30 October 2002

The International Taxation Project
Board of Taxation
c/- The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sirs,

Submission on *Review of International Taxation Arrangements*

Introduction

The Taxation Institute of Australia (Taxation Institute) welcomes the 22 August 2002 release for public comment of the consultative paper: *Review of International Taxation Arrangements* (the Consultative paper) and appreciates the opportunity to respond to the consultative options.

By way of background the Taxation Institute was established in 1943 and has a membership of 11,000 tax practitioners throughout Australia. Our members range from small rural and suburban accountants to senior members of the bar specialising in tax.

This submission has been compiled from comments made by senior tax practitioner members of the Taxation Institute. It includes comments by participants at the September National Tax Symposium and an International Tax Master class organised by the Taxation Institute. Attendees at the National Tax Symposium included Australia's leading tax professionals with international tax expertise from industry, accounting and law firms and the bar. Therefore, this submission highlights the key concerns of senior tax practitioners representing and advising on all areas of Australian business.

General Observations on the Document

Before addressing specific options canvassed in the Consultative paper the Taxation Institute has the following concerns/observations on the structure of Consultation paper. First, although we understand the pragmatic approach taken, the paper concentrates on single issue solutions rather than encouraging fundamental change. The adoption of an often piecemeal approach (not based on any strong theoretical foundation) to counter the problems identified should be in principle resisted. Governments in the past have tended to focus on solutions to specific problems identified by introducing more objective rules to deal with the problems encountered. The second concern is the lack of the comprehensive approach to the recognition of

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the interaction between the various proposals. Both these short comings can inhibit effective consultation.

The structure of the submission

The following submission is prepared in light of these concerns. The submission will address the proposed changes in the attached materials under each of the headings in the Consultative paper, ie:

- Part 1: Attracting equity capital for offshore expansion;
- Part 2: Promoting Australia as a location for internationally focused companies;
- Part 3: Promoting Australia as a global financial services centre; and
- Part 4: Improving Australia's tax treatment of foreign expatriates.

Also attached is a Part 5, which deals with the Taxation Institute's views on crucial issues raised by the Review of Business Taxation (RBT), but omitted from the Consultative paper. The submission will attempt to address the various options under each heading in the required format, ie:

- What is the current law?
- What is the problem?
- What evidence is there of the problem?
- What solutions should be considered?
- How does the problem/solution relate to other options in the consultation paper? Are there any other issues that the problem/solution might impact upon?
- What priority should be given to resolving this problem? Why should it have this priority?

However, as some of the headings are inappropriate for certain options (eg the administrative changes options - Options 5.4) not all the headings are used. Further, in some instances where many of the options are interrelated, the submission groups them so that issues can be addressed using the criteria proposed by the Board of Taxation. This ensures duplication is minimised.

Conclusion

The Taxation Institute views the outcome of this consultative process as crucial to the Australia's future development. The Taxation Institute strongly urges the Board advise Government of the importance of the various reform options and to proceed quickly to remedy those of the highest priority.

Should you require clarification of any of the matters contained in this submission, please do not hesitate to contact Andrew Mills, Chair of the Taxation Institute's National Technical Committee on 0413 020 861 or Michael Dirkis, Tax Director of the Taxation Institute on (02) 9232 3422.

Yours faithfully

Barry Low
President

Part I

Chapter 2: Attracting equity capital for offshore expansion

Chapter 2: Attracting equity capital for offshore expansion

1.1 What is the current law?

Under the imputation rules Australian resident shareholders do not receive credits for foreign company tax (usually the main tax on a company's offshore investments) paid by a branch or offshore subsidiary of an Australian company.

1.2 What is the problem?

The Consultative paper acknowledges the concerns (raised for many years by the Taxation Institute of Australia[1] and other commentators) that the inability of Australian resident shareholders to receive credits for foreign company tax paid by a branch or offshore subsidiary of an Australian company creates a tax bias in favour of domestic investment over Australian multinationals undertaking direct investments offshore.

Further, when imputation was introduced in 1987 firms could choose to expand offshore, where in 2002 competition law and other factors means that for most middle to large companies expansion can only be achieved by investing offshore. This change underpins why the bias is now an issue for all companies seeking expansion.

1.3 What evidence is there of the problem?

The calculations contained in the Appendix A to C of the Business Council of Australia's July 2002 Information paper, "Issues in Australia's International Tax Regime: An International Comparative Review" prepared by David Stevens and Julian Sheezel illustrate this bias.

1.4 What solutions should be considered?

The Consultative paper proposes the following three alternative options for consultation, each of which involves less legislative change than the radical proposals first discussed in the paper.

1.4.2.1 Option A: paying domestic shareholder relief for unfranked dividends out of foreign source income

Under Option A limited shareholder tax relief (a low level credit) is provided in respect of unfranked dividends paid out of a designated category of foreign source income. The Consultative paper notes that the credit would need to be set at a low rate as it is provided without reference to foreign tax paid offshore (which may be low) and that a low rate of credit would avoid any need to quarantine expenses and use of the credit.

The claimed advantages are that it impacts little on the existing imputation system, which would continue to apply to Australian taxed income (and domestic tax preferred income). Option A would run as a separate system alongside the current dividend imputation rules.

The Taxation Institute believes that this alternative is attractive in that it would benefit all resident shareholders of Australian companies deriving foreign source income. In particular, it is believed that the proposal would make the repatriation of profits more attractive. In addition, it has an element of attractive simplicity, as it would depend upon the amount, if any, of foreign tax paid.

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1 See the Taxation Institute of Australia *Submission to the Gibson Committee - Taxation Reform in Australia* (February 1998), 62-65 and Taxation Institute of Australia *Taxation Institute of Australia responds to Discussion Paper No 2 – "A Platform for Consultation"* (16 April 1999), 167.

Also the existence of two separate crediting systems will bring additional compliance costs and complexity arising from the need to identify foreign income and from the existence of two credits on dividend statements.

Its main drawback is that the benefit would be relatively small. Thus, Alternative A seems to represent a compromise. It would mitigate against, but not remove, the bias against offshore investment.

1.4.2.2 Option B: allowing dividend streaming of foreign source income

Under the proposal unfettered dividend streaming would be permitted. Dividend streaming would allow Australian companies to pay franked dividends to shareholders who benefit most from franking (for example, resident shareholders such as superannuation funds) and unfranked dividends to those who benefit least or not at all (for example, non-resident shareholders). The three different models of dividend streaming canvassed in the paper are:

- *Unfettered dividend streaming - this involves removing all restrictions on dividend streaming to simplify imputation provisions.*
- *Streaming of foreign source income from an Australian parent company – this involves the Australian parent company recording designated foreign source income (measured on a repatriation basis) in a separate account, so foreign source income only could be streamed to non-residents. As for Option A, it could use an existing account like the foreign dividend or foreign income account.*
- *Streaming of foreign source income from a foreign subsidiary - stapled stock streaming. Under this option instead of an Australian parent company directly paying all shareholders (resident and non-resident) dividends, its foreign subsidiary could directly pay dividends to non-resident shareholders. In other words it would allow for the streaming of an Australian company's unrepatriated foreign source income.*

In the Consultative paper it is claimed that dividend streaming could be the simplest option to legislate. The change would reduce legislative complexity and decrease administrative and compliance costs created by existing anti-streaming legislation.

The paper, however, warns of the limitations inherent in Option B. Dividend streaming only benefits companies with non-resident shareholders. Further, the extent of benefit depends on the proportions of non-resident shareholders, foreign source income and level of profit distributions. Thus it benefits those companies where the foreign source income percentage and foreign shareholder percentage are comparable.

Outside this comparability there are lesser advantages under streaming. For example the Consultative paper notes that the benefit to them may not be significant to smaller Australian multinationals or companies contemplating offshore expansion (the very group most affected by a bias) as many have a relatively small non-resident shareholder base.

The paper also comments on the different models of dividend streaming. In respect of unfettered dividend streaming the paper (surprisingly, given that currently imputation credits are refundable) still warns that streaming of domestic tax-preferred income in addition to foreign source income raises wider policy issues. In respect of streaming of foreign source income from a foreign subsidiary it is claimed in the paper that this approach could reduce exposures to Australian and foreign dividend withholding taxes, and allow non-resident shareholders to better access home-country shareholder relief mechanisms.

The Taxation Institute believes that this alternative would greatly benefit Australian companies with a relatively large proportion of non-resident shareholders and foreign income. In such circumstances, it would effectively reduce the bias against offshore investment and promote policy objectives. Further, it has been argued that where companies with foreign shareholder and operations are encouraged to grow and invest, other Australian based businesses will benefit from the "tag along" upside of economic growth.

However, in other instances it would be of limited use. The paper rightly states that Australian companies that do not have foreign shareholders will not gain much from dividend streaming. Thus, in many, if not most, instances, Option B would fail to accomplish the underlying outbound policy objectives. Importantly, Option B would not assist Australian-owned companies during the crucial initial years of their offshore operations, where competitiveness is essential. Such an outcome would be unacceptable. The reform must encourage offshore new and fresh offshore operations. It would be inappropriate if the reform would solely focus on large companies that already have substantial offshore operations and non-resident shareholders.

1.4.2.3 Option C: providing franking credits for foreign dividend withholding taxes

Option C is the RBT recommended (Recommendations 20.1) which proposed the provision of franking credits for foreign dividend withholding tax paid by Australian companies by replacing foreign dividend account (FDA) with a foreign income account (FIA). The Government has deferred implementing this measure until the outcome of the Review.[2]

Although acknowledging the reasons behind the recommendation by the RBT[3] the Consultative paper questions the continued relevance of the reasoning in light of the recent protocol to the Australia-United States tax treaty. Under the protocol Australian companies for investments in the United States, the United Kingdom and New Zealand will pay little or no foreign dividend withholding tax. This amounts to around 80 per cent of all direct investment offshore. This will also apply to some other countries in which Australian companies invest.

As a result, this option would only reduce a tax bias against direct investment offshore and improve repatriation incentives in limited cases. Furthermore, as tax treaties provide for a rate of withholding tax on non-portfolio dividends at a zero or low rate (and a higher rate for portfolio dividends), it will not be necessary to provide franking credits to achieve comparability with investments made directly by Australian individuals or funds in foreign companies.

The paper also identifies integrity concerns with this option. First, excess imputation credits, dividends could be routed through Australian conduit companies to cash out the foreign dividend withholding tax. Another problem is Australia's limited scope to obtain verifiable information from offshore jurisdictions to substantiate claims of foreign dividend withholding tax paid. This is despite the existence under the Income Tax Assessment Act 1936 (the 1936 Act) wide access powers (ss 263 and 264) and evidentiary exclusionary powers (s 264A) and the exchange of information articles

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2 Treasurer's Press Release 22 March 2001 - *Business Tax Reform – Implementation Timetable* (No 16 of 2001) delayed the measures until 1 July 2002. On 14 May 2002 the Minister for Revenue and Assistant Treasurer in her Media Release *Maintaining the Momentum of Business Tax Reform* (C57/02) deferred the pending the review.

