Question 1

Part 1

A company is a ‘taxable unit’ for Australian tax purposes.

A company is regarded as a ‘resident’ of Australia for income tax purposes if:

i) it is incorporated in Australia;

ii) it carries on business in Australia and has its central management and control in Australia; or

iii) it carries on business in Australia and has its voting power controlled by Australian resident shareholders.

Since Gromore is a company incorporated in Australia, it will be a taxable unit. In addition, Gromore will be regarded as a resident of Australia since it is incorporated in Australia (i.e. the residency of the directors and location of meetings will not affect Australian tax). Accordingly, Gromore will be subject to tax on its worldwide income.

For completeness, it is noted that if Gromore is also a resident of Vanuatu due to tests such as central management and control, there is a risk of double taxation if Vanuatu imposes any corporation tax. This is because there is no tax treaty between Australia and Vanuatu.

The tax implications for the specific transactions are as follows:

Dividend from a wholly-owned subsidiary in the United States

In general, dividends are assessable under s44. However, there are exceptions for foreign dividends:

- The dividend should satisfy the requirement in Section 23 AJ (which was replaced by S768-6 from 16 October 2014). Since Gromore has more than 10% interest in the company, it is likely to satisfy the conditions in relation to voting rights.

- In addition, if income was attributed to Gromore from the US subsidiary under s456 (CFC), then the dividend (or part thereof) may satisfy the requirements of Section 23 AI. This is unlikely as the US is a listed country.

Accordingly, the dividend should be non-assessable, non-exempt income under S23 AJ or S23 AI (with S23 AI applying in priority to S23 AJ).

Dividend from a shareholding in Vanuatu

The dividend from the shareholding in Vanuatu should be assessable under S44.

For present purposes, it is assumed that the Vanuatu company is not a CFC and that income has not been attributed to Gromore in the past (i.e. that s23 AI does not apply).

Royalty dividend from a wholly-owned subsidiary in Thailand

The royalty dividend from the wholly-owned subsidiary in Thailand will be assessable as ordinary income.

Disposal of shared in the Thai company

It will be necessary to determine if the capital gain may be reduced under S768-6.

The conditions are:

- At least 10% direct voting interest (satisfied);
- Held for at least 12 months in the two years before sale (to be confirmed).

In addition, it will be necessary to review the assets of the company. If the assets are mostly active (more than or equal to 90%), then the gain will be disregarded. Otherwise, only a proportion of the gain will be disregarded.

Shareholding in a Hong Kong company

For present purposes, it is assumed that the Hong Kong company does not carry on business in Australia. Since it is not incorporated in Australia, it will not be a resident of Australia. Since the company is wholly owned by Gromore, it will be treated as a CFC.

It will be necessary to determine if the Hong Kong company passes the active income test. If it doesn't, the income (such as the interest income) will be attributed to Gromore under S456.

It is noted that no dividend was paid in the 2014 financial year.

Part 2

Individual resident in Australia owning 30% of shares

The income will be assessable under S44. If Gromore has paid Australian tax and franked the dividend, a franking offset (refundable) will be available.

Company resident in Australia owning 30% of shares

The income will be assessable under S44. As above, a franking offset will be available. However, the offset is non-refundable but may be converted into a loss.

Company resident in the United States owning 20% of shares

If the dividend is franked, no dividend withholding tax will be payable.

If the dividend is unfranked, no dividend withholding tax will be payable to the extent that the distribution is conduit foreign income (i.e. funded by the dividend from the US, Hong Kong, and the exempt capital gain on sale of Thai shares).

The balance of the dividend will be taxed at 5% (instead of the domestic rate of 30%) under the Australia-US DTA. For present purposes, it is assumed that the limitation of benefit article provides relief.

Individual resident in Vietnam owning 20% of shares

If the dividend is franked, no dividend withholding tax will be payable.

If the dividend is unfranked, no dividend withholding tax will be payable to the extent that the distribution is conduit foreign income (i.e. funded by the dividend from the US, Hong Kong, and the exempt capital gain on sale of Thai shares).

The balance of the dividend will be taxed at 15% (i.e. reduced rate) under the Australia-Vietnam DTA.

Question 2

Tax implications for Bears

Bears conducts ‘some business activities’ in Australia. In addition, it is centrally managed and controlled in Australia. A company that carries on business and has its central management and control in Australia is a resident of Australia.

Accordingly, Bears will be treated as a resident for tax purposes by both Australia and Thailand under their domestic laws.

The issue of dual residence will be resolved by the DTA between Australia and Thailand (i.e. where the place of effective management is located). There is insufficient information to conclude on where the place of practical management is located. So, for present purposes, it is assumed that the administrative and practical management, to give rise to effective management, is located in Australia.

