INTERNATIONAL
BANKS AND SECURITIES
ASSOCIATION OF AUSTRALIA

29 October 2002

The International Tax Project
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

Attention: Mr Gerry Antioch

International Banks and the Review of International Taxation Arrangements

The International Banks and Securities Association of Australia (IBSA) represents the interests of investment banks and securities companies operating in Australia. Virtually all of our members have parent, subsidiary or branch operations overseas, so the Review touches on tax issues central to their business.

Recent Government measures have improved certain business tax arrangements and enhanced Australia's international competitiveness. However, there is further work to be done if we are to reach our full potential in terms of economic growth, investment and employment. In this context, we have prepared the attached submission and outline some key points below.

Permanent establishments (i.e. branches) – Chapter 4

Australia would have no hope of successfully competing for global financial services business without an effective branch tax regime. The separate entity approach to taxing licensed banks in Part IIIB of the Income Tax Assessment Act is a significant step in the right direction, but improvements to that regime are still needed. The tax rules that apply to branches of securities companies and other financial institutions are not based on the separate entity principle and, consequently, are far more complex and uncertain.

Our core recommendation is that the law be rewritten over time to permit separate entity treatment of dealings between a branch of a financial institution (bank or otherwise) and other parts of the entity – in line with recommendation 22.11(a) of the Review of Business Taxation. This approach would:

- Better reflect economic profits attributable to a branch for tax purposes;
- Improve tax neutrality between banks and non-bank financial institutions and between locally incorporated entities and branches;
- Improve tax certainty and reduce compliance costs;
- Have a neutral direct effect on tax revenue but have positive indirect benefits.

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Having accepted the separate entity principle, several other measures then follow. These are set out in recommendations 2-8 in the attachment and include:

- The (conditional) ability for financial entity branches to group for thin capitalisation and loss transfer purposes – bank branches already can do this;
- Separate entity treatment for all financial asset and liability transactions including securities, trading stock and all derivatives;
- Dividends received by a branch are clearly assessed on a net basis and excluded from the withholding tax regime;
- Branches would be entitled to franking credits in respect of dividends received from Australian resident entities.

Foreign entity taxation – Chapter 2

Chapter 2 of the consultation paper is concerned with impediments to attracting capital to Australian companies for offshore expansion. The flip side of the coin is the ability for foreign controlled entities investing into Australia to attract investment directly from Australian investors. The tax law currently discriminates against foreign controlled entities in this regard, and this should also be addressed.

To overcome this discrimination, IBSA recommends that foreign-owned entities (i.e. those with greater than 95% foreign ownership) be permitted to frank distributions to residents who hold equity interests in the entity that are issued in Australia (Recommendation 10).

This would provide a more competitive tax regime for foreign entities and improve the internal consistency of government tax policy – for example, it would complement thin capitalisation policy and have a neutral revenue impact.

In addition, our Recommendation 11 is that a foreign-owned entity within a tax consolidation group should be given the option not to group its losses with other entities in the tax consolidated group. This would help to avoid problems arising from the interaction of Australian and overseas tax regimes.

International treaties – Chapter 3

We recommend that Australia's double taxation agreement negotiations should:

- Seek the inclusion of a non-discrimination clause;
- Target the removal of interest and dividend withholding taxes;
- Be conducted on an open basis with industry consultation afforded to the fullest extent possible, within the parameters of the negotiation process.

We also include suggestions (Recommendation 12) to develop and modernise our international tax rules on an ongoing basis, so that Australia remains competitive.

Expatriate taxation – Chapter 5

The consultation paper correctly identifies the need to remove disincentives to the employment of foreigners in Australia who can lend their skills to the development of a globally competitive economy. This is particularly important in the banking and finance sector, given the international nature of the business.

The Government has made policy commitments to improve the tax treatment of foreign expatriates, notably exemption of their foreign source income from tax in Australia. The package of measures in Taxation Laws Amendment Bill (No. 4) 2002 would have represented solid progress had they passed Parliament. We welcome their recent re-

introduction under Taxation Laws Amendment Bill (No. 7) 2002 and IBSA believes that the Board should stress in its report to the Treasurer the need for these measures to be passed by Parliament at the earliest opportunity.

We do not see any virtue in the Review of Business Taxation recommendation that residents departing Australia provide security for deferred CGT liability, as it would be too difficult to administer.

We cannot see a policy rationale to require temporary residents to be subject to Australia's superannuation arrangements, especially since they do not retire in Australia and, hence, can never be a burden on the state. All temporary residents should be exempt from the arrangements.

Employee share schemes can be a significant component of performance-based remuneration in investment banking and they create complex tax issues. The OECD's suggestion that options should be taxed in the jurisdiction where they are exercised and that tax treaties should recognise and provide relief for periods of employment in other countries appears sensible.

IBSA members report their expatriate staff are often perplexed by Australian taxation arrangements and seek advice from their employers. Therefore, it would be helpful for the ATO to have a specialist cell to provide expatriate tax advice.

Taxation of Financial Arrangements

The rules for taxing financial arrangements involve great uncertainty, complexity and risk for taxpayers and the ATO. Financial institutions are most affected and it is vital for the competitiveness of Australia as a location to conduct international financial business that a comprehensive and economically sensible regime is introduced without delay. Australia is out of step with international best practice as competing tax jurisdictions already have comprehensive tax rules dealing with the taxation of financial arrangements.

We suggest in Recommendation 20 that an elective mark to market tax regime should be introduced for financial arrangements without further delay.

Concluding Comments

We greatly appreciate the opportunity to participate in the consultation process and wish the Board well in its endeavours in this regard. We look forward to the opportunity to discuss the recommendations in our submission.

Yours sincerely

Duncan Fairweather
Executive Director

INTERNATIONAL
BANKS AND SECURITIES
ASSOCIATION OF AUSTRALIA

Submission to the Board of Taxation

Review of International Taxation Arrangements

29 October 2002

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SUMMARY OF RECOMMENDATIONS

Recommendation 1: IBSA recommends that the Review of Business Taxation recommendation 22.11(a) should be implemented through a coordinated package that imposes a consistent approach to permanent establishments (PEs) across the various domestic tax laws.

Recommendation 2: IBSA recommends that financial entities that operate in Australia through PEs should be permitted to elect to group losses with any Australian entity with which they share 100% common ownership (adjusted for qualifying employee share schemes).

Recommendation 3: IBSA recommends that financial entities that operate in Australia through PEs should be permitted to elect to group for thin capitalisation purposes with any Australian entity with which they share 100% common ownership (adjusted for qualifying employee share schemes).

Recommendation 4: IBSA recommends that financial entities should be accorded separate entity treatment in the same manner as ADIs are treated under Part IIIB of the Income Tax Assessment Act, so for example, foreign exchange transactions between the PE and its parent would be recognised for tax purposes.

Recommendation 5. IBSA recommends that Part IIIB be updated to reflect industry developments by expanding the rules to include separate entity treatment in respect of all financial asset and liability transactions, including securities, trading stock and all derivatives (including equity based).

Recommendation 6: IBSA recommends that dividends received by a PE be clearly assessed on a net assessable income basis, as it is for other entities that the PEs compete with, and specifically excluded from the withholding tax regime – similar to the exemption for interest income received by a PE.

Recommendation 7: IBSA recommends that PEs should be entitled to franking credits in respect of dividends received from Australian resident entities.

Recommendation 8: IBSA recommends that the GST Act should be amended to apply separate entity treatment to PEs in respect of dealings with their parent entity.

Recommendation 9: IBSA recommends that Part IIIB should be revised to remove the LIBOR cap in s.160ZZZA(1)(c).

Recommendation 10. IBSA recommends that foreign-owned entities (ie those with greater than 95% foreign ownership) should be permitted to frank distributions to residents who hold equity interests in entities that are issued in Australia. This should apply to both foreign-owned subsidiaries and to PEs that issue equity interests to Australian shareholders.

Recommendation 11: A foreign-owned entity within a tax consolidation group should be given the option not to group its losses with other entities in the tax consolidated group.

Recommendation 12: IBSA recommends that Australia's double taxation agreement negotiations should:

- Be updated and include a non-discrimination clause;
- Target the removal of interest and dividend withholding taxes;
- Be conducted on an open basis with industry consultation afforded to the fullest extent possible, within the parameters of the negotiation process.

Recommendation 13: IBSA recommends that in order to maintain and develop our international tax rules on an ongoing basis:

- A domestic forum should be established to identify and resolve domestic law problems affecting international business and assist in the modernisation of our international tax treaties;
- The Australian tax system should be benchmarked against our leading competitors and international 'best practice' on an ongoing basis;
- Australia maintains a commitment to the international tax dialogue through the ATO and Treasury involvement at the OECD and other relevant international forums.

Recommendation 14: IBSA recommends that a comprehensive conduit regime be developed in order to provide access to regional headquarters' roles in global structures, as these roles will not otherwise arise.

Recommendation 15: IBSA recommends that the Board of Taxation should stress in its report to the Treasurer the need for the measures contained in Taxation Laws Amendment Bill No 7 of 2002 to be passed by Parliament at the earliest opportunity.

