SUBMISSION TO THE BOARD OF TAXATION
REVIEW OF INTERNATIONAL TAX ARRANGEMENTS

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As a lecturer at the School of Business Law, Curtin University of Technology, I recently presented a paper at the Australian Law Teachers Conference, held on the 29 September to 2 October at Murdoch University in Perth. Some of the issues discussed in my paper forms the basis of my submission to the Board of Taxation on the Review of International Tax Arrangements. My paper entitled *Tax Policies for Multinational Enterprises (MNEs)* is attached for a more detailed discussion.

A summary of the issues arising from the conference paper that I firmly believe should be addressed by the Australian Government in reviewing the International Tax Arrangements are outlined below.

1. Targeting Australian Tax Policy to attract MNEs within its jurisdiction

A vast number of different taxation provisions and the double tax treaty rules exist under the current system to which MNEs are exposed. MNEs can respond to the different tax structures by: moving physical locations, headquarters, plant and R&D facilities; financially restructuring so as to pay the lowest overall global tax rate; or using transfer pricing to shift profits to low-tax countries. Individual Governments have responded to this behaviour by altering their policies to attract MNEs within their jurisdiction, thereby creating tax competition.

The reason for countries wanting to attract MNEs within their jurisdiction is that there are numerous benefits arising from having MNEs located within a country. There is evidence of MNEs facilitating export trade. In 1999, US exports associated with U.S. MNEs were 63% of total U.S. exports. The location of headquarters of an MNE increases employment opportunities, especially for skilled workers and in the areas of management, finance, marketing, and research and development. In the U.S., 71% of its MNE employees are located in the United States and 87% of its MNEs research and development is conducted in the United States.[1]

Many countries have reduced their top corporate income tax rate to attract MNEs within their jurisdiction. For example, Ireland has reduced its top corporate income

[1] U.S. Department of Commerce, *Survey of Current Business*, March 2000, cited in Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government" (2002) No 431 *Policy Analysis*, 24.

tax rate by 22% in the last six years. The average top corporate rate for national governments in OECD countries fell from 41% in 1986 to 32% in 2000.[2]

The following table illustrates the drop in the top corporate tax rates of some OECD countries in the six years preceding 2002, together with the current top corporate rate.

Table 1
Top Corporate Income Tax Rates (%)[3]

COUNTRY	REDUCTION IN TOP CORPORATE RATE FROM 1996 TO 2002 (%)	TOP CORPORATE RATE IN 2002 (%)
Australia	6	30
Canada	6	38.6
Germany	19	38.4
Hungary	15	18
Iceland	15	18
Ireland	22	16
Italy	13	40
Japan	10	42
Luxembourg	10	30.4
Poland	12	28
Portugal	7	33
Switzerland	4	24.5
Turkey	11	33
UK	3	30
USA	0	40

The Australian Government, in its consultation paper "Review of International Tax Arrangements" has focused on specific international tax rules. In addition to specific tax changes, Australia can follow the examples of other countries and also reduce the overall corporate tax rate. In order to attract foreign capital, Australia needs to aggressively create policies to encourage foreign MNEs to invest in Australia. Australia should follow the example of Ireland and consider granting tax holidays to MNEs to invest in certain industries that will benefit Australia, e.g. the mining

[2] Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government" (2002) No 431 *Policy Analysis*, 10.
[3] Data extracted from KPMG, "Corporate Tax Rate Survey" January 2002, cited in Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government" (2002) No 431 *Policy Analysis*, 12.

industry. Many mining companies that are starved of capital are going to the U.K. to seek capital for exploration in the Alternative Investment Market.[4]

2. Redesigning the Australian imputation system to allow Australian companies to expand internationally.

One of the major problems with the Australian international tax arrangement is the dividend imputation system, which is not designed for companies to expand and operate in this increasingly globalised world. When Australian companies with both resident and non-resident shareholders frank their dividend distributions,[5] the franking credits on dividends to non-resident shareholders are wasted. The companies are not allowed to stream franking credits to Australian shareholders alone. The main problem is caused by the interaction of the taxation of foreign source income and the dividend imputation system.

It is evident from the consultation paper that the problem caused by the interaction of taxation of foreign source income and the dividend imputation system tax has resulted in creating very few MNEs out of Australian resident companies. Only 2.8% of the total Australian resident companies reported foreign source income. The consultation paper provides three options to reduce this bias.[6] However, these options only marginally remove the bias and may not be enough to encourage Australian companies to become MNEs.

Option A only grants a non-refundable credit of 10%, i.e. one-ninth of the foreign source dividend. In order to match the return, the non-refundable credit should be 30%. Allowing dividend steaming under Option B will only benefit companies with foreign investments and foreign shareholders. It is unlikely to help Australian companies that are not MNEs, to become MNEs. However, Option B may save companies from creating dual listing structures in order to stream dividends. Option C will only be of benefit if the foreign country has deducted withholding tax from the dividend, and this option is only likely to benefit around 20% of Australian direct investment.

The consultation paper released by the Australian Government is definitely a step in the right direction. Australian companies should be encouraged to become MNEs by investing in foreign affiliates, as there is evidence that foreign affiliates boost local exports.[7] In addition, if Australian companies remain small, they may not be able to compete with larger MNEs from other countries. Australia is in a unique position having a diversified population, with migrants from many different countries. It is likely that people who have migrated to Australia have maintained family and

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[4] Bromby R, "London lures miners after cash" The Australian, 9 September 2002.
[5] A franked dividend is paid from a company's taxed profits and can reduce the tax liability of an Australian shareholder by the amount of company tax paid.
[6] Commonwealth of Australia, "Review of International Tax Arrangements" August 2002 [Electronic] Available http://www.taxboard.gov.au.
[7] In the U.S., 63 percent of U.S. exports are associated with U.S. MNEs. See note 205 in Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government" (2002) No 431 *Policy Analysis*, No 431.

business contacts in other countries and would therefore be in a position to exploit overseas markets.

In order to encourage Australian companies to expand overseas, it may even be worth considering replacing the whole structure of taxing Australian residents on world wide income which is based on capital export neutrality, with a territorial system which does not tax foreign source income, as applied in Hong Kong, the Netherlands, and France. A territorial system would encourage Australian individuals and companies to search for foreign markets and expand overseas, while still maintaining headquarters in Australia. Alternatively, the future tax policy design should make the net return from non-portfolio foreign investment the same as the return from an investment in an Australian company.

3. Removing complex anti-avoidance rules

The current Australian controlled foreign companies (CFC) and foreign investment funds (FIF) rules are anti-avoidance rules to protect Australia's tax base. To comply with these complex rules, MNEs are likely to suffer relatively high compliance costs. In order to promote Australia as a location for internationally focused companies, the CFC rules should be re-written without giving favourable tax treatment to certain countries. Similarly FIF rules could also be replaced by a simpler regime.

4. Encouraging complying superannuation funds to invest in Australian companies

Complying superannuation funds should be encouraged to invest in Australian companies through tax incentives. One such incentive may be to neutralise the tax treatment of dividends, i.e. the tax effect should be the same whether the dividend distributed to superannuation fund shareholders is through foreign source income or Australian source income of Australian companies.

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TAX POLICIES FOR MULTINATIONAL ENTERPRISES (MNEs)

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Abstract

Globalisation has increased the mobility of capital, labour and information and as a result, MNEs move to jurisdictions that give them the greatest opportunities and returns. MNEs dominate global markets, with estimates showing that more than 40% of world trade is accounted for by intra-firm flows. The top 100 MNEs own 16% of world assets. Many countries have responded to globalisation by entering into tax competition, reducing personal and corporate income taxes, and at the same time adopting defensive tax rules to prevent their residents from enjoying lower taxes abroad. These defensive rules often have a detrimental effect, driving MNEs away to relocate in other jurisdictions.