So, although Thailand taxes its residents on worldwide income, under domestic law, the Australia-Thailand treaty will treat Bears as a resident of Australia. Accordingly, Australia will have the right to tax Bears’ worldwide income. However, Australia will provide relief from double taxation on income that is taxed by Thailand in accordance with the DTA. The relief is likely to be S23 AH exemption in relation to operations carried out through a permanent establishment in Thailand (e.g. manufacturing).

Thin capitalisation

There is an intercompany loan from Mini-Bears to Bears. Accordingly, it is necessary to consider the thin capitalisation implications under Div 820.

Bears will be regarded as an outward investor under Div 820.

CFC considerations

Mini-Bears is resident in Thailand only, and is a wholly-owned subsidiary of Bears.

Accordingly, Mini-Bears will be treated as a CFC under S340.

The interest income and royalty income will be regarded as ‘passive income’ for CFC purposes. This income will be attributed to Australia under the CFC rules if Mini-Bears does not pass the active income test. Mini-Bears will fail the active income test if the tainted income (interest and royalties) is 5% or more of its total turnover.

Withholding tax

Royalties are subject to 30% royalty withholding tax under domestic law. This will be reduced to 15% under the DTA.

Interest will be subject to 10% withholding tax.

The interest and royalties will not be deductible until Bears has paid the withholding tax.

Transfer pricing

Div 815-B and Article 9 of the Australia-Thailand DTA will be relevant in relation to:

- Royalty payments;
- Interest; and
- Fees for facilitating sales.

The cross-border test is satisfied. Accordingly, it is necessary to determine if the actual conditions in relation to the transactions differ from arm's length conditions.

Foreign branches

The activities of Mini-Bears staff in foreign countries may give rise to a PE risk for Bears in other countries.

Tax implications for Mini-Bears

As a foreign resident, Mini-Bears will only be taxable in relation to Australian sourced income (subject to the Australia-Thailand DTA).

Mini-Bears is a resident of Thailand and will only be subject to tax in relation to its Australian activities (other than royalties and interest dealt with through withholding taxes) if it has a permanent establishment in Australia (i.e. carrying on business through a fixed place in Australia). The ATO regards periods of six months or more as providing the relevant connections. Mini-Bears staff are in Australia for up to nine months. Accordingly, there is a risk that Mini-Bears has a permanent establishment in Australia. Accordingly, the fee received from Bears may be taxable in Australia (under Article 7 of the Australia-Thailand DTA).

Tax implications for Bill

Bill will be subject to tax on the dividend received from Bears.

Tax implications for Beryl

The dividend will be subject to 15% dividend withholding tax (unless the dividend is fully franked or partially franked).

Tax implications for the sales staff

It is assumed that the sales staff are resident in Thailand.

If the staff are in Australia for a period not exceeding 183 days, the remuneration is paid by Mini-Bears, and the amount is not deductible in computing the profits of Mini-Bears in Australia, then the sales staff will not be taxable in Australia.

Otherwise, the sales staff will be taxable on the Australian sourced income (i.e. income in relation to work undertaken in Australia).

Question 3

First, it is necessary to determine if RDS is a 'taxable unit' or a 'flow through' entity for Australian tax purposes. A company or a corporation limited partnership (CLP) will be a taxable unit. A partnership or trust will be a flow through entity in most cases.

RDS does not have the features of a trust (i.e. settlor, trustee, or beneficiary). It has a separate legal status, but no shares.

In light of a separate legal existence and a mechanism (VAM) in relation to 'ownership interest', the closest analogy to an Australian entity is a company.

So RDS should be treated as a company for Australian tax purposes.

RDS is not incorporated in Australia. Based on the absence of information, RDS should not be a resident of Australia under the other tests as well:

i) It does not carry on business in Australia and does not have its central management and control in Australia.

ii) It does not carry on business in Australia and its voting power is not controlled by Australian residents (since the VAMs don't have voting rights).

Since RDS is not a resident of Australia, it will only be subject to tax in relation to Australian sourced income or gains covered by Div 855.

The four types of income set out are not from Australian sources. Accordingly, RDS will not be subject to tax in Australia.

However, it is then necessary to determine if any of the income can be attributed to Australian investors under the anti-deferral rules.

As set out above, RDS is unlikely to be regarded as a trust. Therefore, the transferor trust rules should not apply.