Recommendation 16: IBSA recommends that any capital gains on assets held offshore by expatriates and which do not have the necessary connection with Australia should not be subject to capital gains tax on the departure of the expatriate. This should be made clear in Australian tax law pending the negotiation and ratification of Double Tax Agreements.

Recommendation 17: IBSA recommends that expatriate employees engaged in Australia on temporary visas should not be subject to the Superannuation Guarantee charge.

Recommendation 18: IBSA recommends that the Board of Taxation consider a more flexible taxing arrangement for Australian-based executives who spend significant amounts of time working outside Australia and who pay tax in other jurisdictions on income earned offshore.

Recommendation 19: IBSA recommends that Australian law specify the source rules to apply when tax on employee share rights is deferred until the rights are exercised. In treaty negotiations Australia should follow the OECD approach that share rights should be taxed where they are exercised with relief for periods of employment in other countries.

Recommendation 20: IBSA recommends that an elective mark to market tax regime should be introduced for financial arrangements without further delay.

1. Taxing Branches – A Chapter 4 Issue

Chapter 4 deals with Australia as a global financial services centre. Australia would have no hope of successfully competing for global financial services business in the absence of an effective branch tax regime. The separate entity approach to taxing authorised deposit taking institutions (ADIs) is a significant step in the right direction and has enabled banks to conduct international business from Australia, but it needs to be improved in some areas.[1] The tax regime for non-ADI branches is far more complex and uncertain.

The branch tax regime must be updated and modified to increase taxpayer certainty and reduce distortions if we are to reach our potential as a global financial services centre.

Option 4.11 of the Consultation Paper is welcome because it considers specific tax issues where the lack of separate entity treatment inappropriately impedes the use of branch structures.

In this section, we consider a range of initiatives that would advance the neutrality and competitiveness of the Australian tax system as it applies to branches (or permanent establishments, as we refer to them here).

The issues that we raise here affect all permanent establishments (PEs) to some extent. However, we focus on financial institutions for two reasons:

- IBSA represents investment banks and securities companies, all of which have significant international operations;
- PEs are prevalent in the financial sector and are a vital structure for the conduct of international financial business.

In this submission we distinguish between ADIs and financial entities (i.e. financial institutions that are not ADIs), as current tax law treats each differently.[2]

1.1 The Separate Entity Principle

PEs pose particularly difficult tax design problems. Although they form part of the same legal entity as their parent, tax authorities want to include in their taxable income amounts arising from transactions with their parent. This is at odds with the legal principle that you cannot transact with yourself. The interaction of

[1] ADI means a body corporate that is an ADI for the purposes of the Banking Act 1959.

[2] Financial entity is defined in s.995-1 of the Income Tax Assessment Act to mean an entity other than an ADI that is a registered corporation under the Financial Sector (Collection of Data) Act 2001, or a securitisation vehicle, or is a financial services licensee that (in broad terms) is licensed to deal in securities. The definition of financial entity should also include any entities that are exempt from a licence under s.911A(2)(h) of the Corporations Act. We expect the law will be amended to give effect to this in the near future.

domestic and international tax law fails to deliver a consistent and certain outcome for PEs, primarily due to this problem.

In Australia, non-ADI PEs face most difficulty in the absence of codified separate entity treatment for tax purposes, as the interaction of our general tax principles and international tax treaties gives a complex and uncertain outcome that is very difficult to manage. ADI PEs are better served, as the Income Tax Assessment Act contains specific rules that treat them as a separate entity from their parent for key transactions; for example, foreign exchange and derivatives transactions with the parent entity are recognised for tax purposes.[3] However, there are still deficiencies in the income tax and GST laws governing the taxation of ADI PEs.

More complete separate entity treatment of PEs for tax law purposes would increase certainty. It would not be a perfect solution as, given commercial synergies, the 'whole may be greater than the sum of the parts' for a global entity with a PE structure, but it would generally be far superior to the alternatives.

IBSA participated in OECD consultations on the attribution of income to PEs in April this year and it seems inevitable that the OECD will pursue the further adoption of the separate entity approach to PEs in international tax treaties. While this approach would support our recommendations below, it is not the decisive factor. Australia has moved ahead of the OECD in important areas, like thin capitalisation, and our domestic law must apply a consistent framework for PEs that as far as possible treats branches from different home jurisdictions equitably and avoids tax non-neutralities that distort competition.

The Review of Business Taxation acknowledged these issues in recommendation 22.11 of its report:

> Recommendation 22.11 - General treatment of branches
>
> *Progressive introduction of separate entity treatment*
>
> (a) That the law be rewritten over time to permit, in appropriate circumstances, separate entity treatment of dealings between a branch and other parts of the entity, starting with the supply or acquisition of trading stock.
>
> *Application of thin capitalisation rules*
>
> (b) That the thin capitalisation rules apply to branches, including all foreign bank branches.
>
> *Preparation of financial accounts*
>
> (c) That branches be required to prepare financial accounts for taxation purposes.

Parts (b) and (c) dealing with thin capitalisation and financial reporting have been enacted into law – possibly because these are the key revenue collection priorities. However, it remains for progress to be made on the separate entity treatment of branches proposed in 22.11(a) as it is not yet part of the legislative program to implement the New Business Tax System.

Recommendation 1: IBSA recommends that the Review of Business Taxation recommendation 22.11(a) be implemented through a coordinated package that imposes a consistent approach to PEs across the various domestic tax laws.

[3] Section 160ZZW – Certain Provisions to Apply as if the Australian Branch of a Foreign Bank Were a Separate Legal Entity.

Reasons to support this change include:

- Better reflection of profits attributable to a PE for tax purposes;
- Greater tax neutrality between subsidiaries and PEs.

Benefits include:

- Greater tax certainty and thus reduced compliance costs;
- A more advanced and competitive international tax regime.

Revenue implications:

- Neutral;
- Positive indirect benefits.

1.2 Specific Issues for Financial Entity PEs

Financial entity PEs are competitively disadvantaged because they cannot group for thin capitalisation purposes, nor can they group losses with related group operations in Australia.

In contrast, ADI PEs that financial entities compete against have a more certain outcome through the separate entity treatment in Part IIIB and they can group losses and capital with related entities. Meanwhile, locally incorporated competitors (including foreign-owned subsidiaries) do not have a separate entity problem (by definition) and they have the option to consolidate their conglomerate capital and losses under the tax consolidation regime.

There is a need to rebalance this situation in order to provide a tax neutral competitive environment and improve certainty of tax outcomes for financial entity PEs that is more consistent with the separate entity treatment. In this context, we make several recommendations, which follow from Recommendation 1 above.

Recommendation 2: IBSA recommends that financial entities that operate in Australia through PEs should be permitted to elect to group losses with any Australian entity with which they share 100% common ownership (adjusted for qualifying employee share schemes).

Recommendation 3: IBSA recommends that financial entities that operate in Australia through PEs should be permitted to elect to group for thin capitalisation purpose with any Australian entity with which they share 100% common ownership (adjusted for qualifying employee share schemes).

Recommendation 4: IBSA recommends that financial entities should be accorded separate entity treatment in the same manner as ADIs are treated under Part IIIB of the Income Tax Assessment Act so that, for example, foreign exchange transactions between the PE and its parent would be recognised for tax purposes.

Reasons to support these changes include:

- Tax neutrality between subsidiaries and PEs;
- Competitive neutrality across the financial sector;

- Lower business operating costs;
- Enhanced international competitiveness.

Benefits include:

- Competition in markets enhanced;
- More business conducted in Australia through, at the least, retention of existing market participants;
- Consistent 'whole of government' policy, by complementing financial services regulation reforms.

Revenue implications:

- Neutral direct impact;
- Positive downstream benefits.

1.3 Treatment of PE Financial Assets and Liabilities

Notwithstanding the benefit of Part IIIB and the other targeted tax measures, the tax regime for ADI PEs is imperfect. In particular, it needs to be updated to cover securities, to complement existing recognition of foreign exchange, interest and derivatives. The updated provisions should also apply to financial entity PEs, in accordance with Recommendation 1.

This issue arises in part because the financial sector has continued to evolve at a rapid pace since the early 1990s, when Part IIIB was developed. Important drivers of change include pressure to improve operational performance, reduce costs, increase capital efficiency and expand market reach.

Many foreign entities that operate in Australia offer a variety of services including banking (mainly wholesale, but some retail), stockbroking and funds management. In particular, foreign owned brokers accounted for 8 of the top 10 brokers in terms of market share of ASX turnover in 2001. Five of the top 10 brokers are associated with a licensed foreign bank branch that operates in Australia and a licensed domestic investment bank owns another broker. Reflecting their strong presence in the market, foreign owned brokers also account for the majority of equity raised on the Australian capital market.

It is important that neither the preservation of current levels of participation in Australian capital markets, nor their further development is constrained by tax laws that unnecessarily inhibit foreign entities from adopting the most efficient organisational structure for their operations.

Recommendation 5. IBSA recommends that Part IIIB be updated to reflect industry developments by expanding the rules to include separate entity treatment in respect of all financial asset and liability[4] transactions, including securities, trading stock and all derivatives (including equity based).[5]

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[4] A suitable definition for financial assets and liabilities may emerge from the forthcoming rules for the taxation of financial arrangements (TOFA).