3 The Review of Business Taxation argued this recommendation would partially reduce the bias against foreign investment; reduce the extent to which foreign dividend withholding taxes could discourage the repatriation of profits from offshore; and achieve comparability between offshore investments made through Australian companies and those made directly by individuals or superannuation funds.

contained in Australia's bilateral tax treaties.[4] Companies also could generate additional franking credits through offshore share trading in foreign companies. Further, additional complexity would be introduced by such an extension, as it would require reintroducing a full foreign tax credit system at the Australian company level.

The paper concludes that given the integrity and additional compliance costs, the option may be fundamentally flawed. It also fails in its objective of removing bias if around 80 per cent of all direct investment offshore is not subject to withholding tax.

In Summary the Taxation Institute believes that given valid integrity concerns and new treaty arrangements negotiated or to be negotiated, it would appear that Alternative C, focusing on dividend withholding tax, has diminishing attractiveness.

1.4.2.4 Conclusion

As discussed above there are advantages and disadvantages with all three options. If only one alternative can be implemented, the Taxation Institute believes that Option A should be preferred as it would provide a benefit (be it limited) to a broad range of Australian companies and shareholders.

1.4.2.5 A combination Option

However, an alternative option is not canvassed by the paper which could provide benefits to a slighter wider range of benefits, ie combining Options A and B.

1.5 How does the problem/solution relate to other options in the consultation paper? Are there any other issues that the problem/solution might impact upon?

Option C relates to Option 3.11 and there is a potential impact under the proposals upon the CFC regime.

1.6 What priority should be given to resolving this problem? Why should it have this priority?

The Taxation Institute believes a high priority needs to be given to reconsidering the future structure of the imputation system and the other options examined.

4 However, although they are in theory a good mechanism for obtaining information, they are not a practical mechanism in all situations as their scope is restricted by express and practical limitations, such as bank secrecy laws etc.

Part 2

Chapter 3: Promoting Australia as a location for internationally focused companies

Promoting Australia as a location for internationally focused companies

As the Consultative paper addresses a number of international tax issues that may affect the attractiveness of Australia as a corporate base from which to operate global and regional businesses, the submission addresses them under those broad headings, i.e.:

- CFC rules;
- Australia's international tax treaty network;
- the treatment of income repatriated from direct investment offshore;
- conduit income arrangements; and
- company residency tests.

2.1 The CFC Rule changes

2.1.1 What is the current law?

2.1.1.1 The Policy

Before dealing with the current law it is crucial to revisit what was the policy underlying the introduction of the CFC rules. Simon Crean, the then Minister Assisting the Treasurer, in the Second Reading Speech announced that the Bill broadly will ". . . introduce an accrual system of taxing foreign source income that has been derived in low tax countries by Australian controlled entities and has been accumulated offshore, avoiding Australian tax" but later in the speech adopts the narrower wording used in December 1989. In the draft legislation, the then Treasurer stated that the purpose was "to attribute to Australian residents income derived by a non-resident company that is controlled by Australian Residents, unless the company is subject to a tax system comparable to Australia's or is predominantly engaged in active business". [5]

It must be remembered that the narrow application of the broad policy intent arose against a background of grave doubts about the effectiveness of the transfer pricing regime and a world dominated by trade in goods. Given the growth in services and the effectiveness of the transfer pricing regime, the narrow application of the policy is no longer relevant.

2.1.1.2 The law

Under the CFC measures contained in Part X of the 1936 Act Australian residents are taxed on an accrual basis on their share of certain income earned by controlled foreign companies. The income subject to attribution is both the company's tainted income (ie passive income (such as dividends, interest and royalties) and certain related party income) and income which is not subjected to comparable taxation. Whether income has been comparably taxed is determined by two factors, either:

- the CFC is resident in a comparable tax jurisdiction (ie it is resident in a country designated to have a comparable tax system - a "listed country"; and
- the income is not subject to a tax concession in that listed country (ie it is not eligible designated concession income - income designated as not being taxed at comparable rates).

Since 24 October 1997 there are two classifications of listed countries; "broad exemption listed" countries and "limited exemption list" countries.

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5 Treasurer *Taxation of Foreign Source Income – Draft Legislation: Explanatory notes* (December 1989) AGPS at 3. The same words were used at pages 3 and 5 of Treasurer *Taxation of Foreign Source Income – Draft Explanatory Memorandum and Draft Regulations* (June 1990) AGPS and in Explanatory Memorandum to Taxation Laws Amendment (Foreign Income) Bill 1990.

2.1.2 What is the problem?

The paper acknowledges that current CFC rules are complicated, involve considerable compliance costs and impede the efficient restructuring of Australian multinational groups. It identifies four key areas of concern.

First, the paper notes that the potential application of CGT to the disposal of a CFC's tainted assets (which include shares) may impede the restructuring of an Australian multinational or regional holding company's offshore operations and thereby adversely affect the competitiveness of Australian companies. Although rollover relief is available under the law for CFCs, it is seen as inadequate.

The second area of concern raised in the paper is the impact of tainted service rules on Australian companies with active income from substantial offshore businesses in services. The paper acknowledges that these rules can potentially affect the competitiveness of these operations (when owned by an Australian company) by increasing compliance costs and attributing income from particular transactions.

The third concern raised by the paper arises from 24 October 1997 changes which split the then 60 list exempt countries under the CFC rules into broad exemption listed and limited-exemption list countries. Although the paper claims that non-inclusion of a country on the list is a comparative, not negative, judgement about other countries' tax systems, countries with equally more comparable tax systems were excluded on a basis that is hard to justify.

It is a fact that even where a tax concession does not exist in a listed country, a CFC may derive tainted income, which is subject to tax at a lower rate than applicable in Australia. If the tax arbitrage is positive (despite the loss of franking credits arising from paying foreign rather than domestic tax) taxpayers will seek to derive tainted income in that country. To try and distinguish between listed countries with arbitrage advantages is not administratively possible. The changes adopted to create the broad exemption listed category appear to have been intended to overcome this difficulty. However, they are fundamentally flawed at a policy level, as they will result in the taxation of tainted income, which has already been fully taxed in a former listed country

Finally the paper recognises that a number of technical and second order policy issues concerning the CFC rules need to be considered. Examples include aspects of the control tests, foreign exchange issues and the treatment of start-up companies.

2.1.3 What evidence is there of the problem?

An illustration of the needless compliance costs is statements by the tax manager of a major mining company that company had to carry out CFC compliance work for over a 100 CFC's in their group, despite the fact there was no attributable income.

Views were also presented that the application of CGT to the disposal of a CFC's tainted assets (which include shares) was resulting in Australian companies either stripping foreign assets out of CFCs before being sold, or causing the Australian CFC entities to be at the bottom of the worldwide chain in a restructure.

The tainted services definition can cause modern service based industries (such as certain telecommunication activities) to be treated as "tainted services", which hampers the development of service based industries offshore.

Additionally, for one group the existence of the broad exemption listed category created a compliance induced bias for investment in those countries and (except for Japan) a bias against investing in emerging markets in Asia and the Pacific rim.

Finally, the measures created major problems where a group had a financing company in a comparable tax jurisdiction or was assembling a “war chest” to facilitate an offshore acquisition, as the interest earned (passive income) may result in a breach by the CFC of the tainted income ratio under the active income test in s 432(1)(f) of the 1936 Act.

2.1.4 What solutions should be considered?

The Consultative paper identifies the following four technical and small to medium policy options for consideration. These options are consistent with the RBT that made a number of recommendations (23.1 and 23.2) in respect of the current FSI rules.

Before discussing the merits of the following options a step that would simplify the CFC rules would be to treat CFCs resident in broad exemption listed countries as exempt from the CFC rules. Lower level tiers located in low tax jurisdiction will be caught by the CFC rules existing in the broad exemption listed country of residence. This suggestion received complete support at the Taxation Institute’s National Tax Symposium as a major method of reducing compliance costs for Australian companies investing offshore.

2.1.4.1 Improving rollover relief for corporate restructuring under the CFC rules, while maintaining the integrity of those rules (Option 3.1)

Although improved rollover relief is welcomed, the Taxation Institute believes a better solution may be an exemption from the disposal of a non-portfolio interest in a non-resident company with underlying active assets seems more appropriate. Any change should result in sales of shares having the same tax treatment as the sale of the underlying assets.

2.1.4.2 Better targeting the tainted services income rules, while maintaining the integrity of the CFC rules (Option 3.2).

The Taxation Institute believes this is a crucial due to the growth in the trade in services. At the time the CFC provisions were drafted services were not as important as compared with trade in physical goods, and more importantly, from a tax compliance point of view the operation of the transfer pricing rules is more effective today.

Thus, the Taxation Institute believes that services should cease to be treated as tainted, thereby reflecting modern business practices and intra-group relationships.

2.1.4.3 Expanding the number of “broad exemption listed” countries to minimise compliance costs, and to clarify the criteria for inclusion (or exclusion) (Option 3.3)

If there is to be integrity in the system it is crucial that comparability, rather than trade should be the prime criteria for inclusion as a broad exemption listed country.

A second criterion should be the level of trade. Where the level of trade is high and designated concessions are in place, their importance should be weighed up in light of the fundamental policy underlying measures in determining their inclusion on the list. This policy is aimed at taxing foreign source income that has been derived in low tax countries (not those broadly comparable) by Australian controlled entities and has been accumulated offshore, avoiding Australian tax. If the current narrow approach to designated concessions was adopted in respect of Australia by a foreign jurisdiction, conduit concessions such as the offshore banking unit (OBU) measures could put Australia on a "limited-exemption list". Therefore, an overall level of general taxation and tax administration should be the criteria.

The third criteria would be the existence of a CFC regime in order to support the proposal to treat CFCs resident in broad exemption listed countries as exempt from the CFC rules. This test is already a criteria used.

Under this criteria the Scandinavian countries with more comparable tax systems could be listed as broad exemption listed countries.

2.1.4.4 A process to identify technical and other remaining policy issues regarding the CFC rules, and to consider options to resolve them either on a case-by-case basis or as part of a major rewrite of the provisions (Option 3.4)

There is a need for a complete rewrite and simplification of the CFC rules. It may be done by fusing the CFC regime with the FIF regime into a single attribution regime that targets what attribution is supposed to target – accumulation of passive income in low-tax jurisdictions or low-tax circumstances. However, any change should maintain similar terminologies to minimise transitional compliance costs.

