
Chapter #

Anti-roll-up Rule

Outline of chapter

1.1 Schedule # to this bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to introduce a specific anti-avoidance rule to ensure that Australian residents cannot defer or avoid tax a liability for income held in foreign accumulation funds.

Context of amendments

1.2 Foreign source income attribution rules are designed to ensure that Australian residents cannot accumulate certain passive income in offshore entities and thereby defer, or even avoid, Australian tax. The rules tax residents on an accruals basis on their share of income accumulating in such offshore entities.

1.3 In response to recommendations from the Board of Taxation, the Government announced in the 2009-10 Budget significant reforms to Australia's foreign source income attribution rules.

1.4 In summary, the Government announced that the controlled foreign company (CFC) and transferor trust rules would be retained and modernised, while the foreign investment fund (FIF) and deemed present entitlement (DPE) rules would be repealed. These rules are contained in the *Income Tax Assessment Act 1936* (ITAA 1936).

1.5 The FIF rules apply to Australian residents with non-controlling shareholdings in foreign companies or interests in foreign trusts. These rules apply to approximate a resident taxpayer's share of the undistributed profits of a FIF and assessed the taxpayer on those profits. They capture a wide array of non-controlled offshore investments, with an extensive range of exemptions then applying. Although many investors are eventually not required to attribute income, the approach under the FIF regime imposes relatively substantial obligations in terms of compliance.

1.6 In place of the FIF rules, the introduction of a specific anti-roll-up rule was announced to target investment in certain foreign accumulation funds that re-invest interest-like returns.

1.7 The anti-roll-up rule is designed to be a specific, narrowly defined, anti-avoidance rule that targets the most abusive deferral cases such as investments by Australian residents in accumulation funds located in low tax jurisdictions.

Summary of new law

1.8 The amendments introduce a targeted anti-roll-up rule which applies where:

- an investor holds an interest in a foreign accumulation fund;
- the investor receives a tax deferral benefit as a result of the interest; and
- the investor entered into the scheme with the dominant purpose of obtaining a tax deferral benefit.

1.9 In instances where these rules apply, the Commissioner may make a determination to include the whole or part of the tax deferral benefit in the investor's assessable income for the relevant income year.

1.10 Investors who have an amount attributed to their assessable income as a result of this rule will be protected from double taxation against future distributions from the foreign accumulation fund.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
The anti-roll-up rule is a specific anti-avoidance rule that targets the most abusive non-control deferral cases such as investments by Australian residents in accumulation funds located in low tax jurisdictions.	The FIF rules are a broad based stand alone anti-deferral regime. The rules apply to a wide range of income with an expansive array of exemptions also potentially applying.

Detailed explanation of new law

Who does the rule apply to?

1.11 The anti-roll-up rule applies to an investor that has an interest in a foreign accumulation fund. The term investor is a broad concept covering any type of entity. In general, an investor that is an Australian resident at any point in the income year will fall within the scope of the anti-roll-up rule. *[Schedule #, subparagraph @FAF5(1)(b)(i)]*

1.12 Some classes of investors, however, are specifically carved-out from the operation of the rule. *[Schedule #, subparagraph @FAF5(1)(b)(ii)]*

1.13 An investor that is a 'complying superannuation fund' [in the final version this reference will be to 'complying superannuation entity'], (under section 995-1 of the ITAA 1997), as well as any other type of specifically listed fund will be excluded from the operation of the anti-roll-up rule. *[Schedule #, section @FAF35]*

1.14 An investor will be deemed to have or acquire an interest in a foreign accumulation fund where they have or acquire the legal title to certain foreign life assurance policies. *[Schedule # paragraph @FAF5(1)(x)]*. This Division will not apply to an entity holding the legal title to a foreign life assurance policy where the legal title only enables a distribution on the death (or permanent incapacity) of the title holder. *[this provision will potentially be inserted in Schedule# subsection @FAF5(3)]*

What is a Foreign Accumulation Fund?