[5] The definition of 'derivative transaction' in s.160ZZV is limited to interest rates and foreign exchange transactions and can be view as being limited to "hedging" transactions. All derivative trading positions, including equity-based derivatives, should be encompassed by Part IIIB.

Reasons to support this change include:

- There is a growing commercial drive from both ADIs and non-ADI financial entities to conduct securities business through PEs;
- This reflects a global trend to consolidate business and operate through a single entity, leveraging support platforms and delivering operational efficiencies and cost savings;
- Non-tax regulatory reforms and initiatives recognise the need for this, but their effect could literally be vitiated by inconsistent tax rules.

Benefits to Australia include:

- A more secure base for Australia's capital markets;
- Greater foreign participation than otherwise in Australia's capital market;
- A more competitive market for securities and related financial services;
- Policy synergy with regulatory reforms and on-going initiatives.

Revenue implications:

- Neutral direct impact;
- Positive downstream benefits.

1.4 Treatment of Dividends Received by PEs

The dividend withholding tax rules are problematic for PEs that trade securities and receive dividend income. This is at odds with the commercial drivers of business and can be rectified with minor amendments at little or no cost to revenue.

As a general rule, trading income derived by a PE in Australia is taxable here and expenses incurred in deriving that income would be deductible. Similar to Australian incorporated entities that have international operations, PEs must satisfy thin capitalisation rules, though they are not permitted to consolidate for tax purposes.

The problem is that dividends received by a PE in Australia are taxed in certain circumstances in the same manner as a foreign entity that does not receive the income through a place of business in Australia (i.e. a non-resident with no connection to Australia). Thus:

- Unfranked dividends received by a PE are subject to withholding tax on the gross amount paid[6];
- Franked dividends received are exempt from withholding tax[7] (and excluded from assessable income under s.128D);
- Expenses incurred in earning the dividends are potentially non-deductible.

To complicate matters, the interaction of these rules with some international tax treaties is uncertain (notably, this is true for the UK treaty, which is particularly important in this context – *see Technical Attachment 1*). It may be possible to

[6] Section 128B(1).

[7] Section 128B(3)(ga).

achieve the same outcome as for a subsidiary, but only through negotiation of the appropriate branch result under a double tax treaty with the tax authorities in Australia and the home jurisdiction. This could be required annually and would at least involve cumbersome analysis and administrative procedures, and even this process is not feasible if there is no relevant double tax treaty.

Thus, the outcome of the basic tax rules in the Income Tax Assessment Act is unreasonable – the actual amount of tax paid in Australia by a PE could be more or less than a subsidiary. Balanced relief through international tax treaties is uncertain, and potentially impractical. Certainty of key tax outcomes is a critical feature of an internationally competitive financial centre that promotes competition in the domestic market and generates export income, especially if the underlying economy is small in global terms.

For PEs, dividend income should be clearly assessed on a net assessable income basis, directly under the Income Tax Assessment Act, in the same way that other entities with which PEs compete are taxed. To achieve this outcome dividends derived by PEs should be specifically excluded from s.128B and s.128D. In addition, PEs should be able to utilise franking credits on dividends paid from Australian entities so that the dividends are taxed in the same way as dividends from a subsidiary would be.

Recommendation 6: IBSA recommends that dividends received by a PE be clearly assessed on a net assessable income basis, as it is for other entities that the PEs compete with, and specifically excluded from the withholding tax regime – similar to the exemption for interest income received by a PE.[8]

PEs are presently not entitled to franking credits in respect of dividends that they receive, where the dividends are tax exempt.[9] To complement Recommendation 6, the separate entity principle should also apply to a PE in respect of its dividend receipts. This would be consistent with Recommendation 1 and improve the neutrality of the tax system, by removing what would otherwise be an anomaly.

Recommendation 7: IBSA recommends that PEs should be entitled to franking credits in respect of dividends received from Australian resident entities.

Reasons to support this change include:

- More certain tax rules for PEs that either hold or trade Australian securities;
- More consistent (net) economic outcomes for tax treatment of different forms of entities receiving the same dividend income;
- Tax would have a less important effect on decisions about operational structures - commercial factors would determine the nature of the structure (branch or subsidiary) adopted.

Benefits to Australia include:

- A more secure base for Australia's capital markets;

[8] Section 128B(3)(h)(ii).

[9] The residency requirements are in subdivisions 207-C and 207-D of the *New Business Tax System (Imputation) Act 2002*.

- Greater foreign participation than otherwise in Australia's capital markets;
- A more competitive market for securities and related financial services;
- Policy synergy with regulatory reforms and on-going initiatives.

Revenue implications:

- Neutral direct impact (the current tax rules deliver inconsistent outcomes and correction may increase net tax paid in some instances, while reducing it in others);
- Positive downstream benefits.

1.5 Consistent GST Rules for PEs

The GST Act does not adopt a separate entity approach to PEs and this failure has created uncertainty of tax outcomes and inconsistency in the treatment of ADI PEs across tax laws. Legal devices in the GST Act are meant to replicate separate entity treatment for PEs, but in practice they do not provide a certain tax framework for taxpayers.

The existence of this uncertainty was illustrated recently with the release of the tax ruling that provides advice on the GST treatment of financial supplies (GSTR 2002/2). The oft-stated policy intention is that supplies from a branch in Australia to its overseas parent (including its other branches) should be treated as exports for GST purposes. However, the GST Act fails to securely deliver this outcome because it does not contain a comprehensive separate entity approach to PEs and the technical devices to simulate this are imperfect. A more detailed analysis of the issue is provided in *Technical Attachment 2.*

The initial ATO/Treasury intention was that GSTR 2002/2 should provide advice to deal with this problem, at least in so far as the law is administered by the ATO. However, the advice in paragraphs 181–183 of the ruling actually increases uncertainty. This outcome reflects to some degree the general complexity of PE tax issues referred to above.

The finance industry needs an unambiguous legal position for PEs that is based on a sound conceptual footing – the separate entity approach to PEs would achieve this.

Recommendation 8: IBSA recommends that the GST Act should be amended to apply separate entity treatment to PEs in respect of dealings with their parent entity.

Reasons for the change include:

- Removal of existing uncertainty for PEs that export financial services.

Benefits include:

- Creation of a more secure business environment for exporters of financial services – many financial institutions with an international focus operate through PEs;
- Symmetry between inward and outward supplies under the GST Act;

- Tax rules that are tax neutral and better align with the underlying economics of business.

Revenue implications:
- No material impact.

1.6 Other PE Issues

The LIBOR cap in s.160ZZZA(1)(c) of Part IIIB can result in ADI PEs being denied commercially legitimate deductions that are at arms length. In practice, short term borrowing from related parties can be conducted at commercial arms length rates that exceed the LIBOR rate, though this is the exception rather than the norm. Examples cited by banks include short-term funding for amounts that are not standard parcels to square-off a book at the end of the day and trading in markets outside of London (in other time zones).

Apart from the non-deductibility of amounts greater than the LIBOR rate, this creates an irritating tax compliance cost. This problem could be alleviated and greater efficiency achieved by relying on the transfer pricing provisions of the tax law and the new thin capitalisation regime to penalise any dealings that are not at arms length basis. This would improve the operation of the tax system without compromising its integrity.

This is a minor problem, but it is one that should be corrected.

Recommendation 9: IBSA recommends that Part IIIB should be revised to remove the LIBOR cap in s.160ZZZA(1)(c).

Reasons for the change include:
- Tax revenue is protected through transfer pricing rules that prohibit interest deductions that are not at an arms length rate so there is no need for double regulation.

Benefits include:
- Lower cost of tax compliance, as only one set of rules must be satisfied.

Revenue implications:
- No material impact.

2. Foreign Entity Taxation - Chapter 2 Issues

The source of the problem

The dividend imputation system reduces double taxation by granting franking credits for company distributions in respect of profits that have been taxed at the corporate tax rate. However, measures introduced in 1997 to prevent trading in franking credits effectively discriminate against foreign-owned companies by restricting their financing options in a manner that does not apply to their domestic counterparts.

Thin capitalisation rules accentuate the harm

The discriminatory nature of the franking credit measures is accentuated by the new thin capitalisation regime. This regime mandates a minimum level of equity (or maximum level of debt) for all entities that have an international dimension to their operating structure. Thus, both domestic and foreign-owned entities are required to issue equity capital under the law, but only domestic entities can frank equity related distributions to their Australian shareholders from corporate tax paid in Australia.

As capital structures are now prescribed for tax purposes under the thin capitalisation regime, the tax treatment of distributions should be the same for domestic and foreign-owned entities (including PEs) operating in Australia.

A level playing field is required to ensure that foreign controlled financial entities have equal access to the Australian capital markets and Australian resident investors. Foreign controlled entities and PEs are currently discriminated against under the current imputation regime.

2.1 Foreign Entities' Ability to Frank Dividends Paid to Residents

Franking credits are available to domestic entities but not to foreign entities that are wholly-owned by non-residents.[10] This means that domestic companies can raise equity capital finance in the local capital market at more competitive rates than comparable foreign-owned companies that cannot frank dividends paid to residents, forcing them out of this capital market.

For example, a domestic company that raises convertible preference share finance from the domestic market (eg as part of a capital restructuring) can use its pool of franking credits to frank dividends paid to preference shareholders.