If a rewrite is not possible in the short term (12 months), then immediate technical and small policy changes should be introduced pre 1 July 2003 to simplify compliance obligations, pending a major rewrite. The areas of reform are already will be known to the policy makers (see the attached list – appendix A) of issues raised and ignored at by the National Tax Liaison Group Foreign Source Income Sub-committee).
Particular problems identified which need priority include:

- increasing the tainted income ratio under the active income test (s 432(1)(f)) so that where a group has a financing company in a comparable tax jurisdiction or was assembling a war chest to facilitate an offshore acquisition the test would not be breached. This could be achieved by changing the ratio from 5% to 10%;

- amend the draconian s 47A. Such changes would allow repatriation of profits from low tax jurisdictions; and
- to review the interrelationship of the various new tax measures and the CFC regime. No consideration has been given to the impact of loss integrity and GVSR rules on CFCs and arguably more importantly the debt/equity rules and thin capitalisation. The debit/equity rules can give rise to double taxation in certain circumstances where the foreign treatment of the instrument is different to the domestic treatment.

2.1.5 How does the problem/solution relate to other options in the consultation paper?

A change to a residency based OECD treaty model combined with removal of withholding taxes (as discussed at para 5.2 of the submission) would remove a significant part of the CFC rules alone. Any rewrite would also have an impact on other attribution regimes – FIF and transferor trust regimes.

2.1.6 What priority should be given to resolving this problem? Why should it have this priority?

The option to treat CFCs resident in broad exemption listed countries as exempt from the CFC rules requires a high priority. The short term changes proposed in the Consultative paper also require high priority, in particular the tainted service and broad exemption listed country changes. A rewrite would be a medium term priority (as some of the immediate concerns may addressed through the short term changes).

2.2. Modernising Australia's tax treaty network

2.2.1 What is the current law?

To avoid double taxation, bilateral agreements exist between Australia and other countries (DTAs). Thus, these agreements operate by countries (referred to as "contracting states") agreeing to limit their rights to tax in respect of taxpayers and transactions in their jurisdictional claim. This is achieved by the contracting states apportioning their rights to tax. Australia's DTAs generally follow the OECD model, but vary from the OECD model:

- to give source rule dominance; or
- where there is a belief that the Australian version of the wording in a particular article is more elegant /concise/accurate than the wording used in the OECD treaty.

Under OECD model based treaties the country of residency has the dominance to tax unless the transaction is closely associated with the economic activity of the source country.

2.2.2 What is the problem?

The Consultative paper points out that since 1980-81, the stock of foreign capital invested in Australia has almost quadrupled from 32 per cent of gross domestic product (GDP) to 121 per cent in 2001-02. While Australia remains a net capital importer, the increase in total capital invested offshore has risen also — from 9 per cent of GDP in 1980-81 to 62 per cent in 2000-01. Direct investment in the United States has also moved in Australia's favour. Also, Australia is now the fourth biggest investor in Britain. Given that the trend appears that Australia is moving from a capital importer to a capital exporter then continuing a sourced based treaty model must be questioned.

However, the ability of Australia to translate such change into DTAs in the future is limited by two factors. First, treaties negotiated today will operate for 20 to 30 years hence, limiting the opportunity for future change. Secondly, the bureaucracy has responded slowly to implement such changes as illustrated by the fact that the impact of imputation has taken 10 years to be reflected in treaties.

Another potential problem is that idiosyncrasies of Australian wording can lead to interpretative issues where there is wide divergence from the OECD model. It also flows the negotiation/renegotiation process.

2.2.3 What solutions should be considered?

The RBT made a number of recommendations (22.21 to 22.24) in respect of the current DTA network. These changes have in part been incorporated into the Consultative paper's DTA reform options for consultation. However, before examining these suggestions it is important that the Board of Taxation urge Government to halt current UK DTA negotiation while the review process is being undertaken. The major reason for delay is that this will be the first post-RBT treaty. The UK DTA will trigger most favoured nation consequences through out the EU, which will restrict future change. Further, there is need for consistency across treaties, which means that a clear policy needs to be formed before the UK DTA is completed.

5.2.3.1 To consider whether the recently negotiated protocol to the Australia-United States tax treaty provides an appropriate basis for future treaty negotiations or whether alternative approaches are preferable (Option 3.5);

The USA Protocol is a starting basis, especially given the reduction or elimination of dividend withholding tax. However, given the developing trends in investment, Australia needs to move away from its source biased treaty model to a model which is residency biased. The model that needs to be adopted is the 2000 OECD model. This can be changed by modifying the current Australian DTA model to:

- remove source taxation from the “Other Income” Article (also known as “Income not expressly mentioned” Article);
- eliminate the “Source of Income” Article and enact the rules in domestic law;
- confine “Tax relief” articles (eg Methods of elimination of double tax” Article) to domestic law;
- use OECD definitions to reduce interpretative problems and unintended consequences. An example of the problems that can occur is where there are currently departures from the OECD model, for example with Australia’s version of the tie breaker test. Under that test the Australian Government is not a resident. Such a change will also speed up negotiations as the terms will be familiar to other contracting States;
- remove some rules which should be in the domestic law;
- where there is a need for a special offshore Article, draft one along the UK, Netherlands or Irish models rather than modifying the “Permanent Establishment” (PE) Article’s substantial equipment test;
- change other variations on the OECD PE test in the Australian model which can be addressed either by other Articles (eg “processing” modification can be caught by the “separate enterprise” test in the “Associated enterprise” Article) or are not sustainable in a world market (eg the “construction sites” variation away from the OECD 12 month test);
- remove information requirements variation from the OECD model in the “Business Profits” and “Associated enterprise” Articles, as despite their existence the information is still unattainable;
- insert the OECD “Non-discrimination” Article as recommended by RBT. Australia is the only country that refuses to adopt the article. Further, all the work to prove its the acceptability of the non-discrimination was carried out in 1995 paving the way for its inclusion;
- review the portfolio/non-portfolio distinction in dividend withholding tax relief. Many substantial investments may, given the size of companies’ share registers, be portfolio and adversely treated when compared to smaller non-portfolio investments in smaller companies;
- review withholding tax approaches on interest in light of the exclusion from withholding under s 128F;
- review withholding tax approaches on royalties in order to increase the competitiveness of Australian technology/software entities;
- review approach to capital gains;
- do not adopt the US treaty solution to change in residence, in which Australia gave up source rights,;
- eliminate the “Independent personal services” Article in accordance with changes to the 2000 OECD treaty;
- remove the subject to tax provisions from the “Dependent personal services” Article;
- solve superannuation issues in tax treaties rather than social security agreements; and
- do not adopt US specific clauses such as the “Limitation on Benefits Article” (which dramatically increase the length of treaties) and the “fiscally transparent entity” concept in a revised “Business profits” Article. These issues can be dealt with under Part IVA.

5.2.3.2 To consider whether or not to proceed with the RBT recommendation 21.7 to apply CGT to the sale by non-residents of non-resident interposed entities with underlying Australian assets (Option 3.6);

The RBT's proposal requires relatively complex legislation and has some enforcement limitations. Therefore, although the core policy principle in relation to non-residents is that they should be taxed on Australian-sourced income, the approach should be modified. By adopting the OECD treaty model many conduit issues disappear. Collection and enforcement issues may be addressed by a withholding tax collected by the buyer of the underlying asset (similar to the mechanism operating under the USA Foreign Investment in Real Property Tax Act). This issue also highlights the need to have better source rules.

5.2.3.3 To consider which countries should be given priority for tax treaty negotiations, taking into account negotiations underway with the United Kingdom and Germany, the need to update pre-CGT treaties, and countries that Australia may be obliged to approach because of most favoured nation clauses in existing treaties (Option 3.7); and

In light of the statements above about formulating policy before pursuing new DTAs, the Taxation Institute would recommend halting current negotiation until a new approach is settled. The adoption of OECD approach in respect of the UK treaty negotiations would cause a MFN flow on which would be concluded quickly as there would be little argument about the words and their meaning.

2.2.3.1 To consider options to improve consultation processes on negotiating tax treaties (Option 3.8).

Given the open nature of treaty negotiations by many of our treaty partners (eg the United States placed details of the Australian /United States Protocol on the web for all to see while the details were classified as secret in Australia), this recommendation is overdue.

Further, wider consultation would be fruitful as Government would benefit from submissions by groups that may have particular experience with, or knowledge of, the particular country concerned and its business environment. Involvement should be permitted after the first round negotiation (when issues are identified). This will ensure proper input. The current process of some limited exposure to selected practitioners after the second round means input is restricted to interpretation rather than policy.

2.2.4 How does the problem/solution relate to other options in the consultation paper?

The suggested reforms will have impact on CFC, taxation of capital gains, interest, royalties, changes to domestic law in respect of anti-avoidance legislation, Option 5.3 and source rules.

2.2.5 What priority should be given to resolving this problem? Why should it have this priority?

Given the pending UK DTA negotiation and the potential MFN flow on, setting treaty policy and approach is a high priority.

2.3 The treatment of foreign non-portfolio dividends at the company level

2.3.1 What is the current law?

The paper notes that Australia exempts from company tax, non-portfolio dividends (and certain branch profits) received from 63 listed countries. Non-portfolio dividends from companies in listed countries comprise around 95 per cent of all foreign non-portfolio dividends Australian companies receive. Non-portfolio dividends from unlisted countries are generally taxable with a credit for foreign withholding tax and underlying company tax.

2.3.2 What is the problem?

The existing exemption approach reduces compliance costs only for a limited range of non-portfolio dividends. It also provides an effective conduit regime at the Australian company level for income from direct investment offshore. Its policy rationale is to provide a broadly similar outcome to taxing these dividends as with foreign tax credits. This is possible as the profits from which the dividends are distributed were comparably taxed offshore. It is also based upon the assumption that the limited-exemption list countries are comparably taxed. This is not always the case. Further, it expressly excludes non-portfolio interests held through flow-through entities such as custodians, nominees, and trusts.

2.3.3 What solutions should be considered?

The paper examines an alternative approach of abolishing the list and providing a general exemption for foreign non-portfolio dividends Australian companies receive and (subject to some existing exceptions) foreign branch profits (Option 3.9).

It is claimed this could substantially simplify the international tax rules and encourage repatriation of profits back to Australia. It also would better match the general approach of minimising Australian company tax on direct investment offshore, and the treatment of non-portfolio interests in unlisted countries under the thin capitalisation rules. The branch profit exemption rules could be similarly extended.

The Taxation Institute believes this could be a significant policy step forward. In practice, 95% of non-portfolio dividends are from listed countries anyway. The main advantage would be greater incentive to repatriate profits (mainly from low-tax jurisdiction) into Australia. However, the exemption should also encompass non-portfolio interests held through flow-through entities such as custodians, nominees, and trusts in order to facilitate these benefits

2.3.4 What priority should be given to resolving this problem? Why should it have this priority?

As this is a technical amendment and the entities have already paid the tax the change should have a high priority.