This paper examines the impact of international tax competition on MNEs and the fundamental Australian international tax rules affecting MNEs. Tax competition includes tax policy influence by one country over another country. Like other countries, such as the UK, Ireland, Sweden and Germany, it is time for Australia to enter into the tax competition "game" by making its tax laws more attractive for MNEs to become and then remain resident of Australia. The Australian Government is aware of this and has recently released a consultation paper entitled "Review of International Taxation Arrangements". This consultation paper outlines a number of options for review by the Board of Taxation, a statutory body established to advise the Australian Government on implementing tax policy. These options and their possible impact on MNEs are reviewed in this paper. The paper concludes by examining the criteria for shaping future Australian tax policy in response to international tax competition and the need to attract and maintain MNEs in Australia.

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Tax Policies for Multinational Enterprises (MNEs)

1 Introduction

An MNE is an entity that conducts business in more than one jurisdiction, whether it is a single taxpayer entity or a group of such entities. Arguably, the term MNE has no technical significance as an international taxation regime because the taxation of MNEs does not exist. MNEs are exposed to the laws of the country in which they operate. The taxation of an enterprise that is resident in one country, but has a source of income from another country (therefore an MNE), is currently based on the domestic taxation laws of both the resident and the source countries, and any double tax treaties between those countries.

Many factors have allowed MNEs to become mobile and also increase in size. The behaviour of MNEs therefore has an impact on a country's tax policy. When one country responds by reducing the tax rates to attract MNEs into their jurisdiction, other countries follow. This gives rise to international tax competition. Australia is currently reviewing its international tax policy in an attempt to ensure that Australia remains competitive in the world economy.

This paper is divided into six sections. Following this introduction, the second section provides a general background on MNEs followed by the impact of tax policy on MNEs behaviour in the third section. The fourth section deals with tax competition as a global response to the behaviour MNEs. The fifth section poses the question of whether international tax competition is harmful. The sixth section reviews Australian tax policies for MNEs in an overview of Australia's international tax arrangements, taking into consideration the options in the consultation paper *Australian review of International Tax Arrangements*[1] and the possible future Australian tax policy for MNEs. The paper ends with a brief conclusion.

2 Overview of MNEs

In the last decade, MNEs have grown as a result of rapid technological change, trade and investment liberalisation, privatisation, deregulation and geographic diversification. From 1997 to 1998, there was a 71% increase in Foreign Direct Investment (FDI) by firms into and from OECD countries. FDI normally refers to foreign investments that result in large ownership stake (usually more than 10%) in a foreign affiliate. The main cause of the increase was large-scale cross-border mergers and acquisitions, particularly between American and European firms.[2] Ireland, the Netherlands, Luxemburg and Switzerland accounted for 9% of Europe's GDP, but attracted 38% of the U.S. FDI to Europe between 1996 and 2000.[3] The world's FDI

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[1] Commonwealth of Australia, "Review of International Tax Arrangements" August 2002 [Electronic] Available http://www.taxboard.gov.au.

[2] OECD Report: Financial Market Trends, *Recent Trends in FDI*, No 73, June 1999.

[3] Sullivan M, "Data Show Europe's Tax Havens Soak Up U.S. Capital" (2002) 4 Feb *Tax Notes*.

increased in the10 years preceding 2000 from US$204 billion to US$1.3trillion. In 1999, the United Nations world report revealed 60,000 MNEs in the world, with investments in 500,000 foreign affiliates.[4]

The OECD has recognised that, within the process of globalisation, the taxation of MNEs is becoming an increasingly important issue, given the fact that MNEs are getting bigger:

> "Firms of an annual turnover of US$100 billion dollars are now increasingly common. This exceeds the combined GDP of Papua New Guinea and New Zealand. Multinational enterprises dominate global markets, with estimates showing that more than 40% of world trade is accounted for by intra-firm flows. The top 100 multinationals own 16% of world assets. What these few examples show is that a very large part of the global corporate tax base is now accounted for by the operations of multinational corporations."[5]

MNEs that operate on a global scale play a vital role in the economy. MNEs form the largest trading block in Australia, a trend which is duplicated around the world. During the 1996/97 year, 46% of the total Australian corporate tax revenue was raised from MNEs with operations in at least two countries.[6]

Many countries are giving preferential treatment to MNEs, to lure them within their jurisdiction. For example, Ireland has a 10%[7] tax rate on profits earned by foreign manufacturing companies that move there, and foreign financial companies that operate there.[8] This has been beneficial for Ireland. Due to foreign firms moving there, its GDP now exceeds Britain's, and it is expected to exceed the European Union average by 2005.[9]

Research in the US indicates that in deciding where to locate the production facility of an MNE, regard is given to the foreign tax credit incentives and the US and foreign country tax rates.[10] The savings in taxation arising from the correct choice of location for an MNE more than offsets the costs arising from non-tax factors such as quality of

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[4] Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government" (2002) No 431 *Policy Analysis*, 5.

[5] Shelton J, the Deputy Secretary General of the OECD, at the first joint meeting of the OECD with senior representatives of APEC countries, cited in Azarias J, *OECD-APEC meeting addresses the issues*, International Tax Report, IBC Publishing, 1997.

[6] Maiden M, "ATO focuses on multinationals' global dealings" (1997) [Electronic] Available: http://www.theage.com.au/daily/990706/bus/specials/bus1.html

[7] The 10% rate is a special rate to attract foreign manufacturing companies. The standard corporation tax rate for other trading income is 16%.

[8] The 10% rate will be replaced by 12.5% from 1 January 2003. Existing operations which are eligible for the 10% rate will retain entitlement to this rate until the end of the year 2010 in the case of manufacturing

[9] Bishop M, "A Survey of Globalisation and Tax: The mystery of the vanishing taxpayer" (2000) *The Economist*, 3-18.

[10] Kemsley D, "The effect of taxes on production location" (1998) *Journal of Accounting Research*, 36 (2), 921-941, cited in Shackelford D., and Shelvin T, "Empirical tax research in accounting" (2001) 31 *Journal of Accounting and Economics*, 321-387.

workforce, infrastructure and political stability.[11] Tax holidays are also positive incentives in attracting MNEs, but rank low compared to other factors.[12] These other factors include dividends, royalties and even interest payments.[13]

A tax policy design to attract MNEs within a country requires a study of the behaviour of MNEs and how they respond to tax policy changes. It is worth questioning whether the countries are responding to MNEs behaviour or whether MNEs are responding to the international tax system of individual countries, systems that were originally put into place by countries when MNEs were not a large economic force. The growth in MNEs has been brought about by globalisation, arising from increased trade and investment flows, greater mobility of labour and an increase in electronic commerce. These factors allow an entity to expand into other countries and the entity thus becomes an MNE. The rapid exchange of information not only opened doors for MNEs to take advantage of the foreign markets, foreign capital and foreign technology, but also enabled MNEs to choose the most efficient tax structure. Countries have become aware of this and are responding to this MNE behaviour by altering their tax policies to attract MNEs within their jurisdiction. It has turned into a vicious cycle whereby individual countries respond to MNEs behaviour by altering their tax policy, and MNEs respond to the altered tax policy, leading to more tax policy changes by individual countries. In the long run, an internationally agreed solution may be required to stop this vicious cycle. However in the short term, countries have to enter into the cycle, or be left behind.

3 Tax Policy Impact on MNE Behaviour

3.1 Taxation of MNEs

In order to understand how the tax policy impacts on MNE behaviour, it is first necessary to understand how MNEs are taxed.

