TREASURER

PRESS RELEASE

NO. 49

EMBARGO Budget. Not for release before 7.30 pm AEST, 13 May 1997.

TAXATION OF FOREIGN SOURCE INCOME

Financial Implications ($m)

1997-98	1998-99	1999-00	2000-01
–	150	150	150

Explanation

After considering submissions in response to the Treasurer’s Information Paper (IP) released on 24 December 1996, the Government has now settled the details of the proposed changes to the system for taxing foreign source income.

A new short list of 7 truly comparable tax countries (ie a controlled foreign company (CFC) list) will be established for the purposes of the CFC and transferor trust measures. The list will comprise Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States. Profits derived by CFCs and transferor trusts resident in these countries will continue to be largely exempt from accruals taxation under the CFC and transferor trust measures (certain tax concessions in these countries will be designated in the Income Tax Regulations). The new list will generally take effect for statutory accounting periods of CFCs and years of income of transferor trusts commencing on or after 1 July 1997.

In response to concerns raised in submissions, the definition of tainted services income in the CFC measures will be amended to exclude amounts of services income derived from an associated CFC resident in the same country provided that amount is subject to the normal rate of company tax in that country and does not reduce the attributable income of the associated CFC. The definition of tainted rental income will be amended in similar terms.

As proposed in the IP, the existing list of countries in Schedule 10 of the Income Tax Regulations will be retained, updated and expanded for the purposes of the exemptions provided in sections 23AJ and 23AH and related sections of the *Income Tax Assessment Act 1936* (ITAA) dealing with the repatriation of foreign profits. This list (ie the repatriation list) will apply from 1 July 1997. Also effective from 1 July 1997, the Czech Republic and Vietnam will be added to the repatriation list. Amendments to the law will be made to ensure that Hong Kong continues to be treated as an unlisted jurisdiction following the establishment of the Hong Kong Special Administrative Region of the People’s Republic of China on 1 July 1997. Other proposals in the IP in relation to the repatriation list will be adopted as proposed.

Bank branches operating in countries only on the repatriation list will be provided with an exclusion from tainted income broadly consistent with the exclusion for bank CFCs in repatriation list countries. In view of the continued globalisation of financial markets, the treatment of Australian financial institutions will be kept under review.

The Government will also take the following measures to reduce the compliance costs of the CFC measures:

- the active income test for CFCs in CFC list countries will be relaxed to ensure that it operates in the same way as the test for unlisted country CFCs;
- an active income test concession will be provided for branches of Australian companies operating in repatriation list countries, such that, consistent with CFCs in repatriation list countries, they can derive up to 5 per cent of gross turnover as tainted income and still obtain full exemption under section 23AH;
- transactions involving CFCs resident in the same CFC list country will be excluded from the transfer pricing rules in the CFC measures;
- the requirement to apply thin capitalisation rules and debt creation rules in calculating the attributable income of a CFC will be removed;
- an election to vary a CFC's accounting period for accruals taxation purposes will be allowed to take effect immediately if made during the first period that a company becomes a CFC;
- a taxpayer will be allowed to make elections on behalf of a CFC if the company is wholly owned by the taxpayer either directly or indirectly through other entities; and
- an election by a CFC for capital gains tax rollover relief will be able to be made at a later time (ie when an Australian controller lodges a tax return that is affected by the election).

The Government has also decided to proceed with the proposals in relation to section 457 of the ITAA, tax sparing and the Foreign Investment Fund measures as outlined in the IP.

The Government plans to release draft legislation on the changes prior to 1 July 1997.

The above material is a full extract of the description of the measure as contained in *Budget Paper No 2: Budget Measures 1997-98*. This paper explains all outlays and revenue measures, and is available from Australian Government Bookshops or from the Treasury Internet site at http://www.treasury.gov.au/budget

CANBERRA
13 May 1997

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