign entities will also be taxed under the assessment system. In order to ensure consistent treatment with Australian subsidiaries, non-resident companies (and individuals) will be entitled to the benefit of a franking tax offset on receipt of a franked distribution, to the extent to which it is attributable to an Australian branch of the non-resident.
Changes to the taxation of cross-border employee shares or rights.	The Board's recommendation only referred to the taxation of employee share options. However, shares acquired under employee share schemes are treated in the same way as options under Australian taxation law. This measure extends to all employee shares and rights to ensure consistent treatment.

6.10 Note, this Bill also contains a technical correction to the application rule in sub-item 140(2) in Schedule 2 to the *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004*. The technical correction ensures all the amendments made by Parts 2 and 3 in Schedule 2 operate as intended. Due to its minor nature, no regulation impact statement is required for this amendment.

Assessment of impacts

Impact group identification

6.11 The measures in this Bill specifically impact on those taxpayers identified in Table 6.3.

Table 6.3: Taxpayers affected by measures in this Bill

Measure	*Taxpayers affected*
Extend to Australian branches of foreign financial entities the treatment given to Australian branches of foreign banks under various income tax law provisions.	Foreign financial entities with branches in Australia, and related Australian subsidiaries.
Tax dividends received by Australian branches of foreign entities under the assessment system instead of the withholding tax system.	Non-resident companies and individuals with branches in Australia that are in receipt of dividends from Australian companies, and Australian companies that are paying dividends to the Australian branches of non-residents.
Remove inappropriate consequences that follow from the listing of a country.	Attributable taxpayers of controlled foreign companies where the country of residence of the companies becomes a ‘listed country’.
Changes to the definition of commencing day.	Attributable taxpayers of controlled foreign companies that have assets acquired when there was no attributable taxpayer with a positive attribution percentage.
Changes to the taxation of employee shares or rights	Employees with employee shares or rights who change their country of residence or work in more than one country, and their employers.

Analysis of costs / benefits

6.12 It has not been possible to provide a fully detailed analysis of the impacts on compliance costs because of the lack of available information on affected taxpayers. However, some general observations are outlined.

Compliance costs

Extend to Australian branches of foreign financial entities the treatment given to Australian branches of foreign banks under various income tax law provisions

6.13 There may be additional compliance costs for taxpayers with the introduction of this measure. Under separate entity treatment, certain transactions between foreign financial entities and their Australian branches, previously ignored for taxation purposes, will be recognised. Consequently, foreign financial entities will be required to keep accounting records in respect of their branches in Australia. These accounting records provide a means by which the foreign entities can separately account for money used in the activities of their branches in Australia. Many of these records may already be kept for internal reporting purposes. The conditions imposed on foreign financial entities for the purposes of this measure are no more onerous than those imposed on foreign banks.

6.14 Taxpayers may also incur some additional compliance costs if they require advice from the Australian Taxation Office (ATO) and taxation professionals in respect of this measure.

Tax dividends received by Australian branches of foreign entities under the assessment system instead of the withholding tax system

6.15 This measure will result in compliance cost savings for Australian companies paying unfranked dividends to the Australian branches of non-residents as they will no longer be required to withhold tax when paying unfranked dividends to the Australian branches of non-residents.

6.16 Non-residents operating in Australia through branches will also benefit from this measure. Currently, the law provides different treatment for the branches of residents of Australia's treaty partner countries to that of the branches of residents of non-treaty partner countries.

6.17 Australia's tax treaties require that dividends received by a non-resident with an Australian branch be taxed by Australia on a net profit basis. However, the only mechanism in Australia's domestic taxation law for taxing dividends paid to the Australian branch of a non-resident is withholding tax, which applies to gross amounts. This may result in a mismatch between the amount of tax withheld by the payer of the dividend and the amount of tax that is due and payable on the net dividend under the relevant tax treaty.

6.18 To resolve the mismatch, the ATO currently makes a refund available for any excess of dividend withholding tax over the amount of tax that is calculated under a business profits article. With the implementation of this measure, the ATO will no longer need to administer the law in this manner, leading to significant compliance cost savings, both for taxpayers and the ATO.

6.19 There will likely be few non-recurrent costs, such as taxpayer familiarisation and training, because this measure will make use of the existing assessment taxation system.

Remove inappropriate consequences that follow from the listing of a country

6.20 This exclusion will result in minor compliance cost savings associated with calculating 'adjusted distributable profits' when an 'unlisted country' controlled foreign company becomes a listed country controlled foreign company due to its country of residence becoming listed. Minor compliance cost savings associated with calculating tainted income will also occur when tainted assets are subsequently disposed of. Non-recurrent compliance costs in the form of familiarisation and training, if any, would be minimal because the measure is a simple removal of income from attribution.

Changes to the definition of commencing day

6.21 This change will reduce compliance costs associated with acquisitions of overseas groups and restructuring of overseas operations. This is because the calculation of income is no longer necessary for periods of time where there was no attributable taxpayer with a positive attribution percentage in relation to a foreign company. This measure will present small familiarisation and training costs as it is a minor additional requirement needed to satisfy commencing day.

Changes to the taxation of cross-border employee shares or rights

6.22 This measure will generally benefit taxpayers by clarifying taxation rules and obligations. Currently, the employee share scheme provisions generally require choices about timing of taxation to be made at the time of acquisition of an employee share or right. There is no guidance for taxpayers who commence work in Australia at a later time.

6.23 These amendments will clarify residence and source country taxing arrangements and improve the interaction of the employee share scheme and capital gains tax provisions. It will give greater assurance that no double taxation will result from the crystallisation of a benefit under an employee share or right. Compliance costs associated with taxpayers becoming familiar with the changes will be ongoing because the main affected group is inbound expatriates on short-term assignments to Australia. However, as taxation obligations will be clearer, the amendments will achieve greater certainty for taxpayers.

