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Key issues in structuring outbound investments

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1 Introduction

1.1 Overview

Australia's infrastructure deficit, stable legal system and AAA credit rating has led to a focus on Australian infrastructure investment opportunities. This has naturally led to increasing competition for Australian assets and eye-watering multiples. In turn, this has encouraged Australian infrastructure investors to consider the merits of seeking higher returns from offshore infrastructure assets. The question is whether the Australian tax system adequately facilitates investment in offshore infrastructure.

This paper seeks to:

- contextualise Australia's tax regime relevant to offshore infrastructure investments;
- provide an overview of the key aspects of Australia's tax regime that are relevant to investing in offshore infrastructure; and
- summarise the key decisions for choosing an Australian aggregation vehicle for outbound infrastructure investments.

The presentation of this paper will involve a demonstration of these principles in practice, as well a description of practical issues that may be faced by Australian investors seeking exposure to foreign infrastructure assets.

All legislative references are to the *Income Tax Assessment Act 1997* (Cth) unless otherwise stated.

1.2 Not neutrality

Two fundamental tax principles, broadly adopted across the globe, are that:

- resident entities should be subject to tax on income and capital gains from sources inside and outside their jurisdiction of residence; and
- entities that are not resident in a jurisdiction should only be subject to tax in that jurisdiction on income and capital gains from sources in that jurisdiction.

Australia departs from these principles through various legislated regimes, including those discussed in this paper, for a number of purposes, including the occasional pursuit of efficiency.

Certain efficiency benchmarks have been identified for the taxation of cross-border investments. The benchmarks focus on achieving a non-distorting (neutral) outcome for particular aspects of cross-

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border investments and savings, with a view to improving the efficiency of the national or global economy.[1]

Capital export neutrality is achieved by a jurisdiction where an investor faces the same tax burden regardless of where he or she invests. For an Australian investor, capital export neutrality would mean that an Australian investor faces the same tax rate regardless of whether the investment is made in Australia, a comparable taxing jurisdiction (e.g. UK) or a non-taxing jurisdiction (e.g. Bermuda). This principle presumes that the greatest welfare in a jurisdiction is achieved by permitting an investor from that jurisdiction to efficiently allocate capital to whichever investment produces the highest pre-tax returns.

Capital import neutrality requires that all investments in a given country pay the same marginal rate of tax regardless of the residence of the investor. For example, foreign investors into Australian should pay the same tax rate as domestic investors.

Australia does not pursue, as a blanket policy, capital export neutrality or capital import neutrality. Instead, we have a mismatch of taxing regimes applicable to different entities, different investments and different investors. Critically, capital export neutrality can only be achieved through careful structuring of offshore investments, and in many cases cannot be achieved at all.

Instead, the domestic tax system tends to incentivise Australian infrastructure investors to invest in Australian assets rather than offshore assets. It does not necessarily mean that Australian infrastructure investors in offshore assets are disadvantaged as compared to foreign investors in those assets, but it is often the case.

1.3 Individuals investing

Infrastructure investments are generally intended to provide stable and constant cash flows (i.e. distributions) rather than the accumulation and reinvestment of returns. This means that the incidence of tax should be considered at all levels, from the underlying asset investment level all the way to the ultimate investors, in order to properly understand the Australian tax landscape. For example, a concession that applies only to a company but cannot be distributed to a shareholder in that company must be seen as a limited advantage for the ultimate investor, the shareholder.

In this regard, there are only truly two classes of investors in Australia:

- individuals; and
- superannuation funds.

Ultimately, all funds must be distributed to one of these two classes of investors (assuming limited accumulation and reinvestment) and for this reason the incidence of tax up to and including these investors is considered in this paper.

[1] The Use of Neutralities in International Tax Policy David A. Weisbach The University of Chicago, National Tax Journal, 2015.

Consideration is also given to foreign investors that may, through luck or misfortune, invest in offshore assets through an Australian vehicle.

1.4 Imputed imputation

Australia stands proudly as one of only a handful of countries with a full dividend imputation system, including (at least for now) refundable imputation credits.[2] This creates an obvious incentive to pay Australian tax in preference to foreign tax. In the context of the ultimate investors identified above, this means that:

- anything that shifts the incidence of taxation from overseas to Australia is, prima facie, beneficial for Australian investors; and
- anything that provides the ultimate Australian investors with a credit against their Australian tax liabilities for foreign tax paid should also be beneficial (but not as beneficial as refundable franking credits).

However, other jurisdiction without imputation systems are not blind to the cost of double-taxation that arises on distributions to ultimate investors. Nearly all OECD countries provide alternative forms of relief, either through a credit system (where the credit does not depend on the underlying corporate tax paid) or a reduced personal tax rate for dividends.[3]

This is relevant for determining whether Australian investors are ultimately disadvantaged, as compared to foreign investors, when investing in offshore infrastructure assets.

