# Australian Bankers' Association

## A submission to the Board of Taxation on:

*Review of International Taxation Arrangements: A consultation paper prepared by the Commonwealth Department of the Treasury*

31 October 2002

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***This submission has been prepared with the assistance of PricewaterhouseCoopers***

# Glossary of Terms

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|---|---|
| ABA | Australian Bankers' Association |
| ABS | Australian Bureau of Statistics |
| ATO | Australian Taxation Office |
| BEL | Broad Exemption List (listed countries for CFC purposes) |
| BCA | Business Council of Australia |
| Board | The Board of Taxation |
| CFC | Controlled Foreign Company (pursuant to the regime in Part X of the ITAA 1936) |
| CGFS | Centre for Global Financial Services |
| CGT | Capital Gains Tax (provisions of the ITAA 1997) |
| DFAT | Department of Foreign Affairs and Trade |
| DTA | Double Tax Agreement |
| EDCI | Eligible designated concession income (for CFC purposes) |
| FDA | Foreign Dividend Account |
| FIF | Foreign Investment Fund (pursuant to the regime in Part XI of the ITAA 1936) |
| GDP | Gross Domestic Product |
| IBSA | International Banks and Securities Association of Australia |
| IFCTF | International Financial Centre Task Force |
| IFSA | Investment of Financial Services Association Limited |
| ITAA 1936 | *Income Tax Assessment Act 1936* |
| ITAA 1997 | *Income Tax Assessment Act 1997* |
| IWT | Interest withholding tax |
| LEL | Limited Exemption List |
| NOHC | Non operating holding company |
| RITA | Review of International Taxation Arrangements |
| RITA paper | Consultation paper on RITA prepared by Treasury and |

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|---|---|
| | released on 22 August 2002 |
| SSCSFS | Senate Select Committee on Superannuation and Financial Services |
| Treasury | Commonwealth Department of the Treasury |

# 1 INTRODUCTION

The ABA welcomes the opportunity to provide comments on the RITA paper produced by Treasury.

The ABA is the national organisation of licensed banks in Australia. Any body corporate that has been duly authorised to carry on banking business in Australia may become a member of the ABA. The ABA is funded by its 23 member banks ranging from traditional retail, trading bank style organisations to regional banks, foreign and wholesale banks. ABA members account for well over 90% of the approximately $800 billion of assets held in the Australian banking system.

Members are listed at Appendix 1.

RITA is seen by the ABA as an important step in further enhancing the contribution that the corporate sector in general, and the financial services sector in particular, make to the Australian economy.

Financial services are not only critical to the smooth and safe operation of all Australian businesses, through prudent lending and deposit taking activities, the financial services sector is also a key driver of economic growth in its own right.

The ABA is pleased to note that the Federal Government is seeking to improve Australia's attractiveness as a global and regional financial centre.

The ABA believes that the changes to Australia's international tax regime flowing from RITA could have the potential to stimulate future capital investment, allow all Australian companies to raise cost-effective capital in a more efficient manner, and facilitate the movement of staff with specialist skills.

# 2 SUMMARY OF THE ABA'S VIEWS AND RECOMMENDATIONS

*ABA Recommendation 1: In order for a comprehensive review to occur of the taxation impediments which may prevent Australia becoming a Centre for Global Financial Services, the ABA supports the full implementation of Recommendation 4 of the report of the Senate Select Committee on Superannuation and Financial Services:*

> ***"The Committee recommends that, in order to ensure that Australia has a competitive taxation regime, the Treasurer refer the taxation issues raised during the inquiry to the Board of Taxation for review and advice, and to take action as appropriate."***

***ABA Recommendation 2: The Board should consider the formulation of some high level principles – which can act as a yardstick against which specific options for reform (whether or not actually in the RITA paper) can be tested. The development of such principles should itself be subject to a consultative process, in respect of which the ABA would be a willing participant.***

***ABA Recommendation 3: An integrated approach to attracting equity capital for offshore expansion should be pursued such that:***

- *dividend streaming be permitted to enable foreign shareholders of Australian multinationals to receive dividends directly from foreign earnings, without the imposition of Australian franking penalties;*
- *to the extent that unfranked dividends are paid to Australian resident shareholders out of foreign source income, to provide Australian resident shareholders are provided with an appropriate non-refundable tax credit (at a rate which is sufficient to substantially eliminate the double taxation of foreign earnings); and*

- ***Australian multinationals are permitted to continue paying unfranked dividends out of foreign source income to foreign shareholders without the imposition of Australian dividend withholding tax.***

***ABA Recommendation 4: There should be a complete exemption from the CFC regime for CFCs and FIFs (which are companies) which are resident in BEL countries. Income from BEL branches should also be exempt.***

***ABA Recommendation 5: Australian taxpayers should be allowed to utilise Australian capital losses to offset attributable capital gains of a CFC.***

***ABA Recommendation 6: The CFC rollover rules should be expanded to include CGT rollover relief for the disposal of assets where rollover relief is provided under the laws of any foreign country. That is, where a CFC which is a resident of a foreign country transfers an asset and roll-over relief is available under the tax law of that foreign country, CGT roll-over relief should automatically apply under the CFC rules.***

***ABA Recommendation 7: Rollover relief should be expanded to include the transfer of assets between wholly owned group companies, where those transfers take place between the following countries:***

- ***a BEL to any other BEL (if ABA Recommendation 4 is not accepted);***
- ***non-BEL to BEL; and***
- ***Australia to any country (of an asset that does not have the necessary connection with Australia).***

***ABA Recommendation 8:***

- ***CGT should not apply on the disposal of revenue assets by foreign branches of Australian entities and by CFCs where the gain is exempt from additional Australian tax under s.23AH or Part X of the ITAA 1936.***

- ***Section 103-20 of the ITAA 1997 should be amended such that it does not apply to gains derived on revenue assets disposed of by a foreign branch or a CFC.***

- ***In the alternative, s.103-20 should be amended to make it clear that the CGT does not apply to a revenue asset where the gain on disposal of that asset has been taxed in a comparable tax jurisdiction.***

*ABA Recommendation 9: The Treasury proposal (RITA Option 3.5) to use the US protocol as a basis for future tax treaty negotiations is supported.*

*ABA Recommendation 10: RITA Option 3.9 is supported. The "list" approach should be abandoned in relation to dividend repatriation and a general participation exemption should be provided in respect of all foreign non-portfolio dividends, certain branch profits and CGT gains on the sale of non portfolio interests in foreign companies with active businesses.*

*ABA Recommendation 11: In order for Australia to provide internationally competitive conduit relief, the following measures need to be introduced:*

- *A full participation exemption for income and capital gains. This approach, combined with ABA Recommendation 3, avoids the complexity of other options suggested in RITA and removes the current inconsistent treatment of foreign dividends and capital gains.*
- *An expansion of the existing FDA regime to encompass all foreign income rather than only foreign dividends, and allowing the full flow-through of credits (as is currently the case for franking credits). This approach was recommended by the Ralph Review of Business Taxation.*
- *An exemption from CGT for foreign shareholders to the extent their gain is attributable to foreign investments of a conduit company. The framework for this regime would be as follows:*

- ***Eligible companies would register as Conduit Companies (CC).***
- ***Eligibility would be based on some pre-determined level of foreign ownership, say 80%.***
- ***The concession available to non-resident shareholders of CCs would be that a proportion of capital gains derived from the disposal of CC shares would be exempt from Australian tax. The proportion would be determined by the relative value of foreign investments. For example, if shares in foreign subsidiaries represent 80% of the value of the CC shares, then 80% of the gain would be exempt from Australian tax.***

***ABA Recommendation 12: CGT rollover relief should be available where a branch of an Australian resident company that carries on business in another country is incorporated.***

***ABA Recommendation 13: Specific enabling legislation providing appropriate tax relief to allow non operating holding company structures to be established in a tax neutral manner is required.***

***ABA Recommendation 14: A Panel should be formed by the Board of Taxation to consider the treatment of Tier 1 capital for tax purposes, taking into account the interests of the relevant parties. The Panel should include representatives of the ABA, Treasury and APRA.***

***ABA Recommendation 15: The ABA supports the submission made by IFSA in relation to Chapter 4 of the RITA paper.***

***ABA Recommendation 16: The ABA supports the submission made by IBSA in relation to Chapter 5 of the RITA paper.***

# 3 BACKGROUND

### 3.1 Establishment of RITA

RITA stems from the Coalition's policy statement S*ecuring Australia's Prosperity*, which was released prior to the 2001 Federal Election.

Under the heading of *Addressing the Branch Office Economy,* that policy statement made a number of commitments in relation to the review of Australia's international tax arrangements, including the following:

> *"The Government will, as a matter of priority, consult widely with key stakeholders and industry representatives to examine whether features of the current arrangements still exist which affect the decisions of businesses to remain in Australia or to locate here in preference to other countries.* ***Particular attention will be paid to whether Australia's international tax regime acts as an impediment to Australian companies attracting domestic and foreign equity****, whether it acts as an impediment to them expanding offshore, and whether it acts as an impediment to holding companies and conduit holdings being located in Australia."* (ABA emphasis)

The ABA's focus in this submission on Chapter 2 of the RITA paper is consistent with this statement of intent.

The RITA process was formally announced by the Treasurer on 2 May 2002.

The Treasurer's media release supported the commitment made before the election and noted that RITA would concentrate on "at least four principal areas", including the dividend imputation system's treatment of foreign source income. The Treasurer indicated that RITA would examine business concerns over the imputation "bias" against foreign source income.

The other areas mentioned for review were: foreign source income rules, the overall treatment of "conduit income", and high level aspects of DTA policy and processes.

The RITA paper, released by the Treasurer on 22 August 2002, sets out options which provide a basis for public consultation.

### 3.2 ABA's approach in this submission

The ABA has generally sought to follow the Board's suggested approach to making submissions, that is:

- 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?

The ABA has identified, and commented upon in this submission, those matters which are most pressing for its members. The ABA has also raised a number of key issues for consideration which are not canvassed in the RITA paper.

RITA proposals not discussed in this submission are also important to ABA members. In some cases the ABA is supporting the submissions made by other bodies.

As far as possible, and within the time constraints laid down, the ABA has endeavoured in this submission to respond to the Treasurer's challenge to business, and the Board, "*to demonstrate the benefits from implementing particular options*".

### 3.3 Australia – A Global Financial Centre

Chapter 4 of the RITA paper is devoted to promoting Australia as a global financial services centre, and this is consistent with the current Government's commitment in this area.