2.4 Improving conduit income arrangements - Regional holding companies and capital gains tax

The Consultative paper concedes that Australian tax is imposed on conduit income[6] arising either at the entity level (on disposal of interests in the Australian entity) or on distribution (through withholding taxes) despite the general policy that taxing conduit income should be avoided. It notes that conduit income is highly sensitive to the application of domestic tax, particularly for regional holding companies and managed funds. The paper at this point focuses on problems with the conduit income treatment

6 Conduit income is foreign source income non-residents earn through an Australian entity. Conduit incomes arise for Australian multinationals (as they are likely to have non-resident shareholders and foreign source income) and for regional holding and joint-venture companies established in Australia.

for companies under the CGT and dividend withholding tax provisions, while unit trust CGT and other conduit issues are considered in Chapter 4 of the Consultative paper.

2.4.1 What is the problem?

The importance of an effective RHQ/conduit regime cannot be overstated. A strong flow of capital through Australia would benefit the economy. RHQs/conduits create jobs, buy local services, rent and buy properties, etc. They also give multinationals the opportunity to become more familiar with the local market, and thus consider Australia as an investment and R&D destination. The existence of a reasonable number of large RHQs/conduits then creates sufficient momentum encouraging further movement of capital through and into Australia.

Australia has many competitive advantages. At the corporate level, it provides sound political and secured environment, strong IP laws and a generally modern legal system, top-class educated and relatively cheap workforce, relatively cheap land, excellent infrastructure and advanced communication facilities. In many instances, the decision as to whether to set up a RHQ in a particular country is influenced by the executives that will be responsible for the region. The decision of such executives mostly boils down to lifestyle and education facilities for their children. In this regard, Australia probably prevails over all countries in the region.

Yet, Australia is effectively a dead-end in terms of regional flow-through investment, management and operations.

The Consultative paper starts its analysis of the double capital gains tax problems facing a regional holding company (ie holding companies that own the operating companies of the group in a particular region) established in Australia by using the following example:

> The holding company (or one arising from a foreign company acquiring an Australian multinational) may pay CGT when selling its foreign regional subsidiaries. If the holding company itself is sold, that sale is also subject to CGT. Had the non-residents instead invested directly in the foreign subsidiary (or used a holding company in another country), they would not have paid CGT in Australia on either sale.

2.4.2 What evidence is there of the problem?

An advisor provided the following examples of the lost investment opportunities that have occurred during the past three years.

The first company was a global leader in telecommunication projects. It was interested in setting up in Sydney a management and administrative centre for the region, and a technical support and sales centre for its operations in Australia, New Zealand and the Philippines. The local RHQ would then invest into new projects in the region, supported by its management and technical skills.

The second company specialised in traffic management hardware for communication networks. It wanted to use its successful Melbourne-based subsidiary as an investment vehicle into Asia, which would also manage the Asian operations and sales (apart from Japan).

These enquiries were made after those companies investigated other factors (set out above) and on that basis favoured Australia as a RHQ location. Yet, the fiscal and compliance consequences of an investment into Asia through Australia were fatal to their decisions.

The first company decided not to set up that RHQ in Sydney, but rather, to beef-up its Hong Kong subsidiary, together with 75-100 jobs. The second company set up its RHQ in Singapore, initially employing 20 people there and is still growing that operation. Other foreign companies made similar decisions.

These are not isolated examples with other tax practitioners having similar stories to tell.

2.4.3 What solutions should be considered?

2.4.3.1 A conduit holding company regime

The paper briefly flags the establishment a conduit holding company regime to provide specific CGT exemptions. However, the paper claims that a conduit holding company regime would be complex, have significant compliance and administration costs, raise valuation problems, and potentially benefit non-conduit cases. It also may raise harmful tax practice issues.

To illustrate the issues, the paper examines the proposals for relief for disposals by Australian holding companies of foreign subsidiaries. It sets out the difficulties of a conduit holding company regime and alternatively suggests that relief can be achieved through a general, non-conduit specific, CGT exemption on gains from the sale of a non-portfolio interest in a foreign company where that company has an underlying active business.

2.4.3.2 Capital gains tax exemption for sale of a non-portfolio interest in a non-resident company with an underlying active business.

The paper also explores the option of a capital gains tax exemption for sale of a non-portfolio interest in a non-resident company with an underlying active business, concluding that it would resolve CGT arising on the sale of a foreign subsidiary. The paper claims that this approach would avoid many conduit holding company regime design problems (as the ownership of the Australian company would be irrelevant) and from a policy perspective is consistent with Australia's foreign source income rules which already exempt disposals of underlying active business assets by CFCs.

As with a number of the options explored the paper notes the need for an FIA to achieve equivalence between the sale of a foreign subsidiary and a sale of the underlying business, as the current FDA rules do not exempt a dividend paid out of an exempt CGT gain from withholding tax. The paper also warns of the difficulties of the CGT exemption approach, in particular the legislative design challenges, the application of the active/passive business distinction and information requirements.

2.4.3.3 A conduit restructure relief alternative to a conduit holding company regime

Finally, the paper notes that many of the problems with a conduit holding company regime arise from difficulties in accurately attributing and exempting foreign gains to various taxpayers. This is partly due to mixed combinations of resident and non-resident shareholders and domestic and foreign assets, inadequate information on values, changes in ownership over time, retention of exempt gains and the need for unequal distribution policies.

An alternative approach suggested is to provide relief to corporate restructures that allow a conduit structure to be unwound. Conduit restructure relief would allow a non-resident shareholder to swap an indirect interest in the foreign subsidiary of an Australian company for a direct interest. Sale of the direct interest would then not be subject to CGT. However, the conduit restructure relief alternative is limited as it only extends CGT relief to circumstances where the non-resident exits the investment. It also requires investors to undertake a restructure to access tax relief, which may result in non-tax and foreign tax costs.

2.4.3.4 Summary

Having touched on many of the difficulties involved the Consultation paper proposes consideration of options to:

- provide conduit relief for Australian regional holding and joint-venture companies, including considering the benefits and costs of introducing a general conduit holding company regime;
- providing an exemption for the sale of a non-portfolio interest in a foreign company with an underlying active business; and
- providing conduit restructure relief (Option 3.10).

The Taxation Institute believes that at a policy level there is the need for a better treatment of non-residents and a more comprehensive conduit regime. The rectification of this problem would not replace Australia with Singapore or Hong Kong, but would certainly encourage further investment through and into Australia, thereby creating the benefits associated with RHQs/conduits. The important point about an effective RHQs/conduits regime is that it should not, in policy terms, create revenue loss. The three options mooted will deliver some of those changes and are supported by the Taxation Institute.

However, the Taxation Institute does not believe that these tax changes alone will make Australia a haven for RHQs. An example where conduit tax concessions alone have failed to attract a physical presence and investment in a country is Holland. What is needed is a series of targeted tax incentives (such as R & D concessions).

These concessions would not be granted to investing companies without requiring some commitment to establish a substantial physical presence in Australia. Regional competitors currently impose such conditions. For example in order to get the tax incentives for a regional headquarters locating in Shanghai, the Shanghai municipal government requires (via issued regulations on 20 July 2002) that:

- the holding company establishing the regional headquarters must have a minimum registered capital of USD 400 million;
- the total amount invested in China by the parent company is not less than USD 30 million; and
- the regional headquarters has invested in, or been authorized to manage, at least three enterprises in or outside China.

In summary, the Taxation Institute believes that it is crucial to create an incentive with presence regime to support any conduit relief.

2.4.4 What priority should be given to resolving this problem? Why should it have this priority?

These changes are of medium term priority, particularly if the Government needs to consider the adoption of an incentive with presence scheme.

2.5 Establishing foreign income accounts

2.5.1 What is the current law?

Currently the FDA allows a withholding tax exemption for unfranked dividends paid out of non-portfolio dividends received from listed countries (and from unlisted countries to the extent that foreign tax credits are available).

2.5.2 What is the problem?

As the current rules applied only provide conduit taxation relief to dividends, not other forms of foreign income, resulting in potential double taxation.

Further, due to the interaction between the FDA, dividend imputation and anti-dividend streaming rules, the rules often operate to dilute the benefits of FDA and prevent full utilisation of franking credits by resident taxpayers. This process of burning credits is set out in the Business Council of Australia July 2002 Information Paper, which explains:

- "Dividend streaming is not permitted, the effect being that residents and non-residents will receive a proportional allocation of imputation credits and FDA credits;
- as dividends must be franked by a company to the extent permitted by its franking account surpluses, notwithstanding that the dividends may have FDA credits, non-residents may receive imputation credits that they cannot utilise, resulting in their wastage; and
- similarly, FDAs allocated to residents cannot be utilised by them, resulting in a dilution of FDA benefits to non-residents. The effect being that dividends distributed to non-residents may be unnecessarily subject to withholding tax.

Credits lost under the above applications cannot be redeemed."

2.5.3 What solutions should be considered?

The Consultative paper concludes that an in-principle case exists to establish FIAs to provide conduit taxation relief. This is consistent with the findings of the RBT, which recommended (Recommendations 21.1 to 21.5) expanding the FDA to provide a withholding tax exemption for all conduit income distributed by an Australian company. Thus, the paper proposes consideration of whether to proceed with the FIA rules recommended by the Review of Business Taxation, and whether to allow the tax-free flow-through of FIA amounts along a chain of Australian companies, subject to Option 2.1 (Option 3.11).

The Taxation Institute strongly supports the establishment FIAs to provide conduit tax relief for all foreign tax. However, the Taxation Institute has concerns if the FIAs are structured like the current FDAs, which in practice do not provide the benefits. As mentioned above, the FDAs burn tax credits where there are resident shareholders. Therefore, the FIA change would have to be coupled with the measures that address the interaction of the dividend imputation system with the foreign-source tax rules.

2.5.4 How does the problem/solution relate to other options in the consultation paper?

The paper points out that a final decision on the FIA, and its design, can only be made as part of final consideration of the imputation options in Chapter 2, in particular Options B and C. Further, the paper warns whether the FIA also should be extended to allow effective flow-through of FIA amounts along a chain of Australian companies is also interlinked with the Chapter 2 options. Also, this measure impacts upon Option 3.10.

2.5.5 What priority should be given to resolving this problem? Why should it have this priority?

In terms of the importance of other measures the Taxation Institute believes these changes are of a medium term priority.

2.6 Determining the place of residence of companies

2.6.1 What is the current law?

As noted in the paper, currently the residency status of a company is generally determined by the application of the s 6(1)(b) definition of “resident” or “resident of Australia” in the 1936 Act, via the definition of “Australian resident” in s 995-1 of the Income Tax Assessment Act 1997 (the 1997 Act). The definition contains three alternative statutory tests for determining residency: an “incorporation” test, and two non-incorporation tests (a “central management and control” test and a “voting power control” test). Thus, the definitions deem residency if the place of creation is in Australia or where the place of business activity is Australia and its management is in Australia or its ownership is Australian. This is the same test adopted in the 1930's when the Commonwealth and some states introduced the residency basis of taxation and the test was incorporated unchanged into the 1936 Act.