A typical MNE would have a holding company resident in one jurisdiction, with branches or subsidiary companies in other jurisdictions. Each of the jurisdictions in which an MNE has a presence may have a right to impose taxation. That country's right to impose taxation can be justified on the basis that it is either the country of residence, the country of source, or the country of destination. However, different countries have different rules on the taxation of residence, source and destination. A company resident in one country may have a manufacturing subsidiary or branch in another country with sales of its products in a third country. The country of residence may impose tax on the world-wide income of its resident company. However,

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[11] Wilson P, "The role of taxes in location and sourcing decisions" in Giovannini A, Hubbard G, Slemrod J, *Studies in International Taxation*, University of Chicago Press, 195-231, cited in Shackelford D, and Shelvin T, "Empirical tax research in accounting" (2001) 31 *Journal of Accounting and Economics*, 321-387.

[12] Single L, "Tax holidays and firms' subsidiary location decisions", *Journal of the American Taxation Association*, 19 (2), 1-18, cited in Shackelford D, and Shelvin T, "Empirical tax research in accounting" (2001) 31 *Journal of Accounting and Economics*, 321-387.

[13] Collins J and Shackelford D, "Global organizations and taxes: An analysis of the dividend, interest, royalty, and management fee payments between U.S. multinations' foreign affiliates" *Journal of Accounting and Economics*, 24 (2), 151-173, cited in Shackelford D, and Shelvin T, "Empirical tax research in accounting" (2001) 31 *Journal of Accounting and Economics*, 321-387.

depending on the resident country's tax rules, the subsidiary's profits may be taxed in the holding company's country of residence either as it accrues, or when it is repatriated, or may even be exempt from tax. The country where the manufacturing subsidiary or branch is located would also have the right to tax the profits of the subsidiary or branch on the basis that a permanent establishment exists in their jurisdiction. As a result a juridical double taxation arises from a residence/source clash. This double taxation may be relieved if there is a double tax treaty in place.

Different countries also have different laws of taxing dividends paid by an MNE. If an MNE is a company, it is treated as a separate legal entity. This means that it has an existence independent of its ultimate owners, the shareholders. Some countries tax companies and their shareholders as two distinct taxpayers. This is called the classical system of taxation, as adopted in USA. Other countries, like Australia, have an imputation system, whereby companies are merely conduits through which profits flow to the shareholders. Other countries use a combination of the two approaches. In addition, dividends paid to non-resident shareholders may have yet other rules, and a withholding tax may also be imposed. The rate of withholding tax may vary from country to country, depending on the double tax treaty in place.

3.2 MNEs Response to the Different Tax Structures

A vast number of different taxation and the double tax treaty rules exist under the current system to which MNEs are exposed. MNEs can respond to the different tax structures in the following ways:

MNEs can move physical locations, headquarters, plant and R&D facilities

Many MNEs have moved physical locations to take advantage of better capital write-offs, depreciation deductions and research and development facilities and reliefs. In USA, the Daimler-Chrysler merger was followed by a shift in its headquarters to Germany, partly because of more favourable tax rules. According to statistics published by the Irish Industrial Development Authority, 1,212 foreign companies operated in Ireland in the year 2000, including 497 American companies, 198 British companies and 172 companies from Germany.[14]

James Hardie Industries is a recent example of an Australian MNE relocating overseas to reduce its overall tax rate.[15] Dual listing structures such as that of BHP Billiton and Argyle Diamonds bring about tax advantages.[16] In the case of James Hardie Industries, by moving to the Netherlands it could reduce its worldwide tax rate from between 40 -50% to 25-30%. Most of James Hardie Industry's profitable business is from the US, and 90% of its shareholders are Australian. Under the double tax treaty between Australia and the US, the withholding tax rate to repatriate the profits to Australia was 15%. A Netherland based James Hardie Industries would only pay 5% withholding tax under the Netherlands-US tax treaty. This would increase James Hardie Industry's after-tax profits by about $30 million a year, being savings of

[14] Derived from "The Complete Worldwide Tax and Financial site", at www.worldwide-tax.com
[15] Rennie P, "Offshore Expatriate Hardie gives others itchy feet" (2001) 5 Dec *Business Review Weekly*.
[16] Ibid.

approximately $13 million on withholding tax and $17 million on other Netherlands taxes.[17] Since then, the Australian government has successfully negotiated with the US government a reduction in the withholding tax rate in the Australia-US double tax treaty.

A number of studies done in the USA confirm that high tax rates are negatively correlated with the establishment of new plants and plant expansion. Hines reports dramatic reactions of firms relocating their headquarters from countries with high tax rates to countries with more attractive tax climates. Hines concludes that taxation significantly influences the location of FDI, corporate borrowings, transfer pricing, dividend and royalty payments and research and development performance.[18] Similar studies of U.S. multinationals between 1984 and 1992 found that 30% less US FDI was received by countries which had tax rates 10% higher than other countries.[19] An International Monetary Fund (IMF) study found that countries with lower tax had larger FDI's than countries with higher tax.[20] Corporate data analysed by Hines from 1984 to1992 showed that by 1992, a typical American MNE had become twice as likely to locate its operations where taxation was lowest, compared to its behaviour in 1984.[21]

Financially restructure so as to pay the lowest overall global tax rate

An MNE has the potential to take advantage of the best international tax rules to minimise its tax liability. International tax expert Tim Edgar says multinationals are in a position where the decision to pay taxes becomes almost voluntary. This means that certain companies may take advantage of the international tax regime and drastically reduce their overall tax rate. For example, in 1998, News Corporation paid taxes at a rate of 7.8 per cent on operating income, compared with companies like Walt Disney which had a tax rate of about 28 per cent. Viacom, which owns MTV and Paramount Pictures, paid 22 per cent; Time-Warner, a US-based company that is about the same size as News Corporation, paid about a 17 per cent rate.[22]

There are many ways for MNEs to reduce their overall tax rate. MNEs have the financial and economic strength, enabling them to use the best structure that will

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[17] Ibid.

[18] Hines J, "Lessons from behavioural responses to international taxation" (1999) Vol 52 Issue 2 *National Tax Journal*, 305-322.

[19] Altshuler R, Grubert H, and Newlon S, "Has US Investment Abroad Become More Sensitive to Tax Rates?" *International Taxation and Multinational Activity*, 28, cited in Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government" (2002) No 431 *Policy Analysis*, 7.

[20] Gropp R and Kostial K, "The disappearing Tax Base: Is Foreign Direct Investment Eroding Corporate Income Taxes?" IMF Working Paper 173, Oct 2000, www.imf.org/external/pubind.htm, cited in Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government" (2002) No 431 *Policy Analysis*,7.

[21] See Hines J, "Lessons from Behavioural Responses to International Taxation" (1999) *National Tax Journal*; and Altshuler R, Grubert H, and Newlon S, "Has US Investment Abroad Become More Sensitive to Tax Rates?" (1998) *National Bureau of Economic Research Working Paper*, cited in Bishop, M, "A Survey of Globalisation and Tax: The mystery of the vanishing taxpayer" (2000) *The Economist*, 3-18.

[22] Morris K, Australian Broadcasting Station, Not Shaken, Not Stirred: Murdoch, Multinationals and Tax, 1998 [Electronic] Available: http://www.abc.net.au/news/features/tax/page6.htm

minimise the tax. Decisions whether to operate a foreign business in a branch or a subsidiary can make a difference. A subsidiary is a separate legal entity and the profits of the subsidiary may only be taxed in the country where it is registered and operating and the dividends back to the holding company may either be exempt or eligible for a tax credit. A branch on the other hand is not a separate entity, and some home countries may tax the profits of a foreign branch immediately as they accrue rather than on repatriation.