[2] Part 3-6 of the 1997 Act.

[3] Australian Government, International Comparison of Australia's Taxes (2006).

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2 Relevant regimes

2.1 Overview

Features of Australia's international tax regime that commonly apply to outbound infrastructure investments are:

General regimes

- Part X of the 1936 Act – Attribution of Income in respect of controlled foreign companies;
- Division 770 – Foreign income tax offsets;
- Division 820 – Thin capitalisation; and
- Division 830 – Foreign hybrids.

Corporate tax entity and company regimes

- Subdivision 768-A – Returns on foreign investment;
- Section 23AH of the 1936 Act – Foreign branch income of Australian companies not assessable;
- Subdivision 768-G - Reduction in capital gains and losses arising from CGT events in relation to certain voting interests in active foreign companies; and
- Division 802 – Conduit foreign income.

It is beyond the scope of this paper to provide a detailed explanation of each of these regimes, or the currently proposed anti-hybrid provisions. Instead, the author seeks to highlight the key aspects of each of these regimes as they apply to outbound infrastructure investments.

2.2 Part X of the 1936 Act – Attribution of Income in respect of controlled foreign companies

2.2.1 What?

An Australian resident attributable taxpayer must include in its assessable income its attributable interest of a controlled foreign company's (**CFC**) attributable income.[4]

[4] Section 456 of the 1936 Act.

2.2.2 Why?

The CFC regime preserves capital export neutrality by limiting the extent to which Australian residents can defer taxation through operations in low-tax jurisdictions.

2.2.3 But?

a. Relevance

Infrastructure investments create greater scope for the CFC rules to apply, and to cause material Australian tax exposures, than is ordinarily the case. This is because of:

- expansive views on “associate inclusive control interests”;
- ATO practice regarding “control” in other contexts;
- broad concepts of passive income;
- “eligible designated concession income” classification of foreign investment structures; and
- the overlay of Australia’s complex regime for taxing infrastructure investments.

b. Associate-inclusive control interests

A foreign resident company will be a CFC if:[5]

a. a group of 5 or fewer Australian entities with associate-inclusive control interests in the company is not less than 50% (strict control test);

b. a single Australian entity has an associate-inclusive control interest in the company of not less than 40% and the company is not controlled by another party (**assumed controller test**); or

c. the company is controlled by 5 or fewer Australian entities, either alone or with associates (**de facto control test**).

Regarding tests a. and b.:

- “associate-inclusive control interest in a company” includes direct control interests held by an entity in the company;[6]
- direct control interest includes the percentage of the total paid-up capital of the company that an entity is entitled to acquire at the time;[7] and

[5] Section 340 of the 1936 Act.
[6] Section 349 of the 1936 Act.
[7] Subsection 350(1) of the 1936 Act.

- "entitled to acquire" is defined to include anything that the "entity is absolutely or contingently entitled to acquire, whether because of any constituent document of a company, the exercise of any right or option or for any other reason."[8]

The broad language used to define "entitled to acquire" gives the provision scope to apply to standard investors' agreements, particularly:

- pre-emptive rights on sale; and
- call options on default.

The current ATO view of these arrangements is: [9]

- pre-emptive rights should only give rise to an entitlement to acquire the shares once the pre-emptive trigger has occurred (e.g. notification of intended sale); and
- a call option will give rise to an entitlement to acquire at the commencement of the option agreement, notwithstanding that the option's exercise may be contingent on external factors.

Further, in the Commissioner's view:[10]

> "Where the option entitlement process consists of several steps, then the existence of either an absolute or contingent entitlement will be determined on a 'look-through' basis, for example an option to acquire an option to acquire shares."

An option right embedded in the investors' agreement that arises on the event of default would appear to be caught by the Commissioner's look-through approach.

c. ATO practice regarding control

It hardly bears repeating that the Commissioner has taken a broad view of the term "control," particularly in the context of Division 6C of the 1936 Act, and it is therefore necessary to be alert to these arguments and understand the differences, if any, that arise under the CFC provisions. Otherwise, a single Australian investment of 20% in a foreign entity may cause that entity to be a CFC where the Australian investor has standard veto rights under an investors' agreement.

Relevantly:

- the de facto control test is clearly intended to apply to ownership interests of less than 40%, otherwise it would be rendered redundant by the strict control test and the assumed controller test;
- Division 6C of the 1936 Act uses precise language (specifically, "controlled, or was able to control, directly or indirectly, the affairs or operations of another person in respect of

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[8] Section 322 of the 1936 Act.
[9] Taxation Ruling TR 2002/3.
[10] Taxation Ruling TR 2002/3 paragraph 29.

the carrying on by that other person of a trading business") whereas the de facto control test uses a general statement ("is controlled by");

- the ATO places heavy emphasis on the ordinary meaning of "control" in concluding that the veto rights and other aspects of negative control can constitute "control" for the purposes of Division 6C of the 1936 Act; and

- the Commissioner has contemplated a situation where a taxpayer has de facto control despite not having any rights to the paid-up share capital, voting rights or distributions of the CFC.[11]

Further, the repeal of the foreign accumulation fund rules with effect from 2010-2011 means that there is a gap in Australia's foreign accruals taxation system, and it would not be a stretch for that gap to be plugged through a broad interpretation of "controlled by" for the purposes of the de facto control test.