However, if a foreign owned company were to make a similar preference share issue, it could not issue franked dividends. Thus, it would either have to pay a higher cost of capital or, more likely, not issue convertible preference shares because of their excessive cost. Clearly, foreign entities are disadvantaged relative to domestic companies by this outcome.

[10] That is, companies in which non-residents own more than 95% of the accountable shares on issue.

An issue of shareholder equity also arises. There is no intrinsic reason why an investor in an Australian business that is foreign-owned should be taxed differently to an investor in a comparable business owned by residents. Nor does it seem right that share investors in a foreign-owned company would lose their right to receive franking credits because other shareholders sell their stake to a non-resident, thereby lifting the total non-resident shareholding above 95%.

It is possible to overcome these problems by permitting franking credits to be paid to residents that hold an equity interest in the foreign entity, to the extent that it has paid corporate tax in Australia.

It may appear, at first instance, that the amount of equity that could be issued in this manner (less than 5% of the company) would be small. However, even this level can be very restrictive and pose competitive issues. By way of example, financial institutions must maintain mandated levels of equity capital to satisfy their thin capitalisation obligations. Financial institutions should be able to issue equity interests to meet this obligation, with the assistance of domestic capital raisings, as it would be entirely consistent with overall policy objectives.

Naturally, the foreign controlled entity must be able to pay franked dividends to resident Australian investors without the franking credit streaming provisions applying. The reasons for this proposition are simple. The consultation paper contemplates at Option 2.1 a range of measures to provide shareholder relief to remove a dividend imputation bias for resident shareholders. In particular, Option 2.1A proposes to extend a form of imputation relief to unfranked dividends paid out of foreign source income not taxed in Australia, while Option 2.1B proposes to provide streaming relief against foreign source income.

Therefore it makes perfect and logical sense to allow dividends in respect of which Australian tax has actually been paid in Australia to be franked to Australian resident shareholders on equity interests issued by foreign controlled entities. To do otherwise would be in effect a double discrimination between foreign and locally controlled entities – first, via existing restrictions on foreign controlled entities' ability to issue equity interest and frank on even terms with resident controlled entities, and second, by providing additional new entities outlined in Option 2.1.

2.2 Foreign Entities' Ability to Issue Equity Interests and Pay Franked Dividends

Foreign bank branches operating as PEs in Australia suffer a similar form of discriminatory treatment under the imputation system except it is more extensive in that PEs currently have difficulty issuing equity interests. The separate entity approach (outlined is Section 1.1 above) requires that foreign bank branches (and other financial institutions) be able to issue equity interests that are attributable to the PE. As noted above, Part IIIB of the Income Tax Assessment Act already provides a useful mechanism to facilitate and control issuance of equity capital for income tax purposes by PE to Australian resident investors directly. The rationale for PEs being able to issue equity interests and make franked distributions is similar to that raised in 2.1 above and is not repeated here for brevity, although

other supporting reasons exist that may be discussed at a follow-up consultation process.

These points are raised against the background of an inexorable move toward PEs as the most effective way for foreign financial institutions to operate their banking and securities businesses in Australia, driven by tax and regulatory measures. This shift towards a PE structure means that a balanced and equitable approach to their taxation treatment is required for Australia to continue to benefit from the ongoing development of global business operations in Australia.

Recommendation 10. IBSA recommends that foreign-owned entities (ie those with greater than 95% foreign ownership) should be permitted to frank distributions to residents who hold equity interests in entities that are issued in Australia. This should apply to both foreign-owned subsidiaries and to PEs that issue equity interests to Australian shareholders.

Reasons for the change include:

- It would remove a discriminatory measure that disadvantages foreign-owned entities that operate in Australia;
- Significant non-neutrality in the tax system would be removed;
- It would improve the internal consistency of government taxation policy – for example, it would permit entities to more readily meet their thin capitalisation requirements;
- There would be an important policy synergy, as it would complement the Government's initiatives to develop Australia's capital markets, provide an outlet for superannuation investment and enhance our international competitiveness as a financial centre.

Benefits to Australia include:

- A better balanced and more competitive tax regime for foreign entities;
- A more broadly based capital market that would increase investment options for local investors (including rapidly growing superannuation funds) and shift some overseas investment opportunities into Australia;
- Greater international business through a more competitive tax regime for foreign institutions, that could raise equity locally and avoid currency exposure and related hedging costs on equity infusions from offshore;
- Greater flexibility for business financing;
- Enhanced opportunities for foreign companies to develop employee share schemes for their Australian employees.

Revenue implications:

- Neutral direct impact;
- Positive downstream benefits.

2.3 Tax Consolidation

The Government has introduced consolidation rules that permit foreign-owned entities (except PEs) to consolidate for tax purposes. The objective is to provide conglomerate groups with flexibility and reduced compliance costs. Also, a range of tax grouping provisions is being deleted with the introduction of the

consolidation regime. Therefore, there is a significant incentive for entities to consolidate for tax purposes, or at least there is a significant disincentive to not doing so (including the 'one in, all in' principle).

The tax position of foreign-owned entities is made more complex by the interaction of Australian tax rules with those of the home jurisdiction, where income is ultimately assessed for tax against the parent entity on a global basis with credit relief provided as appropriate for tax paid in Australia. There may be circumstances where an entity may not wish to consolidate fully for tax purposes.

In particular, the US 'double dip' rules on losses may inhibit an entity from grouping its losses with other members of its tax consolidation group. If the entity is given the option to consolidate its losses with profits from other members of the consolidation group, this would increase its operational flexibility and increase tax payable in Australia.

Recommendation 11: IBSA recommends a foreign-owned entity within a tax consolidation group should be given the option not to group its losses with other entities in the tax consolidated group.

Reasons to support the change include:

- It would provide more flexible tax arrangements for foreign-owned entities consistent with the underlying objective of the law;
- It would increase tax payable in Australia if an entity elected not to group/consolidate its losses.

Benefits to Australia include:

- A more competitive tax regime for foreign entities.

Revenue implications:

- Positive.

3. Chapter 3 Issues

3.1 Australia's Tax Treaty Network

A non-discrimination Clause

With the exception of the US treaty, Australia's existing international tax treaties do not include a non-discrimination article. In the interests of fair and balanced competition for foreign participants in Australia's financial markets, this omission should be corrected in new treaty negotiations. In our experience, there have been occasions in recent years when the existence of an effective non-discrimination article would have at least inhibited outcomes that discriminated against foreign-owned entities that conduct business in Australia (for instance, the 1997 measures to prevent trading in franking credits).

IBSA believes that, as a matter of principle consistent with the Government's tax, trade and investment objectives, a non-discrimination clause should be included in all of Australia's double taxation agreements.

Withholding Taxes

Australia should pursue the elimination of withholding taxes through its international treaty renegotiation process, as a means to help reduce barriers to international finance and investment that support economic development.

The outcomes achieved through the US treaty protocol are a welcome step in this regard.

The difficulty in targeting the incidence of withholding tax has long been recognised through the s.128F exemption regime for interest payments to non-residents. Meanwhile, the introduction of a comprehensive thin capitalisation regime should address any concerns about the shifting of capital returns offshore through interest payments to parent entities and the need to capture part of this through an interest withholding tax.

In addition, member banks have reported instances where the existence of withholding taxes in Australia's treaty partners can militate against the conduct of some international business from Australia, due to uncertainty about the capture of a full tax credit for withholding taxes paid overseas.

Renegotiation Process

We appreciate bilateral treaty negotiations may need to be conducted with a degree of confidentiality that depends in part on the willingness of the other jurisdiction to facilitate an ongoing consultation dialogue with industry during the negotiation process. However, confidentiality must be balanced against the significant benefits to be gained by fully utilising industry expertise and experience through an effective public consultation process.

Our judgment is that the process could be more open than it has been in the past. For instance, members have reported that some issues that might have been dealt

with through the US Protocol could have been better identified and prioritised through a more effective consultation process.

Recommendation 12: IBSA recommends that Australia's double taxation agreement negotiations should:

- Be updated and include a non-discrimination clause;
- Target the removal of interest and dividend withholding taxes;
- Be conducted on a more open basis with industry consultation afforded to the fullest extent possible, within the parameters of the negotiation process.

3.2 Maintenance of the International Tax System

International taxation is a problem for companies and banks that operate across many jurisdictions because tax systems that are nationally based do not interact very well in some cases. Bilateral tax treaties ameliorate the consequent problems but they need to be maintained to keep abreast of economic, financial and legal developments.

The 'OECD Model Tax Convention on Income and Capital' forms the basis of the extensive network of bilateral international tax treaties. Despite the existence of the Convention, double taxation of some income still occurs due to inadequacies in the treaties and differences in their interpretation. Australia has played a positive role at the OECD in the ongoing development of the Convention. Looking to the future, this will require an ongoing commitment of resources, which we believe is justified by the importance of international business to the Australian economy. It is important that Australia does not depart markedly from international norms and that deviations are managed so that they do not unduly disrupt international business.

In this context, it is also important that there is a mechanism to support the ongoing maintenance of Australia's international tax system. It will not be possible for the Review to adequately address all of the issues raised by industry, given the time frame and resources available to it. There should be a mechanism to pick up problems that are not resolved through the current process.