Appropriate financing decisions can dramatically reduce the overall tax rate of MNEs. Financing the foreign operations by way of loan capital, rather than share capital can bring about an advantage of obtaining a tax deduction of the loan interest. If home country tax rates are lower than the foreign country, then it may be better to fund foreign country operations by way of loan capital, since loan interest would obtain a higher tax deduction in a foreign country and be assessed on a lower rate in the home country. An MNE can therefore achieve a shift of profits from a high tax to a low tax country. On the other hand, if foreign country tax rates are lower than the home country, then funding foreign operations by way of share capital achieves a shift of profits from a high tax to a low tax country. In making this decision, MNEs have to observe any thin capitalisation rules with debt/equity restrictions.

When buying a foreign business, MNEs can reduce the overall tax rate by considering whether to buy the assets in the foreign business or shares in the company that owns it. The price paid for the assets may be tax deductible outright as an inventory or subject to capital or depreciation deduction. On the other hand, the price paid for shares is a capital cost and available for offset against the sale proceeds in calculating the capital gains tax on the sale of shares. If a foreign business has accumulated losses, then the purchase of shares in the company may allow the benefit of tax losses to be offset against future income in the company.

Depending upon any anti-avoidance rules that are in place, an MNE may be able to obtain a tax benefit by transferring a holding company to a jurisdiction that provides special tax privileges to holding companies. Such jurisdictions include the Netherlands, Switzerland and Luxemburg. The benefits include the reduction of withholding tax rate, deferral of tax on dividend and best utilisation of foreign tax credit. Other tax reduction techniques used by MNEs include tax treaty planning, providing loans to a foreign subsidiary via a suitably located finance company that pays little or no tax on interest received, and ownership of intangible rights such as trademarks and copyrights in a suitable offshore company, which pays little or no tax on royalties received. Similarly property, plant and equipment can be rented from a suitably located property investment company.

Use transfer pricing to shift profits to low-tax countries

In the global economy, a large share of the world trade consists of transfer of goods, intangibles and services within MNEs. During the process of transfer, MNEs can use a technique called transfer pricing to reduce their overall tax liability by agreeing upon prices or payments or other terms in ways that enables them to influence the taxable quantum of either party, the taxpaying entity, the taxing jurisdiction and other tax aspects, such as timing and collection. MNEs can use transfer pricing techniques

to shift profits from its affiliates in a high tax jurisdiction to its affiliates in a low tax jurisdiction to minimise the MNEs overall taxation liabilities. As a result, countries have to enact anti-transfer pricing laws to protect their revenue base.

National governments have become increasingly concerned about protecting their domestic tax bases from this type of tax avoidance. Both governments and MNEs should ideally confront the problem of allocating tax revenues among various countries on an equitable basis.[23] Income shifting studies form the largest area of international tax research in accounting. Studies by Mills and Newberry (2001) reveal that the amount of tax paid by a foreign corporation to the US Government varies, depending upon factors such as the US tax rate in comparison to the tax rates in other jurisdictions, the financial performance of the corporation and the method of funding used.[24]

The OECD has been working for several years to achieve an international consensus on transfer pricing rules. Since 1979, the OECD has been involved in setting guidelines based on the arms length principle to determine the prices of transactions between associated enterprises. The OECD's Committee on Fiscal Affairs was also seriously concerned about transfer pricing developments in the US in 1992.[25] As a result of this concern, the OECD released the "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration" in 1995.[26] Since then additional materials have been published periodically. In October 1999, the OECD published an update to the 1995 guidelines.[27]

The OECD is currently focusing on providing guidance on how to apply the general principles of its guidelines to complex situations. The OECD also has the role of monitoring the guidelines and updating them as it becomes necessary, eg. it has recently released a discussion draft on the attribution of profits to a permanent establishment.[28] The aim of the OECD is to pursue a global dialogue on international taxation to provide an environment to attract cross-border investors.

4 Global Response to MNEs behaviour: Tax Competition

Since MNEs take advantage of the international tax arrangements of individual countries in order to reduce their overall tax rates, individual Governments respond to this behaviour by altering their policies to lure MNEs within their jurisdiction, thereby creating tax competition. In the context of international tax policy, tax competition

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[23] Arnold & McDonnel, "The Allocation of Income and Expenses Among Countries: Report on the Invitational Conference on Transfer Pricing" (1993) Vol 10 No 4 *Australian Tax Forum*.

[24] Mills L, Newberry K, "Cross-jurisdictional income shifting by foreign-controlled U.S. corporations" Working paper, University of Arizona, Tucson, AZ, cited in Shackelford D, and Shelvin T, "Empirical tax research in accounting" (2001) 31 *Journal of Accounting and Economics*, 321-387.

[25] Arnold & McDonnel, "The Allocation of Income and Expenses Among Countries: Report on the Invitational Conference on Transfer Pricing" (1993) Vol 10 No 4 *Australian Tax Forum*.

[26] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, 1995, [Electronic] Available www.oecd.org

[27] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, 1999, [Electronic] Available www.oecd.org

[28] OECD, *Discussion Draft of Profits to Permanent Establishments*, 2001, [Electronic] Available www.oecd.org

occurs where a country enacts domestic tax legislation usually by providing a lower tax rate or a tax holiday that affects the tax base of another country. In addition, Governments do not want their residents to take advantage of lower foreign tax rates, so they adopt complex defensive rules, like the Australian controlled foreign companies (CFC) and foreign investment funds (FIF) rules.

The reason for countries wanting to attract MNEs within their jurisdiction is that there are numerous benefits arising from having MNEs located within a country. There is evidence of MNEs facilitating export trade. In 1999, US exports associated with U.S. MNEs were 63% of total U.S. exports. The location of headquarters of an MNE increases employment opportunities, especially for skilled workers and in the areas of management, finance, marketing and research and development. In the U.S., 71% of its MNE employees are located in the United States and 87% of its MNEs research and development is conducted in the United States.[29]

Many countries have reduced their top corporate income tax rate to attract MNEs within their jurisdiction. For example, Ireland has reduced its top corporate rate by 22% in the last six years. The average top corporate rate for national governments in OECD countries fell from 41% in 1986 to 32% in 2000. The average top national individual income tax rate fell from 55% in 1986 to 41% in 2000. The OECD average top individual rate fell from 67% in 1980 to 47% by 2000.[30] The following table illustrates the drop in the top corporate tax rates of some OECD countries in the six years preceding 2002, together with the current top corporate rate.

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Iceland	15	18
Ireland	22	16
Italy	13	40
Japan	10	42

[29] US Department of Commerce, *Survey of Current Business*, March 2000, cited in Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government" (2002) No 431 *Policy Analysis*, 24

[30] Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government" (2002) No 431 *Policy Analysis*, 10.

[31] Data extracted from KPMG, "Corporate Tax Rate Survey" January 2002, cited in Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government" (2002) No 431 *Policy Analysis*, 12.

Luxembourg	10	30.4
Poland	12	28
Portugal	7	33
Switzerland	4	24.5
Turkey	11	33
UK	3	30
USA	0	40

The tendency has been for countries to have a low flat rate on capital income, but higher progressive rates on labour income. Many countries have implemented consumption taxes to maintain their tax base. Some countries have been more aggressive than others in reforming their international tax regimes. The U.K., Ireland and Germany are only a few examples of countries that have changed their international tax arrangements to attract MNEs.