For completeness, there was a proposal to re-introduce foreign accumulation fund rules that would seek to indirectly tax the foreign income of a non-controlled foreign subsidiary company. These were announced by the Hon. Bill Shorten MP in his previous role as Assistant Treasurer, but have not been enacted and do not look like being enacted anytime soon.[12]

d. Broad concepts of passive income

For CFCs in unlisted countries, income will only be attributable income if is passive income, tainted sales income or tainted services income.[13]

For infrastructure investments:

- passive income includes "tainted rental income";[14]

- tainted rental income includes income derived by way of rent in respect of a lease of land unless a substantial part of the income is attributable to the provision of labour-intensive property management services in connection with the land, being services provided by directors or employees of the company;[15] and

- "lease" includes "sublease."[16]

Therefore, any amount of rent being earned from leasing the infrastructure (in part or in whole) may be considered passive income that forms part of the attributable income of the CFC. This will ultimately depend on the form of the arrangements entered into with respect to the infrastructure. Indeed, with more jurisdictions seeking to establish real estate investment trust (**REIT**) regimes it may be that leasing of infrastructure becomes more common.

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[11] ATO ID 2008/5.

[12] Assistant Treasurer, the Hon. Bill Shorten MP, *Government Moves to Attract More Regional Headquarters for Foreign Business* (17 February 2011).

[13] Section 419 of the 1936 Act.

[14] Section 446 of the 1936 Act.

[15] Section 317 of the 1936 Act.

[16] Section 317 of the 1936 Act.

Further, there is a technical question of whether the arrangement needs to be lease (or sublease) according to Australian law, or an equivalent arrangement under the foreign law applicable to the CFC.

Finally:

- passive income includes "tainted interest income";[17]
- tainted interest income includes "interest or a payment in the nature of interest";[18]
- there is a technical question of whether a notional loan, with notional interest, that arises on the application of Division 250 to a CFC in calculating its attributable income (as a resident[19]) gives rise to a payment in the nature of interest (i.e. whether passive income must be understood by first applying the basic assumptions);[20] and
- more worryingly, payments for the use of the asset, where the asset transfers to the payee, may include an amount in the nature of interest even absent the application of Division 240 or Division 250.[21]

e. Eligible designated concession income classification of foreign investment structures

CFCs in listed countries will only have attributable income if the CFC has eligible designated concession income.[22]

Relevantly, eligible designated concession income includes:[23]

- **Canada:** passive income of a company that operates as an investment corporation or a mutual fund corporation under Canadian law and is not taxed in Canada at the normal company tax rate;
- **France:** passive income of a company that operates in France as a société d'investissement à capital variable (**SICAV**) under French law and is not subject to tax in France;
- **Germany:** ordinary capital gains in respect of shares in a Germany company that is not taxed at the normal German company tax rate;
- **United Kingdom:** passive income of an entity that operates in the United Kingdom as an open-ended investment company that is not taxed in the United Kingdom at the normal company tax rate; and

[17] Section 446 of the 1936 Act.
[18] Section 317 of the 1936 Act.
[19] Section 383 of the 1936 Act.
[20] Section 383 of the 1936 Act.
[21] *Federal Court in Federal Commissioner of Taxation v. Ballarat & Western Victoria T.V. Limited* 78 ATC 4630.
[22] Section 385 of the 1936 Act.
[23] Regulation 17 of the *Income Tax Assessment (1936 Act) Regulation 2015* (Cth).

- **United States:** passive income of an entity that operates as a regulated investment company that is not taxed in the United States at the normal company tax rates;

Therefore, considerable care needs to be exercised when invest in or through entities in listed jurisdictions, including entities designed to attract domestic concessions on exit.

f. Overlay of Australia's complex regime for taxing infrastructure investments

Certain provisions of the 1936 Act and 1997 Act are "turned off" for the purposes of calculating the attributable income of a CFC. Helpfully, the concessions in Subdivisions 768-A and 768-G (discussed below) are not turned off.

However, key provisions relating to infrastructure are also not turned off. Specifically, the following provisions would need to be considered when calculating the attributable income of a CFC:

- Division 57;
- Division 58;
- Division 240; and
- Division 250.

The application of any one of these provisions could cause a significant discrepancy between the attributable income of the CFC and the actual taxable income of the CFC for the purposes of calculating its foreign tax liability.