In the 1936 Act there are also specific “residency” definitions for deemed companies (“corporate limited partnerships” (s 94T), and the “resident unit trusts” (ss 102H and 102Q) definition used for the purposes of “corporate unit trusts” (s 102J) and “public trading trusts” (s 102R)) and dual resident companies (“prescribed dual resident” (s 6(1)) and a “dual resident investment company” (s 6F)). All of these definitions incorporate the “central management and control” test.

2.6.2 What is the problem?

The paper recognises that under the non-incorporation tests of residence offshore subsidiaries of Australian companies, multinationals or regional holding companies can be treated as resident companies. Dual listed companies also face risks under the non-incorporation tests.

The paper is correct in pointing out that this outcome is not the intended scope of “central management and control” test, which was intended to apply “ . . . to companies . . . whose central management and control is in Australia” thereby ensuring that a “ . . . number of companies incorporated outside Australia whose sole or principal business is located in Australia” were taxable as residents.[7]

However, the other non-incorporation test, the “voting power control” test was intended to apply “ . . . to companies . . . whose shareholders controlling the voting power of the company are residents of Australia” to ensure that profits are not charged with tax outside Australia and resident shareholders, who receive dividends from those profits, will be taxable on dividends if they are not charged with tax outside Australia.[8] Thus, the paper is misleading in suggesting that the outcome under the non-incorporation tests were never intended.

However, the paper does confirm that both tests are avoidable by careful planning. The planning can be costly, inconvenient and unnecessary (on policy grounds). The paper also acknowledges that more uncertainty arises in a technological age (eg video conferencing, internet, etc) as the ascertainment of the residence under both non-incorporation tests is broadly based upon geographic ties which are determined as a question of fact.

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7 Note on Clause 2 in *Explanatory Notes on Amendments contained in a Bill to amend the Income Tax Assessment Act 1922-1929*, Government Printer, Canberra, 11.

8 Ibid.

The paper argues that "central management and control" will, in practice be found where the board of directors meet as the test is focused on the people who occupy the pinnacle of power, the directors, not the minor day to day managers.[9] Although the place of meeting may in some circumstances be where "central management and control" is found,[10] in other situations "central management and control" is located at the place of principal business activity (as that is where the important decisions are undertaken).[11] The place of business can determine the place where "central management and control" is exercised, even where the board meets away from the place of business.[12] Again, a simplified explanation of the law is misleading.

Finally the paper argues that a difficulty with the "central management and control" test is merely exercising central management and control itself may constitute the carrying on of a business. Although the "central management and control" test in s 6(1) consists of two elements (the company must be carrying on business in Australia and it must have its central management and control in Australia), the High Court in *Malayan Shipping Co v Federal Commissioner of Taxation*[13] found it may not be necessary to examine both elements. The paper warns that if this interpretation was to prevail, it would significantly broaden the range of the test, and some businesses might arrange their affairs (at some cost) to guard against this. Interestingly, the paper notes that the ATO applies the test so that the "carrying on of a business" is separate to the "central management and control."

it is obvious that the rules for determining the residency of an individual are inefficient, complex, unfair, and in desperate need of reform. In fact as far back as 1975 the Aspery Committee found that there was " . . . a case for extending the exercise of jurisdiction to tax on the basis of residence so that all foreign income is subject to Australian tax and credit so far as administratively feasible."[14]

2.6.3 What evidence is there of the problem?

In order to avoid residency, board meetings are held offshore.

2.6.4 *What solutions should be considered?*

Before examining the solutions it is important to set out some overall concerns. The adoption of a piecemeal approach (not based on any strong theoretical foundation) to counter the problems identified should be in principle resisted. Governments have tended to focus on solutions to specific problems identified by introducing more objective rules to deal with the problems encountered. For example in Australia s

9 Peter J Gillies notes that Lord Lorebum LC in *De Beers Consolidated Mines v Howe* [1906] AC 455 inserted "the adjective "central" to his test indicating that he was concerned to identify the people who occupy the pinnacle of power" - "Understanding company residence: Central management and control" (1989) 1(4) *CCH Journal of Australian Taxation* 52 at 54.

10 *De Beers Consolidated Mines v Howe* [1906] AC 455, *The Calcutta Jute Mills Company Limited v Nicholson* (1876) 1 TC 82, and *Cesena Sulphur Co Ltd v Nicholson* (1876) 1 TC 88.

11 In *North Australian Pastoral Company Ltd v Federal Commissioner of Taxation* (1944) 71 CLR 623; 3 AITR 314; 8 ATD 121. Dixon J concluded that a pastoral company does not carry on " . . . a financial or trading business the control and management of which might be considered to depend on decisions of policy and upon the judgement and capacity of the general manager independently of the locality. It was essentially localized. There has not been a case so far in which . . . the company has been held not to reside there." (634; 322; 129).

12 Similarly, in *The Waterloo Pastoral Company Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 262; 3 AITR 329; 8 ATD 165 Williams J noted that while the " . . . board of the appellant had power under the articles of association to require that all important decisions should be subject to its confirmation, and it could have met regularly and exercised this control instead of leaving these decisions to Messrs Bowater and Bingle. But to exercise this control effectively it would have been necessary for the directors to visit the stations and meet there because so many of these decisions could only be made on the spot." (267; 332; 168 respectively).

13 (1946) 71 CLR 156; 8 ATD 75; 3 AITR 258.

14 Taxation Review Committee (Aspery Chair) *Full Report* (1975) AGPS, 260, para 17.42.

23AG was introduced to remove the residency question for some foreign employed taxpayers (ie those without other Australian taxable income). Similarly the FSI measures were introduced to bring forward income recognition. However both approaches mask the defects in the residency test rather than seeking to resolve them.

To ensure fundamental reform, a clear articulation of Australia's taxation jurisdictional claims is needed. It is only with this policy articulation that simple, equitable and efficient residency rules can be designed. In formulating this reform policy, consideration must be given to determine who (persons and entities) should be a resident and who should not. Who is ultimately included as a resident will also depend upon economic and social value judgments, and costings. Further, any analysis of residency solutions must also consider in tandem the impact of possible changes to the source concept and international developments around DTAs in light of international concerns about the impact of the Internet.

Consideration of options to clarify the test of company residency so that exercising central management and control alone does not constitute the carrying on of a business (Option 3.12).

The Taxation Institute accepts that the central management and control test creates severe practical difficulties for Australian multinationals, and further discourages foreign multinationals from establishing management centres in Australia. The exercise of central management and control should not, without more, constitute the carrying on of a business. This change if adopted would also address most of the concerns associated with dual-residency.

2.6.5 How does the problem/solution relate to other options in the consultation paper?

Any change to cental management and control residency definition will have an impact on the residency definitions for deemed companies ("corporate limited partnerships" (s 94T), and the "resident unit trusts" (ss 102H and 102Q) definition used for the purposes of "corporate unit trusts" (s 102J) and "public trading trusts" (s 102R)) and dual resident companies ("prescribed dual resident" (s 6(1)) and a "dual resident investment company" (s 6F)). It will also have an impact on the tie-breaker test in treaties. There may be a need to remove the voting power residency test. There may be impacts on the transfer pricing and the foreign source income accrual provisions.

2.6.6 What priority should be given to resolving this problem? Why should it have this priority?

In terms of the importance of other measures the Taxation Institute believes these changes are of a medium term priority.

2.7 Excluding dual residents

2.7.1 What is the current law?

Under the current law the application of the domestic tax rules are modified for dual resident companies to prevent them obtaining possible tax advantages from that status. Thus, a "dual resident investment company" definition, found in s 6F of the 1936 Act (and incorporated in the 1997 Act via s 995-1), was introduced in 1990 as part of measures aimed at denying dual resident investment companies (usually a group financing vehicle) the ability to transfer its income and net capital losses to

Australian group members,[15] thereby stopping "double dipping" by Australian losses and foreign losses being offset against domestic gains or income.

Similarly the "prescribed dual resident" test in s 6(1) of the 1936 Act (and incorporated in the 1997 Act via s 995-1) was inserted to deny such dual residents, who are not fully subject to Australian tax, entitlement to domestic tax benefits such as dividend rebates, capital gains rollover relief, and the transfer of capital and revenue losses, make them subject to the thin capitalisation and debt equity rules and restrict their access to deductions arising accrued liabilities on securities held by offshore associates. [16]

2.7.2 What is the problem?

The creation of special rules to deal with dual residency creates complexity.

2.7.3 What solutions should be considered?

The paper flags the possibility of avoiding this complication through the adoption of the United Kingdom (s 249 of the Finance Act 1993 (UK)) and Canadian (s 250(5) of the Income Tax Act (Can)) approach of amending the domestic definition of residency so that it was overridden where a company was taken to be a non-resident as a consequence of applying a treaty tie-breaker. That is, a company resident under Australia's domestic tax law that is resident of a treaty partner under the relevant treaty tie-breaker would be treated as non-resident for all income tax purposes.

Thus, the paper recommends consideration of whether a company that is a non-resident for tax treaty purposes should be treated as a non-resident for all purposes of the income tax law, as an alternative to the current dual resident company provisions (Option 3.13). The Taxation Institute supports this change on the basis it overcomes complexity.

2.7.4 How does the problem/solution relate to other options in the consultation paper?

The impact on the Australian model treaty needs to be considered.

2.7.5 What priority should be given to resolving this problem? Why should it have this priority?

Given the existence of international precedents, this is a simple change that could be done quickly. Therefore, the Taxation Institute believes these changes are of a high priority.

Legislative models of this changes are as follows:

Section 250(5) of the Income Tax Act (Can) states

(5) Deemed non-resident

Notwithstanding any other provision of this Act (other than paragraph 126(1.1)(a)), a person is deemed not to be resident in Canada at a time if, at that time, the person would, but for this subsection and any tax treaty, be resident in Canada for the purposes of this Act but is, under a tax treaty with another country, resident in the other country and not resident in Canada.

The United Kingdom model of such a provision is longer. Section 249 of the Finance Act 1994 (UK) states:

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15 *Explanatory Memorandum to Taxation Laws Amendment Bill 1990*, 17-18.

16 Michael Morley "International taxation measures in the 1996-1997 Budget" (1996) 25 *Australian Tax Review* 202, 204.

249.—(1) A company which—

(a) would (apart from this section) be regarded as resident in the United Kingdom for the purposes of the Taxes Acts, and
(b) is regarded for the purposes of any double taxation relief arrangements as resident in a territory outside the United Kingdom and not resident in the United Kingdom,

shall be treated for the purposes of the Taxes Acts as resident outside the United Kingdom and not resident in the United Kingdom.