In the U.K., the *Finance Act 2000* worsened the UK's tax regime for international companies, and companies such as Vodaphone and BAT threatened to move the base of their operations out of the UK.[32] The business community put pressure on the UK Government to take corrective measures. The UK Government therefore issued a consultation paper in July 2001, stating its views that the corporate tax system in the UK should keep pace with changes in the global business environment, but not be distorted by tax considerations.[33] The U.K. Government has legislated to allow a relief for capital gains on the substantial shareholdings of companies, and possibly reform the treatment of dividends from foreign countries. Currently, foreign dividends are taxed under a foreign tax credit system.[34]

Germany also reformed its tax system in 2001 in order to become more internationally competitive. The corporation rate was reduced to 25%, applicable to both resident and non-resident companies. The dividend imputation system was abolished, and replaced by the classical system. As of January 2001, a dividend received by a German company from subsidiary companies has no tax deducted at source. Similarly, foreign source income that has been subject to foreign tax comparable to Germany will also remain exempt in Germany. A number of changes on capital gains exemptions are also likely to benefit non-resident corporate shareholders.[35]

In the U.S., since 1984, portfolio interest earned by foreigners on government and private securities is not taxed. These rules were implemented because the US Government realised that there was competition from foreign low-tax jurisdictions to attract international investors. As a result of those rules, USA today attracts US$1.1

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[32] Gorringe J, "The UK's International Competitiveness: The UK Budget 2001 - The UK As A Base For International Holding Companies", [Electronic] Available http://www.lowtax.net/lowtax/html

[33] HM Treasury, Inland Revenue, A Consultation Document: Large Business Taxation: The Government's strategy and corporate tax reforms, July 2001.

[34] Ibid.

[35] Wachtel M, and Capito A, "White Paper: Removing Barriers to International Growth" Business Council of Australia, 2001, [Electronic] Available www.bca.com.au

trillion of foreign deposits in U.S. banks.[36] This mobile capital helps to fuel the US economy and would end up elsewhere if not for the tax policy.

5 Is International Tax Competition Harmful?

When one country reduces its corporate rate or changes its tax policy to attract foreign investment flows, this may have an impact on the tax base of another country. The other country may follow suit and also alter its tax policy and tax rates, leading to international tax competition. International tax competition is like any other competition, except that if competition within a closed economy or country is curtailed by monopolistic behaviour, domestic laws can be put into place to control the harm arising from this curtailment. If international tax competition is abused and leads to monopolistic behaviour by MNEs, there are no international laws to deter this conduct. Organisations such as the OECD can set guidelines, but these guidelines do not have a mandatory force.

The question that needs to be addressed is whether international tax competition is good or harmful to the economy. The term competition was explored in the case of *Re Queensland Co-operative Milling Association Ltd; Re Defiance Holdings Ltd (the QCMA case)*[37] as follows:

> "...Competition may be valued for many reasons as serving economic, social and political goals. ...Thus we think of competition as a mechanism for discovery of market information, It is a mechanism, first, for firms discovering the kinds of goods and services the community wants and the manner in which these may be supplied in the cheapest possible way....At the same time, competition is a mechanism of enforcement: firms disregard these signals at their peril, being fully aware that there are other firms, either too willing to encroach upon their market share and ultimately supplant them.
> ...Competition is a dynamic process; but that process is generated by market pressure from alternative sources of supply and the desire to keep ahead.
> ...effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and that there should be independent rivalry in all dimensions of the price-product-service packages offered to consumers and customers."

MNEs are customers and consumers in the global market. The market for international tax competition relates to all the countries in the world with their political, economic, and social structure, including their tax legislation. Tax competition may make Governments' efficient, as they have an inbuilt tendency to increase costs and therefore increase taxation. Democracy may exert some control over government practices. However democracy can be an inefficient check of government power when it comes to taxation, as there is an increased distance between the electorate and the Government. International tax competition, on the

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[36] US Department of Commerce, *Survey of Current Business*, March 2000, cited in Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government" (2002) No 431 *Policy Analysis*, 18.
[37] (1976) 25 FLR 169

other hand, can act as a restraint on an individual country's Government to increase taxation.[38]

In the 1950's, Charles Tiebout, an American economist argued that tax competition, like any other competition, is good. Governments can compete by offering different combinations of public services and taxes.[39] Tiebout's study was on local governments, and he said that tax competition provides political incentives to improve government efficiency. The international flows of labour and capital are becoming more like local governments and they compete for taxpayers across national borders.[40]

Many theories have been put forward on tax competition. Some of them conclude that tax competition is harmful since it leads to a "race to the bottom" and resources may not end up where they are most needed. Others conclude that tax competition is efficient. The OECD also has a programme to curtail harmful tax competition.[41] The OECD report identifies 6 negative effects of harmful low-tax regimes:
1. distorts financial and real investment flows
2. undermines the integrity and fairness of tax structures
3. discourages compliance by all taxpayers
4. increases administrative and compliance burdens of tax authorities and taxpayers
5. reshapes the desired level of mix of taxes and public spending
6. causes undesired shift of part of tax burden to less mobile tax bases

It has been argued that the OECD seems to be contradicting itself, as cutting taxes to attract investors is good policy, but if it erodes another country's tax base then it is harmful.[42] The OECD reports that the key source of harm occurs when the tax policy in one country affects the tax bases of other countries. A reduction in the tax rate in one country may harm the tax base of another country. However, the OECD also reports that reduction of tax rates is good, that a competitive environment can promote greater efficiency in government expenditure programs.[43]

From an MNEs perspective, tax cuts can result in large economic gains for MNEs. If a country wants part of the MNE output to be within its jurisdiction, it may have to provide some attraction, such as lower tax rates or a tax holiday to create and lure MNEs. Countries may have to choose between lower taxes or higher spending programs. Lower tax rates may mean attracting more investments, thereby increasing the country's tax base. It may also mean more employment opportunities for its residents, and so less is required for expenditures such as social security. Alternatively, if a country's tax revenues decline as a result of lowering the tax rates,

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[38] Teather R, "Multinational tax competition: A legal and economic perspective" 12th Tax Research Network Conference, The University of Cambridge, U.K., September 2002.
[39] Bishop M, "A Survey of Globalisation and Tax: The mystery of the vanishing taxpayer" (2000) *The Economist*, 3-18.
[40] Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government" (2002) No 431 *Policy Analysis*, 20.
[41] See OECD, *Harmful Tax Competition: An Emerging Global Issue*, [Electronic] Available http://www.oecd.org
[42] Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government" (2002) No 431 *Policy Analysis*, 21.
[43] See OECD, *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report*, [Electronic] Available http://www.oecd.org

it may need to compensate the loss on revenues through other taxes, such as consumption tax.

Under the current international tax regime, countries have little choice but to enter into tax competition in order to attract MNEs into their jurisdiction, or end up falling behind. It is difficult to judge whether this behaviour will result in promoting a more even distribution of wealth in the world, or lead to an uneven distribution of world resources. This behaviour may also lead to the growth of very large MNEs who may then behave in a monopolistic manner. For example, if there is a shortage of world cocoa supplies, large MNEs producing chocolates may secure deals from major cocoa suppliers. The smaller companies may either have to pay hefty prices to secure their supplies or go out of business. If international competition leads to harmful consequences, then it may be inevitable in the long run for countries to harmonise and even create a world tax authority.[44] The United Nations have indicated the possible creation of an International Tax Organisation in order to eliminate harmful tax competition.[45]

It cannot be said with certainty that the current behaviour by countries of lowering their tax rates to attract MNEs within their jurisdiction is harmful tax competition. Many countries such as the UK, Germany, Sweden, Singapore, and Israel have recently changed their tax laws to ensure that they attract and retain MNEs within their jurisdictions and Australia has little choice, but to follow suit or it may end up falling behind.

6 Australian Tax Policies for MNEs

6.1 An overview of Australia's international tax arrangements

There are two ways of responding to the taxation problems of MNEs. The first is to enact complex tax avoidance laws to ensure that an MNE pays its fair share of tax in a particular jurisdiction. Alternatively, a country may be willing to forgo some tax revenues in order to attract MNEs into its jurisdiction, and benefit in other ways, for example, an increase in employment. Australia appears to have taken the first option.