- 1.15 Under this rule, a foreign accumulation fund is an entity:
- that is a foreign resident;
 - that is not a CFC;
 - whose investment returns are subject to a low level of risk; and
 - that does not distribute substantially all of the profits and gains of the fund

[Schedule #, section @FAF10]

1.16 An entity that is a foreign resident at any time of the income year may be considered a foreign accumulation fund providing it is not a CFC. Entities that are CFCs are dealt with under the CFC rules.

Low risk returns on investments

1.17 In order for a foreign resident entity to be a foreign accumulation fund it is necessary to establish that the investments made by the fund are subject to low levels of risk. This is to be determined on an annual basis, with the test applying from beginning of the income year. Regard must be had to the overall investments of the foreign entity in determining whether they are structured in a way that gives rise to low levels of risk on expected returns. *[Schedule #, section @FAF10(2)]*

1.18 Low-risk returns constitute a fundamental characteristic of a foreign accumulation fund under the anti-roll-up rule because an investor who is reasonably assured as to the amount of return on an investment is more able to effectively engage in strategic planning to reduce future tax liabilities.

1.19 In general terms, risk may be regarded as the probability that the actual return from an investment will be different than that anticipated at the time of investment. From this perspective, a direct correlation exists between the relative level of risk and likelihood of return, which also includes the possibility of loss of some or all of the original investment.

1.20 The imposition of taxation on an accruals basis under this rule may therefore be an appropriate measure in instances where the level of return on an investment held by a foreign accumulation fund is considered sufficiently certain. Interest-like returns guaranteed by government bonds and bank call deposits are examples of returns that would ordinarily be considered to be sufficiently certain.

1.21 For the purposes of this Division, a return will be considered sufficiently certain where the following requirements are met:

- it is reasonably expected that the foreign entity will receive returns from the investments that it makes. This analysis is to be done on the assumption that the foreign entity will hold the interest for the remaining term of its life or until maturity; and
- at least some of the amount or value of the return from the investments that it makes are, at the time of investment, fixed or determinable with reasonable accuracy.

1.22 In determining whether the returns on a foreign entity's investments are sufficiently certain, regard should be had to the overall nature of the foreign entity's other investments. In instances where the interaction between two or more investments means that the foreign entity

can reasonably predict both the likelihood and the amount of a return on an interest, such returns might also be considered sufficiently certain.

Exception for distributing funds

1.23 An entity will *not* be a foreign accumulation fund if it distributes substantially all of the profits and gains it makes during an income year. The distribution must occur either during the relevant income year that the profits and gains are made, or within a period of three months immediately following the end of that income year. [Schedule #, subsection @FAF10(3)]

1.24 For the purposes of the substantial distribution exception, the phrase ‘profits and gains’ refers to any realised profits and gains that the entity makes during the relevant income year. [Schedule #, paragraph @FAF10(4)(a)]

Example 1.1

An offshore investment fund has realised profits and gains of \$100.00 in the 2011-12 income year. The offshore investment fund distributes [\$95.00] back to its investors on the 30 June 2012. The offshore investment fund will not be considered a foreign accumulation fund because it has distributed substantially all of the profits and gains it has made during the 2011-12 income year.

1.25 In circumstances where the entity holds an interest in another entity and the other entity has realised profits and gains, those realised profits and gains will be considered to be the profits and gains of the first entity to the extent of the interest held. [Schedule #, paragraph @FAF10(4)(b)]

1.26 This provision applies to both direct and indirect interests and acts as a look-through mechanism that operates irrespective of the number of entities that may be interposed between the first entity and the entity that has realised profits and gains. The rule is designed to ensure that the rules cannot be circumvented by arrangements through which profits and gains are retained within a chain of entities.

Example 1.2

An offshore investment fund has no realised profits or gains for an income year but wholly owns a subsidiary fund. The subsidiary fund makes \$100.00 in realised profits and gains from its investments during an income year and retains the whole amount rather than distributing it back to the offshore investment fund. Under this provision, the realised profits and gains of the subsidiary are considered to be profits and gains of the offshore investment fund and

as such the offshore investment fund is regarded as having profits and gains of \$100.00 for the relevant income year.

