Draft ATO guidance for sovereign immunity and superannuation funds for foreign residents exemptions

11 December 2019

Explore more insights 365

In brief

On 4 December 2019, the Australian Taxation Office (ATO) released the draft Law Companion Ruling (LCR) 2019/D4, providing guidance on the new rules limiting concessions available to foreign superannuation funds, and the newly codified rules for sovereign immunity that were enacted earlier this year.

The draft LCR provides guidance on some of the new concepts and definitions. In particular, the draft LCR contains guidance on the "influence test" (which has relevance to both the exemption for foreign superannuation funds and sovereign immunity) and guidance on the following new terms and definitions relevant to the sovereign immunity rules:

- Sovereign entity group
- Return on public monies
- Public financial entity and public non-financial entity; and
- "Central banking activities" and "consular functions".

While the draft LCR 2019/D4 explains the Commissioner's view on a limited number of new concepts, there still remain a number of uncertainties and questions about the practical application of these rules by the ATO which may mean some entities will be required to seek private rulings from the ATO to confirm their eligibility to apply the exemptions.

Comments on the draft LCR are due by 21 February 2020.

In detail

New rules were enacted in April 2019 by the *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2019* (the Act), which introduced additional eligibility conditions to access the dividend and interest withholding tax exemption applying to superannuation funds for foreign residents and a newly codified regime for sovereign immunity. Subject to the transitional rules, both of these measures apply to income derived on or after 1 July 2019.

The eligibility conditions in the foreign superannuation fund rules impose two additional requirements which must be met by superannuation funds for foreign residents seeking to be eligible for an exemption from withholding tax - the portfolio interest test and the influence test. The new codified sovereign immunity rules also introduce a portfolio interest test and influence test. However, the new sovereign immunity rules impose these conditions on the 'sovereign entity group', rather than just the investor. The

sovereign immunity rules also introduced additional restrictions on the type of investment that could be held, the type of activities that could be conducted by the investing entity, and the sources and uses of the monies for the investment.

Draft LCR 2019/D4 explains the Commissioner's view on a number of these new concepts, which we discuss in further detail below.

The influence test (applying to the foreign superannuation fund and sovereign immunity rules)

The draft LCR 2019/D4 provides that the influence tests introduced in the foreign superannuation fund and sovereign immunity rules are 'almost identical', identifying the following two sub-tests that need to be considered by taxpayers:

1 Identity of decision-makers

The draft LCR indicates that the investor's ability to determine the identity of the decision-makers of the test entity is a question of fact, and includes the mere right to make the decision, without having to have exercised that right at any time in the past or an intent to do so in the future.

The draft LCR provides that an indirect and direct right to influence the identity of a decision-maker would be relevant to this sub-test. The examples that follow highlight that it is important to understand the rights that are available to the investor in their own right, in addition to the rights that they may have based on aggregate investment thresholds with other investors under the constituent documents of the investment entity.

In the draft LCR, the Commissioner of Taxation acknowledges that the directors of a company usually make decisions on the control and direction of a company's operations. However, the guidance provides that the class of persons that are decision-makers needs to be considered more widely, and is not restricted to directors. The class of persons should include any person who has a role in the high-level decision-making process or governance of a company and could include a member of an advisory committee or investment committee, where such a committee is required to approve the director decisions. Where this is the case, this may amount to influence.

The comments in the draft LCR make clear that the satisfaction of this requirement requires a broad analysis of the rights of the investors, potential rights of the investors under the constituent documents of the investment entity, and any direct or indirect ability to influence the control and direction of the entity. The introduction of such an important concept to underpin 'influence' more generally was given very little additional guidance, so we expect that this will be a matter for which the ATO will need to provide further guidance.

Helpfully, the ATO provides that irrevocably and unconditionally waiving your rights to determine the identity of those that make decisions by way of a legally enforceable agreement indicates that you should not be 'able' to determine those that make the decisions for the purpose of the influence test.

2 Influence through decision-makers

Relevant influence exists where a decision-maker of the investment entity would be accustomed or obliged to act, or might reasonably be expected to act, in accordance with the directions, instructions for wishes of the investor. The draft LCR provides that "*the test for these purposes, requires something more than mere coincidence, but does not require control*".