Australia's international tax arrangements are based on its resident's being taxed on worldwide income and non-residents being taxed on source income. Australia has 41 bilateral treaties with other countries to counter double taxation and has controlled foreign company (CFC), foreign investment fund (FIF), transfer pricing, and thin capitalisation legislation to ensure that Australia captures its fair share of the revenues.

The Business Council of Australia (BCA) has reported that the current Australian taxation system discourages locally based companies from expanding abroad and adds

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[44] For a discussion of the operation of the world tax authority, see Fernandez P, Heij G, Pope J, "Tax Policy and Electronic Commerce" (2002) Vol 56 No 1 *International Bureau of Fiscal Documentation Bulletin*, 30 -38; and Fernandez P. and Oates L, "Creation of A Cyber-Entity" (1999) *New Zealand Journal of Taxation Law and Policy*, 96.

[45] UN, *Report of the High-Level Panel on Financing for Development*, June 2001 [Electronic] Available www.un.org/reports/financing

pressure to Australian businesses to relocate offshore.[46] This is evident as Australian MNEs have relocated offshore or chosen dual listing structures as discussed earlier.

One of the major problems with the Australian international tax arrangement is the dividend imputation system, which is not designed to enable companies to expand and operate in this increasingly globalised world. When Australian companies, with both resident and non-resident shareholders frank their dividend distributions,[47] the franking credits on non-resident shareholders are wasted. The companies are not allowed to stream franking credits to Australian shareholders alone.

The main problem is caused by the interaction of the taxation of foreign source income and the dividend imputation system. The Bureau of Industry Economics (BIE) recognised such inefficiencies and put forward proposals to resolve the problem.[48] History of the foreign source income rules in Australia reveals that since 1987 the system has been changed twice. The Government's main reasons for the change were concerns about losing tax revenue. Prior to 1987, Australia adopted the classical system of taxing companies and their shareholders. The problem with this system was that it provided tax deferral opportunities and made it difficult to enforce tax liabilities against non-resident entities.[49]

On 1 July 1987, the foreign tax credit system (FTCS) was introduced. The problems of this system were highlighted when the Australian company tax rate was reduced from 49% to 39% with effect from 1 July 1989. However, many industrialised countries had higher tax rates at that time, thus the tax paid in overseas countries with higher rates of tax were not fully credited in Australia.[50]

From 1 July 1990, a hybrid system involving exemptions and credits was introduced. The FTCS deferral problem was addressed by introducing the accruals legislation firstly for CFCs[51] and later for FIFs.[52] The FTCS efficiency problem was resolved by providing exemptions on branch profits derived from branches in listed comparable tax countries,[53] and also exempting Australian companies receiving non-portfolio[54] dividends from companies in listed comparable tax countries.[55] Around 95% of non-portfolio dividends are from listed countries. The exemption from taxation lowers compliance costs, but when the foreign taxed income is distributed to the shareholders, it gives rise to double taxation as the shareholders are fully taxed on the

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[46] Anderson P, and Capito A, "A model to facilitate dividend streaming" (2000) Vol 2 No 2 *Business Council of Australia Papers*..

[47] A franked dividend is paid from a company's taxed profits and can reduce the tax liability of an Australian shareholder by the amount of company tax paid.

[48] Bureau of Industry Economics Dividend Imputation Forum of September 1993 reported in Bureau of Industry Economics Report, *Dividend Taxation and Globalisation in Australia*, 96/8.

[49] See *Esquire Nominees Ltd v Federal Commissioner of Taxation* (1971) 129 CLR 177.

[50] *Taxation of Foreign Source Income – A Consultative Document*, AGPS, Canberra, 1988, p2.

[51] Part X of the *Income Tax Assessment Act* 1936.

[52] Part XI of the *Income Tax Assessment Act* 1936.

[53] Section 23AH of the *Income Tax Assessment Act* 1936.

[54] A "non-portfolio" dividend is a dividend paid to a company that holds at least 10% voting power in the company paying the dividend.

[55] Section 23 AJ of the *Income Tax Assessment Act* 1936.

dividend without an offset from imputation credit, since no Australian tax has been paid.

It is these exemptions that now create a problem and make it very unattractive for non-resident shareholders to invest in Australian companies. This is demonstrated in the Table 2 below, comparing the following two scenarios:

Scenario 1
An Australian company has Australian profits of $1,000,000 on which tax of $300,000 has been paid and the balance of $700,000 is distributed as dividends to shareholders. An Australian individual shareholder holds 10% shares and is entitled to 10% distribution of dividends. The shareholders net tax return is computed using the 2001/02 individual tax rates.

Scenario 2
An Australian company has earned the $1,000,000 profit from an overseas country that has comparable tax to Australia. The Australian company pays tax in that foreign country of $300,000 and distributes the balance $700,000. An Australian individual shareholder holds 10% shares and is entitled to 10% distribution of dividends. The shareholders net tax return is computed using the 2001/02 individual tax rates.

Table 2

	Scenario 1	**Scenario 2**
Dividend Received	70,000	70,000
Imputation Credit	30,000	0
Taxable Income	100,000	70,000
Tax on Taxable Income	34,380	20,280
Less Franking Rebate	30,000	0
Net Tax Payable	4,380	20,280
Net Return	65,620	49,720

The example shows that the Australian individual shareholder would have to pay $15,900 extra Australian tax when deriving dividends from an Australian company who has distributed foreign taxed income as opposed to Australian taxed income.

The Australian Government has been aware of this problem since the early 1990's, but no solution has been implemented to date. Various Government bodies have been lobbying for the Australian Government to resolve this problem. A dividend-streaming proposal put forward by the Bureau of Industry Economics was to allow dividend streaming.[56] The Business Council of Australia has also put forward a stock-

[56] Bureau of Industry Economics Report, *Dividend Taxation and Globalisation in Australia*, 96/8.

stapling model that allows foreign shareholders to be paid dividends from foreign-sourced income.[57]

The Ralph review rejected the dividend streaming option on the basis that it would be too costly and benefit a larger range of entities, with no advantage to Australian companies with few foreign shareholders.[58] However, what the review played down is the future trend towards increased foreign shareholding due to globalisation.[59]

Finally, after 12 years, the Government has released a consultation paper to address the dividend imputation problem as summarised in table 3 below.

Table 3

Review of International Tax Arrangements: Attracting Equity Capital for Offshore Expansion[60]

AREA OF CHANGE Impact of shareholder level tax bias against direct investment offshore
REASONS FOR CHANGE The current dividend imputation system causes an overall tax bias against Australians investing in highly taxed and comparably taxed countries, whereas a tax bias is caused in favour of individuals investing in low taxed countries. An analysis of Australian direct investments offshore by destination shows 54.7% investments in USA, 17.4% in the UK, 7.2% in New Zealand and most of the balance in Hong Kong, Singapore and Canada.[61] The paper seeks consultation on the extent of this bias and how much this bias costs Australian companies. According to the consultation paper, the imputation system may only be one factor affecting the foreign tax system. By correcting the imputation system only, the result would be a bias favouring offshore investments by individuals and funds. This would be difficult to justify. There can be numerous foreign and Australian taxing points on foreign profits before they finally reach the Australian investor. The dividend imputation only affects the tax payable at the final stage. The consultation paper makes the point that the tax changes should look at all the taxing points, not just the dividend imputation.
OPTIONS FOR CONSULTATION ***Option A*** involves providing Australian individual shareholder a non-refundable tax credit for unfranked dividends paid out of foreign source income. This option would reduce the bias at the individual shareholder level and maintain the advantages of the current dividend imputation system. ***Option B*** involves allowing dividend streaming by the companies, to be able to pass on franking credits to shareholders who benefit the most. Currently Australian tax legislation does not permit dividend streaming and companies with non-resident shareholders waste franking credits as companies are forced to allocate franking credits

[57] Anderson P and Capito A "A model to facilitate dividend streaming" (2000) Vol 2 No 2 *Business Council of Australia Papers*.