The financial services sector in Australia is a major contributor to economic growth and prosperity in Australia:

1. The financial services industry has been the fastest growing contributor to GDP in recent years. During the year 1999-2000, the finance and insurance sector contributed 7.2% to Australia's GDP, up from 6.8% in 1998-1999.[1]

2. The financial services sector is Australia's third largest exporter of services.[2] Since 1986, financial services exports have grown by 15% a year, above the total goods and services export growth average of 9%.[3]

3. Around 30% of the profits earned by Australian based banks are derived from overseas.

Previous initiatives of the current Government in relation to tax measures for the global financial centre include:

- The *'Australia – A Regional Financial Centre'* component of the Government's *Investing for Growth* Statement made on 8 December

[1] Figures compiled by Axiss Australia using ABS data

[2] Figures compiled by the Department of Foreign Affairs & Trade using ABS data

[3] Figures compiled by Axiss Australia using ABS data

1997. This package included improvements to the OBU regime, extensions of IWT exemptions and improvements to the FIF rules.

- Widening of the key IWT exemption (pursuant to section 128F of the ITAA 1936) announced on 13 August 1998.

- Further amendments to IWT exemptions announced on 29 August 2001.

As a wider (non-tax specific) initiative, the Government announced on 17 May 1999 the establishment of the IFCTF which was to be established within Treasury. The IFCTF was charged with developing and implementing a coordinated campaign to promote Australia as a CGFS. The IFCTF was originally to have two-year life span, after which it was envisaged that the CGFS promotional strategy would be taken over by the private sector. Axiss Australia was established in late 1999 to take over and to continue the work of the IFCTF.

Against this backdrop, the ABA wishes to draw to the Board's attention the March 2001 Report of the SSCSFS entitled: *The Opportunities and Constraints for Australia to Become a Centre for the Provision of Global Financial Services.*

This Senate Select Committee noted at page xiv of its report that:

> *"the Committee considers that there are significant opportunities for Australia to strengthen its position as a global financial services centre."*

The SSCSFS went on to note at page xv:

> *"A number of constraints hampering Australia's goal to become a global financial services centre were drawn to the Committee's attention during the course of the inquiry.* ***These constraints primarily related to taxation matters****, Australia's regulatory regime, some corporations law issues and the treatment of expatriate staff".* (ABA emphasis)

In the body of its report (at page 62) the SSCSFS stated:

> *"6.4 Based on industry evidence received by the Committee,* ***Australia's taxation regime would appear to be the most active constraint on Australia's competitiveness in the international market place****. According to some, Australia has a reputation as a 'high tax' country and this impedes its development as a finance centre. While there was no suggestion that Australia should seek to replicate the tax concessions offered by some competitors, nor to compete with tax havens such as the Republic of Vanuatu, evidence to the inquiry emphasised that Australia's success depends on having an internationally competitive tax system. Other submitted that, where possible, we should 'outflank' competitors with superior information technology and telecommunications capability, superior workforce and capacity to respond more quickly to changing markets.*
>
> *6.5 Whilst they are all interrelated, the issues raised primarily concerned Australia's Offshore Banking Unit regime, the treatment of Collective Investment Vehicles, withholding taxes, instances of double taxation, and other corporate tax issues. In the view of some, these issues, which are discussed in turn below, 'threaten the competitiveness of the funds management industry in Australia' and 'are detrimental or not favourable to international activity in financial markets here'."* (ABA emphasis)

In short, and notwithstanding the CGFS measures announced to date, the SSCSFS identified a wide range of tax measures that needed to be addressed in promoting Australia as a financial services centre. Those measures, especially as they relate to OBUs, IWT and GST, go well beyond the scope of Chapter 4 of the RITA paper (which only addresses FIF matters) or indeed the rest of the RITA paper.

***ABA Recommendation 1: In order for a comprehensive review to occur of the taxation impediments which may prevent Australia becoming a Centre for Global Financial Services, the ABA supports the full implementation of Recommendation 4 of the report of the Senate Select Committee on Superannuation and Financial Services:***

> ***"The Committee recommends that, in order to ensure that Australia has a competitive taxation regime, the Treasurer refer the taxation issues raised during the inquiry to the Board of Taxation for review and advice***

The ABA understands that the Government is still considering its response to the recommendations of the SSCSFS.

While not specific to the financial services sector, the March 2002 Report released by the DFAT, *The Big End of Town and Australia's Trading Interests*, highlights the importance of large enterprises for the Australian economy and its trade and foreign investment interests. The Report notes the importance of taxation issues and the need to ensure that Australia has a globally competitive taxation environment.

# 4 RITA CHAPTER 1: MAINTAINING AUSTRALIA'S COMPETITIVENESS IN A GLOBAL ECONOMY

## 4.1 Introduction

The RITA paper responds to the terms of reference laid down by the Treasurer, and in particular, it addresses the four specific areas set out in the Treasurer's media release of 2 May 2002. The RITA paper also (at page 8) very briefly refers to some fundamental principles of international tax: residency, source of income and economic neutrality benchmarks.

The RITA paper does not present a comprehensive statement of the high level principles which should underpin a review of international taxation. It moves too quickly to a consideration of detailed issues.

***ABA Recommendation 2: The Board should consider the formulation of some high level principles – which can act as a yardstick against which specific options for reform (whether or not actually in the RITA paper) can be tested. The development of such principles should itself be subject to a consultative process, in respect of which the ABA would be***

Some key questions still need to be addressed:

- What should be the overall goals and principles of international tax reform?
- What do we want Australia's international tax regime to look like at the end of the implementation of RITA reform measures?

- What sort of "business behaviour" is to be encouraged or discouraged by the revised regime?
- What criteria should govern the tax law design process?

The RITA process will be far more effective if there is agreement between the parties on overall goals and principles.

The ABA believes that the overall goals and principles can be divided into two categories:

- Substantive outcomes
- Tax system design and process issues.

### 4.2 Substantive outcomes

The ABA proposes the following substantive outcomes as objectives for the post-RITA Australian international tax regime:

1. Australian-based companies are encouraged to remain headquartered in Australia.

2. Australian-based companies are encouraged to invest offshore so as to share in the benefits of a global economy.

3. Foreign investors are appropriately encouraged to invest in Australian companies and other businesses.

4. Domestic investors are neutral as between investing in domestic companies with only Australian-based activities and domestic companies with foreign-based activities.

5. Foreign companies are encouraged to locate regional ownership, management and service/support functions in Australia.

6. Australian-based companies can raise debt and equity capital in an internationally cost competitive manner, with recognition of the highly mobile nature of capital in modern global financial markets.

7. Australia is an attractive location for talented people whose technical, managerial and other skills are needed by companies conducting business in Australia (whether Australian or foreign controlled).

8. Australian and foreign-based companies are encouraged to undertake research and development in Australia and to have Australian ownership of (and hence reward for) intangible property and other intellectual capital.

9. Revenue protection measures (such as CFC and FIF rules) are appropriate, internationally competitive and targeted to specific and material threats to the Australian revenue base.

10. Compliance costs (particularly in relation to the CFC regime) are minimised for taxpayers, with resulting lower administration and audit costs for the ATO.

### 4.3 Tax system design/process issues

The standard criteria for tax system design are:

1. Equity (fairness)
2. Efficiency
3. Simplicity

These long-standing criteria are widely quoted and cited. For example, see Chapter 3 of the Full Report of the (Asprey) Taxation Review Committee in 1975 and Chapter 1 of the Reform of the Australian Tax System – Draft White Paper in 1985.

The Draft White Paper in 1985 summarised the criteria as follows:

> *"1.1 The essential criteria for assessing a tax system are equity, efficiency and simplicity. An equitable tax system is critical, not only to the attainment of economic and social objectives, but also to the maintenance of a basic respect for the tax system from which a high degree of voluntary compliance derives. In initiating this review of the Australian taxation system, the Government attaches particular importance to achieving a fairer sharing of the tax burden. A more efficient tax system is necessary in order to improve Australia's economic performance. With a more efficient tax system, resources will be more likely to move into activities where they will generate the largest economic gains to the nation, rather than activities where they will simply yield the largest tax gain to investors. A simpler tax system is essential so that the law can be understood by the people to whom it applies. A simpler tax system will also mean that less resources will be devoted to socially unproductive activities such as tax planning and tax litigation."*

# 5 RITA CHAPTER 2: ATTRACTING EQUITY CAPITAL FOR OFFSHORE EXPANSION

Given the limited size of the Australian banking and financial services market and competition constraints within Australia, Australian banks have limited opportunities to pursue expansion and growth strategies in Australia. As a result, Australian banks need to explore offshore opportunities in order to obtain the necessary scale to compete both internationally and with foreign financial institutions in the Australian financial markets. Therefore, the issue of attracting equity capital for offshore expansion is a critical issue for Australian banks.

Option 2.1 in the RITA paper provides three alternative options for enhancing Australia's ability to attract equity capital for offshore expansion.

The ABA has considered the merits of these three options, along with other alternatives in developing its preferred position.

***What is the current law?***

At present, Australia's imputation system has a number of design features that adversely impact the ability of Australian companies to attract equity capital for offshore expansion. The current Australian tax law discourages foreign expansion by:

- not providing any form of shareholder tax credit for foreign tax paid on foreign profits distributed to Australian shareholders; and

- effectively prohibiting dividend streaming of foreign profits to foreign shareholders, through complex anti-streaming rules which limit the ability of companies to pass on imputation credits to Australian shareholders, and deny non-residents benefits under their own local tax jurisdictions.

The ABA believes that an integrated solution is needed to address the above concerns.

The dividend imputation example attached as Appendix 2 to this submission seeks to model the current law for an Australian company that has both foreign source income and foreign shareholders. The operation of the current law is illustrated in the Base Case. The negative tax impact of distributing foreign source income to resident shareholders is highlighted.

***What is the problem?***

As noted above, the current dividend imputation (and FDA) rules create a disincentive for Australian multinational companies to expand their foreign operations and generate foreign profits. This is because such profits, when distributed to Australian resident shareholders, are subject to effective double taxation, when compared with the distribution of Australian-sourced profits.

These structural inefficiencies in the current dividend imputation system in turn increase the cost of capital and adversely impact the overall competitiveness of Australian-based multinational companies. This has led some Australian companies to consider options for relocating their head offices and to assess complex global merger structures, such as dual listed company arrangements.

Some Australian companies have considered other corporate structures in response to their desire to pursue global growth strategies and at the same time address specific concerns and impediments such as the double taxation of foreign earnings. This is not to say that if the tax impediment was removed Australian companies would not consider these structures, but it would be likely to remove taxation as an important factor in the assessment of these structures.

***What evidence is there of the problem?***

The ABA and certain member banks are participating in an exercise being coordinated by the BCA, and involving Access Economics, which is designed to analyse and model certain outcomes which are likely to arise from adopting one or more of the options in Chapter 2 of the RITA paper.

Part of this exercise will involve the collection of data and anecdotal evidence of current issues and problems from participating companies, including some ABA members.

Certain ABA members have indicated that they will lodge their own submissions to the Board which may contain more specific evidence of the problems arising under the current system.

Further evidence can also be found in the reports of the SSCSFS and DFAT (refer to Section 3.3 of this submission). These reports specifically refer to requests being made by the business community for dividend streaming and the difficulties caused by this solution not being available.