(2) For the purpose of deciding whether the company is regarded as mentioned in subsection (1)(b) above it shall be assumed that—

(a) the company has made a claim for relief under the arrangements, and
(b) in consequence of the claim it falls to be decided whether the company is to be regarded as mentioned in subsection (1)(b) above.

(3) This section shall apply whether the company would otherwise be regarded as resident in the United Kingdom for the purposes of the Taxes Acts by virtue of section 66(1) of the [1988 c. 39.] Finance Act 1988 (company incorporated in UK to be regarded as resident there) or by virtue of some other rule of law.

(4) In this section—

(a) "double taxation relief arrangements" means arrangements having effect by virtue of section 788 of the Taxes Act 1988;
(b) "the Taxes Acts" has the same meaning as in the [1970 c. 9.] Taxes Management Act 1970.

(5) This section shall be deemed to have come into force on 30th November 1993.

Part 3

Chapter 4: Promoting Australia as a global financial services centre

Promoting Australia as a global financial services centre

3.1 What is the current law?

Since 1993 various Australian Governments have sought to promote Australia as a global financial services centre. In order to encourage the use of Australia as an offshore banking centre, Division 9A was introduced[17] to provide a concessionary rate of tax (10 percent) to offshore banking (OB) income derived after 30 June 1992. Some State Governments also keen to encourage the establishment of OBUs in their states provided exemption from state taxes (e.g. debits tax, land tax, payroll tax and stamp duty).[18] Following these changes, on 18 June 1993, in a major statement on the Government's banking policy,[19] the then Treasurer announced a series of measures to tax branch income of foreign banks.[20] The measures were in response to the Prime Minister's February 1992 announcement that foreign banks engaged in wholesale operations in Australia would be permitted to operate through branches instead of operating through subsidiaries incorporated in Australia.[21]

Early in 1994 the Government indicated that it was considering providing tax concessions to encourage multinationals to establish their regional headquarters in Australia.[22] On 4 May 1994 the Government announced[23] details of a two tier approach aimed at encouraging relocation. It involved concessions to compensate the companies for relocating and then the on-going concessional treatment of their foreign income. These changes were introduced into Parliament on 30 June 1994.[24] In 1997 the current Government reinforced the policy aim of making Australia a more attractive finance centre. [25]

3.2 *What is the problem?*

However, these early initiatives were subject to criticism. Cooper argues that "Australia's approach appears to be one of providing a tax concession and assuming that would be sufficient to attract offshore banking activity."[26] He believes that by failing to make the concessions easy to understand and practical to use the Government has hindered rather than assisted Australia in becoming a regional financial centre. The Business Council of Australia in its 11 December 2001 report Removing Tax Barriers to International Growth again highlighted the policy failures.[27]

The Consultative paper also recognises the specific concerns of funds managers, which identify a number of tax impediments that prevent them operating to their full potential, for both their domestic and international clientele. The areas of principal concern are:

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17 Taxation Laws Amendment Act (No 4) 1992.
18 The Offshore Banking Units and Regional Headquarters Act 1993 (Qld).
19 *Banking Policy Statement* (1993) AGPS.
20 The Statement covered issues like competition policy, the Banking Code of Practice and bank and life company mergers.
21 Hon P Keating (1992) *One Nation, Statement by the Prime Minister* AGPS, Canberra, 69. The Prime Minister was partially implementing a recommendation contained in the November 1991 report of the House of Representatives Committee on Finance and Public Administration, *A Pocket Full of Change* (Martin, Chair) AGPS Canberra, 160. This change did not extend to foreign banks engaged in retail banking, which are still required to operate through subsidiaries incorporated in Australia.
22 "Big tax lure for foreign business", Australian Financial Review (15 February 1994), 1 and 12.
23 Australia *Working Nation White Paper on Employment* (1994) AGPS, Canberra.
24 Taxation Laws Amendment Bill (No 3) 1994.
25 John Howard *Investing for Growth, Australia – A Regional Finance Centre* (1997) AGPS, Canberra, 1.
26 Gordon Cooper "Offshore Banking Units: OBUs - Only Barely Useable?" (1994) 2 *Taxation in Australia Red Edition* 150.
27 Michael Wachtel and Alf Capito *Removing tax barriers to international growth* (11 December 2001) Business Council of Australia.

- application of the FIF provisions to the funds management industry; and
- the CGT treatment of investments by non-residents in Australian managed funds (unit trusts).

3.3 What solutions should be considered?

The paper suggests that rationalising and improving the current tax treatment of foreign trusts is also important to the financial services industry, and could improve the integrity and simplicity of the tax system. The paper then explores reform options in respect of FIF and the CGT treatment of investments by non-residents in Australian managed funds.

3.3.1 Foreign investment fund rules

3.3.1.1 What is the current law?

The policy

The Treasurer indicated that Australia's foreign investment fund (FIF) measures are targeted at closing off avenues for off-shore tax avoidance gained from holding substantial passive investments in non-resident entities, that are not Australian controlled and fall outside the scope of the Foreign Source Income (FSI) measures.[28] Specifically they seek:

- to overcome the deferral advantage arising from escaping Australian tax on a current basis and where the income is never returned to Australia; and
- the advantages arising from the conversion of lowly taxed (or untaxed) income of the entity into a tax exempt form (e.g. loans) or more favourably taxed receipts like capital gains.

The law

The measures located in Part XI of the 1936 Act apply to any proprietary interest or right to acquire (as defined in s 488) such an "interest" (as defined in s 483) in:

- a foreign trust or company (a "FIF" as defined in s 481); or
- a life assurance policy issued by a foreign entity (a "FLP" as defined in s 482).

However, the interest will only be subject to the FIF measures if the resident's interest in a FIF is held at the end of the year of income and the notional accounting period of the FIF also ends during that year. Thus, where the taxpayer disposes of the interest in a FIF before the end of that year of income, there will be no FIF taxation for that income year, as the interest is not held. This differs for FLPs, where the taxpayer disposes of the interest in a FLP before the end of that year of income the interest will be taxed in that income year.

3.3.1.2 What is the problem?

The paper acknowledges that the current Australian FIF rules are very complex, with high compliance costs for affected taxpayers and managed funds. Also the rules may catch certain investments in what are, in effect, active businesses.

Further, the rules bring forward the incidence of capital gains tax, where the shares are still held

28 Treasurer *Taxation of interests in Foreign Investment Funds – An Information Paper* (1992) Commonwealth Government Printer, 6.

3.3.1.3 What evidence is there of the problem?

Funds managers have indicated that it was necessary for them to go right through their portfolio to identify whether they had FIF interests and not just look at those that they thought might be FIF interests. Further, to avoid compliance costs many advisors will seek to treat the investment as a CFC rather than an FIF.

The FIF provisions caused funds managers to do wash sales on 30 June in each year, disposing of their entire portfolio and re-acquiring it rather than having to deal with the compliance burden of the FIF measures. This wash sale result is a design feature of the measures (see "Short term holding" exemption - s 485). The wash sales represented a pre-payment of tax and are not economically sound.

The measures have adverse economic effects. A member has indicated that NZ investors bypassed Australia altogether and invested directly with UK fund managers because of the FIF rules. Banks avoid portfolio investment because of the FIF measures, as do some offshore funds. Further, direct investment by foreigners of less than 10% of an Australian public company does not bear capital gains tax whereas a foreign investor who invested into an Australian managed fund would pay Australian CGT on realisation of an investment in a target company, which represented less than 10% of a target company.

Finally, some members believe that the measures seem to be missing the integrity objective, as individual investors wanting to avoid tax wouldn't invest through fund managers.

3.3.1.4 What solutions should be considered?

Given these problems and an overseas trend to review these rules (in United States, United Kingdom, and New Zealand) the paper recommends consideration be given to longer-term consideration to a replacement of the current FIF rules to provide a better balance between maintaining the integrity of the tax system while minimising compliance and other costs for taxpayers (Option 4.1).

This recommendation is strongly supported by the Taxation Institute. However, perhaps the better approach is not to add another layer of complex rules to the existing complex FIF rules, but rather, to reduce the scope of the FIF provisions to what they were originally designed to target, namely to prevent avoidance through accumulation of passive income. Specific exemptions, dealing with investments through Australian funds by non-residents can be built into such a simplified regime.

In the short term the Consultative paper suggests that the existing FIF rules could be refined to ensure the current rules are better targeted and minimise compliance costs and other distortions. The key options for consultation identified are:

- to consider, including undertaking detailed case studies in conjunction with industry, increasing the 5 per cent balanced portfolio exemption threshold in the FIF rules (Option 4.2);
- to consider exempting Australian managed funds that follow widely recognised indices from the FIF rules (Option 4.3);
- to consider exempting complying superannuation funds from the FIF rules (Option 4.4); and
- to consider amending the FIF rules to allow fund management services to be an eligible activity for the purposes of the FIF rules (Option 4.5).

Again the Taxation Institute supports these options.

However, as with the reform of the CFC rules the Taxation Institute would support treating FIFs resident in broad exemption listed countries as exempt from the FIF rules. Lower level tiers located in low tax jurisdiction will be caught by the FIF rules existing in the broad exemption listed country of residence.

3.3.1.5 How does the problem/solution relate to other options in the consultation paper?

Impacts upon the CFC rules. Also, as with the CFC rules any review should include a review of the interrelationship of the various new tax measures and the FIF regime. For example, it is not clear how the debt/equity measures might impact.

3.3.1.6 What priority should be given to resolving these options? Why should it have this priority?

As with the CFC options, the option to treat FIFs resident in broad exemption listed countries as exempt from the FIF rules requires a high priority. The short term changes proposed in the Consultative paper also require high priority. A rewrite would be a medium term priority (as some of the immediate concerns may addressed through the short term changes).

3.3.2 Improving the treatment of international investors in Australian managed funds

3.3.2.1 What is the problem?

The Consultation paper notes that CGT provisions currently treat non-resident investors who invest directly, or through offshore-managed funds, in certain Australian assets more favourably than if they were to invest via Australian managed funds. This diminishes the competitiveness of Australian-based managed funds. Therefore, in order to overcome these problems the paper supports two strategies.

3.3.2.2 What solutions should be considered?

The first strategy proposed is to facilitate inbound investment through key CGT changes. The options for consultation identified are:

- to consider exempting from CGT gains to which non-resident beneficiaries are presently entitled that relate to assets without the necessary connection with Australia. Whether an asset has the necessary connection with Australia could be determined as if the trustee of the resident trust was a non-resident (Option 4.6); and
- to consider the feasibility of exempting from CGT gains on the disposal of a non-portfolio interest in a unit trust that relate to unrealised gains on assets that do not have the necessary connection with Australia (Option 4.7).