[58] Ralph JT, *Review of Business Taxation, Full Report* AGPS, Canberra, 1999.

[59] For a further discussion of Ralph reforms see, Pope J and Fernandez P, "Current Tax Reform in Australia: An Ambitious Program" (2001) No 2 *British Tax Review*, 135 -151.

[60] Commonwealth of Australia, "Review of International Tax Arrangements" August 2002 [Electronic] Available http://www.taxboard.gov.au.

[61] The reason for most Australian company's investing in comparable tax countries could be due to the design of the Australian tax legislation, providing exemption for non-portfolio dividend from such countries.

to all shareholders equally. The streaming option can be either a complete removal of the current streaming restrictions; or only allow an Australian parent company to stream its foreign source income; or a stapled stock streaming would allow a foreign subsidiary to be able to pay dividends directly to the non-resident shareholders, instead of passing through the Australian holding company. The dividend streaming option will only benefit companies with overseas investments, and not smaller companies that want to expand overseas. Dual listed companies already benefit from dividend streaming.

Option C involves the Australian Government allowing a credit for foreign withholding taxes. Around 80% of Australian direct investments are in countries where the double tax treaties will take care of the withholding taxes. Thus the benefit of this option is minimal. This option would also create the problem of verifying the foreign withholding taxes and require a full foreign tax credit system to operate at the company level in Australia.

The consultation paper has also addressed a number other international tax arrangements to promote Australia as a location for internationally focused companies and to promote Australia as a global financial service centre. A summary of these issues are addressed in the tables 5 and 6 found in the appendix and the end of this paper.

6.2 Application of Government proposals

It is evident from the consultation paper that the problem caused by the interaction of taxation of foreign source income and the dividend imputation system has resulted in creating very few MNEs out of Australian resident companies. Only 2.8% of the total Australian resident companies reported foreign source income.[62] The consultation paper provides three options to reduce this bias as illustrated in table 3.[63] However, these options only marginally remove the bias and may not be enough to encourage Australian companies to become MNEs. This is illustrated by applying the three options to Scenario 2 in Table 2, the results of which are shown in Table 4 below.

Table 4

	Scenario 1	Scenario 2	Option A	Option B	Option C
Dividend Received	70,000	70,000	70,000	70,000	70,000
Imputation Credit	30,000	0	0	0	0
Other Non-Refundable Credits			7778		
Taxable Income	100,000	70,000	77,778	70,000	70,000
Tax on Taxable Income	34,380	20,280	23,935.66	20,280	20,280
Less Franking Rebate	30,000	0	7778.00	0	0
Net Tax Payable	4,380	20,280	16,157.66	20,280	20,280
Net Return	65,620	49,720	53,842.34	49,720	49,720
Extra return compared to Scenario 2			4,122.34	0	0

[62] Commonwealth of Australia, "Review of International Tax Arrangements" August 2002 [Electronic] Available http://www.taxboard.gov.au.
[63] See discussion above on page 19.

Extra tax payable compared to Scenario 1		15,900	11,777.66	15,900	15,900
Other Benefits				May save companies from creating dual listing structures	Benefits if withholding taxes have been deducted by the foreign country.

Option A only grants a non-refundable credit of 10%, i.e. one-ninth of the foreign source dividend. In order to match the return in Scenario 1, the non-refendable credit should be 30%. Allowing dividend steaming under Option B will only benefit companies with foreign investments and foreign shareholders. It is unlikely to help Australian companies that are not MNEs, to become MNEs. However, Option B may save companies from creating dual listing structures in order to stream dividends. Option C will only be of benefit if the foreign country has deducted withholding tax from the dividend. This will only benefit around 20% of Australian direct investments, as about 80% of all offshore Australian direct investments may not attract withholding tax.

6.3 The future Australian tax policy for MNEs

The consultation paper released by the Australian Government is definitely a step in the right direction. Australian companies should be encouraged to become MNEs by investing in foreign affiliates, as there is evidence that foreign affiliates boost local exports.[64] In addition, if Australian companies remain small, they may not be able to compete with larger MNEs from other countries, who may then behave in a monopolistic way. Australia is in a unique position having a diversified population with migrants from many different countries. It is likely that people who have migrated to Australia have maintained family and business contacts in other countries and would therefore be in a position to exploit overseas markets.

In order to encourage Australian companies to expand overseas, it may even be worth considering replacing the whole structure of taxing Australian residents on world wide income which is based on capital export neutrality, with a territorial system which does not tax foreign source income, as applied in Hong Kong, Netherlands and France. The territorial system would encourage Australian individuals and companies to search for foreign markets and expand overseas, whilst still maintaining the headquarters in Australia. Alternatively, the future tax policy design should make the net return from non-portfolio foreign investment the same as a return from an investment in an Australian company.

[64] In the U.S., 63 percent of U.S. exports are associated with U.S. MNEs. See note 205 in Edwards C and Rugy V, "International Tax Competition A 21st-Century Restraint on Government'" (2002) No 431 *Policy Analysis*, No 431.

It appears that the Australian Government is only targeting its options narrowly on specific international tax rules. In addition to specific tax changes, Australia can follow the examples of other countries and also reduce the overall corporate tax rate. In order to attract foreign capital, Australia needs to aggressively create policies to encourage foreign MNEs to invest in Australia. Australia should follow the example of Ireland and consider granting tax holidays to MNEs to invest in certain industries that will benefit Australia, e.g. the mining industry. Many mining companies that are starved of capital are going to the U.K. to seek capital for exploration in the Alternative Investment Market.[65]

The current CFC and the FIF rules are anti-avoidance rules to protect Australia's tax base. To comply with these complex rules, MNEs are likely to suffer relatively high compliance costs. In order to promote Australia as a location for internationally focused companies, the CFC rules should be re-written without giving favourable tax treatment to certain countries. Similarly FIF rules could also be replaced by a simpler regime.

Complying superannuation funds should be encouraged to invest in Australian companies through tax incentives and whether the dividend distributed to superannuation fund shareholders is through foreign source income or Australian source income of Australian companies, the tax effect should be the same.

7 Conclusion

There is extensive qualitative evidence that international taxation influences the volume and location of FDI. There is also evidence that foreign trade is enhanced by MNEs with foreign affiliates. Since MNEs respond to the tax policies of individual countries, this carries implications for not only international tax policies, but also domestic tax policies.

The Australian domestic tax policy should be designed with careful consideration of its impact on MNEs. Australia can allow tax holidays and reduce its corporate tax rate to attract FDI. Australian companies should also be encouraged to invest overseas as this is likely to boost Australian exports. The concept of economic efficiency or neutrality suggests that tax should not influence an investment decision. This is a fine concept in theory and can only operate if all the countries in the world apply it. Since countries have adopted tax policies to attract foreign investments and are also luring some Australian MNEs away from Australia, it is time for Australia to act aggressively to secure Australia's prosperity.

[65] Bromby R, "London lures miners after cash" The Australian 9 September 2002.