***What solutions should be considered?***

It is considered that where Australian multinational companies with foreign shareholders have non-portfolio investments (including branches) in listed comparable tax countries, the foreign income from such investments should be allowed to be distributed to foreign shareholders without any further Australian tax or negative Australian franking consequences. Conversely, the Australian-sourced income of Australian multinationals should be allowed to be distributed to Australian resident shareholders with appropriate recognition for foreign tax paid on the earnings out of which the dividends are sourced.

Appendix 2 presents a number of possible solutions to the dividend imputation problem outlined above. Specifically, the impact of adopting RITA Options 2.1A and Option 2.1B (either on a stand-alone basis or as a combined model) is quantified.

The Appendix also presents an alternative option that provides a full exemption from Australian tax for unfranked dividends, sourced from foreign profits.

These four options are compared with the current taxation system as illustrated in the Base Case.

The ABA makes the following recommendation, but notes that, as discussed with the Board, it will be presenting in a separate document, supplementary material, including a full analysis of the economic impact of its Recommendation and a detailed justification for the adoption of the course of action recommended. This supplementary submission will based on the BCA/ABA research project mentioned in section 5.

***ABA Recommendation 3: An integrated approach to attracting equity capital for offshore expansion should be pursued such that:***

- ***dividend streaming be permitted to enable foreign shareholders of Australian multinationals to receive dividends directly from foreign earnings, without the imposition of Australian franking penalties;***
- ***to the extent that unfranked dividends are paid to Australian resident shareholders out of foreign source income, to provide Australian resident shareholders are provided with an appropriate non-refundable tax credit (at a rate which is sufficient to substantially eliminate the double taxation of foreign earnings); and***
- ***Australian multinationals are permitted to continue paying unfranked dividends out of foreign source income to foreign shareholders without the imposition of Australian dividend withholding tax.***

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

The solution recommended should be pursued as a high priority, given that the current dividend imputation rules are an impediment to Australian companies pursuing global expansion strategies and being able to attract equity capital for that purpose.

The ABA believes that the economic benefits and Revenue impact of its recommendation will be as follows.

Permitting companies to stream foreign earnings directly to foreign investors together with a shareholder tax credit for foreign tax paid on foreign profits distributed to Australian shareholders (at a rate which is sufficient to substantially eliminate the double taxation of foreign earnings) would overcome many of the difficulties facing Australian based multinationals.

The likely benefits from such a proposal are as follows:

- increased foreign investor demand for shares of Australian multinationals due to the ability of foreign shareholders to benefit under their local tax;
- increased Australian investor demand for shares of Australian multinationals because of the increased franking capacity;
- increased capacity for Australian multinationals to raise cost effective capital in domestic and foreign capital markets, in order to fund global expansion and growth strategies, resulting in increased earnings;
- increased capacity for Australian multinationals to use their shares as acquisition currency in order to expand their foreign operations; and
- a reduction in the incentive for Australian multinationals to consider options to relocate their head office and to assess complex global merger structures, such as dual listed company arrangements.

It is acknowledged that the implementation of dividend streaming, together with a shareholder tax credit for unfranked dividends from foreign source income, will give rise to an ongoing cost to Australian Revenue. However, to the extent that these measures improve outcomes for shareholders, share prices should increase and this will have an offsetting impact on the cost to Revenue in a number of ways, namely:

- increased share prices should directly produce additional tax revenue through the imposition of CGT on the disposal of the relevant shares;
- improved earnings and share prices should reduce the cost of capital, creating a preference for equity over debt financing, with a resulting reduction in interest deductions claimed; and
- increased repatriation of foreign profits to Australia and ultimately increased distribution of those profits to Australian shareholders, will lead to increased Australian tax collections.

Enabling Australian multinationals to stream foreign profits directly to foreign shareholders should enable foreign investors to benefit under their local tax rules (for example access to local imputation or foreign tax credit benefits) in ways that would not be available for an equivalent Australian dividend. Further, not having to repatriate foreign income to Australia could also potentially result in significant savings in foreign dividend withholding tax. Such tax benefits should lower the cost of raising equity capital in foreign countries, without directly impacting the Australian Revenue collected.

The Appendix quantifies the overall impact on the cost of capital for each case.

# 6 RITA Chapter 3: Promoting Australia As A Location For Internationally Focused Companies

## 6.1 Introduction

Chapter 3 of the RITA paper deals principally with international tax arrangements that affect the attractiveness of Australia as a location for Australian-based multinationals and regional holding companies. The ABA supports this objective, which should encourage Australian-based multinationals to remain headquartered here and remove the current significant tax impediments for foreign companies to establish regional holding companies in Australia.

The disincentive, due to the current imputation and FDA rules, for Australian-based multinationals to expand offshore and generate foreign profits has been addressed in section 5 of this submission. In this part of the submission, the ABA examines the following key reforms required to achieve the objective of removing barriers in the Australian tax system:

- Updating the CFC system
- Modernising our DTAs
- Introducing conduit taxation

The ABA notes that there are significant outstanding technical and policy issues associated with the CFC regime which RITA should address. However, the ABA is concerned that a major rewrite of the existing provisions may fail to address what the ABA vizews as the key impediments created by the existing CFC system.

For this reason, the ABA's submission focuses on some particular issues with the CFC provisions. Any major rewrite should occur only after the immediate problems are fixed.

### 6.2 Treatment of CFCs (and FIFs) which are resident in BEL countries [ABA Option]

*What is the problem?*

Currently, the list of BEL countries consists of seven countries, namely United Kingdom, United States, Canada, Japan, Germany, New Zealand and France. These countries have been designated as BEL countries because they have a taxation system that is sufficiently comparable to Australia's tax system. The policy of the CFC regime is that amounts taxed at full rates by countries on the BEL should not be subject to Australian accruals tax or taxation on repatriation to Australia.

This part of the CFC regime still requires Australian companies to maintain appropriate information systems to determine whether they are required to calculate attributable income and then to actually calculate the attributable income from CFCs which are resident in BEL countries. This gives rise to significant compliance costs.

Where an Australian entity has an interest in a foreign company which is not an Australian CFC, that interest will be treated as an interest in a foreign investment fund (FIF) under the FIF regime. Unless a specified exemption under the FIF regime applies, the Australian entity will be required to calculate FIF income (broadly an amount equal to the increase in the market value of its investment, or an amount based on a deemed rate of return on the value of its investment, or an amount calculated based on the accounts of the FIF) under the FIF regime which will be subject to Australian tax.

The FIF regime also gives rise to unreasonable compliance costs for many Australian entities.

***What evidence is there of the problem?***

Taxation Statistics for 1998-1999 and 1999-2000 indicated that the Australian tax revenue collected from Australian companies under the CFC regime in relation to BEL countries was approximately $42.9m and $51.4m respectively. This revenue was collected from approximately 94 and 108 Australian companies respectively.

Given the small amount of revenue collected from BEL countries and the small number of taxpayers affected, the conclusion is that the revenue collected is not proportional to the compliance costs incurred by affected taxpayers.

In relation to tax revenue collected from the taxation of FIF income, Taxation Statistics for 1998-1999 and 1999-2000 indicate that approximately $40m and $48m of tax revenue was collected from Australian companies.

***What solutions should be considered?***

> ***ABA Recommendation 4: There should be a complete exemption from the CFC regime for CFCs and FIFs (which are companies) which are resident in BEL countries. Income from BEL branches should also be exempt.***

This will substantially reduce compliance costs for Australian companies, and based on the above tax revenue statistics, the tax revenue foregone is likely to be small (in the range of $50m per annum for CFCs and even less for FIFs).

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

The solution recommended should be pursued as a high priority to reduce compliance costs and ensure that the CFC/FIF rules do not act as an impediment to Australian companies carrying on active businesses, or having an interest in companies with active businesses in foreign countries which have a comparable tax system to the Australian tax system. The legislative amendments to the CFC and FIF regimes to give effect to this recommendation should be minor and the revenue impact should be small.

## 6.3 Extension of Roll-over Relief in the CFC Rules [RITA Option 3.1]

### 6.3.1 Determination of Eligible Designated Concession Income

***What is the current law?***

Under the CFC provisions, Regulations[4] define the narrow circumstances where roll-over relief granted by a foreign country in relation to a capital gain will not give rise to EDCI for the purpose of determining the attributable income of a BEL country CFC.

Therefore, in any reorganisation involving shares (which are tainted assets) by a BEL country CFC outside these circumstances, a tax liability may be generated under the CFC rules.

***What is the problem?***

The current rules for CGT rollovers involving CFCs lack flexibility. In essence, the Regulations have not kept pace with changes in Australian domestic law (eg, scrip for scrip rollover and demerger tax relief) and fail to recognise tax deferrals provided by BEL country Governments.

Such inflexibility inhibits the corporate restructuring of the foreign operations of Australian multinationals to take advantage of business opportunities and to rationalise unwieldy structures that may have been acquired through takeovers and mergers.

[4] Principally Regulations 152E and 152G.

Additionally, the progressive harmonisation of the tax laws of countries which are part of the European Community provides scope for many Australian multinationals to restructure their European operations without any immediate tax burden in those countries. However, the lack of flexibility in Australia's rollover rules dealing with CFCs discourages Australian multinationals from taking advantage of such developments. This puts Australian multinationals at a competitive disadvantage.

Capital gains may be subject to attribution where the BEL country provides a deferral of tax in respect of compensation received for compulsory acquisition, loss or destruction, disposal of an asset to a group company, reinvestment of proceeds of a disposal of business assets, share exchanges in the same company, or the consolidation or subdivision of shares or rights and demergers.

These difficulties are exacerbated by the fact that losses cannot be transferred between CFCs, and a capital gain of a CFC is converted into foreign source income that cannot be sheltered by capital losses available to the Australian group.

Significant time and effort is consumed in ensuring that reorganisations proceed in a way that will not trigger tax under the Australian CFC system.

***What evidence is there of the problem?***

The narrow scope of operation of these provisions provides a significant obstacle to many reorganisations of corporate groups which are undertaken for legitimate commercial reasons. Many of the BEL countries provide more flexible roll-over relief rules which are seen as sufficient to protect the Revenue base of those countries but are not so narrow as to prevent legitimate group reorganisations. For example, the US provides roll-over relief for the contribution of assets to a partnership where the other partners are not 100% group companies, and the disposal of assets to companies which are part of a consolidated group (that is, more than 80% common ownership) but are not 100% group companies.

In the UK, rollover relief is available where a company (A) issues shares to a person in exchange for shares in another company (B) and after the exchange, A owns more than 25% of the ordinary shares of B.

Double taxation may arise where assets are transferred by a CFC and rollover relief is available under the tax law of the foreign country but not under the Australian CFC rules. There may be an element of double taxation where the gain on the transfer of the asset is included in the attributable income of the transferor CFC under Australia's CFC rules, and the same gain is subject to tax in the foreign country when the relevant asset is eventually disposed of.