A foreign company will be a CFC if any of the following conditions are satisfied:

i) Strict control test
A group of five or fewer Australian residents, who hold at least 1% on an associate-inclusive basis or are entitled to acquire 50% or more of the interest in the company. The facts indicate a 'group of individuals' owning 55% of RDS. The test requires five or fewer to hold 50% or more.

ii) Assumed controller
There is a single Australian resident whose direct and indirect interest is not less than 40% and nobody else controls the company. There is no information on any 40% or greater individual holding among the Australian shareholdings.

iii) De facto control
The company is in fact controlled by five or fewer Australian residents. There is no information to conclude on this.

So the problem that arises in the fact pattern is that if the Australian shareholding is widely held, the company will not be a CFC and the income cannot be attributed to Australian shareholders (since the repeal of the FIF rules).

Attributable taxpayers must have a direct or indirect interest of 10% or more in the CFC if the strict control test or the assumed controller test for the CFC is to be satisfied.

However, a shareholder that holds 1% will be an attributable taxpayer if the de facto control test is satisfied.

There is insufficient information to identify attributable taxpayers.

If the company is a CFC, the tax treatment of the transactions will be as follows:

1) $50,000 bank deposit interest
   Tainted interest income (passive income).

2) $40,000 royalty income
   Tainted royalty income (passive income).

3) $300,000 business income
   Even though the hotel income includes 'rental' income, this amount will be excluded from tainted rental income. In addition, it should be excluded from tainted sales and tainted service income.

4) $500,000 capital gains on sale of the hotel
   The main issue is whether the asset is a tainted asset. In general, disposal of property used to generate rental income gives rise to a tainted capital gain. However, since the property is used to generate income that is not tainted rental income, the amount should be excluded from passive income.

<u>Active income tests</u>

We assume that the company is resident in an unlisted country at all times during the year.

In addition, it is assumed that the other conditions are satisfied:

- Keeping of accounting records.

- Carrying on business through a PE in Volantis. If the hotel has been sold, it is unclear if RDS will carry on business through a PE for the entire year.

Tainted income = $70,000 / $890,000 = approximately 7%

In principle, the active income test will be failed, or the condition to apply the active income test cannot be satisfied.

So, the tainted income of $70,000 will be attributed to the attributable taxpayers in proportion to their interests under S456.

Foreign tax offset

No foreign tax offset will be available in relation to the tax on capital. This is because it is not a foreign income tax as defined in S770-15 (i.e. tax on income or tax on profits or gains).

Question 6

Part 1

In general, Australian residents are subject to tax in relation to all of their capital gains. However, if foreign taxes were payable in relation to the capital gain, then foreign tax offsets are available (subject to the limits in Div 770).

There are three main exceptions under domestic law:

i) If a company held at least 10% of a foreign company for at least 12 months in a two year period, then the capital gain may be reduced by the active asset percentage. If the active business assets (e.g. goodwill) are 90% or more of total assets, the entire gain is disregarded. If part (or the whole) of the gain is disregarded, then the foreign tax offset is reduced accordingly.

ii) If a company carries on operations through a foreign branch, then the gain may be exempt if the asset is not 'taxable Australian property' unless:

- the gain is on a 'tainted asset' from a PE in a listed country where that gain is to EDCI; or
- the gain is from a tainted asset from a PE in an unlisted country.

iii) The gain relates to depreciable assets.

A temporary resident is only subject to capital gains as a foreign resident would be taxed. As such, a temporary resident will not be subject to tax on foreign assets.

If a DTA applies to exempt an Australian resident from tax in a foreign territory, then the taxpayer must claim relief under the treaty. If the taxpayer has paid the tax, then Australia is not obliged to provide relief.

This might arise if there is no PE in the other territory (i.e. the reverse of the Thiel facts).

Part 2

A foreign resident is subject to tax in relation to taxable Australian property (Div 855). This includes:

- Taxable real property interests;
- Assets used in carrying on a business through a PE in Australia;
- 'Indirect' Australian real property interests; and
- Other items listed in Div 885.

The indirect Australian real property interest rule applies where:

- the non-resident has a 10% or greater interest in the relevant entity; and
- more than 50% of the market value of the entity or asset is attributable to Australian real property.

In principle, the outcome under domestic law and tax treaties is likely to be the same.

If an asset is not taxable Australian property, the gain will not be taxable in Australia (treaty relief is not legal).

If the gain relates to the disposal of assets in connection with a permanent establishment, the gains will be taxable under Div 855 and Australia will have taxing rights under Article 7 of the DTA. In the case of Thiel, there was no such PE.

If the gain relates to the disposal of land or shares in 'land nil' companies, the gain will be taxable under Div 855 and Australia will have taxing rights under Article 13. The indirect shareholding issue identified in Lamesa was addressed through S3A of the International Tax Agreement and treaty updates.

Resource Capital Fund dealt with Article 13. Undershaft and Virgin dealt with pre CGT treaties. The tax outcomes above will not be affected by these cases.