Deloitte Touche Tohmatsu Ltd
A.B.N. 41 092 223 240
A.C.N. 092 223 240

Grosvenor Place
225 George Street
Sydney NSW 2000
PO Box N250 Grosvenor Place
Sydney NSW 1217 Australia

DX 10307SSE
Telephone (02) 9322 7000
Facsimile (02) 9322 7001
www.deloitte.com.au

Deloitte Touche Tohmatsu

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The International Taxation Project
Board of Taxation Secretariat
C / - The Treasury
Langton Crescent
Parkes ACT 2600
AUSTRALIA

Dear Sir/Madam

REVIEW OF INTERNATIONAL TAXATION ARRANGEMENTS - TREASURY CONSULTATION PAPER

We make the following comments by way of submission on behalf of the Australian firm of Deloitte Touche Tohmatsu ("Deloitte") on the consultation paper published by the Australian Treasury entitled Review of International Tax Arrangements ("the consultation paper").

As you will be aware, Deloitte is one of the world's leading professional services organisations. Deloitte has over 95,000 people in more than 140 countries and serves approximately one-fifth of the world's largest companies. Our Australian practice has over 2,500 people employed nationwide.

We unreservedly welcome the opportunity represented by the Review of International Taxation Arrangements, as fundamental reform of Australia's international tax regime is long overdue. Our foreign clients constantly tell us that the complexity and uncompetitiveness of Australia's tax system has a substantial impact on their investment decisions. Consequently, the commercial returns required from Australian investments are relatively higher than from other countries.

On the other hand, our Australian based clients experience real barriers to offshore expansion and investment represented by higher tax and compliance costs. For them, the commercial returns required of offshore investments are higher than equivalent domestic investments. Unlike foreign investors, however, Australian businesses do not really have the choice to 'stay at home'. Ongoing survival and prosperity dictates that they must increasingly compete in the global marketplace while, in most cases, sourcing their capital from Australian investors.

Our sincere wish is that the unique opportunities presented by the Review of International Taxation Review to remove the inherent distortions and complexity of the current tax legislation as it impacts on international business and to enhance Australia's global competitiveness are realized to the full. This will require a detailed consideration of all available options, not just those canvassed in the consultation paper. The end product of the review will need to stand the test of time and handle the constantly changing global business landscape.

Following a brief executive summary of our main submissions to the Secretariat, our detailed comments are set out below.

EXECUTIVE SUMMARY

Chapter 2: Attracting Equity Capital For Offshore Expansion

- We are of the view that the imputation system does have an unacceptable bias on investment decisions in the Australian capital markets. Until more Australian multinational companies gain better access to overseas capital markets, this bias will continue unless the imputation system is revised or replaced.

- We are of the view that the dividend streaming option should be implemented. Moreover, further work should be undertaken to explore the relative merits of the shareholder credit model as compared with a full or partial exemption model. In the case of the shareholder credit model, we strongly favour a higher level of credit across the board than is proposed in the consultation paper.

Chapter 3: Promoting Australia As A Location For Internationally Focussed Companies

- We largely support the views and recommendations outlined in Chapter 3 of the consultation paper.

- Our preferred approach with regard to reforming the controlled foreign companies (CFC) regime is to make specific material improvements to the current rules prior to conducting a comprehensive review of the regime. The short-term improvements in the CFC regime brought about by these improvements should help to ensure the success of the comprehensive review.

  Our immediate CFC reform recommendations are set out below:

  - The current list of broad-exemption listed countries should be taken outside of the CFC rules completely or, at the very least, the list of broad-exemption listed countries should be significantly expanded.

  - The ‘tainted services income’ rules should be modified so as to confine their operation to services provided by CFCs to Australian resident associates and to exempt from attribution all services provided by a CFC to Australian resident associates where the CFC is undertaking an active business of providing those services to, or for the direct benefit of, non-associates.

  - Capital gains tax (CGT) rollover relief should be extended to cover the following situations (in order of priority):

    - where a CFC resident in a broad-exemption listed country undertakes a transaction that qualifies for rollover relief under the taxation laws of that broad-exemption listed country;
    - where a CFC transfers shares to another CFC or to a non-CFC in exchange for shares;
    - where an Australian resident transfers shares in a CFC to another CFC, where all companies are members of the same wholly owned group; and
    - where a CFC transfers assets to another CFC where they are part of the same wholly owned group.

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  - An ‘active business’ safe harbour exemption and / or a purpose test should be introduced in to the CFC rules. Those tests could be relevantly modelled on the equivalent tests in the Australian foreign investment fund (FIF) rules and the UK CFC provisions.