***What solutions should be considered?***

***ABA Recommendation 5: Australian taxpayers should be allowed to utilise Australian capital losses to offset attributable capital gains of a CFC.***

***ABA Recommendation 6: The CFC rollover rules should be expanded to include CGT rollover relief for the disposal of assets where rollover relief is provided under the laws of any foreign country. That is, where a CFC which is a resident of a foreign country transfers an asset and roll-over relief is available under the tax law of that foreign country, CGT roll-over relief should automatically apply under the CFC rules.***

It is not readily apparent why extending rollover relief under the CFC rules to follow rollover relief available in a foreign country should cause any concerns. Rollover relief for the transfer of assets under the tax law of a foreign country merely defers tax on the accrued gain. On the eventual disposal of the relevant asset any capital gain calculated under the tax laws of the foreign country will be subject to foreign tax.

Alternatively, and assuming that ABA Recommendation 4 to exempt BEL country CFCs from the CFC regime is not accepted, the concept of EDCI for the purposes of *BEL countries* should be limited to specifically listed items of concessionally taxed income. In this way, where a CFC which is resident of a BEL country disposes of an asset and rollover relief is available in that country, CGT rollover relief would automatically be available under the CFC regime.

This would remove the need for general rules specifying when foreign country rollover relief will be accepted. The justification will be on the basis of equity, reduction in complexity and reduction in compliance costs. Precedent for the exclusion of capital gains derived by CFCs can be found in the UK rules, where UK residents generally do not include capital gains as attributable income of the CFC.

If the Government believes that particular rollover concessions in specific BEL countries are "too generous" and will have a significant impact on Revenue, such concessions could be included on the specific list of EDCI.

This extension of rollover relief should not cause any concerns on the basis that the foreign Government is providing a **deferral** rather than an **exemption** from tax.

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

The solution recommended should be pursued as a high priority, given that the current CGT roll-over rules for CFCs are an impediment to potential commercial transactions and corporate restructures involving foreign subsidiaries of Australian multinationals in countries which have tax systems which are comparable to the Australian tax system.

### 6.3.2 Calculation of Attributable Income

***What is the current law?***

For the purpose of calculating attributable income of a CFC, the Australian CGT rollover relief provisions are applied to capital gains derived by a CFC subject to modifications[5].

Section 419 operates to allow the transfer of assets between wholly owned group companies where those transfers take place between the following country examples:

- BEL to the **same** BEL;
- non-BEL to any non-BEL; and
- any country to Australia.

***What is the problem?***

The CGT rollover rules in Australia were introduced to provide companies with the flexibility to undertake such reorganisations that involve the transfer of assets within wholly owned groups. In the ABA's view, these same rules should be applied for the purpose of calculating the attributable income of all CFCs.

***What evidence is there of the problem?***

Difficulties arise where Australian corporate groups seek to reorganise their foreign operations to achieve a foreign tax advantage. For example, an Australian-based company may seek to:

- interpose, say, a Mauritian holding company to hold its investments in Indonesia and India in order to take advantage of favourable dividend withholding taxes between those countries; or

- change its offshore holding company location from Germany to the UK.

In each case, these proposals would (assuming the shares have appreciated in value) give rise to taxable income (under the Australian CGT or CFC system), although the transactions involve a purely internal group reorganisation.

***What solutions should be considered?***

***ABA Recommendation 7: Rollover relief should be expanded to include the transfer of assets between wholly owned group companies where those transfers take place between the following countries:***

- ***a BEL to any other BEL (if ABA Recommendation 4 is not accepted);***
- ***non-BEL to BEL; and***
- ***Australia to any country (of an asset that does not***

To prevent abuse, transfers of tainted assets by BEL country CFCs outside the group should be deemed to give rise to EDCI if that asset had been previously rolled into that CFC from another CFC resident in a non-BEL country. Deemed EDCI should also arise where a de-grouping event has occurred in relation to an asset which had previously been rolled over to a BEL country from a non-BEL country. These rules are necessary to prevent groups rolling assets into BEL countries and then claiming no EDCI on a transfer of those assets outside the group.

On the basis that these recommendations will only allow the rollover of assets within a wholly owned group, and will contain provisions to prevent abuse, the Revenue impact is unlikely to be significant. However, this change would remove a significant obstacle to international restructuring for the Australian-based companies and eliminate the unnecessary costs associated with ensuring the existing rules are not breached.

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[5] Section 419 of the Income Tax Assessment Act 1936.

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

The ABA views this is as high priority, for the same reason given in relation to Recommendation 5 above.

### 6.4 Conversion of Foreign Currency Amounts for CGT purposes

*What is the current law?*

Section 103-20 of the ITAA 1997 sets out the rule for converting foreign currency denominated amounts into Australian currency for CGT purposes. The rule applies to all assets (both revenue and capital) where the asset (or its acquisition cost and disposal proceeds) is denominated in a foreign currency.

*What is the problem?*

Strictly, s.103-20 applies to the disposal of foreign currency denominated revenue assets held by foreign branches of Australian entities and by CFCs. Where it applies, s.103-20 can produce unintended consequences. The policy rationale of s.23AH and Part X of the ITAA 1936 is that where income of foreign branches and CFCs has been subject to tax in a comparable tax jurisdiction, it should not suffer further Australian tax.

In the case of the disposal of a revenue or trading asset by a foreign branch or a CFC, the gain in foreign currency terms may be fully subject to foreign tax (and thus exempt from additional Australian tax under s.23AH or Part X). However, the application of s.103-20 would mean that it would also be necessary to consider whether or not a capital gain in Australian dollar terms was derived on the disposal of the asset. The CGT reconciliation provision in s.118-20 of the ITAA 1997 would not apply to reduce the capital gain. Consequently, CGT could potentially apply in relation to a comparably taxed gain derived on the disposal of a revenue asset by a foreign branch or a CFC.

***What solutions can be considered?***

> ***ABA Recommendation 8:***
>
> - ***CGT should not apply on the disposal of revenue assets by foreign branches of Australian entities and by CFCs where the gain is exempt from additional Australian tax under s.23AH or Part X of the ITAA 1936.***
>
> - ***Section 103-20 of the ITAA 1997 should be amended such that it does not apply to gains derived on revenue assets disposed of by a foreign branch or a CFC.***

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

The solution recommended should be pursued as a high priority. The legislative amendment to give effect to this recommendation would be minor and the revenue impact should be small.

## 6.5 US/Australia Tax Treaty Protocol [RITA Option 3.5]

### *What is the current law?*

The announcement on 27 August 2001 by the Australian Government foreshadowed a protocol to the tax treaty with the US which, for the first time, recognised the increased levels of capital exported by Australian based multinationals. The major changes proposed are:

- 0% withholding tax (down from 15%) on dividends from 80% or more subsidiaries of listed public companies.
- An exemption from branch profits tax for Australian listed public companies with branches in the US.
- An exemption from withholding taxes for financial institutions.
- 5% withholding tax (down from 10%) on most royalties and equipment rentals excluded from the definition of royalties.

### *What is the problem?*

The ABA generally welcomes these changes and would encourage the use of the US protocol as a guide for new tax treaties.

However, the protocol potentially provides US banks with access to Australian markets on a tax-free basis from 1 July 2003 (as interest paid **to** US resident financial institutions will not be subject to Australian interest withholding tax). The ABA submits that Australian banks must be entitled to compete on an "even playing-field" and therefore should have access to tax deductible tier 1 capital, (refer Section 6.10 of this submission below).

In addition, to enable Australian financial institutions to compete effectively with foreign financial institutions in the Australian market and to raise cost effective funds from offshore sources, future renegotiations of double tax agreements should proceed on the basis that interest paid **by** financial institutions should not to be subject to interest withholding tax.

### *What evidence is there of the problem?*

It is well publicised that a key driver in the migration of James Hardie to the Netherlands was the punitive 15% dividend withholding tax imposed on the profits of their US operations.

Significant lobbying by Australian-based companies led to the watershed US protocol. As a result, it is expected that significant retained earnings will be repatriated to Australia once the US protocol becomes effective.

### *What solutions should be considered?*

> ***ABA Recommendation 9: The Treasury proposal (RITA Option 3.5) to use the US protocol as a basis for future tax treaty negotiations is supported.***

The ABA would also strongly encourage the Government to ensure that the US protocol becomes law in the US and Australia in time for the anticipated 1 July 2003 commencement.

Finally, the ABA suggests that treaties with Australia's key trading partners be renewed as a matter of high priority.

## 6.6 General Participation Exemption [RITA Option 3.9 and Additional ABA Options]

### *What is the current law?*

In 1997 the Government made significant changes to the manner in which the CFC regime operates. A fundamental change included the segregation of "listed" countries into BEL countries and LEL countries.

For the purposes of attribution, all countries other than the seven BEL countries, are treated as "tax havens" for the purposes of attribution and the branch profits exemption.

In relation to repatriation of profits, non-portfolio dividends received by companies from BEL and LEL countries are typically exempt. The fundamental premise underlying this design feature of Australia's foreign income system is compliance. It was considered likely that the profits from BEL and LEL CFCs would have suffered direct and underlying tax of at least, at that time, 49%[6] (now 30%). Therefore a credit approach would yield no additional Revenue. Indeed, given the drop in the Australian corporate tax rate many companies are disadvantaged by the exemption system as excess foreign tax credits are not available.

In addition, extremely complex anti-avoidance measures (principally section 47A, which operates in addition to the robust transfer pricing rules) are necessary to preclude the movement of profits from unlisted countries to LEL/BEL countries.

### *What is the problem?*

The existing rules which require that all dividends from unlisted countries be subject to tax with a credit for underlying tax, gives rise to significant compliance costs, complexity, the unnecessary retention of profits offshore and the need for complex profit shifting rules.

In some cases, income derived by Australian CFCs resident in unlisted countries is not subject to attribution because it is active income or it is specifically exempt from attribution (eg it qualifies for the Australian Financial Institution Subsidiary exemption in sections 449/450 of the ITAA 1936). However, this income would be subject to tax if it were repatriated to Australia. Therefore, this discourages Australian groups from repatriating surplus capital from CFCs in unlisted countries and restricts the ability of Australian companies to actively manage their capital structures. The surplus capital is reinvested in the foreign businesses instead of being repatriated and invested in the Australian business or distributed to Australian shareholders.

Allowing dividends out of non attributable profits of a CFC in an unlisted country to be repatriated to Australia without being subject to Australian corporate tax is consistent with current policy. This policy applies to non portfolio dividends paid out of non attributable income by CFCs resident in listed countries and should be applied equally to non portfolio dividends paid out of non attributable income by CFCs in unlisted countries.

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[6] At the time of the design process prior to 1 July 1989, the corporate tax rate was 49% and it was reduced to 39% from 1 July 1989.