The second strategy is to improve conduit arrangements for Australian managed funds. The option for consultation is to consider amending the CGT rules so that a distribution of income to which a non-resident is presently entitled, but which is not assessable because the income has a foreign source (or a CGT exempt gain that arises from Option 4.6), does not reduce the non-resident investor's cost base in a unit trust (Option 4.8).

The Taxation Institute supports the adoption of these measures to facilitate this change as it removes the direct/indirect bias in investment into Australia.

3.3.2.3 What priority should be given to resolving these options? Why should it have this priority?

In terms of the importance of other measures the Taxation Institute believes these changes are of a high priority.

3.3.3 Foreign Trusts

3.3.3.1 What is the current law?

An investment in a foreign trust is potentially subject to, in descending application, the FIF measures, the deemed entitlement rules in ss 96A to 96C of the 1936 Act and then Division 6 of the 1936 Act. This means that where the interest in the non-resident trust is either:

- excluded from the FIF measures (ie where that interest is held by an attributable taxpayer in respect of a transferor trust under Division 6AAA or attributable taxpayer in respect of a CFT under Part X); or
- is an exempt interest in a FIF under the foreign employer-sponsored superannuation fund exemption, the small investor exemptions, the country fund exclusion, exempt visitor exclusion, or is a deceased estate,

the interest is dealt with under Division 6 rather than the FIF measures. Section 96A(2) provides a small investor exemption which takes account of indirect off-shore investments, held through interests in resident public unit trusts.

Section 96B provides a basis for calculating the way in which the income of non-resident trust estates is to be calculated and attributed to their Australian beneficiaries, who are not assessed under the FIF measures.

The first step is to calculate the net income of the trust. The net income of a non-resident trust is calculated as it always has been under Division 6 under s 95(1), that is, the assessable income of the trust is calculated in accordance with the Act as if the trustee were a taxpayer and a resident of Australia and deducting allowable deductions. It would include, for instance, assessable FIF income from interests that the trustee holds in a lower tier FIF.

A similar two tier test (as in s 582) is used in s 96C to determine the beneficiaries' share of the net income of the trust. First, the net income (being all of the trust's accounting income, profits and gains are income, to which the beneficiaries are presently entitled, or that have been distributed to the beneficiaries within two months of the end of the income year) is multiplied by "the attribution percentage" (being the percentage of the total income, profits and gains of the trust estate to which the beneficiary is presently entitled or that were paid to or applied for the benefit of the beneficiary in the year of income of that trust or within 2 months after the end of the year of income).

Second, where the conditions for application of the method are not met, the beneficiary's share of the net income of the trust estate is determined by ss 96C(2) to (5). This involves calculating the beneficiary's share of the net income referable to interests held in a trust estate for the whole year and adding it to the beneficiary's share of the net income referable to interests held in a trust estate for only part of the year.

3.3.3.2 What is the problem?

Thus, the law is complex. In fact the "small investor exclusion" (de minimis rule) in ss 515 and 96A have the effect of treating the holders of small exempt FIF trust interests harsher than larger FIF trust interests caught under the measures. This arises, as holders of exempt interests are required to compute their share of the net income of the foreign trust in accordance with normal Australian tax laws. The lack of information means that they can never comply.

As a result, the Consultation paper notes that there is a need to make changes to the foreign trust rules, but it focuses on RBT recommendations.

3.3.3.3 What solutions should be considered?

In respect of the taxation of foreign trusts the Consultation paper recognizes two areas of possible reform.

3.3.3.2.1 Deemed present entitlement rules for foreign trusts

The paper seeks reconsideration of whether the RBT proposals (Recommendations 20.8 and 20.9) for removing the deemed present entitlement rules for foreign trusts should proceed (Option 4.9). Under this proposal the FIF rules alone would apply to foreign fixed trusts, except where foreign beneficiaries exist. In this case, the FIF rules would apply to the resident beneficiaries and the transferor trust measures for other amounts.

The Taxation Institute believes that there is a real need to streamline the various provisions that apply to non-resident trusts. The FIF provisions should deal with them, and the Taxation Institute supports removal of the deemed present entitlements rules.

3.3.3.2.2 Removing the current exemptions for transfers for offshore discretionary trusts.

The paper also seeks reconsideration of whether the RBT proposals (Recommendations 20.10 to 20.12) for removing some of the current exemptions for transfers, particularly the 'control test' for offshore discretionary trusts established before the transferor came to Australia or before the transferor trust rules were announced should proceed (Option 4.10). The recommendations also proposed an amnesty applying to trusts affected by the removal of the exemptions.

The Taxation Institute has concerns about the workability of the RBT proposals and the effect of any modification of the RBT proposals. The practical impact of the proposals and whether they would have the desired effect of encouraging repatriation are also issues of concern.

It is noted that these measures have been the subject of confidential consultation in July 2000, but the paper contains no details of the issues raised at that meeting nor whether the model discussed at that meeting followed the RBT proposals. This lack of disclosure only harms full and frank discussion on the acceptability of this option.

If the measures are to proceed, then consultation and design needs to be more open. Further, if adopted, the proposals needs to be a package that includes the amnesty.

3.3.3.3 What priority should be given to resolving these options? Why should it have this priority?

In terms of the importance of other measures the Taxation Institute believes these changes are of a medium term priority.

3.3.4 Taxing branches

3.3.4.1 What is the problem?

The Consultative paper notes that corporate branch (permanent establishment) structures offer (non-retail) financial services businesses (established by foreign multinationals in Australia) some commercial advantages compared with alternative legal structures (such as subsidiaries).

3.3.4.2 What solutions should be considered?

The paper's key option for consultation is to consider specific tax issues outside the Government's current tax reform program where the lack of separate entity treatment inappropriately impedes the use of branch structures (Option 4 .11).[29]

The Taxation Institute believes that there are good policy reasons to treated branches of foreign companies like separate entities for tax purposes. The present rules create instances of unequal treatment (eg withholding tax apply to subsidiaries), which should be addressed. Again, the underlying principle is to tax a non-resident on Australian-sourced income. An example of a legislative model that treats for tax law purposes a branch as separate entity exists in New Zealand.

3.3.4.3 What priority should be given to resolving this problem? Why should it have this priority?

In terms of the importance of other measures the Taxation Institute believes these changes are of a medium term priority.

29 *A Tax System Redesigned* Recommendation 22.11.

Part 4

Chapter 5: Improving Australia's tax treatment of foreign expatriates

Improving Australia’s tax treatment of foreign expatriates

4.1 Tax Treaties and the CGT treatment of departing residents

4.1.1 What is the current law?

Australia's adopts a hybrid approach to countering mobility of residents. On entry to the country, a new resident is deemed (via s136-40 of the 1997 Act) to have acquired the asset at the market value at the time of becoming resident. Upon departure Australia reserves the right to tax persons on capital gains either when they become non-resident[30] or upon later disposal of assets, which have "necessary connection with Australia".[31] This calculation can be avoided by the person electing for the provision not to apply.[32] If that occurs each of those assets is taken to have the "necessary connection with Australia" until the earlier of either a CGT event happening in relation to the asset or the person again becomes an Australian resident. [33]

4.1.2 What is the problem?

As these rules do not match those rules applying in other jurisdictions, they do result in a foreign expatriate being liable for a capital gain in respect of an unrealised gain in the price of an asset (eg shares), which was owned prior to residency and retained after departure. Where CGT relief does not exist under a Treaty, the resident would be taxed upon disposal in country of residence on realisation of the shares but would not be entitled to a credit for the Australian tax paid on the unrealised gain.

4.1.3 What solutions should be considered?

Rather than addressing the problem the Consultative paper recommendation is to consider whether to proceed with the RBT recommendation 22.20 that residents departing Australia provide security for deferred CGT liability (Option 5.1). The Consultative paper notes the problems with the current CGT treatment would be exacerbated if the RBT recommendation were adopted. The current rules involve considerable compliance and administrative costs.

The Taxation Institute accepts the policy principles espoused by the RBT, however, the approach advocated increases inequity and administrative costs. Therefore, the Taxation Institute recommends abandonment of the RBT recommendation.

The paper also notes that the Government is seeking to address the double tax problems country by country through renegotiating treaties. However, the treaty relief does not assist taxpayers where there was no gain in United State dollar terms but there is a gain on realisation in Australian dollars due to exchange rate movements. The Taxation Institute recommends a review of the model CGT relief clause to explore whether it can be changed to address this problem.
Further, the Taxation Institute is concerned that the treaty approach is only a piece meal solution (given the limited number of countries with which Australia has treaties) and is a slow mechanism for delivering reform (given Australia’s source approach to

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30 Where a person loses his or her Australian residency there is a GCT event I1, which triggers a capital gain calculation for all assets other than those that have a "necessary connection with Australia" - s 104-160(3) of the Income Tax Assessment Act 1997 (the1997 Act).

31 The nine categories of assets with the "necessary connection with Australia" are defined in s 136 -35. They include land (interests in land), a building, structure or stratum unit, assets used in carrying on a business through a permanent establishment, a share in a resident, private company, an interest in a resident trust, a 10% by value share or unit in a public company/resident trust owned (directly or indirectly) at any time during the last five years before the CGT event happens etc.

32 s 104-165(2) of the 1997 Act.

33 s 104-165(3) of the 1997 Act.

treaties which slows negotiation, despite the existence of most favoured nation clauses). The solution is to place relief within the domestic law.

Another quicker solution, that would be limited to expatriates, would be to give s 457 visa holders exemption from capital gains tax other than on Australian assets acquired and sold as a resident. This would effectively bring Australia much more in line with many other jurisdictions, particularly the United Kingdom.

4.1.4 How does the problem/solution relate to other options in the consultation paper?

Any change to the Treaty model would impact on Option 3.5.

4.1.5 What priority should be given to resolving these options? Why should it have this priority?

As this is merely an announcement to remove an RBT option from the agenda, it should be done quickly – high priority.

Given that the Australia-United Kingdom treaty renegotiation is considering the CGT treatment of departing residents that the potential changes could trigger most favoured nation clauses, it is crucial to settle an approach to address the CGT treatment of departing residents. Therefore, the priority of the alternative options suggested is also high.

4.2. Removing double taxation of employee share options

4.2.1 What is the problem?

The paper accepts that foreign expatriates may be subject to double taxation on the benefits arising from employee share options. This can arise where an employee is issued share options offshore that are conditional on a certain period of service with the employer, part of which occurs offshore and part in Australia. Alternatively, the employee may be issued share options in Australia that are similarly conditional.

Double taxation could arise because countries have different approaches to taxing the benefits arising from these options. Some countries tax the benefit at the time the option is granted, or when the option vests, or when the option is exercised, or when the shares acquired under the option are sold. Some countries may not tax the benefit from the share option separately, but catch it under their capital gains tax provisions.