2.3 Division 770 – Foreign income tax offsets

2.3.1 What?

Foreign income derived by an Australian resident that is subject to foreign tax, and not exempt from tax, may benefit from a foreign income tax offset (**FITO**) to alleviate double taxation.[24] The FITO is, broadly speaking, capped at the amount of tax otherwise payable in Australia on foreign income in an income year, and any excess is non-refundable and cannot be carried forward.

2.3.2 Why?

This feature reflects the CEN principle and operates to prevent double taxation on the income. Since double taxation would undoubtedly be a deterrent to genuine offshore business expansions of Australian entities, the measure can be seen as promoting (or not dissuading) offshore investment by Australian residents.

[24] Division 770.

2.3.3 But?

a. Foreign income taxes "paid"

A taxpayer's entitlement to a FITO is dependent on the taxpayer having paid foreign income tax in respect of an amount that is included in their assessable income for the year. This includes amounts actually paid by the taxpayer and amounts deemed to have been paid by the taxpayer.

Specifically, a taxpayer is deemed to have paid foreign income tax if that tax "has been paid …by another entity under an arrangement with [the taxpayer] or under the law relating to the foreign income tax."[25] This means that an Australian resident can claim a FITO where foreign income taxes are paid:

- on behalf of the taxpayer under a withholding tax regime;
- by a trust where the taxpayer is a beneficiary; and
- by a partnership where the taxpayer is a partner.

This means that, among other things, FITOs can be claimed by Australian resident investors in:

- both Australian and foreign trusts, where foreign income taxes (including withholding) are paid by the trust; and
- foreign partnerships (including foreign hybrids), where the foreign income taxes have been paid by the partnership.[26]

However, underlying taxes paid by a foreign company will not give rise to a FITO for an Australian resident investor in that company because the tax is paid by the foreign company in respect of the assessable income of that foreign company (and not the Australian taxpayer) unless there is attributable income of a CFC.

b. An amount included in assessable income

Generally speaking, the FITO will only be available if an amount, in respect of which the foreign income tax has been paid, is included in the taxpayer's assessable income.27

As discussed briefly below, the foreign income of a company may be non-assessable, non-exempt income where it is carrying on business at or through a permanent establishment in that country.28 In such a case, no FITOs would be available.

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[25] Section 770-130.
[26] ATO ID 2010/94.
[27] Section 770-10(1).
[28] Section 23AH of the 1936 Act.

The same applies to a company with interposed trusts or partnerships between the company and the permanent establishment.[29]

c. Discount capital gains

Foreign income tax counts towards the FITO if the taxpayer “paid it in respect of an amount that is all or part of an amount included in [the taxpayer’s] assessable income for the year.”[30] The wording of the legislation does not include the proviso “to the extent that” or otherwise mandate an apportionment approach.

Despite this, the Commissioner has concluded the following in respect of discounted capital gains:[31]

> “…where a resident of Australia pays foreign income tax on the whole of a foreign capital gain but only 50% of the gain is included in the assessable income of the taxpayer in Australia because the taxpayer is entitled to the CGT discount, only 50% of the foreign income tax counts towards the foreign income tax offset under subsection 770-10(1) of the ITAA 1997.”

It is recognised by the Commissioner that this conclusion contradicts Example 1.20 in the Explanatory Memorandum to the Tax Laws Amendment (2007 Measures No. 4) Bill 2007.

2.4 Division 820 – Thin capitalisation

2.4.1 What?

Division 820 limits the amounts of debt deductions that can be claimed against Australian income for entities or groups with both Australian and foreign assets. Broadly speaking, debt deductions will be denied where the interest-bearing debt of an entity exceeds the higher of certain ascertainable amounts.

2.4.2 Why?

The regime is specifically designed to “ensure that multinational entities do not allocate an excessive amount of debt to their Australian operations.”[32] This is necessary because the “difference in the income tax treatment of debt compared to equity funding provides an incentive to finance investments using debt rather than equity.” [33] The measure is aimed, in a mild way, at preserving capital import neutrality in Australia by subjecting foreign investors to the similar Australian tax rate as domestic investors.

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[29] Section 23AH(10) of the 1936 Act.
[30] Section 770-10.
[31] ATO ID 2010/175.
[32] Explanatory Memorandum to *New Business Tax System (Thin Capitalisation) Act 2001* (Cth).
[33] Explanatory Memorandum to *New Business Tax System (Thin Capitalisation) Act 2001* (Cth).

2.4.3 But?

A taxpayer can, subject to the thin capitalisation rules, claim debt deductions incurred in investing foreign companies that produce non-assessable, non-exempt income under section 768-5.[34] This reduces the need for taxpayers to trace funds borrowed to the underlying investments.

However, the quid pro quo is that the taxpayer cannot include the value of “controlled foreign entity” when determining its maximum allowable debt under Division 820.[35] Curiously, this applies to all entities, including trusts, and not just companies that benefit from section 25-90’s application to equity returns on foreign investments.