In addition, it will be necessary to continue to review and modernise existing tax treaties and negotiate new treaties. This should be part of a 'repair and maintenance' program for the tax system and, perhaps, could be facilitated by the Board of Taxation through a regular forum for discussion of international tax issues affecting business.

It is hoped that the Review will ultimately lift Australia's international tax competitiveness. The Government should secure these gains and build on them by benchmarking our system on a regular basis against overseas systems to identify productive opportunities for reform.

Recommendation 13: IBSA recommends that in order to maintain and develop our international tax rules on an ongoing basis:

- A domestic forum should be established to identify and resolve domestic law problems affecting international business and assist in the modernisation of our international tax treaties;

- The Australian tax system should be benchmarked against our leading competitors and international 'best practice' on an ongoing basis;
- Australia's maintains a commitment to the international tax dialogue through the ATO and Treasury involvement in the OECD and other relevant international forums.

3.3 Conduit Income

The current tax treatment of foreign source income earned by the foreign subsidiaries of foreign-owned entities that conduct business from Australia inhibits the use of Australia as a regional hub. A broader and more effective conduit relief system would increase the attractiveness of Australia as a holding base for foreign investment.

This would be a good complement to existing Government policies to facilitate the conduct of regional and global business from Australia and it would help to promote the further development of our capital markets. General conduit relief is a feature of the tax systems of most other developed countries and appropriate relief would address an imbalance affecting our international competitiveness.

In principle, all foreign income and gains of the foreign subsidiaries of Australian incorporated companies should be able to flow through to the non-resident shareholders of those companies without being subject to tax in Australia.

Recommendation 14: IBSA recommends that a comprehensive conduit regime be developed in order to provide access to regional headquarters' roles in global structures, as these roles will not otherwise arise.

4. Expatriate Taxation – Chapter 5 Issues

The high marginal rate of tax on personal income in Australia is a significant disincentive to Australian employees and it deters skilled foreign workers from working in Australia. In our view, this involves a significant economic cost that should be addressed. We do not canvas the matter here as it is outside the scope of the Review, but rather bring it to the attention of the Board of Taxation and the Government as an issue that should be addressed in the future.

4.1 Improving Australia's Tax Treatment of Foreign Expatriates

The Consultation Paper correctly identifies the need to remove disincentives to the employment in Australia of foreigners who can lend their skills to the development of a globally competitive economy in Australia.

This is particularly important in the field of banking and finance. The engagement of global investment banks in the Australian market helps to integrate Australia into world financial systems and meet the Government's objective of positioning Australia as a leading regional and global financial centre. Since deregulation in the 1980s, foreign banks have established a significant presence in Australia – in 2002, 38 of the 50 licensed banks in Australia have a foreign parent.

Reform of expatriate taxation will help to make Australia a more attractive career posting for highly skilled and experienced finance professionals that will benefit Australia.

For global investment banks, the seamless interchange of talent and specialist skills among their worldwide staff is an important element of their global business strategies and career development programs.

The ability of international banks to post high calibre staff to Australia is critical to innovation, to the transfer of knowledge and to positioning their Australian operations at the leading edge of financial services capability to the benefit of their Australian customers.

HOW EXPATRIATES CREATE BUSINESS AND JOBS

Case Study 1

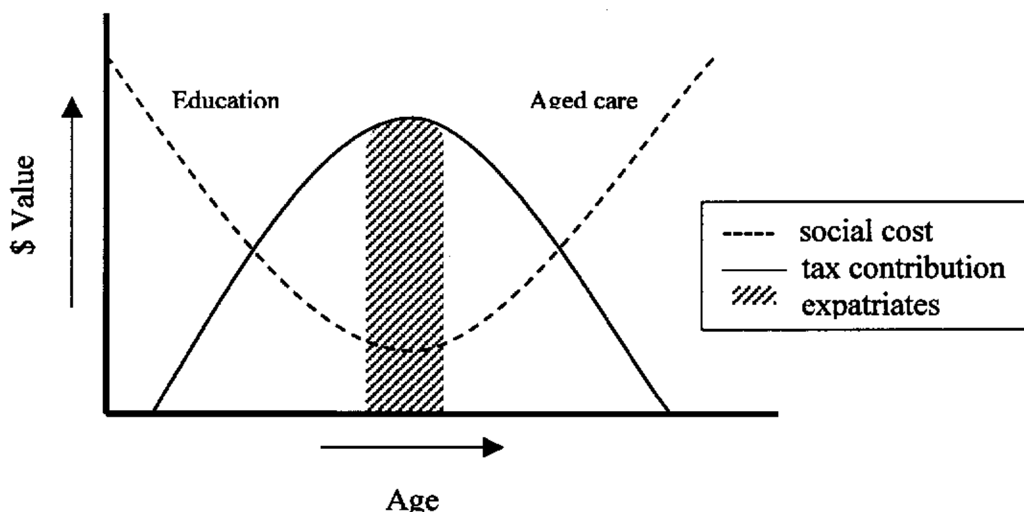
In 2000, an IBSA member bank transferred a senior manager from its North American office to establish the bank's Private Client (Retail) business. In the two years he led this business unit, the expatriate manager fostered the recruitment and development of Australian staff. The number of Australians employed rose from 167 to 300 by the time he left in 2002. An Australian manager now heads the business. During the expatriate manager's tenure, several new products were introduced to the Australian market, including a private portfolio product that enables Australian clients to invest in international shares not traded on the ASX. The expatriate manager also encouraged professional training for Australian staff and a number of them gained their Series 7 qualification, which allows them to trade on the New York Stock Exchange.

Case Study 2

The same IBSA member bank also created 25 jobs in the bank's Investment Banking division following the transfer in 1999 of an expatriate manager to head up the Investment Banking (Corporate Finance) business. The expatriate manager developed new products and services for the bank's clients in the mining and steel-making sector and established a new Structured Capital Markets Group. When he leaves Australia in 2003, he is expected to be replaced by an Australian manager.

4.2 Lifestyle costs and benefits

The temporary posting to Australia of mid-career finance professionals with specialist skills is a net positive for the Australian economy and taxation system. Australia gains the benefits of their specialist skills and taxes them generally at the top marginal rate without having to invest in their early education and professional training and without having to bear the costs of supporting them in their retirement.



4.3 Profile of expatriates in investment banking

While the majority of people employed by investment banks in Australia are Australian, there is a steady stream of foreign finance specialists transferred to the Australian offices of investment banks.

Under the immigration agreement IBSA maintains with the Department of Immigration, Multicultural and Indigenous Affairs, about 200 foreign finance professionals are granted temporary residence visas to work in Australia each year. This compares with an estimated 22,000 Australians employed in the investment banking sector.

An analysis of temporary residence visas granted under the IBSA Labour Agreement shows:

- Almost 70% of expatriates are on salaries of $150,000 and below; only 8% are on salaries greater than $250,000;
- Over 60% are categorised as managers or specialists, with Chief Executives only accounting for 6% of all expatriates;
- 65% fall within the 26-35 age range.