The examples used by the Commissioner demonstrates that the influence test may not be satisfied even where the investor holds less than 10 per cent of the interests in the investment entity. A specific example is provided where an investor has a representative on the Advisory Committee and the Board of the investment entity habitually complies with the recommendations of the Advisory Committee, which indicates that the investor does have the requisite level of influence to fail the influence test.

As most of these Advisory Committees are in place for investor protection, it will be important to understand how the ATO will practically consider the role of the Advisory Committee (or similar).

A similar concept of 'sufficient influence' has recently been considered by the Full Federal Court in *Commissioner of Taxation v BHP Billiton Limited* [2019] FCAFC 4. As this case is currently the subject of a High Court appeal, we can expect that the Commissioner's guidance will continue to evolve depending on the outcome of this appeal.

Sovereign entity group

The draft LCR provides guidance on determining a sovereign entity group. It is made clear that given the various structures and levels of government that exist in different countries, a uniform approach cannot be provided for determining the relevant different parts of a foreign country. The example that follows in the draft LCR provides that in a scenario where a foreign country has three levels of government - federal, state and provincial - any sovereign entity of a specific state will be a member of the sovereign entity group. However, sovereign entities of other states or provinces within the same country will not be grouped with such a sovereign entity group.

The draft LCR notes that the various structures and levels of government globally mean it is not possible to provide a uniform approach to this definition, which has the result that affected entities will need to engage further with ATO.

Return on…

Referring to paragraph 4.37 of the Explanatory Memorandum to the Bill that enacted the new rules, the draft LCR merely restates that the return on a membership interest, debt interest or non-share equity interest held by the sovereign entity in the test entity (which is regarded as non-assessable non-exempt income) will also include returns that are passed through a managed investment trust (MIT). Namely, dividends including non-share dividends, interest and revenue gains arising on disposal of interest in the test entity. It also provides that fund payments made by an MIT other than fund payments attributable to non-concessional MIT income will also be regarded as non-assessable, non-exempt income.

…public monies

The draft LCR expresses the Commissioner's view that the phrase 'public monies' means monies of a foreign government (including tax revenue, proceeds from the issue of government bonds and privatisation of assets) which is held for a public purpose and which would be accounted for in the foreign government (or part of a foreign government) equivalent to Australia's Consolidated Revenue Fund (ACRF). This seems to require each sovereign country to consider its equivalence to the Australian Consolidated Revenue Fund, and to form a uniform approach to this is challenging.

The ensuing examples in the draft LCR provide that public monies will include funds out of prior-year budget surpluses of the foreign government but will not include superannuation funds administered by a foreign government for its employees which are not equivalent to ACRF or the monies that are transferred out of ACRF equivalent fund to such superannuation funds. The examples indicate that where a sovereign entity is also a pension fund, that the entity will not be funded solely by public monies (where it is funded by a combination of employee and employer contributions). It follows that such entities would need to consider their eligibility to the exemption to withholding tax for superannuation funds for foreign residents instead of their eligibility to sovereign immunity.

However, the draft LCR also indicates that the Commissioner's initial view that public monies will not include monies obtained by foreign government by way of third-party debt funding. With limited support as to how the ATO have come to this conclusion, and in view of the comment that funds raised by way of government bonds are public money, this comment raises more questions than it answers and requires clarity from the ATO. Sovereign entities will need to determine how these apply to their circumstances.

Public financial entity and public non-financial entity

Under the new provisions, a sovereign entity is only eligible for sovereign immunity where it is neither a "public financial entity" nor a "public non-financial entity". The draft LCR provides common examples of public financial entities (including banks, deposit-taking financial corporations, captive financial institutions, pension/superannuation funds, insurance corporations and entities in the business of investment management, share trading or money lending) and provides limited additional guidance on what constitutes a public non-financial entity.

While the draft LCR provides guidance on the meaning of the term 'principal' for the purpose of ascertaining the principal activity of the sovereign entity, i.e. the entity's chief or foremost activity, the draft LCR does not currently include guidance on what it means to 'trade' in financial assets and liabilities, or to 'operate commercially' in the financial markets.