2.5 Division 830 - Foreign hybrids

2.5.1 What?

Certain foreign limited partnership that would otherwise be taxed as a corporate limited partnership under Division 5A of Part III of the 1936 Act may instead be treated as partnerships subject to Division 5 of Part III of 1936 Act.[36]

Similarly, specific limited liability companies foreign hybrid companies will be given partnership treatment for the purposes of the income tax law.

2.5.2 Why?

The rules were introduced to provide certainty and remove unintended consequences for taxpayers that resulted from the tax treatment of investments in foreign hybrids under the CFC regime, where they would be considered companies (i.e. taxpayers) despite not being tax paying entities.

2.5.3 But?

a. Limited partnerships, limited application

The most notable feature of the foreign hybrid regime is its limited application.

A limited partnership can be a foreign hybrid limited partnership where:[37]

a. it is formed in a foreign country;

b. foreign income tax is imposed under the law of the foreign country on the partners, not the limited partnership, in respect of the income or profits of the partnership;

c. it is not a resident of that country that imposes tax on the partnership;

d. it is not an Australian resident (disregarding section 94D(5) of the 1936 Act); and

[34] Section 25-90.
[35] Sections 820-90, 820-95, 820-100 and 820-105.
[36] Division 830.
[37] Section 830-10.

e. it is a CFC of an attributable taxpayer with an attribution percentage greater than nil, or the partner makes an irrevocable election.

Examples of foreign limited partnerships that can satisfy these criteria include:

- United States limited partnership (**USLP**);[38]
- German Kommanditgesellschaft (**KG**); [39]
- United Kingdom limited partnership (**UKLP**).[40]

However, a strict interpretation of condition b. by the Commissioner has limited the scope of these provisions by requiring that the jurisdiction of the partnership actually impose income tax on the partners. This means that limited partnerships in jurisdictions commonly used internationally for establishing limited partnerships, such as Bermuda and the Cayman Island, cannot meet the foreign hybrid limited partnership criteria.[41]

Further, the hurdle requirement that the entity be a "limited partnership" means that it must not be a body corporate. This means that certain entities that would, on face value, appear to be within the scope of the provisions cannot, in fact, qualify (for example, a United Kingdom Limited Liability Partnership).[42]

b. Limited companies, limited application

Foreign hybrid companies are even rarer, since the provisions required that it be a company:

- formed in the United States, not a resident of a country and treated as a partnership or an eligible entity that is disregarded as an entity separate from its owner under United States tax law;[43] or
- formed in a foreign country, not a resident of a country, treated as a partnership under the foreign country's tax law, and be specifically mentioned in the regulations.

Currently, only a partnership formed under the *Limited Liability Partnerships Act 2000* (UK) satisfies the second limb.[44] However, given that a UK Limited Liability Partnership is apparently a company for domestic tax purposes, consideration must be given to whether a captive UK Limited Liability Partnership may be a company that is a resident of Australia as a consequence of effective management being in Australia, and therefore unable to qualify as a foreign hybrid company.[45]

c. Trust in confusion

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[38] ATO ID 2010/94.
[39] ATO ID 2007/47.
[40] ATO ID 2006/334.
[41] TD 2009/2, ATO ID 2006/149.
[42] ATO ID 2006/332.
[43] Section 830-15(2).
[44] Regulation 830-15.01 Income Tax Assessment Regulations 1997 (Cth).
[45] ATO ID 2006/331.

A pertinent consideration for a trust investing in a foreign hybrid company or a foreign hybrid partnership is whether the investment amounts to carrying on a trading business. For example, will an Australian resident unit trust be carrying on a trading business (for the purposes of Division 6C of the 1936 Act) if it holds a portfolio interest in a:

- foreign hybrid company that carries on a trading business; or
- foreign hybrid limited partnership that carries on a trading business?

Since a foreign hybrid company is treated as if it were a partnership[46], with the shareholders being partners in the partnership,[47] it would be reasonable to conclude that the Australian tax law should apply as if the Australian resident unit trust is actually carrying on the activities of the foreign hybrid company as a partner in a partnership.

However, the Commissioner takes a different approach. In the Commissioner's view, being brought within the term "partnership" does not "imbue the arrangement with all the characteristics of a general law partnership."[48] This position is not entirely consistent with the Explanatory Memorandum to the foreign hybrid rules (which, like the legislation, emphasises that foreign hybrid companies "will be treated as partnerships"[49] and shareholders will "be treated as partners"[50]).

Nevertheless, the Commissioner does cite a wealth of case law that, to a greater or lesser extent, supports the proposition that deemed treatment is generally not so extensive for the deeming to replace all facts for all purposes.[51]

In the case of a foreign hybrid limited partnership, however, the opposite conclusion would need to be reached. The Australian resident unit trust will, in fact and at law, be a partner in a partnership that is carrying on a trading business.