4.2.2 What solutions should be considered?

The paper examines the OECD approach, adopted in treaty negotiations, for resolving the problem. The OECD approach allocates full residence taxation to the treaty partner in which the share options are exercised. The other treaty partner's taxing right is limited to that proportion of the income or gain on the option which relates to the period(s) between the grant and the exercise of the option during which the individual has worked in the partner country. This approach is able to deal with residence-source issues where share options are subject to tax in more than one country, but it does not always appropriately deal with situations where share options are taxed in three or more countries on a residence and/or source basis.

The paper suggests that consultation on the adoption of such an approach through bilateral tax treaty negotiations and possible consequential changes to Australia's domestic tax law treatment should be explored (Option 5.2).

The Taxation Institute believes that double-taxation of employee share options should be ideally addressed through the treaties to ensure reciprocity. However, as treaties do not apply to all employees and treaty negotiations may take a long time, the matter, in practice, may need to be addressed by domestic legislation.

4.2.3 How does the problem/solution relate to other options in the consultation paper?

Any change to the Treaty model would impact on Option 3.5.

4.2.4 What priority should be given to resolving this problem? Why should it have this priority?

Given that the granting of relief domestically is a technical change the Taxation Institute believes this change is of a high priority.

4.3 Whether a resident's departure from Australia is a cessation event under Division 13A of the 1936 Act.

4.2.1 What is the problem?

Under Division 13A tax may be deferred for up to ten years on a discount given to an employee for "qualifying" shares or rights acquired under an employee share scheme unless a "cessation time" event occurs. The RBT recommended (Recommendation 22.19(a)) to treat ceasing to be an Australian resident as a cessation event for employee share schemes under Division 13A of 1936 Act

4.3.2 What solutions should be considered?

Thus, the paper seeks consultation on whether to proceed with the RBT recommendation to treat ceasing to be an Australian resident as a cessation event for employee share schemes under Division 13A of 1936 Act (Option 5.3).

The Consultative paper notes that the RBT Recommendation could cause cash flow and currency valuation issues similar to those under the deemed disposal CGT rules where the new non-resident is still employed by the current employer.

Also, treating the breaking of Australian residence as a cessation time for Div 13A purposes could give rise not only to cash flow difficulties, but also could significantly disadvantage departing individuals due to fluctuations in share prices arising after departure. It would be quite possible to have taxation arising on exit, only later to find out that the options were never exercised because the share price fell subsequent to the individual breaking residence.

Further, the approach could also be contrary to the Government's general policy direction in taxing foreign expatriates and departing residents.

Given the difficulties expressed in the paper about cash flow, the Taxation Institute believes that ceasing to be an Australian resident should not be a cessation event for the purposes of Division 13A.

4.3.3 What priority should be given to resolving this problem? Why should it have this priority?

As this is merely an announcement to remove an RBT option from the agenda, it should be done quickly – high priority.

4.4 Superannuation arrangements for temporary residents

4.4.1 What is the problem?

The Consultative paper identifies a number of double taxation issues that arise in respect of superannuation. Foreign expatriates working temporarily in Australia, especially those near retirement age, may wish or be required to continue in their home-country retirement plan so as to maximise the return on their investment and retirement benefit. Unless superannuation concessions are available to foreign expatriate workers, the requirement to make contributions to a complying superannuation fund could increase the cost to Australian employers of hiring those foreign skilled workers who wish or are required to remain in their home-country retirement plans.

The Consultative paper indicates that one of the methodologies is to provide exemptions where Australia has entered into a Superannuation Double Coverage (SDC) Agreement with another country. Australia has SDC agreements with three countries (the United States, the Netherlands and Portugal) as part of broader social security agreements. The paper indicates that negotiations are continuing with other countries, including Belgium, Chile, Croatia, Finland, Norway and Switzerland.

The problem with SDC's are that they are not part of a DTA nor are they included or cross referenced in the International Tax Agreements Act 1953. As a result they are difficult to locate and if the process continues they are likely to create complexity and confusion akin to that resulting from the existence of two income tax Acts.

4.4.2 What solutions should be considered?

The Taxation Institute strongly urges the Board to advise the Government to cease the creation of SDC agreements separate from DTAs. These issues should be part of DTAs. However, if SDCs continue to be negotiated separately, then legislative links need to be created in the International Tax Agreements Act cross referencing to those SDCs.

4.4.3 How does the problem/solution relate to other options in the consultation paper?

Any change to the Treaty model would impact on Option 3.5.

4.4.4 What priority should be given to resolving this problem? Why should it have this priority?

Given the pending UK DTA negotiation and the potential MFN flow on, setting treaty policy and approach is a high priority.

4.5 Creation in the Australian Taxation Office (ATO) of a specialist cell to deal with foreign expatriates

4.5.1 What is the problem?

The Consultative paper acknowledges that foreign expatriates working in Australia face increased compliance costs as they are dealing in an alien tax system in respect of a wide range of domestic and international tax issues.

4.5.2 What solutions should be considered?

The paper proposes for consultation the creation by the ATO of a specialist cell to work with employers to deal with the tax administration concerns of foreign expatriate employees (Option 5.4).

This is a practical solution that should be implemented. Many temporary residents are not familiar with the general ATO culture or have language difficulties when complex tax issues are concerned. A specialist cell could enhance efficiency without compromising revenue. It may also be expanded to specifically deal with Regional Headquarters/conduits.

The Government should be urged to provide funding for this task if it cannot be facilitated in the ATO's current administrative budgets. Further, the matter should be advanced with the Commissioner (as under the Taxation Administration Act 1953) the Commissioner of Taxation is responsible for the general administration.

4.5.3 What priority should be given to resolving this problem? Why should it have this priority?

Given the relative low cost, this issue could be pursued as a matter of priority.

Part 5

RBT Recommendations Omitted from the Consultative Options

RBT Recommendations Omitted from the Consultative Options

The Consultative paper does acknowledge that there are some issues not considered in detail as the Government is currently progressing those issues. These include the uncertainty over the income tax treatment of foreign exchange gains and losses, and treatment under the CFC rules of limited partnerships established overseas. However, there are a number of other issues not being advanced, in particular reform of the source rules.

5.1 Source Rules

5.1.1 What is the current law?

Section 995-1 of the 1997 Act defines "Australian source" to be

> Australian source: *ordinary income or *statutory income has an Australian source if, and only if, it is *derived from a source in Australia for the purposes of the Income Tax Assessment Act 1936.

However, the word "source" is not defined, the 1936 Act. What the s 995-1 definition incorporates in the 1997 Act is a number of statutory rules in the 1936 Act and the common law "rules" that have been imported into the interpretation of the word "source" in the 1936 Act by the Courts. However, the source of income under the common law is not a matter of law, rather it is a matter of fact.[34] As a result the outcome of many cases in this area will turn on their particular facts, appearing to given rise to conflicting results.

The statutory rules in the 1936 Act are ad hoc rules, not governed by any general principles. The rules deem an Australian source for dividends,[35] interest payments (where the monies are secured by mortgage on an Australian property),[36] certain royalties payments,[37] certain natural resource payments,[38] business income where business carried partly in and partly out of Australia,[39] overseas shipping payments[40] and certain insurance premiums.[41] Except for the royalty provisions, which were introduced in 1968 and 1986, the genesis of many of these rules is the 1936 Act, and in some cases, the Income Tax Assessment Act 1915 (1915 Act) and earlier State Acts.[42]

DTAs also vary source taxing rights between contracting states.

5.1.2 What is the problem?

As the current source rules are a collection of statutory and treaty provisions, and common law rules (which require the close examination of any given factual setting) they give rise to unnecessary uncertainty, complexity and compliance costs.
These facts were recognised by the RBT, which recommended rewriting the source rules. Under Recommendation 23.2(c) the existing source rules were to be a consolidation in the tax laws, subject to a new general source principle that income is to be sourced in Australia to the extent such income derives from assets located or

34 *Cliffs International Incorporated v Federal Commissioner of Taxation* (1985) 16 ATR 601, 620; 85 ATC 4374, 4390.
35 s 44 (1)(b) of 1936 Act.
36 s 25(2) of 1936 Act.
37 s 6C of 1936 Act.
38 s 6CA of 1936 Act.
39 Division 2, Subdivision C of Part III of 1936 Act.
40 Division 12 of Part III of 1936 Act.
41 Division 15 of Part III of 1936 Act.
42 For example the ship chatterer source rules were introduced into New South Wales in 1895 by s 24 of The Land and Income Taxation Assessment Act 1895 (NSW) (59 Vic No 15 of 1895) and in Victoria in 1896 by s 18 of the Income Tax Act 1896 (Vic) (60 Vic No 1467 of 1896).

used in Australia, or risks are assumed in Australia. Under the proposed rules the place where a contract was concluded was to be disregarded for source purposes.

Consideration of the RBT's recommendation is a clear omission from the Consultative paper.

5.1.3 What solutions should be considered?

In order to provide a greater degree of certainty, there is support for specific source rules for specific types of income, based on the OECD Model Convention source rules. The Taxation Institute in its 16 April 1999 *Platform for Consultation* submission stated that it generally supports the need for clearer rules to determine the source of income. This is especially the case for cross border electronic commerce transactions and other transactions where the party deriving the income can initiate, negotiate and conclude the transactions over the internet without having a physical presence in the particular jurisdiction in which the counter party is located.

Thus, the specific source rules should then be periodically reviewed and revised as appropriate to ensure that they keep pace with technological developments and other commercial innovations.

5.1.4 How does the problem/solution relate to other options in the Consultation paper?

Impacts upon the FSI rules (CFC, FIF, and transferor trusts).

5.1.5 What priority should be given to resolving this problem? Why should it have this priority?

Given that the codification of the source rules is fundamental to the tax base, this is not an option that can be rushed. To ensure fundamental reform the Taxation Institute see this as a longer term priority

5.2 Rewrite of International Tax Legislation

5.2.1 What is the problem?

Complexity and associated compliance cost burdens arises currently under both the CFC and FIF regimes as they are written in a global way, capturing all entities and transactions unless specifically excluded. The impact of other legislative rules (such as transferor trusts and foreign tax credits) and the common law further compounds these problems.

Although the Consultative paper flags the possibility of a rewrite of the FIF rules (Option 4.1) the paper does not go as far as the RBT, which recommended (Recommendation 23.3) a major rewrite and redesign of international tax legislation. Despite the acknowledged complexity of the system, this recommendation also appears to have fallen off the agenda.

5.2.2 What solutions should be considered?

To rewrite the entire international tax legislation so that it targeted at the specific problems.

5.2.3 What priority should be given to resolving this problem? Why should it have this priority?

A rewrite would be a longer term priority as some of the immediate concerns may addressed through the short term changes mooted in the Consultative paper.