Chart 1: Salary ranges of IBSA expatriates

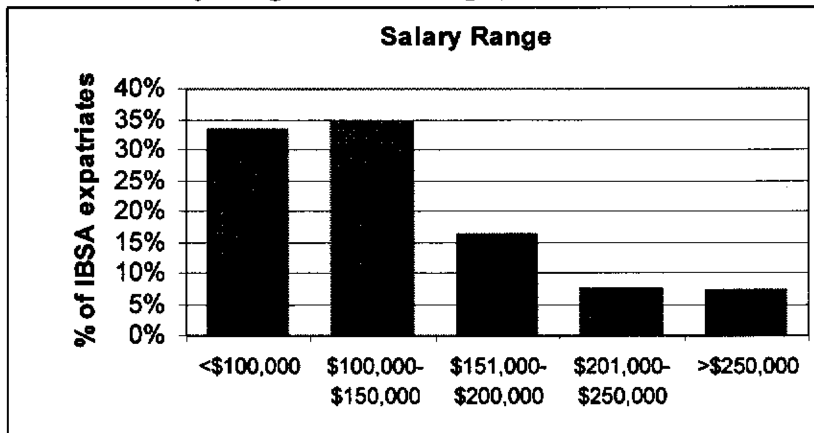


Chart 2: Occupational grouping of IBSA expatriates

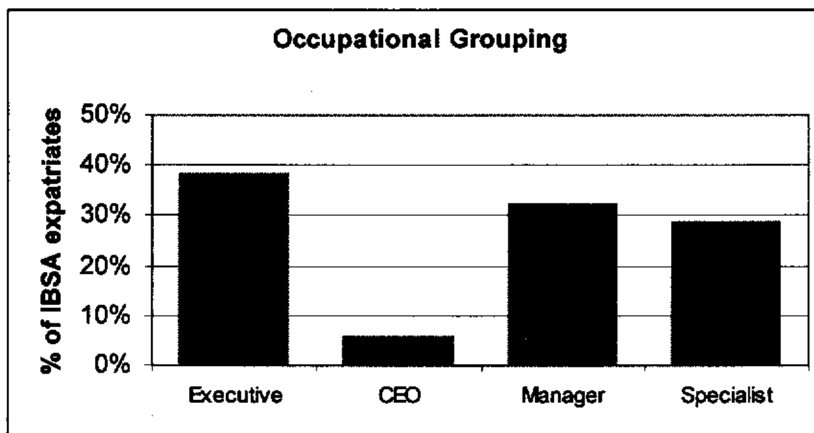
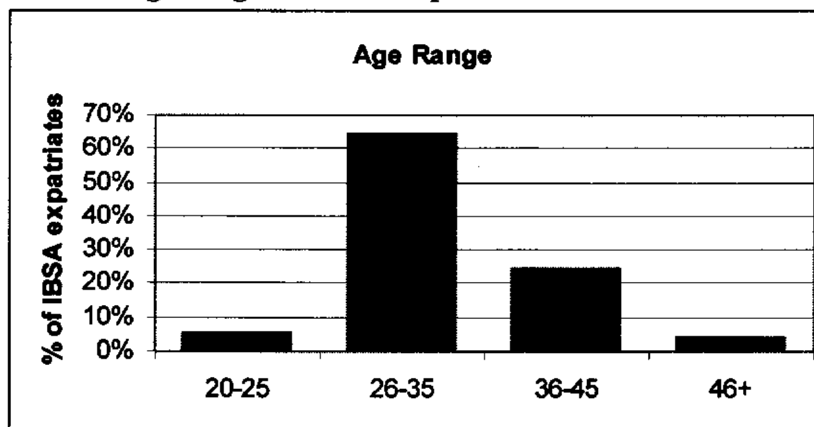


Chart 3: Age ranges of IBSA expatriates



Data source for charts: IBSA Monitoring Survey 1996-2002

These figures indicate that the majority of expatriates working for investment banks on temporary visas are relatively young, on mid-range salaries and have managerial or specialist skills. This bears out our point that expatriates engaged by IBSA members make a positive contribution to the Australian economy through the skills they deliver and the taxes they pay.

4.4 Taxation of Expatriates

IBSA believes the general principles to be followed with regard to the taxation of expatriates are:

- They should be subject to the same taxation as Australians on income they earn while employed in Australia and on income and capital gains on assets with a necessary connection to Australia.
- They should not be subject to tax on foreign source income or capital gains from assets held offshore without a necessary connection with Australia, particularly if the gain is deemed.
- They should not be subject to Australia's superannuation rules while temporarily resident here.
- If they convert their status from temporary to permanent residence, they should then be subject to the same tax rules on their Australian and foreign source income as Australians.

Australia's relatively high levels of income tax – highlighted in the recent IMF Country Report 02/201– are already a disincentive to foreign expatriates. They should not be faced with additional taxes on income they earn from non-Australian sources or capital gains on assets held offshore with no connection with Australia.

Where employers adopt the practice of "tax equalisation" by making up the difference in after-tax income earned in Australia to the same level as the employee's home country, the taxes applied in Australia can be a disincentive to posting international staff to this country.

It may be argued by some that removing tax on foreign source income for temporary residents is a tax break for foreign executives at the expense of their Australian counterparts. This argument does not recognise the policy purpose of reforming Australia's taxation of expatriates – which is to give Australia a competitive edge by making this country a more attractive place for international executives to be based, in order to generate business and strengthen Australia's capability in global markets such as financial services.

As noted in the Consultation Paper, the Government has already made policy commitments to improve the tax treatment of foreign expatriates:

- Exempt from tax foreign-source income for temporary residents;
- Ensure no capital gain or loss arises for tax purposes on the disposal by temporary residents of assets held offshore;
- Remove withholding tax on interest payments made by temporary residents in respect of assets held offshore, regardless of when they were acquired;

- Relax the time limit on exemption from the FIF rules for people on temporary visas.

These measures were included in the 2002 Budget legislation (Taxation Laws Amendment Bill No 4) but were defeated in the Senate. Subsequently, the Government re-introduced the measures in Taxation Laws Amendment Bill No 7.

Recommendation 15: IBSA recommends that the Board of Taxation should stress in its report to the Treasurer the need for the measures contained in Taxation Laws Amendment Bill No 7 of 2002 to be passed by Parliament at the earliest opportunity.

Other policy commitments by the Government are:

- Renegotiation of tax treaties to remove concerns relating to the capital gains tax treatment of departing temporary residents.
- Rebate of superannuation contributions on permanent departure from Australia, subject to recovery of the superannuation tax concession (this is now legislated). We argue below that this measure does not go far enough.

4.5 Capital Gains Tax Liability for Temporary Residents on Departure
(Option 5.1)

IBSA does not support the present method of deeming a capital gain on assets held offshore by temporary residents when they leave Australia.

Deeming a capital gain where the gain has not been realised is arbitrary and inherently unfair. This is compounded if the capital gains tax liability is deferred on departure and the asset continues to accrue liability until the capital gains tax is paid. It is unlikely that the source country would allow relief for the Australian tax paid on the gain, thus resulting in potential double taxation.

As noted above, the principle that should apply here is that any capital gain on assets without the necessary connection to Australia should not be subject to tax. This is in line with the approach outlined in Chapter 3 that Australia's general practice with regard to treaties is to allow the source country to tax capital gains. It is also in line with the policy adopted by the Government with regard to foreign source income. It is consistent with practice in the UK and would allow Australia to compete more effectively with Singapore, which does not apply capital gains tax.

Given this approach, we do not see any virtue in the Review of Business Taxation recommendation that residents departing Australia provide security for deferred CGT liability. As indicated in the Consultation Paper, this would be difficult to administer. However, if introduced, the scope of the measure should be limited to Australians departing Australia (as opposed to temporary residents leaving Australia).

From this general standpoint, we recognise and support the Government's efforts to negotiate mutual and equivalent capital gains tax treatment of expatriates under

Tax Treaties, for example, the CGT measures contained in the Protocols to the DTAs with Canada and the US.

However, we note the lengthy delays involved with the negotiation of bilateral agreements and the lengthy ratification period following the negotiation of new agreements. We understand that the new Protocol to the Australia/US double tax agreement is unlikely to receive ratification by the US Congress this year and will not therefore take effect from 1 July 2003 as originally intended. In this context we urge the government to address CGT anomalies discussed in the consultation paper via amendments to Australian domestic law as well as through bilateral negotiations.

Recommendation 16: IBSA recommends that any capital gains on assets held offshore by expatriates and which do not have the necessary connection with Australia should not be subject to capital gains tax on the departure of the expatriate. This should be made clear in Australian tax law pending the negotiation and ratification of Double Tax Agreements.

4.6 Superannuation Arrangements for Temporary Residents

The Government has recently passed legislation allowing temporary residents to withdraw their superannuation savings on departure, subject to a special tax to recover the income tax concession for superannuation contributions.

IBSA argued in submissions to the Government before the legislation was introduced that this is a cumbersome solution. Our view is that Australia is not responsible for the retirement savings of foreigners and there should be no requirement on temporary residents or their employers to make superannuation contributions. This would allow the Government to collect full income tax up front from temporary residents without having to go to the administrative effort of clawing back the superannuation tax concession on departure, thus reducing compliance costs for the tax office, employers and superannuation fund managers.

Given that our preferred position is that temporary residents should not be subject to Australia's superannuation arrangements at all, we support the Government's exemption of certain senior executives from the Superannuation Guarantee and the negotiation of Superannuation Double Coverage Agreements with other countries as at least steps in the right direction. We note that new agreements with Canada and Germany do not address the issue of double coverage and there are no plans to negotiate a new agreement with the UK. All countries with which negotiations for new agreements are taking place are rather minor source countries of expatriates (Chile, Croatia, Finland, Norway, Slovenia, Switzerland, Belgium, Greece and Turkey).

The international tax review provides an opportunity for the Government to reconsider its policy on the superannuation treatment of expatriates and remove temporary residents from the Australian superannuation system.

Recommendation 17: IBSA recommends that expatriate employees engaged in Australia on temporary visas should not be subject to the Superannuation Guarantee charge.

Addressing other matters raised in the Consultation Paper:

4.7 Foreign Workdays

A distinction can be made between Australian nationals working temporarily in another country for project work (for example, a consultant undertaking a specific assignment) and foreign nationals working temporarily in Australia for a multi-national corporation who have a base in Australia but work obligations in other countries. Australia's efforts to attract regional headquarters will create more executives in the latter category.

In our view, the existing foreign earnings exemption is appropriate for Australian nationals working temporarily overseas. Those who do not meet the qualifying period and are thus liable to Australian tax on their foreign earnings can claim a foreign tax credit for foreign tax paid. Given Australia's high rates of tax relative to other countries in the region, the taxpayer's total tax burden is typically limited to their Australian rate of tax.

However, the requirement for a continuous 91-day period offshore is inflexible and inappropriate for foreign nationals based in Australia with regional responsibilities. A better approach may be to adapt the foreign earnings exemption for temporary residents such that the exemption applies where the taxpayer has spent a period of more than 90 days offshore in a tax year without the need for those days to be continuous. Where less than 90 days are spent offshore in a year, the temporary resident would continue to be subject to Australian tax on the foreign earnings but would still be liable to claim a foreign tax credit to the extent that they have paid foreign tax on those earnings.

