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When is an Australian Company Exempt from the FIF Rules?

As you will be aware the Foreign Investment Fund (FIF) rules as they currently stand have been operative since 1 April 2007 and no doubt like us, you will have found that the rules are overly complex, driving up compliance costs for you and your clients. Take for instance the exemption in section EX 31 of the Income Tax Act 2007 relating to Australian companies. Wouldn't it be nice if the exemption merely stated that your interest in the company is exempt provided the company was an Australian resident company at all times you held the investment. Alas no, why make it easy! In fact ALL of the following requirements in Section EX 31 must be met for an interest in an Australian company to be exempt:

- At all times in the year when a person holds a right in a company, the company must be resident in Australia; **and**
- At all times in the year when a person holds a right in the company, the company is not treated as resident in a country other than Australia under Double Tax Agreement; **and**
- The company must have shares included in an index that is an approved index under the ASX Market Rules, made under Chapter 7 of the Corporations Act 2001 (Aust), either
 - At the beginning of an income year, if subparagraph/or
 - When the person acquires the shares, if the person does not own shares in the company earlier in the year; and
- At all times in the year when a person holds a right in the company, the company is required to maintain a franking account.

Currently we understand those companies listed on the ASX All Ordinaries index, S+P/ASX 200, S+P/ASX 50 and the S+P/ASX 200 Property Index satisfy the above market rule test. Only 477 companies out of some 1,800 listed Australian companies are included. There are a number of Australian companies listed on the ASX that are not Australian tax residents, such as News Corporation Inc. now resident in the United States.

Consequently the Inland Revenue Department has managed to make even the simplest of things overly difficult for the average taxpayer to comply with. In our view the Inland Revenue Department has a responsibility to provide taxpayers with the relevant information to enable them to determine if their interest in an Australian company is exempt.

It is our understanding that the Inland Revenue Department has undertaken to put together a list for publication of all Australian listed companies that will meet this exemption and continue to maintain that list on a regular basis. This is long overdue! If you have any queries on the application of the FIF rules or would like us to review your portfolios and assist with calculations, please do not hesitate to contact your nsaTax advisor.

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Capitalisation Rate Versus Discount Rate

The most common methods for valuing a going concern business or shares in companies operating such a business, encompass the discounting or capitalisation of some measure of economic income.

A discount rate is used to convert a monetary sum (or series of monetary sums) payable or receivable in the future into present value.

A capitalisation rate is any divisor (usually expressed as a percentage) that is used to convert income into value.

It is generally accepted that applying a discount rate to a series of future monetary sums is the theoretically correct way to value income producing investments. This method includes both income and capital appreciation (if expected). By contrast a capitalisation rate converts only a single return flow number (e.g. EBIT or EBITDA) to an indicative present value.

So what is the difference between the two rates?

If one assumes the investment has perpetual life (i.e. capital appreciation is not realised) the difference between the discount rate and the capitalisation rate is the average annually compounded percentage rate of growth (or decline) in perpetuity in the economic income. This relationship can be expressed as a simple formula:

$$c = k - g$$

Where: c = capitalisation rate

k = discount rate

g = annually compounded rate of growth in income

Accordingly, assuming perpetual life the discount rate and the capitalisation rate will only be the same in instances where no growth or a decline in economic income is expected.

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