In addition, and consistent with comments below in relation to conduit taxation, the ABA believes that this participation exemption should equally extend to CGT, such that the disposal of shares in an active foreign CFC should not be subject to Australian CGT. The recent changes in the UK may provide useful guidance regarding the drafting of these provisions. The ABA believes that this change would remove the existing weakness in the Australian tax system that naturally encourages Australian based companies to directly sell assets and/or extract dividends prior to the sale of an active CFC. Often there is a foreign dividend withholding tax cost of this approach (which is less than the associated reduction in Australian CGT).

Many European countries exempt gains made by domestic companies on the sale of non portfolio interests or substantial shareholdings in foreign companies (eg. UK, Austria, Denmark, The Netherlands, Portugal, Spain and Germany). This allows domestic companies to remain internationally competitive and make investment and reinvestment decisions in relation to their offshore businesses without domestic taxation constraints.

***What evidence is there of the problem?***

ABA members indicate that compliance costs in relation to dividends from unlisted countries is substantial and Australian tax collections are negligible.

In addition, RITA acknowledges that only 5% of all foreign non-portfolio dividends are received from unlisted country CFCs.

This provides support for the view that Australian companies are discouraged from repatriating surplus profits from CFCs resident in unlisted countries where those profits have not been subject to attribution.

Australian companies with CFCs are forced to consider complex asset sale structures for the disposal of their CFC businesses because this form of disposal would not be subject to CFC attribution, regardless of whether or not any foreign tax has been paid on the sale. The entity sale would be subject to CFC attribution tax if not subject to tax in the foreign country.

In addition, Australian companies find it difficult to compete for corporate assets in many European countries with CGT exemptions, because foreign competitors are able to take into account potential tax benefits on a subsequent sale which Australian companies cannot under our CFC rules.

***What solutions should be considered?***

***ABA Recommendation 10: RITA Option 3.9 is supported. The "list" approach should be abandoned in relation to dividend repatriation and a general participation exemption should be provided in respect of all foreign non-portfolio dividends, certain branch profits and CGT gains on the sale of non portfolio interests in foreign companies with active businesses.***

The ABA believes that this will substantially reduce compliance costs, encourage the repatriation of profits back to Australia for deployment in Australia, improve the efficiency of the capital management strategies of Australian companies and increase the ability of Australian companies to compete for corporate assets in foreign countries. The ABA does not believe that there is any significant Revenue at risk given the robust nature of the existing CFC attribution rules.

For these reasons, a participation exemption should extend to capital gains as well as dividends.

A similar rule should apply to foreign branches. In principle, this would operate so that, subject to the active income test, only tainted EDCI of BEL branches and tainted income of non-BEL branches would be taxable.

### 6.7 Conduit Relief [RITA Option 3.10]

***What is the current law?***

Conduit income is foreign sourced income which non-residents earn through an Australian entity. For example, an Australian company might have a mixture of foreign and Australian shareholders. It might also earn foreign income (such as dividends from foreign operating subsidiaries or gains from the sale of those subsidiaries) which it will distribute to its shareholders.

A combination of the following features of Australia's tax system discourages many companies from choosing Australia as a viable location in which to establish a regional holding company or a multinational group parent company:

(i) Australian CGT at the foreign shareholder level.

(ii) Australian CGT at the Australian company level.

(iii) An outdated and inflexible CFC system.

(iv) Shortcomings in the existing FDA and franking regimes. In essence, these rules do not recognise all conduit income and lead to unnecessary wastage of credits.

Items (ii) – (iv) are broadly dealt with elsewhere in this submission and the ABA believes that the solutions suggested will dramatically improve Australia's attractiveness as a conduit location from a tax perspective. The focus of the discussion and suggested solution below relates to CGT at the foreign shareholder level, which the ABA believes warrants new rules to reduce the disincentive to invest through an Australian company.

***What is the problem?***

Australia is frequently dismissed as an attractive location to hold overseas investments of a multinational corporation. This is despite the many other attractions such as a highly skilled workforce, stable political system, well-regulated business environment and an affordable and comfortable lifestyle.

CGT presents a major impediment at both the foreign shareholder and Australian company levels. A holding company established in Australia may pay CGT when selling its foreign subsidiaries (the discussion above in relation to a foreign participation exemption would address this issue). However, if the holding company itself is sold, the sale is also subject to CGT. In contrast, if the non-resident shareholders invested directly into the foreign subsidiary, they would not have been exposed to any Australian CGT.

***What evidence is there of the problem?***

Many countries provide generous concessions to encourage groups to establish holding companies. Even the UK and Germany have recently made changes which provide CGT exemption for the sale of foreign subsidiaries. In this region, countries such as Singapore, Malaysia (and even New Zealand) provide more attractive conduit taxation regimes.

There is ample anecdotal evidence to indicate that there is a need to provide reform in this area to encourage the use of Australia as a viable location to establish regional holding companies or a multinational group parent company. In essence, foreign-owned groups would never, for tax reasons alone, own other foreign subsidiaries through Australia. In fact, the first step in tax planning by a foreign-owned company acquiring an Australian subsidiary would be to transfer foreign subsidiaries out of Australia.

***What solutions should be considered?***

***ABA Recommendation 11: In order for Australia to provide internationally competitive conduit relief, the following measures need be introduced:***

- ***A full participation exemption for income and capital gains. This approach, combined with ABA Recommendation 3, avoids the complexity of other options suggested in RITA and removes the current inconsistent treatment of foreign dividends and capital gains.***
- ***An expansion of the existing FDA regime to encompass all foreign income rather than only foreign dividends, and allowing the full flow-through of credits (as is currently the case for franking credits). This approach was recommended by the Ralph Review of Business Taxation.***
- ***An exemption from CGT for foreign shareholders to the extent their gain is attributable to foreign investments of a conduit company. The framework for this regime would be as follows:***
    - ***Eligible companies would register as Conduit Companies (CC).***
    - ***Eligibility would be based on some pre-determined level of foreign ownership, say 80%.***
    - ***The concession available to non-resident shareholders of***

In the ABA's view, Australia continues to fall further behind the rest of the world when it comes to the treatment of conduit income. If the Government is truly committed to improving the attractiveness of Australia as a location for Australian-based multinationals and regional holding companies, then these significant changes to the tax system must be implemented.

### 6.8 Foreign branch/subsidiary CGT roll-over [ABA Option]

*What is the current law?*

At present, Australia's tax laws do not provide a CGT rollover for the transfer of foreign branch assets to a wholly owned foreign company situated in the same foreign country. Of most relevance is section 23AH(8) of the ITAA 1936 which provides an exemption from Australian tax for capital gains arising on the disposal of certain assets that have been used to produce foreign income of branches operating in listed countries. There are, however, some modifications to the CGT rules to cater for transfers of assets between CFCs. For example, CGT rollover applies where there is the transfer of assets between CFCs resident in the same BEL country (see 6.2.2 above). In addition, the transfer of shares in CFCs between wholly owned resident subsidiaries would also qualify for CGT rollover.

*What is the problem?*

Australian banks have traditionally operated overseas by way of branch structures rather than subsidiary companies. In recent times however, the regulators in some overseas countries (New Zealand especially) have required the conduct of foreign banks to be by way of locally incorporated companies. It is said that local incorporation can address the perceived bias to depositors in the home and that local incorporation provides for clearer balance sheet and regulatory obligations in the local jurisdiction. For Australian banks already operating in such countries by way of branch structures, this approach has required consideration of the incorporation of those branches and the resultant transfer of the assets of the branch business to a newly incorporated entity.

Currently, where for commercial or regulatory reasons the business conducted by a foreign branch of an Australian bank is transferred to a locally incorporated company, any resultant CGT gain is taxable in Australia. This legislative impost acts as a disincentive to Australian banks incorporating their foreign branches and does not appear to be supported by policy considerations, as there is no disposal of assets outside a wholly owned Australian group. From the relevant group's perspective, there is no economic gain realised on the transfer of foreign branch assets to a wholly owned foreign company situated in the same foreign country.

***What solutions should be considered?***

> ***ABA Recommendation 12: CGT rollover relief should be available where a branch of an Australian resident company that carries on business in another country is incorporated.***

In the A t such a measure to either particular types of taxpayers (eg banks), or to particular countries (eg BEL countries), however such restrictions could be considered if a "blanket" approach was seen as too open-ended.

### 6.9 Establishment of Non Operating Holding Companies [ABA Option]

***What is the problem?***

As a result of the Wallis Financial System inquiry, the Federal Government accepted a recommendation to allow approved deposit-taking institutions which are banks to establish NOHCs. This would allow the holding companies to own licensed banks. The Government's policy is now enshrined in the *Banking Act 1959* as a result of an amendment made by the *Financial Sector Reform (Amendments and Transitional Provisions) Act 1998*.

Unfortunately, it has not been possible for Australian financial institutions to give effect to the Government's policy, because under the current tax law it is not possible for an Australian bank to restructure by establishing a NOHC in a way which is tax neutral for the bank and/or its shareholders.

***What evidence is there of the problem?***

Detailed industry submissions have been made to the Government over the past three years articulating the tax issues and the preferred action to address these tax issues. However, these issues remain unresolved.

***What benefits will arise?***

Implementation of the Government's NOHC policy would provide the following public benefits:

1. Increased transparency, resulting in a more effective prudential oversight of complex financial conglomerates and associated risks.

2. Better protection of depositors by more effectively "ringfencing" banking activities within a financial conglomerate.

3. Increase levels of competition in non-banking businesses by allowing financial conglomerates to pursue interests in non-banking activities without the constraints of the banking regulatory framework.

In order for organisations conducting a banking business to establish a NOHC there are two broad approaches that may be taken:

1. A new NOHC would acquire all the shares in the existing operating holding company in exchange for shares in the new NOHC (the "upstream restructure").

2. The existing operating holding company would transfer its business to a new operating subsidiary in exchange for shares in the new operating

subsidiary (the "downstream restructure") such that the existing operating holding company becomes the NOHC.

*Tax issues with an upstream restructure*

(a) While scrip for scrip tax roll-over relief should apply to most shareholders, it would not apply to shares and options held by employees and it would not apply to shares held as revenue assets (eg. some institutional shareholders such as insurance companies).

(b) Under scrip for scrip tax roll-over relief, pre CGT shares in the existing holding company which are exchanged for shares in the new NOHC do not retain their pre CGT status.

*Tax issues with a downstream restructure*

(a) The tax consolidation regime is likely to enable a restructure to occur with minimal tax consequences to the corporate group undertaking the restructure, but it does not apply to entities which are less than wholly owned group entities.

(b) The transfer of business assets is likely to give rise to potential stamp duty costs unless the States are prepared to grant corporate restructure relief or a blanket exemption.

(c) There are significant extraterritorial legal issues with the transfer of business assets and liabilities that would make a downstream restructure impractical if not virtually impossible.

Under existing tax law, banking institutions wishing to avail themselves of the Government's policy using the most effective and efficient approach (an upstream restructure) are constrained by the potential tax issues explained above. It is very unlikely that Australian banks would restructure to establish NOHCs because of the potential tax costs involved. Accordingly, banks will continue to operate using sub-optimal structures and therefore the benefits of NOHCs for the industry, the market and the economy will not be realised.