2.6 Division 768-A – Returns on foreign investment

2.6.1 What?

Subdivision 768-A provides exempts non-portfolio foreign returns on equity to Australian resident companies from Australian income tax by treating those returns as non-assessable, non-exempt income.

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[46] ITAA 1997 s 830-20.
[47] ITAA 1997 s 830-25.
[48] ATO ID 2011/35.
[49] Explanatory Memorandum to the *Taxation Laws Amendment Act (No. 1) 2004* (Cth), [9.39].
[50] Explanatory Memorandum to the *Taxation Laws Amendment Act (No. 1) 2004* (Cth), [9.41].
[51] For example, *AAT Case 12/95* 95 ATC 175 at 181, *Re Commissioner of Taxation v. Peter Joseph Walsh and Beatrice Joan Walsh As Trustees of Lisa Marie Walsh Trust* [1983] FCA 132.

2.6.2 Why?

Subdivision 768-A is a re-write of section 23AJ of the 1936 Act, which relevantly helped:[52]

> "…ensure that the foreign subsidiaries are able to compete on an equal footing with other businesses located in that foreign country."

In other words, the provision is designed to promote capital import neutrality by ensuring that an Australian corporate investor pays the same marginal tax rate as an entity in that jurisdiction.

2.6.3 But?

Subdivision 768-A acts as a deferral regime only. That is, it allows the accumulation and reinvestment of funds earned offshore by an Australian corporate without those funds being subject to Australian income tax. However, if those funds are distributed to Australian resident shareholders, then:

- the dividends will be treated as assessable income;[53] and
- no franking credits will be available because no Australian income tax has been paid on the earnings.

This is because the exemption only applies to foreign returns on equity received by:[54]

- companies;
- public trading trust;
- corporate unit trust;
- corporate limited partnership; or
- a trust or a partnership, but only if the beneficiary or the partner is one of the entities described above and holds the requisite interest in the foreign entity.[55]

In other words, there is no ability for the ultimate investors (being individuals or superannuation funds) to treat the foreign returns on equity as non-assessable, non-exempt income. This means that the returns to the ultimate investors may be taxed twice – once at the foreign company level, and then again when finally distributed to the ultimate investor.

Further, the exemption only applies to distributions "made by a company."[56] This means that a foreign entity must be considered a "company" under Australian income tax law (i.e. a body corporate) in order for the exemption to apply.

[52] Explanatory Memorandum to the *Tax and Superannuation Laws Amendment (2014 Measures No. 4) Act 2014* (Cth).
[53] Section 44 of the 1936 Act.
[54] Section 768-5.
[55] Section 768-5(2).
[56] Section 768-10.

2.7 Section 23AH of the 1936 Act – Foreign branch income of Australian companies not assessable

2.7.1 What?

Australia curtails its taxing rights where a resident company earns foreign source income at or through a foreign permanent establishment (**PE**). However, as with the exemption under Subdivision 768-A (discussed above) this amounts to a deferral regime only.

If the PE is in a "listed country"[57], the foreign income earned through the PE (including capital gains[58]) will generally be non-assessable, non-exempt income of the Australia resident.[59] This treatment is subject to very few exclusions, which address specific income that is concessional taxed in the foreign jurisdiction.[60]

For PEs in non-listed country, the income of the PE will only be non-assessable, non-exempt income if it is not passive income or related-party income[61] (unless the passive or related-party income is only a very small percentage of the total income of the PE[62]). Such foreign income will be subject to the FITO regime described below.

2.7.2 Why?

The driving theory behind this concession is capital import neutrality at the corporate level.

This hold true even though there is no differentiation between active and passive income for PEs in listed countries. The listed countries are listed on the basis that they have taxing regimes comparable to Australia, such that even passive income (other than specific income that is treated concessionally) should be considered to have been comparably taxed as income derived in Australia.

2.7.3 But?

The application of section 23AH turns on whether an Australian company in carrying on a business, at or through a permanent establishment of the company in a listed country or unlisted country.[63] "Permanent establishment," in this context, means either the definition in section 6(1) of the 1936 Act or under an applicable double tax agreement.

The exemption only applies to companies, including companies that have an interest in a permanent establishment through an interposed partnership or trust, rather than corporate tax entities.

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[57] Canada, France, Germany, Japan, New Zealand, United Kingdom and United States of America as set out in Schedule 9 of the Income Tax Regulations 1936 (Cth).

[58] Section 23AH(4) of the 1936 Act.

[59] Sections 23AH(2) and (5) of the 1936 Act.

[60] Section 23AH(5) of the 1936 Act and Schedule 9 of the Income Tax Regulations 1936 (Cth).

[61] Sections 23AH(2) and (7)(c) of the 1936 Act.