Example 1.3

The subsidiary fund in the above example also holds a 50 per cent interest in a third entity which made realised profits and gains of \$100.00 in the same income year. The third entity did not distribute those profits and gains to the subsidiary fund. In such circumstances, both the \$100.00 of realised profits and gains of the subsidiary and \$50.00 of the realised profits and gains of the third entity (being half of its realised profits and gains apportioned on the basis of the subsidiary's interest) are considered to be profits and gains of the offshore investment fund. Under this provision the offshore investment fund would therefore be regarded as having profits and gains of \$150.00 for the relevant income year.

What is a Tax Deferral Benefit?

1.27 An investor's tax deferral benefit for an income year is the difference between the investor's share of the realised profits and gains in the foreign accumulation fund (including realised profits and gains of subsidiary entities) and the actual distributions of those profits and gains received by the investor during the course of an income year. *[Schedule #, section @FAF40]*

Example 1.4

Sam holds a 10 per cent interest in an offshore investment fund. During an income year, the investment fund makes a total of \$100.00 in profits and gains arising from its own realised profits and gains and those of its subsidiaries. The offshore investment fund distributes \$10.00 to its investors and is therefore considered a foreign accumulation fund as this is not substantially all of the profits and gains of the fund. Sam receives \$1.00 through this distribution and would therefore be considered to have a tax deferral benefit of \$9.00 under this provision (being the difference between the \$10.00 to which Sam was entitled and the \$1.00 he received).

What matters must be considered in determining an investor's purpose?

1.28 The test of purpose under proposed FAF 45 is a test of objective purpose. The question posed by the rule is whether, objectively, it would be concluded that a person who entered into the investment, did so for the purpose of obtaining a tax deferral benefit including a permanent deferral benefit.

1.29 When considering the dominant purpose of the investor, regard must be had to the distribution pattern of the fund. This consideration extends to instances where the fund is a non-distributing fund. In considering the distribution pattern of the fund, any statement from the fund (such as information contained in a prospectus) should be taken into account where such statements details the foreign entity's approach or policy in making income or capital distributions. Where the fund is an established fund (and not newly created in the relevant income year) regard must also be had to the actual pattern of distributions in previous periods. [Schedule #, subparagraphs @FAF45(1)(a)(i)&(ii)].

1.30 Consideration of the distribution pattern will provide an indication of whether the investor could reasonably have known whether the fund was likely to distribute its realised profits and gains.

1.31 Regard must also be given to potential differences in the tax outcomes for amounts held in the fund. When comparing differences in tax outcomes, it is necessary to consider whether the tax paid on the income in the foreign fund broadly reflects the tax that would have been paid had the fund's profits and gains been distributed and the relevant amount included in the investor's assessable income. [Schedule #, paragraph @FAF45(1)(b)]

1.32 Regard might be had, for instance, to how Australia and the foreign jurisdiction assess the tax base for the periods of assessment. Where the tax paid in the foreign jurisdiction on the tax deferral benefit in an income year is equal to, say, [90] per cent of the tax that would have been paid by the investor had the benefit been distributed in Australia, such circumstances might indicate that the investor did not enter into the arrangement for the dominant purpose of avoiding or deferring tax.

1.33 Treasury is currently considering whether regard should be had to the different rates of tax imposed between Australia and the foreign jurisdiction. Such a requirement might be formulated along the following lines:

1.34 In comparing rates of tax the regard must be had to the tax rate pertaining to the income in the fund compared to the highest rate that the investor could pay in Australia. Generally the rates will be considered comparable if the rate applying to the foreign fund is equal to [90] per cent or more of the rate that the Australian entity could attract.

Example 1.5

An Australian company invests in a foreign accumulation fund. The foreign accumulation fund is required to pay tax on its income at a rate of 30 per cent. Had the foreign accumulation fund made a distribution

to the Australian company then it could be expected that the Australian company would have paid tax at the Australian company tax rate of 30 per cent. In this case a comparison of tax rates would not, of itself, support the conclusion that the investor had a dominant purpose of obtaining a tax deferral benefit.