"Central banking activities" and "consular functions"

The draft LCR provides that the activities carried out by Australia's central bank provide a useful reference for the purpose of determining whether a public financial entity carries on central banking activities (which would exclude a sovereign entity from the 'public financial entity' definition). Activities such as monetary policy development, issuing national currency, acting as custodian of international reserves and providing banking services to government will be considered as "central banking activities". However, a public financial entity that carries on both central banking activities and non-central banking activities (for example, commercial banking) will not be regarded as carrying on only central banking activities.

The draft LCR also provides examples of consular functions, namely, issuing passports and travel documents, helping and assisting nationals, acting as a notary and civil registrar and in capacities of a similar kind, certain functions of an administrative nature and transmitting judicial and extrajudicial documents. Any income arising from such functions will be regarded as non-assessable, non-exempt income.

The takeaway

Foreign superannuation funds and sovereign entities should consider the draft LCR in light of their current and proposed investments, in particular noting:

- The satisfaction of the influence test requires a very broad analysis of the rights of the investors, including potential rights of the investors under the constituent documents of the investment entity, and any direct or indirect ability to influence the control and direction of the entity. It is also not limited to the composition of the Board of Directors but can extend to appointments to advisory or investment committees.
- Helpfully, the ATO provides that irrevocably and unconditionally waiving rights to determine the identity of those that make decisions by way of a legally enforceable agreement indicates that you should not be 'able' to determine those that make the decisions for the purpose of the influence test.
- Where a sovereign entity is also a pension fund, that entity will not be funded solely by public monies (where it is funded by a combination of employee and employer contributions). It follows that such entities would need to consider their eligibility to the withholding tax exemption for foreign superannuation funds for foreign residents instead of their eligibility to sovereign immunity.
- The draft LCR provides that proceeds from the issue of government bonds should be public monies, but sovereign entities funded with a mixture of government monies and external debt will not satisfy the definition of a sovereign entity for the purposes of the exemption. As both sources of funding are in effect third party debt sourced from private markets, further clarity will need to be sought on this.
- Based on the current definition of public monies, it appears that returns from existing investments, that have not been accounted for in the foreign government's ACRF will not form part of public monies. Further guidance will need to be sought to confirm whether profits - for example, in a wholly-owned SPV - must be upstreamed to the sovereign entity and re-invested to satisfy this requirement.

Ultimately this may be driven by the sovereign entity's own procedures as to whether profits from investments automatically form part of its budget/ACRF.

- The definition of 'public financial entity' in the law has been drafted widely, but very limited guidance has been provided in the draft LCR. For example, it does not currently include guidance on what it means to 'trade' in financial assets and liabilities, or to 'operate commercially' in the financial markets.

Draft LCR 2019/D4 is very welcome guidance from the ATO as it explains the Commissioner's view on a range of new concepts, but there are some issues that have not been addressed, and questions remain about the practical application of these rules and positions that have been taken by the ATO which were unexpected. If further clarification is not provided in the finalised ruling, taxpayers may be left in a similar position as they were prior to the codification of these rules and continue to be required to seek private rulings with the ATO to confirm their eligibility to apply for the exemption.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Mark O'Reilly, Sydney
+61 (2) 8266 2979
mark.oreilly@pwc.com

Christian Holle, Sydney
+61 (2) 8266 5697
christian.holle@pwc.com

Glenn O'Connell, Brisbane
+61 (0) 409 000 370
glenn.oconnell@pwc.com

Luke Bugden, Sydney
+61 (0) 412 695 670
luke.bugden@pwc.com

Nick Rogaris, Sydney
+61 (2) 8266 1155
nick.rogaris@pwc.com

Abhi Aggarwal, Brisbane
+61 (7) 3257 5193
abhi.aggarwal@pwc.com

Kirsten Arblaster, Melbourne
+61 (0) 414 491 683
kirsten.arblaster@pwc.com

Sach Pelpola, Melbourne
+61 (3) 8603 1376
sach.pelpola@pwc.com

Liam Collins, Melbourne
+61 (0) 408 573 363
liam.collins@pwc.com

WL127057726