[62] Sections 23AH(2) and (5) of the 1936 Act.

[63] Section 23AH of the 1936 Act.

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The section 6(1) definition is drafted broadly as "a place at or through which the person carries on any business," subject to certain exclusions. In a different context, the Commissioner has issued a draft ruling that:[64]

> "…where a limited or NL company is established and maintained to make a profit for its shareholders, and invests its assets in gainful activities that have both a purpose and prospect of profit, it is likely to be carrying on a business in a general sense…"

Where the company holds an interest in a foreign limited partnership that is a general law partnership, and that limited partnership holds shares in a company, it will be necessary to understand any activities undertaken by the foreign partnership (including potentially by the general partner) to determine whether there is a "place" through which the business of investing in shares is carried on.[65] This may affect the deductibility of any debt deductions incurred in Australia in relation to the investment.[66]

2.8 Subdivision 768-G - Reduction in capital gains and losses arising from CGT events in relation to certain voting interests in active foreign companies

2.8.1 What?

Subdivision 768-G provides a reduction in the capital gain (or capital loss) made by an Australian company where:[67]

- a CGT event happens to the shares in a foreign company; and
- the company holds a direct voting percentage of 10% or more in the foreign company for a certain period before the CGT event happens.

The amount of the reduction is, broadly, the percentage of the assets of the foreign company that are used in an active business.

2.8.2 Why?

The measure is not designed to exempt Australians from Australian tax on the disposal of foreign investments. Rather, it is a deferral regime intended to "provide Australian companies (and controlled foreign companies) with greater flexibility in corporate restructuring decisions where other avenues of CGT relief are not available."[68]

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[64] TR 2017/D7.
[65] ATO ID 2011/35.
[66] TD 2016/6.
[67] Section 768-505.
[68] Explanatory Memorandum to the *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004* (Cth), paragraph 1.3.

It is also intended to align the Australian tax treatment of an asset disposal by a foreign company (which may produce a non-assessable, non-exempt dividend) with the treatment of a disposal of the foreign company itself.

2.8.3 But?

a. Capital gains

A key limitation is that the provision will only apply to capital gains realised on disposal of shares in a foreign company. In this regard:

- ordinary income for the purposes of s 6-5(3) is defined by s 6-5(1) to include "income according to ordinary concepts";
- the word "income" is not a term of art and that what receipts ought to be treated as income was to "be determined in accordance with the ordinary concepts and usages of mankind";[69]
- income may be derived from an isolated transaction where it arises from a business operation or commercial transaction entered into with the intention or purpose of making a profit or gain from the transaction;[70]
- a receipt from an isolated transaction may be stamped with the character of income where the profit purpose or profit making intention can be seen from the receipts arising in the ordinary course of the business, or where the receipt is an incident of the business;[71]
- a receipt may not have the character of income where it is derived outside of the ordinary scope of the business and the taxpayer did not have the purpose of making profit by the very means by which the profit was in fact made; and
- the receipt will bear the stamp of income where the taxpayer did have the purpose of making profit from the ultimate disposal of investments.[72]

Therefore, where a profitable realisation of an investment by disposal is an objective of the investment by the company from the beginning, the concession is unlikely to apply.[73]

b. Active assets – partnership

[69] *Scott v Commissioner of Taxation* (1935) 35 SR (NSW) 215 at 219.

[70] *Californian Copper Syndicate Ltd v Harris (Surveyors of Taxes)* (1904) 5 TC 159; *Federal Commissioner of Taxation v Myer Emporium Ltd* (1987) 163 CLR 199, 211; *Commissioner of Taxation v Montgomery* (1999) 198 CLR 639, [104]-[106].

[71] *London Australia Investment Co Ltd v Federal Commissioner of Taxation* (1977) 138 CLR 106, 117-8, 128, 130.

[72] *Westfield Ltd v Federal Commissioner of Taxation* (1991) 28 FCR 333, 344.

[73] *Resource Capital Fund IV LP v FCT* [2018] FCA 41.

A company's active assets do not include interests in a partnership for the purposes of calculating the active foreign business asset percentage.[74] According to the Commissioner, this means that a company that is a partner in a partnership:[75]

- cannot include the partnership's assets in the foreign company's total assets because it does not have absolute ownership of each asset;
- must include the interests in the partnership assets in the foreign company's total assets; and
- those interests are not (and cannot be) active assets.

Applying this view, the disposal of a company that only holds a foreign hybrid limited partnership cannot result in a reduction of the capital gain under these provisions.

c. Active assets – rent

An asset is not an active asset if its main use, in the course of carrying on a business, is to derive rent (unless its main use for deriving rent was only temporary.[76]

"Rent" is not defined in for these purposes. Therefore, it must take its ordinary meaning within the context it is found. A narrow interpretation would require that the amount be paid by another party for the granting of exclusive possession of land to that party.[77]

However, the risk is that either:

- the arrangement for foreign infrastructure amounts includes giving a Government entity or agency exclusive possession of the infrastructure; or
- the context in which this appears, which concerns arrangements entered into by foreign companies, means that a broader interpretation should be favoured, potentially including payments for the use of infrastructure.