APPENDIX

The following tables 5 and 6 summarises the issues raised by the Australian Government in the consultation paper to promote Australia as a location for internationally focused companies and to promote Australia as a global financial service centre.[66]

Table 5

Promoting Australia as a location for Internationally Focused Companies

AREA OF CHANGE	REASONS FOR CHANGE	CONSULTATION
A complete re-write of CFC rules	Australia has CFC rules to ensure that non-active income, i.e. tainted income, is not accumulated offshore in low taxed countries. However these rules are complex resulting in high compliance costs.	Design of new CFC rules
Roll-over relief under existing CFC rules	The CFC rules have limited roll-over reliefs to allow group restructuring.	Design of roll-over reliefs under existing CFC rules
Targeting tainted service income	Tainted service income, being income provided by a CFC to a related party in Australia has rules similar to the transfer pricing provisions and can apply to Australian companies with offshore active businesses. With the growth in electronic commerce, the current rules may be disadvantaging Australian companies. However, slacking the rules may leave room for companies to shift service income to a low tax country.	How to target tainted service income.
Broad exemption list of countries	Currently there are only seven countries on the list, where most of Australia's offshore investment lies. However, there are no set criteria for inclusion or exclusion of countries in this category.	Criteria for increasing countries to be included in the broad exemption list for CFC rules to apply.
Tax treaty negotiation	Since the 1990's, the Australian Government has given up some of its tax treaty rights to impose withholding tax on franked dividend, in order to make Australia an attractive location for internationally based companies. It has also negotiated with other countries, such as the USA, to reduce or eliminate withholding tax for non-portfolio dividends paid to Australian companies. Certain treaties were negotiated before Australia's capital gains tax provisions came into effect. These treaties may need to be revised to remove the uncertainty of whether these countries will grant tax credit for Australian capital gains tax.	Basis on which future treaty negotiations should be conducted by Australia in order to promote Australia's national interest.
Non-resident disposing shares in a non-resident company that holds Australian assets.	A non-resident, holding Australian assets through a non-resident company may escape Australian capital gains tax by selling the shares in the non-resident company.	Whether Australia should legislate to remove this loophole, as recommended by the Review of Business Taxation.

[66] Commonwealth of Australia, "Review of International Tax Arrangements" August 2002 [Electronic] Available http://www.taxboard.gov.au

AREA OF CHANGE	REASONS FOR CHANGE	CONSULTATION
Tax treaties negotiation due to "Most Favoured Nation" clauses.	Tax treaties often have MFN clauses, whereby Australia has to provide the same rules to the countries with MFN clauses that it does to any other country. When an MFN clause is triggered, Australia needs to renegotiate the treaties.	The tax treaty programme that Australia should pursue and the whether the negotiations should be publicly announced and consulted by way of an advisory panel.
Limited exemption listed countries under CFC rules	The current CFC rules lists countries under three categories, broadly exempt listed, limited exemption listed and unlisted. Different tax treatment applies to each category of countries. For example, non-portfolio dividend is exempt if it is arisen from broad and limited exemption listed countries. Countries with limited exemption may become sensitive to choosing Australia as location for investment.	Whether the limited exemption list should be abolished and replaced by a general exemption on non-portfolio dividend to encourage repatriation of profits back to Australia.
Taxation of conduit income	Current laws on taxing conduit income may discourage MNEs from choosing Australia as a regional headquarter. For example, an MNE has a regional holding company in Australia. If the regional holding company sells a foreign subsidiary in the region, Australia imposes capital gains tax. However, if the foreign MNE had directly sold the foreign subsidiary, then no Australian CGT arises. To avoid this New Zealand has conduit holding regime rules in place, but these rules are complex and may also benefit non-resident portfolio investors.	To exempt CGT on the sale of foreign subsidiary with active business by an Australian regional holding company, or to allow the unwinding of the conduit structure and provide a conduit restructure relief.
Withholding tax on conduit income.	Currently, exemption from withholding tax only applies when foreign income is passed through an Australian company as dividends to a non-resident shareholder from a listed country or an unlisted country to the extent of the tax credit in a foreign dividend account.	Replacing the foreign dividend account with a foreign income account exempting from withholding tax on all conduit income.
Special arrangement between Australian and New Zealand	An Australian shareholder in a New Zealand company does not receive imputation credits for Australian tax paid by the New Zealand company or its branches or subsidiaries.	Whether Australia and New Zealand should recognise each others dividend imputation system.
Definition of "residence" for Australian companies.	The current rules based on incorporation, management and control, and shareholder voting power may be outdated. MNEs and dual listed companies risk being considered Australian residents if they hold directors meeting in Australia, as they may be exercising central management and control in Australia.	How to clarify the central management and control test.
Tie-breaker rules for dual residence companies	Companies considered resident in two countries under their rules often have to abide by the effective management tie-breaker rule to decide the residency of that company. When this occurs, the tie-breaker decision only applies to treaty provisions and not for the purpose of the income tax law.	Whether the tie breaker rules should extend to all the tax laws and not just the treaty provisions.

Table 6

Promoting Australia as a Global Financial Service Centre

AREA OF CHANGE	REASONS FOR CHANGE	CONSULTATION
A complete re-write of FIF rules	According to the Consultation paper, Foreign Investment funds (FIF) rules are in place in Australia to ensure that an Australian investor does not accumulate passive income in an overseas entity and defer Australian tax until the overseas entity distributes the income to the Australian investor. The Australian investor could even sell the interest in the overseas entity before the income is distributed, thereby converting the income tax payable into a capital gains tax, with a 50% discount. Thus FIF rules are necessary to maintain the basic Australian tax principle of taxing the worldwide income. However, the FIF rules are complex with high compliance costs.	Design of new FIF rules. Possible options could be to identify and exempt funds or jurisdictions unlikely to accumulate passive income, or devise a simple test for identification.
5% exemption threshold under current FIF rules	The current FIF rules operate by including any interest in an offshore company or a trust and then providing a number of exemptions. One such exemption is a balanced portfolio exemption, where a taxpayer is exempt from the FIF measures if 5% or less of the taxpayer's interests are in FIF's at the end of an accounting period. Many taxpayers sell their interests at the end of the accounting period to come within the exemption	Whether the 5% balance exemption threshold exemption should be increased.
Exemption from FIF regime	Australian managed funds with investments in a widely recognised index established on commercial terms should be exempt from the FIF regime. Another appropriate exemption could be given to complying superannuation funds as the deferral benefits obtained by superannuation funds are much lower than an Australian individual. The reason for this is that superannuation funds are taxed at 15%, as opposed to the maximum 48.5% highest marginal rate including Medicare levy for individuals, and the superannuation funds only receive 33% discount on capital gains tax, as opposed to 50% discount for individuals.	Whether the category of exemptions should be extended.
Management services under FIF rules.	The FIF rules not only include passive income from foreign funds, but also include an investment in a business that provides fund management services	Whether such income should be treated as active income and be exempt from the FIF regime
CGT exemptions	In order to promote Australia as a global financial service centre, it is necessary to improve the treatment of international investors in Australian managed funds. Currently a non-resident directly disposing a portfolio investment in an Australian company does not attract capital gains tax, but this is not so for investments through an Australian managed fund.	Whether non-resident beneficiaries investing through a resident Australian trust should be exempt from CGT when assets with no connection to Australia are disposed.
CGT Event E4	The CGT rules may need further amendment (especially CGT Event E4) to ensure that the cost base of the non-resident's interest in the unit trust is also not reduced.	Whether it is feasible to exempt non-residents from CGT when they dispose a non-portfolio interest in a unit trust, where the unit trust has unrealised gains from assets with Australian connection.

AREA OF CHANGE	REASONS FOR CHANGE	CONSULTATION
Branch v Subsidiary structure	Foreign MNEs often use branch structures to provide financial services in Australia. Since a branch is not taxed as a separate entity, it may be tax advantageous to use a subsidiary instead.	Address tax issues that hinder a branch from being used as a structure in Australia due to the lack of separate entity treatment.