Recommendation 18: IBSA recommends that the Board of Taxation consider a more flexible taxing arrangement for Australian-based executives who spend significant amounts of time working outside Australia and who pay tax in other jurisdictions on income earned offshore.

4.8 Removing double taxation of employee share options
(Options 5.2, 5.3)

Employee share entitlement schemes can be a significant (more than half in some cases) component of performance-based remuneration for employees in investment banking. Generally, these share entitlement schemes entail a qualifying period before the benefits are taken and taxed.

Employees are transferred between countries to meet the business needs of global investment banks and to broaden their professional experience. The result is often that share rights are accumulated from service in several countries and may be exercised in a different country from where they were earned. This can lead to complex tax situations for individuals and their employers.

For example, the US and UK have rules to split taxation between onshore and offshore periods of employment but Australia does not, leading to uncertainty about the tax position of offshore staff posted to Australia (and Australians posted

overseas) and cost to employers who 'tax equalise' by ensuring that employees receive the same after-tax income as they would in their home country. This cost and uncertainty can complicate secondment programs within global companies and make the transfer of talented people to Australia less attractive to them.

Given that this issue was not included in the recent US treaty, and other treaties will take time to negotiate, Australian tax law should specify the source rules to be applied to qualifying shares/rights where tax is deferred until the rights are exercised. New treaties should then reconcile any differences in approach and overcome double taxation problems when employee share options are taxed at different points and tax credits may not be allowed for tax paid in another jurisdiction. It would also be helpful for the Australian tax law to make it clear whether the taxation of share options is to be on the basis of capital gain or remuneration or both.

The OECD's suggestion that options should be taxed in the jurisdiction where they are exercised (in keeping with the principle that gains should be taxed when and where they are taken) and that tax treaties should recognize and provide relief for periods of employment in other countries appears sensible and should be pursued by Australia.

Recommendation 19: IBSA recommends that Australian law specify the source rules to apply when tax on employee share rights is deferred until the rights are exercised. In treaty negotiations Australia should follow the OECD approach that share rights should be taxed where they are exercised with relief for periods of employment in other countries.

4.9 Providing Administrative Support for Foreign Expatriates and Employers

(Option 5.4)

The need for a special tax advisory service for foreign expatriates and their employers can be seen as a measure of the complexity of the tax rules. IBSA members report their expatriate staff are often perplexed by Australian taxation arrangements and seek advice from their employers. It would be helpful for the ATO to have a specialist cell to provide expatriate tax advice, within reasonable administrative cost. This need might be lessened by adopting the general and easy to understand principle that temporary residents in Australia should be taxed on their Australian sourced income and investment gains and should not be taxed on foreign source income or changes in foreign asset values.

5. Other Issues

5.1 Taxation of Financial Arrangements

As they stand, the rules for the taxation of financial arrangements (TOFA) involve great uncertainty, complexity and risk for taxpayers and the ATO. Financial institutions are most affected and the amount of tax payable under the law may have little bearing on their economic performance.

It is vital for the competitiveness of Australia as a location to conduct international business that a comprehensive and economically sensible TOFA regime is introduced without delay. TOFA is already over a decade in planning and it is too important to contemplate further slippage.

TOFA should include elective mark-to-market valuation rules for taxation and recognition of internal hedging for financial arrangements. We acknowledge and welcome the Governments proposal to address the serious complexity and uncertainty surrounding the taxation of foreign currency transactions through legislation in the Spring sittings. However, it is necessary to introduce a comprehensive set of arrangements from the beginning of the income tax year that occurs on or after 1 July 2003 (to take account of taxpayers with substituted accounting periods) and taxpayers should be able to adopt mark-to-market valuation on an elective basis.

Benefits would accrue in the following areas:

Profit Measurement - Mark-to-market tax valuation would provide a proper reflection of economic profits for tax purposes. The current focus on realisation values delivers a low natural correlation between taxable profits and the economic profits and imposes a significant compliance cost on financial institutions.

International Competitiveness - Australia's unique methods for taxing financial arrangements are dated and out of step with international practice, under which mark-to market tax valuation is the norm. This creates significant tax problems, for banks that conduct international business from Australia.

Efficiency - Market valuation for tax purposes would better accord with banks' financial accounting processes and would deliver significant efficiencies relative to the existing taxation rules. Banks must generate a significant amount of tax specific information under the existing rules.

Certainty - Unrealised timing differences under the existing tax rules require complex and often large adjustments to the financial management records. It is to the benefit of both taxpayers and the tax authorities that this is minimised.

Recommendation 20: IBSA recommends that an elective mark to market tax regime should be introduced for financial arrangements without further delay.

TECHNICAL ATTACHMENTS

Technical Attachment 1

The UK treaty[11] provides a useful basis to review the problems associated with dividends received by permanent establishments (PEs) as, given the standing of London as a global capital market, it is a realistic location for a parent of a securities company that might want to operate through a branch in Australia.

Assume a PE and a subsidiary of a UK securities company both receive three dividends, each of $70:

- The first dividend is unfranked;
- The second dividend is fully franked in relation to a share that is held for more than 45 days;
- The third dividend is fully franked in relation to a share that is held for less than 45 days.

Assume both incur deductible expenses (however determined) of $50 in relation to each dividend.

1. Unfranked dividends

Subsidiary

The subsidiary would be taxed on the dividend and get a deduction for the expenses. Therefore, in this example it would pay tax on a net $20 (tax liability of $6). There is no withholding tax liability, so the tax would be paid via the on-going instalment system. Thus, the subsidiary could pay $14 in dividends to its UK parent and receive a tax credit for tax already paid in relation to this in Australia.

Permanent establishment (PE)

In contrast to the subsidiary, the treatment of the PE is not clear. The dividend is subject to withholding tax (s.128B(1) and (4), with no exclusion in ss.(3)) but the application of those rules in conjunction with the Australia-UK Tax Treaty is anything but clear.

The prima facie rate of tax is 30% of the gross dividend of $70 (s.7, *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974*) and related expenses would not be deductible.

It is not clear how the payer of the dividend would have to treat the dividend. The PE would have an Australian office and bank account. Accordingly, s.12-210 of *Taxation Administration Act 1953* (TAA) would not require withholding as the dividend payment would always be to an Australian address. Section 12-215 of the TAA may or may not apply. It would not apply if the dividend is paid directly to the non-resident branch (s.12-215 requires a different recipient from the beneficial owner), but it would apply if the dividend was paid to a resident

[11] The UK treaty is used here as an example, which differs in some respects from other treaties, ie France.

custodian or nominee (in the latter case, there would be a payment to a "person in Australia" and a foreign resident that is then entitled to the dividend).

Assuming that some withholding was required under s.12-215, the amount to withhold is also unclear. Taxation Administration Regulation 40 seems to be the only relevant domestic rule. Reg.40(2)(b) is the relevant paragraph for s.12-215 and it provides that tax should be withheld at the rate prescribed in the relevant double tax agreement (DTA).

There is no explicit rate provided in the UK DTA, as Article 8 does not apply to dividends effectively connected with a PE.

Article 5 might apply, but it is not clear at what rate of withholding tax. It seems unlikely that a company or custodian would have systems to allow "variable" withholding rules for a particular investor/client, so in practice either no withholding tax would be levied or, more likely, tax would be deducted at 15% of the gross dividend (just as it would be to any other UK resident). Alternatively, the PE could apply to the ATO for a ruling to permit an "average" rate of withholding, and then advise each company/custodian of that rate. The difficulties inherent in this process cannot be over-stated given a potentially large number of investments with varying dividend and franking rates.

While the withholding rules may provide for 30% tax on gross income, Article 5 of the UK treaty would determine the actual tax, as double tax agreements override the domestic law in this respect.

However, this is very hard to apply in a practical sense. Section 128D makes the dividend "exempt" income, so it cannot simply be included on a tax return with a claim for associated expenses. The PE would probably need to lodge a treaty claim with the ATO, showing all dividend income, the expenses that relate to that income and any amount of withholding tax deducted.

It would be necessary to convince the ATO of the reasonableness of this position and then seek a refund, or pay tax, on the difference between the actual amount due and the withholding tax already deducted. It is likely that more tax would be withheld than was due, so the PE would have to fund that tax pending receipt of the refund.

The practical aspects of all this are discomforting. The required tracing of expenses to dividends would be very difficult to implement and that would make forecasting tax and after-tax results equally difficult.

Once all of this is worked out, it would be necessary to pursue the revenue authorities in the UK for a credit in respect of the net tax paid. The administrative work required in the UK to affirm the application of Article 5 would likely include agreement with the UK revenue authorities.

In short, Article 5 of the DTA may give rise to the right result in the end (being the same overall tax as for the subsidiary), but only after quite a bit of complexity and additional administration for both the ATO and taxpayer that would impose significant additional costs and risk on the branch.

2. Franked dividends, "qualified" investor

Subsidiary

A subsidiary would be taxed on the dividend and the franking credit (s.207-20 of the *New Business Taxation System (Imputation) Act 2002*) and it would get a deduction for the expenses. Effectively, the credit would offset tax on the gross dividend, so the subsidiary should get additional deductions of 50 (potentially worth $15 at a 30% tax rate if able to be used). The implied accounting profit of 35 (70-50+15) could be distributed to the UK parent without further Australian tax.