Administration costs

Extend to Australian branches of foreign financial entities the treatment given to Australian branches of foreign banks under various income tax law provisions

6.24 The administration cost impact of this measure should be minimal. On the basis that foreign financial entities with branches in Australia will now be treated the same as foreign bank branches in Australia, the ATO has systems in place that could also be used to administer this measure.

6.25 The ATO may be required to provide additional advice to taxpayers and taxation professionals in relation to this measure, including by public and private rulings. The information provided through the ATO's website and publications may also need to be updated for this measure.

Tax dividends received by Australian branches of foreign entities under the assessment system instead of the withholding tax system

6.26 This measure will provide immediate relief to the ATO in relation to its administration costs. In particular, dividends paid to treaty partner residents operating in Australia through a branch will be treated as taxable on a net assessment basis, both in the domestic taxation law and under Australia's tax treaties.

6.27 Further, the systems required to administer this measure are already in place, thereby minimising its administration cost impact. However, the ATO may need to make some minor changes to published information as a result of this measure to ensure that affected taxpayers are aware of the changes.

Remove inappropriate consequences that follow from the listing of a country and changes to the definition of commencing day

6.28 The administration cost impact of these measures should be minimal. The systems required to administer these measures should already be in place. However, the ATO may be required to provide additional advice to taxpayers and taxation professionals in relation to these measures. As a result of these measures, minor changes to information provided through the ATO's website and publications will be necessary.

Changes to the taxation of cross-border employee shares or rights

6.29 The administration costs of this measure are expected to be minimal. The affected taxpayers are likely to be employees of multinational corporations in Australia temporarily who receive professional taxation advice from their taxation advisor, their employer or their employer's taxation advisor. Consequently, it is anticipated that the ATO will receive relatively few requests for advice on the measure.

6.30 No systems changes will be required for implementation. The ATO will incur some costs in training staff and developing information products.

Government revenue

6.31 The revenue impact of the new definition of commencing day is unquantifiable. The revenue cost of the changes to remove inappropriate consequences that follow from the listing of a country is insignificant and has been rounded down to nil.

6.32 A reliable revenue estimate of the other measures cannot be provided. However, none of these measures is expected to have a discernible effect on revenue.

Economic benefits

Extend to Australian branches of foreign financial entities the treatment given to Australian branches of foreign banks under various income tax law provisions

6.33 Providing similar tax outcomes for the Australian branches of foreign financial entities as for foreign banks will foster competitive neutrality between these two types of financial service providers. The measure also provides a more neutral treatment of the corporate structuring decisions of foreign financial entities.

Tax dividends received by Australian branches of foreign entities under the assessment system instead of the withholding tax system

6.34 As with the measure above, this measure will improve tax neutrality between Australian branches of non-residents and Australian subsidiaries of non-residents. It will also improve the cash flow position of non-resident individuals and companies in receipt of Australian dividends through an Australian branch. At present, withholding tax is required to be paid at the time of a dividend payment. On an assessment basis, tax is not required to be paid until a later time (usually at the time of lodgement of the income tax return).

Remove inappropriate consequences that follow from the listing of a country

6.35 These of themselves are unlikely to have a significant economic impact as they have no effect before a new country is listed (which has not yet occurred), or they correct a technical deficiency.

Changes to the definition of commencing day

6.36 This change will have a limited economic effect, in that it will reduce the 'lock-in effect' for gains relating to a time when an asset should not have been in the capital gains tax net. The lock-in effect is the incentive a taxpayer faces to not dispose of an asset because of the tax cost that disposal would crystallise, even though disposal will allow a more efficient utilisation of capital.

Changes to the taxation of cross-border employee shares or rights

6.37 By reducing the risk of double or nil taxation, providing more certainty to taxpayers, and aligning the taxation treatment of cross-border employee shares and rights more closely with international norms, the changes will assist in attracting highly skilled workers to Australia as well as the industries that employ them.

Consultation

6.38 Business, legal and accounting representatives and the ATO have been consulted extensively and have actively assisted in developing these initiatives. This involved the establishment of an advisory group constituted by members of industry and professional peak bodies to help in the design of legislation. The more technical issues and the details of the measures, or those that affect a specific interest group, were referred to particular sub-groups. In addition, direct discussions with taxpayers affected by these measures were undertaken as necessary.

6.39 Bodies consulted with as part of the processes outlined above included the Business Council of Australia; Investment and Financial Services Association; International Banks and Securities Association of Australia; Australian Bankers' Association; Taxation Institute of Australia; Corporate Tax Association; Law Council of Australia; Institute of Chartered Accountants in Australia; and Certified Practicing Accountants Australia.

6.40 Suggestions on the legislative details of the measures made by those consulted with group members were adopted where they were consistent with the intended policy objectives and the integrity of the measures. For example, that the measure changing the treatment of cross-border employee rights be extended to employee shares. The consultative groups have been supportive of the consultation process and have no remaining concerns with the final form of the measures.

Conclusion

6.41 The measures in this Bill are a further instalment of reforms to implement the Government's response to the review of international taxation arrangements. The measures are consistent with the Government's policy objectives of increasing the attractiveness of Australia as a location for business and investment.

6.42 Most of the measures will also reduce compliance costs and increase certainty for taxpayers. The improved treatment of financial entity branches may impose some additional compliance costs, but the costs are not significant when compared with the expected benefits of the measure, which include more neutral taxation treatment of Australian branches of foreign financial entities and Australian subsidiaries and improved competition in the financial services sector.

6.43 The Treasury and ATO will monitor these taxation measures, as part of the whole taxation system, on an ongoing basis.

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