Example 1.6

An individual Australian resident invests in a foreign accumulation fund in a tax haven. The rate of tax applicable to income in the foreign fund is 0 per cent. The investor is a low income individual with an average tax rate of 10 per cent. In determining whether the tax rates are comparable the Commissioner would compare the 0 per cent rate with 48.5 per cent being the highest rate an individual could pay in Australia rather than the average tax rate of the investor.

1.35 The following factors are also relevant and relate to a scheme set out in the general anti-avoidance provision in Part IVA of the ITAA 1936 paragraph 177D(b). This paragraph sets out the range of matters to which regard is to be had in coming to a conclusion as to whether a relevant person had the degree of taxation purpose that must exist if Part IVA applies. These are:

- the manner in which the scheme was entered into or carried out;
- its form and substance;
- the particular time at which the scheme was entered into and the period during which it was carried out;
- the tax result that, but for Part IVA, would be achieved by the scheme;
- any change resulting from the scheme in the financial position of the taxpayer;
- any such change in the financial position of a person with whom the taxpayer has business, family or other connections;
- any other consequence of the scheme for the taxpayer or a connected person;
- the nature of any connections between the taxpayer and a connected person whose financial position changes as a result of the scheme.

[Schedule #, subsection @FAF45(c)]

1.36 Any other factors that may be relevant should also be considered. [Schedule #, subsection @FAF45(d)]

Commissioner may make a determination

1.37 Where this anti-avoidance rule applies (in respect of FAF 40 and FAF 45), the Commissioner may make a determination that the whole or part of the tax deferral benefit identified in FAF 40 is included in the investor's assessable income for the relevant income year. [Schedule #, subsection @FAF50(1)]

1.38 Any such determination made by the Commissioner must be in writing. [Schedule #, section @FAF50]

1.39 In considering whether to make a determination in relation to the whole or any part of the tax deferral benefit the Commissioner must have regard to the following two factors. The first is the extent to which the profits of the fund are realised, including those referred to in FAF10(4). [Schedule #, paragraph @FAF 50(2)(a)].

1.40 The second factor that the Commissioner must have regard to is the number of days in the income year the investor was an Australian resident [Schedule #, paragraph @FAF 50(2)(b)]. As only residents are taxable on their foreign source income, the Commissioner will have regard to the number of days in the relevant income year that the investor was an Australian resident in determining the proportion of any tax deferral benefit that should be assessed in the income year.

1.41 The Commissioner may take any other factors he considers relevant into account in considering whether to make a determination in relation to the whole or part of an investor's tax deferral benefit. [Schedule #, paragraph @FAF 50(2)(c)]

Review

1.42 FAF 60 will enable the machinery provisions of Part IVC of the *Taxation Administration Act 1953* concerning the review of assessments and appeals against decisions of the Commissioner to apply in relation to determinations made by the Commissioner under FAF 50. A taxpayer dissatisfied with a determination will have the same rights of review and appeal as if the determination were an assessment; indeed the determination may form part of the assessment. [Schedule #, paragraph @FAF 60]

1.43 Where, for example, income is attributed via a determination made by the Commissioner and circumstances change such that it

becomes apparent that the investor will never receive a return on the investment the provisions of Part IVC will be capable of providing relief.

Double Tax

1.44 FAF 65 will provide that distributions of profits or gains will be non-assessable and non-exempt to the extent that they have been included in the assessable income of the taxpayer in a previous income year as a result of the Commissioner making a determination under FAF 50. *[Schedule #, section @FAF65].*

Application and transitional provisions

1.45 Division FAF will apply to profits and gains arising on or after [XXX].

1.46 The Commissioner need not assume that arrangements in existence prior to the commencement of this Bill lacked the requisite purpose of obtaining a tax deferral benefit.

Consequential amendments

1.47 *[Click here and insert text]*