Permanent Establishment

The position for the PE is different. Section 128D makes the dividend exempt income, so no deductions are allowed against it. Section 128B does not impose any tax due to the exemption for franked dividends (s.128B(30(ga)). The net result is an accounting profit of 20 (70 income less 50 expenses), which could be distributed to the head office with no further tax and the branch is worse off to the extent that it cannot use the deductions that the subsidiary could.

3. Franked dividends, "unqualified" investor

Subsidiary

A subsidiary would include the dividend (but not the franking credit due to s 207-145 of the *New Business Tax System (Imputation) Act 2002*) in assessable income, claim the $50 expenses as deductions, and pay tax of $6 on the $20 net profit. The remaining $14 could then be distributed to the UK parent as a fully franked dividend free of any further tax.

Permanent Establishment

As the dividend is franked, no withholding tax would apply (s.128B(ga) is not affected by the qualified investor rules). Section 128D makes the dividend income exempt and the expenses are ignored (as they relate to exempt income). That net exempt income does not need to be offset against any other tax losses in the PE (s 36-20).

Thus, the PE makes an accounting profit of $20 that could be distributed without any further Australian tax to the UK head office. The PE obtains a more favourable outcome in this circumstance, but this must be qualified by the several significant factors.

The 'benefit' assumes that the tax treatment of the home country respects that benefit. In this example, the $20 'tax free' gain would be taxed in the UK with no credit, so the group would have paid the same amount of tax. Obviously, that may be beneficial in some cases if the home country has a lower rate of tax or an imputation system, or where foreign source income that is taxed overseas is exempt from home country tax. However, the UK is not the only country where that would not be case.

Further, share trading will attract all three types of dividends and it is not possible to run only franked but unqualified dividends through the PE. To get the 'benefit' from being an unqualified investor, the PE would also get the 'detriments' associated with the unfranked and qualified holdings. The problems with the unfranked dividends in particular would diminish, if not override, any enthusiasm for seeking this form of benefit.

Solution

The practical answer to this problem is a simple one: to exclude from 128B and 128D dividends the derivation of which are effectively connected with a branch in this country. That would reflect the treatment of interest and bring such dividends to tax on an assessment basis. This would seem to result in the same treatment of permanent establishments and subsidiaries for unfranked and unqualified franked dividends.

PEs would still be at a disadvantage in respect of franked qualified dividends but only on the basis of a "policy" question - viz, whether the residency requirements in Sub-Divisions 207-C and 207-D (*New Business Tax System Imputation) Act 2002*) are appropriate or not. This matter would be resolved if Recommendation 7 of our submission were adopted.

Technical Attachment 2

This attachment outlines the need for greater certainty in regard to the legal status of supplies from an Australian branch to its offshore parent. The Government's policy position is quite clear and industry is in agreement with it – a supply from a branch in Australia to its overseas parent should be treated in effect as an export.

The GST Act – How it Reflects Cross-border Branch/Parent Dealings

The starting point in GST law is that transactions between an Australian branch of a foreign bank and its parent bank are not recognised. This is based on the legal principle that you cannot contract with yourself and is confirmed sup 1.17 of the Senate Supplementary Explanatory Memorandum to the GST Act.[12]

Division 84 treats all "transfers" of anything to a branch in Australia from its overseas parent as if it were a transfer between two separate entities and collects GST on imports of taxable service supplies. [13] However, this treatment is asymmetrical, as outbound supplies to the parent entity are not recognised in the same way.

The Act attempts to replicate separate entity treatment for outward-bound supplies from the Australian branch to its overseas parent (exports according to government policy) using a different approach to Division 84. This method relies on two devices:

1. If the parent bank uses a supply that it receives from its Australian branch to make a financial supply – s.11-15(3) generates an input tax credit for acquisitions by the branch in relation to that supply.
2. If the parent bank uses a supply that it receives from its Australian branch to make a supply other than a financial supply – s.11-5 generates an input tax credit for the acquisitions, which are considered to be "in course of carrying on an enterprise".

The GST Act Fails to Deliver a Secure Outcome for Branch Exports

Unfortunately, these legal devices fail to deliver a reliable outcome and it may be arguable that branch supplies to its overseas parent are not recognised as exports (i.e. do not generate an input tax credit).

With regard to the first device; s.11-15(3)

This device is faulty because (unlike s.84-15) it does not explicitly recognise the supply from the branch to the parent bank. It does not treat the parent bank as a

[12] In regard to a supply from a branch in Australia to its parent entity offshore (including other overseas branches), the supplementary EM states, "The GST Bill does not currently treat such transfers to overseas branches as exports because it is a supply entirely within the entity". The EM does not refer to the use to which the supply is put by the parent, so it apples equally to parent financial and non-financial supply activity.

[13] Also, note the extremely broad import of the terms "transfer" and "anything". It appears that these concepts are intended to be uniquely expansive, extending beyond the notion of supply and thing. The result could be that branches are taxed more broadly than any other supplier.

separate entity to the branch but rather seeks to look through the supply from the branch to the parent. It does not rely on what branch does with its acquisition to generate an input tax credit, but rather skips a stage in the production process and looks to the supply by the parent for that purpose (after the input has been transformed by the branch and embedded in a supply to the parent).

It effectively pretends that the branch does not exist and places the parent bank in Australia as the acquirer of the input purchased by the branch – and it appears that because the financial supply by the parent is presumed to be to a non-resident, it is treated as an export, thus generating a credit.[14]

It follows that, in order to generate an input tax credit, it would be necessary to trace the acquisition to the supply by the parent. Tracing in this manner is unrealistic from a practical perspective and calls into question the functional value of the device.

The solution to the tracing problem may be that, taking the GST Act as a whole, all supplies by the branch to the parent bank are effectively treated as exports and, hence, there is no need to trace (i.e. to identify those supplies to the parent that are for input taxed or other supplies). If the Act worked as intended, this would be the outcome. Unfortunately, there are two problems:

1. It is not clear that a strict reading of the law by a court (or indeed by an ATO officer on a tax audit in five years time) would deliver a view that no tracing is required, since the underlying connection between the branch acquisition and parent bank supply is explicitly stated in the Act and, hence, may have to be demonstrated.

2. Probably more importantly, if any part of the first or second devices fails, then not all supplies from the branch to the parent will generate an input tax credit and tracing would then be required. This matters because there are doubts about the reliability of the Act in other respects – an issue that we now turn to.

With regard to the second device; s.11-5

Section 11-5 provides an input tax credit for the acquisitions that are considered to be "in course of carrying on an enterprise". However, this section may not cover a branch acquisition in relation to a later supply by its overseas parent offshore that is not covered by s.11-15(3) (i.e. a non-financial supply by the parent).

Consider a branch that serves as a centre of excellence, or regional management function, within the global parent bank. In this regard, it makes a supply only to the parent bank (i.e. no part of the supply is made to a third party).[15] For example,

[14] This raises the interesting question of what the appropriate treatment should be if the parent bank makes the financial supply to an Australian resident.
[15] This seems to be a supply of the type referred to in the supplementary EM (Sup. 1.18) as being entirely within the same entity.

the branch in Australia may undertake market risk analysis for the parent bank within the region, with no element of this supply made to an external client.[16]

Is the acquisition by the centre of excellence made "in course of carrying on an enterprise"? This is by no means certain, as the centre within the branch does not produce any 'output' under the GST Act – the parent bank does make a downstream output but, unlike s.11-15(3), s.11-5 does not seek to look through to the parent bank's supply to generate an input tax credit.

Section 9.20(1) defines an enterprise to be "an activity or series of activities, done:

(a) in the form of a business; or
(b) in the form of an adventure or concern in the nature of trade; or
(c) ....etc

Business is defined in s.195-1 as including "any profession, trade, employment, vocation or calling".

Now, can a supply by you to yourself be an activity in the form of a business? That is, does an activity within an entity that is dedicated entirely to the supply of a service to that entity constitute an enterprise?

If not, then the supposition in Treasury's interpretation of the Act that the branch centre of excellence could claim an input tax credit is open to question.

It is interesting that s.9.20(3) states that because an entity is limited to making supplies to members of that entity, it not prevented from being treated as a business, within the meaning of s.9.20(1)(a) above. However, it does not state that similar treatment applies to supplies between enterprises within the one entity (unless members can be read to include enterprises, which is not apparent).

Implications

The legal devices to deliver an input tax credit for inputs relating to branch supplies to its overseas parent are faulty because they do not deliver an acceptably certain legal outcome. Moreover, there is no symmetry between inward and outward supplies. We need an unambiguous legal position that is on a sound conceptual footing and the separate entity approach would deliver this.

A PE is in effect a surrogate "entity". This is recognised in the Review of Business Taxation Report (see recommendation 22.11) and is reflected in the approach taken by the ATO in its implementation of transfer pricing rules. Importantly, if a PE is treated as a separate entity the entire Act operates with almost seamless precision across all provisions, dispensing with the ever-expanding piecemeal specific provisions that seek to provide the same outcome.

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[16] To complicate matters, in some circumstances, the underlying transaction contemplated by the parent bank may fall through (eg because the bank loses a client), in which case no subsequent supply takes place at all.