***What solutions should be considered?***

***ABA Recommendation 13: Specific enabling legislation providing appropriate tax relief to allow non operating holding company structures to be established in a tax neutral manner is required.***

This would eliminate the tax impediments to NOHC restructures and would allow Australian banks to restructure and give full effect to the Government's policy on NOHCs.

There are many precedents for specific enabling legislation, principally involving banking mergers.

Such enabling legislation can be drafted to ensure that it is limited to appropriate restructures which give effect to the Government's NOHC policy, including possibly the requirement for banks to seek ACCC approval for proposed restructures to ensure that they are consistent with the overall Government policy. The enabling legislation might also contain a sunset clause under which banks would have a set period (say five years) from the date of the commencement of the enabling legislation to restructure in reliance on the new regime.

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

This matter should be given high priority as the current tax impediments to NOHCs prevent increased competition, restrict innovation and impede efficient corporate structures. This means that the public benefits explained above cannot be achieved.

There is a clear lack of competitive neutrality in that new entrants in the financial services industry can establish efficient corporate and operating structures, yet existing banks are prevented from restructuring to achieve the same structures by the cost of restructuring.

The "cost" to revenue is likely to be a one-off cost and it has previously been estimated to be in the range of $300m. However, this is not a cost that should have been factored into the Government's Revenue estimates, as it is very unlikely that Australian banks will restructure and incur the potential tax cost (on the existing legislation). The ABA believes that allowing Australian banks to restructure with NOHCs is likely to deliver ongoing flow on benefits to the economy from increased competition, more effective regulation of the industry, greater protection for depositors and greater product innovation.

### 6.10 Treatment of Tier 1 capital [ABA Option]

***Overview of the ABA's position***

The ABA notes that the overall objective of the Government is to review "international tax issues that may affect the attractiveness of Australia as a corporate base from which to operate global and regional businesses".

The ABA has previously argued for the proposition that Australia's interests in the region would be served by Australia supporting a strong banking system, including Australian banks that can compete on equivalent terms with foreign banks for business in Australia and overseas.

The ABA has provided to Government an analysis of the means by which low cost capital funding has allowed banks in many foreign countries, including the UK, US, Germany and Switzerland to increase financial strength and lend at reduced margins while still remaining profitable. One aspect of this analysis addresses the practices of foreign banks accessing hybrid capital within limits stipulated by domestic regulators and the Basel Committee on Banking Supervision.

***Treasury's position***

An element of hybrid capital is often tax relief for payments under the domestic tax laws of the issuer bank. The ABA notes that Treasury previously rejected the ABA request for tax laws in Australia to facilitate such treatment within the extent of hybrid capital limits. The reasons given by Treasury for this rejection principally related to factors that either have changed or were not adequately established in the course of the discussion of the prior submission, in particular:

*Dividend Streaming*

Treasury contended that the impact of hybrid capital, if held by foreign investors, was to facilitate dividend (i.e. franking) streaming. The RITA paper clearly contemplates that dividend streaming is a potentially valid policy attribute to assist Australian business competing overseas. Hence, this principal basis for rejection by Treasury may no longer be valid.

*Loss of Australian Revenue*

Treasury contended that foreign investors would dominate the acquisition of hybrid capital instruments of the Banks, such that deductible payments would be made free of withholding tax to foreign investors, and Australia's tax base would be eroded. The ABA can show that:

- existing hybrid capital securities have been largely acquired by Australian investors in the primary and secondary markets;
- to the extent that foreign investors have invested, instead of Australian investors, an equivalent amount of Australian funds remain in Australia for investment involving derivation of taxable income; and
- refunds of excess franking to super funds has further reduced the "franking wastage" that was assumed to be a structural feature of the franking system, favouring revenue arising from equity investment, rather than debt investment.

***What evidence is there of the problem?***

*Tax Free Entry of US Banks*

Access by US Banks to Australian markets on a tax free basis from 1 July 2003, as a result of the Protocol to the US Double Taxation Agreement, will mean that US Banks will be able to lend to Australian companies free of any Australian tax liability or substantive regulation, while enjoying in the US the benefits of low cost hybrid funding in the US. It is understood similar terms are to be included in new UK and German Treaties.

*Safe Harbour Hybrid Instruments*

Foreign Regulators and Tax Authorities have agreed to terms for acceptable hybrid capital instruments which entitle the issuer bank to tax relief in their domestic jurisdiction. Hence, foreign banks can now operate with low cost hybrid capital with confidence, while Australian Banks cannot.

ABA submits that Australian banks must be entitled to compete on a "level playing- field" with foreign banks both in Australia and overseas, and should be able to raise a proportion of their capital in a form that is deductible in Australia, subject to normal APRA hybrid limits.

***ABA Recommendation 14: A Panel should be formed by the Board of Taxation to consider the treatment of Tier 1 capital for tax purposes, taking into account the interests of the relevant parties. The Panel should include representatives of the ABA, Treasury and APRA.***

# 7 RITA CHAPTER 4: PROMOTING AUSTRALIA AS A GLOBAL FINANCIAL SERVICES CENTRE

***ABA Recommendation 15: The ABA supports the submission made by IFSA in relation to Chapter 4 of the RITA paper.***

As noted in section 3.3 of this submission, the ABA recommends that the Government implement Recommendation 4 of the Senate Select Committee's Report. This will enable the Board to conduct a much fuller enquiry regarding the taxation impediments to Australia becoming a global financial services centre. This will necessarily go beyond the narrow FIF matters dealt with in Chapter 4 of the RITA paper.

# 8 RITA CHAPTER 5: IMPROVING AUSTRALIA'S TAX TREATMENT OF FOREIGN EXPATRIATES

***ABA Recommendation 16: The ABA supports the submission made by IBSA in relation to Chapter 5 of the RITA paper.***

# 9 APPENDIX 1: ABA MEMBERS

Adelaide Bank Limited
AMP Banking Limited
Arab Bank Australia Limited
Australia & New Zealand Banking Group Limited
Bank of Cyprus Australia
Bank of Queensland Limited
Bank of Western Australia Limited
BNP Paribas
Bendigo Bank Limited
Citibank Australia
Commonwealth Bank of Australia
Credit Suisse First Boston
HSBC Bank (Australia) Limited
Mizuho Corporate Bank Limited - Sydney
Laiki Bank (Australia) Limited
Macquarie Bank Limited
National Australia Bank Limited
NM Rothschild and Sons (Aust.) Limited
Primary Industry Bank of Australia
St George Bank Limited
Suncorp-Metway Limited
United Overseas Bank Limited
Westpac Banking Corporation

# 10 APPENDIX 2: DIVIDEND IMPUTATION ANALYSIS

## Dividend Imputation Example

**Financial Assumptions**

| | |
|---|---|
| Profit before tax | 1,000 |
| Level of Australian profits | 70% |
| Level of Foreign profits | 30% |

**Shareholder Assumptions**

| | |
|---|---|
| % of Australian shareholders | 75% |
| % of foreign shareholders | 25% |

**Tax Assumptions**

| | |
|---|---|
| Australian Corporate tax rate | 30% |
| Foreign tax on foreign earnings | 30% |
| Tax rate on resident shareholders | 48.5% |
| Credit for unfranked dividends | |
| Example 1 | 1/9 |
| Example 3 | 1/9 |

Unfranked dividends are sourced from after tax foreign income

**Analysis of Profits and Tax**

| | **Aust** | **Foreign** | **Total** |
|---|---|---|---|
| | **$** | **$** | **$** |
| Net Profit Before Tax | 700 | 300 | 1,000 |
| Less Tax | -210 | -90 | -300 |
| Net Profit After Tax | 490 | 210 | 700 |

**Payout Ratio**

| | *Assumption* | *Distribution Amount* | *Level of Franking* | *Dividend Per Share* |
|---|---|---|---|---|
| | 100% | 700 | 70.0% | 0.70 |

**Dividend Assumptions**

| | |
|---|---|
| Total shares on issue | 1,000 |
| Annual dividend per share | $0.70 |
| Annual dividend payment | $700 |
| Imputation Credits | $210 |
| Level of franking | 70% |

| | |
|---|---|
| **Assumed Share Price** | $17.15 |

**Cost of Capital Assumptions**

| | |
|---|---|
| Annual dividend per share | $0.70 |
| Level of franking | 70% |
| Value of franking credits | 50% |
| Corporate tax rate | 30% |
| Growth rate in dividends | 6.5% |
| Risk free rate of return | 5.5% |
| Market risk premium | 6.0% |

**Revenue Assumptions**

The negative revenue impact is determined on a present value basis to infinity, as the cost to the Revenue will be on going.

The offsetting once of capital gain due to the increase in value of the shares is assumed to be realised equally over Years 1 – 4. The impact of capital gains arising to non-residents has been excluded.

Other offsetting second round revenue impacts have not been modelled.

| Comparison of Various Models | | Example 1 (Option 2.1A) | Example 2 (Option 2.1B) | Example 3 (Options 2.1A & 2.1B) | Example 4 (Full Exemption) |
|---|---|---|---|---|---|
| (Refer Individual Worksheets for Detail) | **Base Case** $ | **Unfranked Dividend Credit Case** $ | **Dividend Streaming Case** $ | **Dividend Streaming & Credit Case** $ | **Dividend Exemption Case** $ |
| **Cash Distribution to Shareholders** | | | | | |
| *Resident Shareholder* | | | | | |
| Net cash dividend after tax | 351 | 361 | 379 | 381 | 428 |
| % return above Base Case | | 2.6% | 7.7% | 8.3% | 21.7% |
| *Effective Tax Rate on Income* | 53.1% | 51.9% | 49.5% | 49.3% | 43.0% |
| (Note: Includes underlying Australian & foreign tax paid on profits distributed) | | | | | |
| *Non- Resident Shareholders* | | | | | |
| Net cash dividend (before foreign tax) | 175 | 175 | 175 | 175 | 175 |
| **Imputation credits utilised** | | | | | |
| Resident shareholders | 158 | 158 | 210 | 210 | 158 |
| Non-resident shareholders | 53 | 53 | - | - | 53 |
| Total Used | 210 | 210 | 210 | 210 | 210 |
| **Imputation Credits Carried Forward** | - | - | - | - | |
| **Total tax benefit to resident share-Holders compared to Base Case** | | | | | |
| Reduction/(increase) in gross Australian tax payable | | -8 | -25 | -27 | 76 |
| Additional imputation credits utilised | | 0 | 53 | 53 | 0 |
| Additional credit - unfranked dividends | | 18 | 0 | 4 | 0 |
| Total Tax Benefit | | 9 | 27 | 29 | 76 |
| **Net Revenue Impact** | | -391 | -131 | -141 | -530 |
| (Refer Revenue Impact Worksheet) | | | | | |
| **Cost of Capital including franking** | 10.0% | 11.5% | 9.6% | 9.6% | 9.5% |
| (Refer Cost of Capital Worksheet) | | | | | |