2.9 Division 802 – Conduit foreign income

2.9.1 What?

The conduit foreign income (**CFI**) rules provide tax relief on certain distributions to foreign residents by Australian companies if those distributions relate to 'CFI' (in broad terms, foreign income received by a foreign resident through an Australian corporate tax entity). Generally, the measure only applies to foreign income that is sheltered from Australian tax when it is received by the Australian corporate tax entity.

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[74] Section 768-540(2)(c).
[75] TD 2008/23.
[76] Section 768-540(2)(g).
[77] *C.H. Bailey Ltd v. Memorial Enterprises Ltd* [1974] 1 All ER 1003 at 1010, *United Scientific Holdings Ltd v. Burnley Borough Council* [1977] 2 All ER 62 at 76, 86, 93, 99, *Radaich v. Smith* (1959) 101 CLR 209.

Where it is declared to be CFI, an unfranked dividend paid by an Australian company to a foreign resident is non-assessable non-exempt income and isn't subject to section 128B of the 1936 Act.[78]

2.9.2 Why?

The CFI rules are designed to encourage the establishment in Australia of regional holding companies for foreign groups and to improve Australia's attractiveness as a continuing base for its multinational companies.[79]

2.9.3 But?

A public trading trust is a "corporate tax entity" and can therefore distribute CFI.[80] The introduction of Subdivision 768-A means that a public trading trust can also receive non-assessable, non-exempt foreign equity distributions.

However, section 23AH does not apply to public trading trusts. Therefore, foreign branch income (including capital gains) of a public trading trust does not form part of the basic conduit foreign income amount (although the exemption may flow-through to corporate beneficiaries of the trust). It is only if the public trading trust is entitled to foreign tax credits on the income that it receives that it will be able to distribute the amount as conduit foreign income.[81]

Interestingly, where a FITO arises under Division 770, giving rise to an amount that can be distributed as CFI, there is no requirement for the income giving rise to the FITO to be foreign sourced.[82] This can be contrasted with the rules applicable to an Australian resident unit trust under Division 6, whereby income can only be distributed to a foreign resident without additional tax being imposed if the income has a foreign source.[83]

This is particularly relevant for interest income. The source of interest is not a legal concept but is to be determined as "a practical hard matter of fact."[84] Factors that need to be considered are:

- where the loan agreement is made;[85]
- where the money is lent, which may be more relevant for physical transfers (e.g. cheques) rather than electronic transfers;[86]
- where negotiations take place, which is unlikely to be determinative but has importance if no negotiations take place in the jurisdiction where the agreement is made.[87]

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[78] Section 802-15.
[79] Section 802-10.
[80] Section 995-1,
[81] Section 802-40.
[82] Section 802-40.
[83] Section 98 of the 1936 Act.
[84] *Nathan v FC of T* (1918) 25 CLR 183 at p 189.
[85] *Studebaker Corporation of Australasia Ltd v C of T* (NSW) (1921) 29 CLR 225.
[86] *Spotless Services Ltd v FCT* (1993) 25 ATR 344.
[87] *Thorpe Nominees Pty. Limited v FC of T* 88 ATC 4886.

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3 Puzzling pieces

The following table attempts to summarise the key decisions for choosing an Australian aggregation vehicle for outbound infrastructure investments. The proposed introduction of a corporate collective investment vehicle (**CCIV**) will increase the options available to investors but its use will be limited by the requirement that the CCIV not carry on or control a trading business.

	Company	Trust	CCIV
Restrictions			
- Ownership	No	Maybe	Yes
- Activities and investments	No	Maybe	Yes[88]
Resident investors			
- Franking credits[89]	Yes	No	No
- Foreign income tax offsets	No	Yes	Maybe
- CGT discount on disposal of underlying investments	No	Yes	Yes
Non-resident investors			
- Distribution of foreign income without Australian withholding tax	Yes, subject to CFI rules	Yes, provided that it is foreign sourced	Yes, provided that it is foreign sourced
- Foreign income tax offsets	No, but can be distributed as CFI	Maybe[90]	Unlikely[91]
- Potential Division 855 exemption for capital gain made on disposal of underlying investments	No	Yes, provided it is a fixed trust	Likely

[88] Proposed section 276-35.
[89] Assuming no franked dividends are received from Australian company subsidiaries.
[90] This may depend on the characterisation of the trust by the non-resident (e.g. whether the non-resident looks through the trust to recognise the underlying foreign tax paid).
[91] This may depend on the characterisation of the CCIV by the non-resident (e.g. whether the non-resident looks through the CCIV to recognise the underlying foreign tax paid).