## Base Case: No Dividend Streaming

**Assumptions**

| | | |
|---|---|---|
| Annual dividend paid | 700 | |
| Available Imputation Credits | 210 | |
| Level of franking (all shareholders) | 70% | |
| Level of resident individual shareholders | 75.0% | |
| Marginal tax rate of resident shareholders | 48.5% | |
| Level of non-resident shareholders | 25.0% | |
| Annual dividend paid to resident shareholders | 525 | |
| Annual dividend paid to non-resident shareholders | 175 | |
| Withholding tax on unfranked dividends | - | (Note 1) |

**Tax Position of Resident Shareholder**
(Assume all shareholders individuals)

| | | |
|---|---|---|
| Franked dividend | 368 | |
| Unfranked dividend | 158 | |
| Imputation credits | 158 | |
| Total Income | 683 | |
| Tax | 48.5% | |
| Gross Tax Payable | 331 | |
| Less Imputation credit franked dividend | -158 | |
| Net Tax Payable | 174 | |
| Net Cash Dividend | 351 | |
| *Effective Tax Rate on Income* | 53.1% | (Note 3) |

**Tax Position of Non-Resident Shareholder**

| | | |
|---|---|---|
| Franked dividend | 123 | |
| Unfranked dividend | 53 | |
| Total Income | 175 | |
| Less Dividend withholding tax | - | (Note 1) |
| Net Cash Dividend (before foreign tax) | 175 | |

**Available imputation credits post dividend**

| | | |
|---|---|---|
| Opening balance of imputation credits | 210 | |
| Imputation credits used by resident shareholders | -158 | |
| Imputation credits used by non-resident shareholders | -53 | (Note 2) |
| Available balance post dividend | - | |

## Base Case: No Dividend Streaming (Notes)

**Note 1: Dividend withholding tax**
Assumed that dividend withholding tax is nil as unfranked dividend is source from foreign dividend/income account

**Note 2: Imputation Credits Used by Non-residents**
Prima facie dividend withholding tax on franked dividend based on amount of franked dividend * 15%. Imputation credits (from Australian tax paid at 30%) are used to eliminate dividend withholding tax. (ie Franked dividend x 30/70)

**Note 3: Effective Tax Rate on Income**

| | |
|---|---|
| Franked dividend | 368 |
| Unfranked dividend | 158 |
| Total dividend | 525 |
| Underlying Corporate Tax (ie Total dividend * 30/70) | 225 |
| Gross Income Before Tax | 750 |
| Tax Payable | |
| Underlying corporate tax | 225 |
| Net additional individual tax | 174 |
| Total tax | 399 |
| Effective Tax Rate | 53.1% |

## Example 1
## Unfranked Dividend Credit Case
(Options 2.1A)

**Assumptions**

| | | |
|---|---|---|
| Annual dividend paid | 700 | |
| Available Imputation Credits | 210 | |
| Level of franking (all shares) | 70.0% | |
| Effective level of franking (resident shareholders) | 0.0% | (Note 4) |
| Level of resident individual shareholders | 75.0% | |
| Marginal tax rate of resident shareholders | 48.5% | |
| Level of non-resident shareholders | 25.0% | |
| Annual dividend paid to resident shareholders | 525 | |
| Annual dividend paid to non-resident shareholders | 175 | |
| Withholding tax on unfranked dividends | - | |

**Tax Position of Resident Shareholder**
(Assume all shareholders individuals)

| | | |
|---|---|---|
| Franked dividend | 368 | |
| Unfranked dividend | 158 | |
| Imputation credits | 158 | |
| Other credit | 18 | (Note 1) |
| Total Income | 700 | |
| Tax | 48.5% | |
| Gross Tax Payable | 340 | |
| Less Imputation credit franked dividend | -158 | |
| Less credit for unfranked dividends from foreign profits | -18 | (Note 1) |
| Net Tax Payable | 165 | |
| Net Cash Dividend | 361 | |
| *Effective Tax Rate on Income* | 51.9% | (Note 3) |

**Tax Position of Non-Resident Shareholder**

| | | |
|---|---|---|
| Streamed dividend (from foreign profits) | 175 | |
| Total Income | 175 | |
| Less Dividend withholding tax | - | (Note 2) |
| Net Cash Dividend (before foreign tax) | 175 | |

**Available imputation credits post dividend**

| | |
|---|---|
| Opening balance of imputation credits | 210 |
| Imputation credits used by resident shareholders | -158 |
| Imputation credits used by non-resident shareholders | -53 |
| Available balance post dividend | - |

**Tax benefit to Australian resident shareholders over Base Case**

| | |
|---|---|
| Reduction/(increase) in gross Australian tax payable | -8 |
| Additional imputation credits utilised | 0 |
| Credit for unfranked dividend | 18 |
| Tax Benefit | 9 |

Example 1

**Dividend Streaming & Credit Case (Notes)**

## Note 1: Credit Unfranked Dividends from Foreign Earnings

It is assumed that the unfranked dividend paid to resident shareholders is available as a non-refundable tax credit, provided the unfranked dividend is paid out of foreign source income. This credit is also included in assessable income. The level of credit is set on the assumptions page, for example one-ninth (as per Option 2.1A - page 19: Review of International Tax Arrangements).

## Note2: Dividend withholding tax

Assumed that dividend withholding tax is nil as dividend streamed from foreign source income.

**Note 3: Effective Tax Rate - Income**

| | |
|---|---|
| Franked dividend | 368 |
| Unfranked dividend | 158 |
| Total dividend | 525 |
| Underlying Corporate Tax (ie Total dividend * 30/70) | 225 |
| Gross Income Before Tax | 750 |
| Tax Payable | |
| Underlying corporate tax | 225 |
| Net additional individual tax | 165 |
| Total tax | 390 |
| Effective Tax Rate | 51.9% |

**Note 4: Effective Level of Franking**

The effective level of franking treats the other credit arising from the unfranked dividend as if it were an additional imputation credit. The effective level of franking is used to determine the overall impact on the cost of capital, for example an increase in the effective level of franking will lower the cost of capital, where the value of the franking credits is greater than 0. (Refer Cost of Capital Worksheet).

## Example 2
## Dividend Streaming Case
(Option 2.1B)

**Assumptions**

| | | |
|---|---|---|
| Annual dividend paid | 700 | |
| Available Imputation Credits | 210 | |
| Level of franking (all shares) | 70.0% | |
| Effective level of franking (resident shareholders) | 93.3% | (Note 3) |
| Level of resident individual shareholders | 75.0% | |
| Marginal tax rate of resident shareholders | 48.5% | |
| Level of non-resident shareholders | 25.0% | |
| Annual dividend paid to resident shareholders | 525 | |
| Annual dividend paid to non-resident shareholders | 175 | |
| Withholding tax on unfranked dividends | - | (Note 1) |

**Tax Position of Resident Shareholder**
(Assume all shareholders individuals)

| | | |
|---|---|---|
| Franked dividend | 490 | |
| Unfranked dividend | 35 | |
| Imputation credits | 210 | |
| Total Income | 735 | |
| Tax | 48.5% | |
| Gross Tax Payable | 356 | |
| Less Imputation credit franked dividend | -210 | |
| Net Tax Payable | 146 | |
| Net Cash Dividend | 379 | |
| *Effective Tax Rate on Income* | 49.5% | (Note 2) |

**Tax Position of Non-Resident Shareholder**

| | | |
|---|---|---|
| Streamed dividend (from foreign profits) | 175 | |
| Total Income | 175 | |
| | - | (Note 1) |
| Net Cash Dividend (before foreign tax) | 175 | |

**Available imputation credits post dividend**

| | |
|---|---|
| Opening balance of imputation credits | 210 |
| Imputation credits used by resident shareholders | -210 |
| Imputation credits used by non-resident shareholders | - |
| Available balance post dividend | - |

**Tax benefit to Australian resident shareholders over Base Case**

| | |
|---|---|
| Reduction/(increase) in gross Australian tax payable | -25 |
| Additional imputation credits utilised | 53 |
| Additional imputation credits for unfranked dividend | 0 |
| Tax Benefit | 27 |

## Example 2
## Dividend Streaming Case (Notes)

**Note1: Dividend withholding tax**

Assumed that dividend withholding tax is nil as dividend is streamed form foreign source income

**Note 2: Effective Tax Rate on Income**

| | |
|---|---|
| Franked dividend | 490 |
| Unfranked dividend | 35 |
| Total dividend | 525 |
| Underlying Corporate Tax (ie Total dividend * 30/70) | 225 |
| Gross Income Before Tax | 750 |
| Tax Payable | |
| Underlying corporate tax | 225 |
| Net additional individual tax | 146 |
| Total tax | 371 |
| Effective Tax Rate | 49.5% |

**Note 4: Effective Level of Franking**

The effective level of franking assumes that all the franking credits are available for resident shareholders due to the existence of dividend streaming. The effective level of franking is used to determine the overall impact on the cost of capital, for example an increase in the effective level of franking will lower the cost of capital, where the value of the franking credits is greater than 0. (refer Cost of Capital Worksheet)

## Example 3
## Dividend Streaming & Credit Case
(Options 2.1A & 2.1B combined)

**Assumptions**

| | | |
|---|---|---|
| Annual dividend paid | 700 | |
| Available Imputation Credits | 210 | |
| Level of franking (all shares) | 70.0% | |
| Level of franking for resident shareholders due to streaming | 93.3% | |
| Effective level of franking (resident shareholders) | 95.1% | (Note 4) |
| Level of resident individual shareholders | 75.0% | |
| Marginal tax rate of resident shareholders | 48.5% | |
| Level of non-resident shareholders | 25.0% | |
| Annual dividend paid to resident shareholders | 525 | |
| Annual dividend paid to non-resident shareholders | 175 | |
| Withholding tax on unfranked dividends | - | |

**Tax Position of Resident Shareholder**
(Assume all shareholders individuals)

| | | |
|---|---|---|
| Franked dividend | 490 | |
| Unfranked dividend | 35 | |
| Imputation credits | 210 | |
| Other credit | 4 | |
| Total Income | 739 | |
| Tax | 48.5% | |
| Gross Tax Payable | 358 | |
| Less Imputation credit franked dividend | -210 | |
| Less credit for unfranked dividends from foreign profits | -4 | (Note 1) |
| Net Tax Payable | 144 | |
| Net Cash Dividend | 381 | |
| *Effective Tax Rate on Income* | 49.3% | (Note 3) |

**Tax Position of Non-Resident Shareholder**

| | | |
|---|---|---|
| Streamed dividend (from foreign profits) | 175 | |
| Total Income | 175 | |
| Less Dividend withholding tax | - | (Note 2) |
| Net Cash Dividend (before foreign tax) | 175 | |

**Available imputation credits post dividend**

| | |
|---|---|
| Opening balance of imputation credits | 210 |
| Imputation credits used by resident shareholders | -210 |
| Imputation credits used by non-resident shareholders | - |
| Available balance post dividend | - |

**Tax benefit to Australian resident shareholders over Base Case**

| | |
|---|---|
| Reduction/(increase) in gross Australian tax payable | -27 |
| Additional imputation credits utilised | 53 |
| Credit for unfranked dividend | 4 |
| Tax Benefit | 29 |

**Example 3**
**Dividend Streaming & Credit Case (Notes)**

**Note 1: Credit Unfranked Dividends from Foreign Earnings**

It is assumed that the unfranked dividend paid to resident shareholders is available as a non-refundable tax credit, provided the unfranked dividend is paid out of foreign source income. This credit is also included in assessable income. The level of credit is set on the assumptions page, for example one-ninth (as per Option 2.1A - page 19: Review of International Tax Arrangements).

**Note2: Dividend withholding tax**

Assumed that dividend withholding tax is nil as dividend streamed from foreign source income.

**Note 3: Effective Tax Rate on Income**

| | |
|---|---|
| Franked dividend | 490 |
| Unfranked dividend | 35 |
| Total dividend | 525 |
| Underlying Corporate Tax (ie Total dividend * 30/70) | 225 |
| Gross Income Before Tax | 750 |
| Tax Payable | |
| Underlying corporate tax | 225 |
| Net additional individual tax | 144 |
| Total tax | 369 |
| Effective Tax Rate | 49.3% |

**Note 4: Effective Level of Franking**

The effective level of franking assumes that all franking credits are available for resident shareholders and also treats the other credit arising from the unfranked dividend as if it were an additional imputation credit. The effective level of franking is used to determine the overall impact on the cost of capital, for example an increase in the effective level of franking will lower the cost of capital, where the value of the franking credits is greater than 0. (Refer Cost of Capital Worksheet)

## Example 4
## Unfranked Dividend Exemption Model

**Assumptions**

| | | |
|---|---|---|
| Annual dividend paid | 700 | |
| Available Imputation Credits | 210 | |
| Level of franking (all shareholders) | 70% | |
| Effective level of franking (resident shareholders) | 100.0% | (Note 5) |
| Level of resident individual shareholders | 75.0% | |
| Marginal tax rate of resident shareholders | 48.5% | |
| Level of non-resident shareholders | 25.0% | |
| Annual dividend paid to resident shareholders | 525 | |
| Annual dividend paid to non-resident shareholders | 175 | |
| Withholding tax on unfranked dividends | - | (Note 1) |

**Tax Position of Resident Shareholder**
(Assume all shareholders individuals)

| | | |
|---|---|---|
| Franked dividend | 368 | |
| Unfranked dividend | 158 | |
| Imputation credits | 158 | |
| Total Income | 683 | |
| Less exemption for unfranked dividend | -158 | (Note 4) |
| Taxable Income | 525 | |
| Tax | 48.5% | |
| Gross Tax Payable | 255 | |
| Less Imputation credit franked dividend | -158 | |
| Net Tax Payable | 97 | |
| Net Cash Dividend | 428 | |
| *Effective Tax Rate on Income* | 43.0% | (Note 3) |

**Tax Position of Non-Resident Shareholder**

| | | |
|---|---|---|
| Franked dividend | 123 | |
| Unfranked dividend | 53 | |
| Total Income | 175 | |
| Less Dividend withholding tax | - | (Note 1) |
| Net Cash Dividend (before foreign tax) | 175 | |

**Available imputation credits post dividend**

| | | |
|---|---|---|
| Opening balance of imputation credits | 210 | |
| Imputation credits used by resident shareholders | -158 | |
| Imputation credits used by non-resident shareholders | -53 | (Note 2) |
| Available balance post dividend | - | |

**Tax benefit to Australian resident shareholders over Base Case**

| | |
|---|---|
| Reduction/(increase) in gross Australian tax payable | 76 |
| Additional imputation credits utilised | 0 |
| Credit for unfranked dividend | 0 |
| Tax Benefit | 76 |

**Example 4**
**Unfranked Dividend Exemption Model (Notes)**

**Note 1: Dividend withholding tax**
Assumed that dividend withholding tax is nil as unfranked dividend sourced from foreign dividend/ income account

**Note 2: Imputation Credits Used by Non-residents**
Prima facie dividend withholding tax on franked dividend based on amount of franked dividend * 15%. Imputation credits (from Australian tax paid at 30%) used to eliminate dividend withholding tax. (ie Franked dividend * 30/70)

**Note 3: Effective Tax Rate on Income**

| | |
|---|---|
| Franked dividend | 368 |
| Unfranked dividend | 158 |
| Total dividend | 525 |
| Underlying Corporate Tax (ie Total dividend * 30/70) | 225 |
| Gross Income Before Tax | 750 |
| Tax Payable | |
| Underlying corporate tax | 225 |
| Net additional individual tax | 97 |
| Total tax | 322 |
| Effective Tax Rate | 43.0% |

**Note 4: Dividend Exemption**

Unfranked dividends paid out of foreign source income, which has been subject to foreign tax, are exempt from additional Australian tax in the hands of Australian resident shareholders under this model.

Note 5: Effective Level of Franking

In determining the effective level of franking under this model, the unfranked dividend from foreign source income has been treated as if it was a fully franked dividend.
The effective level of franking is then used to determine the overall impact on the cost of capital, for example an increase in the effective level of franking will lower the cost of capital where the value of the franking credits is greater than 0. (Refer Cost of Capital Worksheet)

## Cost of Capital Model

| Comparison of Various Models | | | | Example 1 (Option 2.1A) | Example 2 (Option 2.1B) | Example 3 (Options 2.1A & 2.1B) | Example 4 (Full Exemption) |
|---|---|---|---|---|---|---|---|
| | (Refer Individual Worksheets for Detail) | | Base Case $ | Unfranked Dividend Credit $ | Dividend Streaming Case $ | Dividend Streaming & Credit Case $ | Dividend Exemption Case $ |
| **Cost of Capital** | | | | | | | |
| d | Annual dividend per share | | $0.70 | $0.70 | $0.70 | $0.70 | $0.70 |
| f | Level of franking | (Note 1) | 70.0% | 0.0% | 93.3% | 95.1% | 100.0% |
| v | Value of franking credits (Note 2) | (Note 2) | 50% | 50% | 50% | 50% | 50% |
| t | Corporate tax rate | | 30% | 30% | 30% | 30% | 30% |
| g | Growth rate in dividends | | 6.5% | 6.5% | 6.5% | 6.5% | 6.5% |
| r | Risk free rate of return | | 5.5% | 5.5% | 5.5% | 5.5% | 5.5% |
| p | Market risk premium | | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% |
| k1 | Cost of equity capital excluding franking = r + p | | 11.5% | 11.5% | 11.5% | 11.5% | 11.5% |
| k2 | Cost of equity capital including franking = (r+p)*(1-t)/{1-(t*(1-f*v))} | | 10.0% | 11.5% | 9.6% | 9.6% | 9.5% |
| | Implied Share Valuation = d(1+g)/(k1-g)*(1-t)/(1-t(1-f*v)) | | $17.15 | $14.91 | $17.89 | $17.95 | $18.11 |
| **Incremental Value over Base Case** | | | | | | | |
| | Incremental value per share | | | -$2.24 | 0.75 | 0.80 | 0.96 |
| | Number of shares on issues | | | 1000 | 1,000 | 1,000 | 1,000 |
| | Increase in value of shares | | | -2237 | 746 | 801 | 959 |

**Notes**

1 For the purposes of the cost of capital model, the credit for unfranked dividends in Examples 1 & 3 has been treated as if it where an additional imputation credit

For the purposes of the cost of capital model, the unfranked exempt dividend in Example 4 has been treated as if it was a fully franked dividend

2 The assumption relating to the value of franking credits has been determined having regard to the broad consensus of opinion that currently exists.
Further information on the value of franking credits can be obtained from the following sources:

Weighted Average Cost of Capital for Revenue Determination: Gas Distribution, Staff Paper No ,1 Office of the Regulator-General, Victoria, 28 May 1998
Weighted Average Cost of Capital, Discussion Paper, Independent Pricing and Regulatory Tribunal of New South Wales, August 2002.

| **Revenue Impact** | | **Example 1** | **Example 2** (Option 2.1B) | **Example 3** (Options 2.1A & 2.1B) | **Example 4** |
|---|---|---|---|---|---|
| | **Base Case** **$** | **Unfranked Dividend Credit** **$** | **Dividend Streaming Case** **$** | **Dividend Streaming & Credit Case** **$** | **Exemption Unfranked Dividends** **$** |
| **Cash Distribution to Shareholders** | | | | | |
| Resident Shareholder | | | | | |
| Net cash dividend after tax | 351 | 361 | 379 | 381 | 428 |
| % return above Base Case | | 2.6% | 7.7% | 8.3% | 21.7% |
| Tax Saved on dividend income | | 9 | 27 | 29 | 76 |
| Increase in value of share | | -2237 | 746 | 801 | 959 |
| (Refer Cost of Capital Worksheet) | | | | | |
| Tax on Gain @ 24.25% | | -542 | 181 | 194 | 232 |
| Gain Attributable to Australian residents | | -407 | 136 | 146 | 174 |
| **Summary of Revenue Impact Years 1 - 4** | | | | | |
| Discount Rate (using cost of capital) | | 11.5% | 11.5% | 11.5% | 11.5% |
| *Revenue Cost* | | | | | |
| Year 1 onwards | | -78 | -235 | -253 | -664 |
| Total | | -78 | -235 | -253 | -664 |
| *Revenue Benefit* | | | | | |
| Year 1 | | -102 | 34 | 36 | 44 |
| Year 2 | | -102 | 34 | 36 | 44 |
| Year 3 | | -102 | 34 | 36 | 44 |
| Year 4 | | -102 | 34 | 36 | 44 |
| Total | | -407 | 136 | 146 | 174 |
| *Present Value* | | | | | |
| Revenue Cost | | -78 | -235 | -253 | -664 |
| Revenue Benefit | | -312 | 104 | 112 | 134 |
| Net Revenue Benefit/(Cost) | | -391 | -131 | -141 | -530 |

| Share Price Impact | Base Case | Dividend Streaming | Dividend Streaming | Dividend Streaming & Credit | Exemption Unfranked Dividends |
|---|---|---|---|---|---|
| Total shares on issue | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 |
| Annual dividend per share | $0.70 | $0.70 | $0.70 | $0.70 | $0.70 |
| Assumed share price | $17.15 | $14.91 | $17.89 | $17.95 | $18.11 |
| Valuation of Company | 17,147 | 14,910 | 17,892 | 17,947 | 18,105 |
| Net Dividend Yield | 4.08% | 4.69% | 3.91% | 3.90% | 3.87% |