  - Non-controlled joint ventures should be excluded from the CFC rules.

  - Australia’s transfer pricing rules should be excluded from applying where funds are lent interest free between CFCs.

  - Ensure that income derived by a CFC is attributed only to taxpayers who are attributable taxpayers at the time the income is derived.

- The exemption in section 23AJ should be expanded to cover all foreign non-portfolio dividends received by an Australian company.

- Where an Australian company has a non-portfolio interest in a CFC, a profit made from the sale of that interest should be exempt from Australian CGT, at least in situations where the CFC is carrying on an active business or is a holding company for such company.

- With regard to ‘conduit’ issues, our recommendations are as follows:

  - A holding company regime should be introduced that offers, as a minimum, a tax free flow through of foreign dividends, from whatever source, and a CGT exemption for gains on sales of shares in foreign subsidiaries, with associated measures to allow tax-free distribution of that gain from Australia.

  - For the sake of simplicity, it may be necessary for the conduit regime to apply only to 100% foreign owned companies.

  - Such a regime would still be compromised to a material extent by the application of our existing CFC rules. Ideally, these rules should not apply to CFCs that fall within the conduit rules. Provided, however, those rules were modified along the lines suggested in our submission, they may potentially be retained.

  - In the case of regional headquarters companies, it would be necessary to exempt those companies from Australia’s transfer pricing rules or to provide such companies with a concessional tax rate that was competitive in the region. Whether such an approach is warranted will depend on the expected benefits that would flow from having such companies in Australia. This would require more detailed consideration.

- The proposal to apply Australian CGT to the sale by non-residents of non-resident interposed entities should be dropped from the legislative agenda.

- While the newly negotiated Protocol to the Australia–USA treaty represents a marked improvement in the Australian approach to treaty negotiation, an in-depth review of the merits of this approach is still warranted.

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- We support the proposal to clarify the existing law regarding 'residence' and ensure that central management and control alone will not create Australian residency. We also believe that consideration should also be given to replacing the central management and control test with an incorporation test.

Chapter 4: Promoting Australia As A Global Financial Services Centre

- We support the views and recommendations outlined in Chapter 4 of the consultation paper.

- Consideration should also be given to introducing a FIF exemption for all investments made by Australian residents in comparably taxed jurisdictions (including, at a minimum, all broad-exemption listed countries).

Chapter 5: Improving Australia's Tax Treatment of Foreign Expatriates

- We largely support the views and recommendations outlined in Chapter 5 of the consultation paper.

- The RBT recommendation that residents departing Australia provide security for deferred CGT liability should be set aside due to practical and logistical problems. Further, problems associated with double taxation of a gain realised upon ultimate disposal of an asset should become the focus of future tax reforms in this area.

- The double taxation of employee share options should be dealt with via bilateral tax treaty negotiations. However, these negotiations need to be coupled with domestic tax law changes that provide more certainty around the sourcing of employee share option gains.

- We support and encourage the establishment of a specialist cell within the Australian Taxation Office to deal with the often-complicated tax issues faced by foreign expatriates and their employers.

- Superannuation arrangements should be reformed to assist globally mobile employees in funding their retirement. SDC agreements should be extended to include circumstances where voluntary Australian superannuation contributions are maintained during an assignment. Moreover, the transfer of superannuation funds accumulated whilst on temporary assignment to Australia should not attract a withholding tax where the funds are transferred to an appropriate home country retirement fund.

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CHAPTER 2: ATTRACTING EQUITY CAPITAL FOR OFFSHORE EXPANSION

Current law

Under the current imputation system, Australian resident investors receive franking credits on dividends paid by Australian companies, dependent on what Australian tax is paid at the company level.

Broadly speaking, no franking credits are generated for Australian shareholders when Australian companies suffer foreign tax on their overseas operations. Where a sizeable portion of an Australian company's profits are derived offshore, then this may impact on the ability of the company to pay fully franked dividends at a level that is acceptable to its shareholder base. It is generally acknowledged that Australian investors place a high value on those companies that consistently pay acceptable levels of fully franked dividends.

From the shareholders' viewpoint, the receipt of unfranked dividends paid out of foreign taxed profits can lead to an effective tax rate in excess of 70% when foreign income and withholding taxes are taken into account along with the shareholders' own Australian tax liability.

Problems with the existing law

It has been said that the current imputation system has created an inherent bias favouring investment in Australian companies with mostly Australian operations on the basis of the after-tax return to shareholders. That is to say, to achieve the same after-tax result for its Australian shareholders, an Australian company with significant overseas operations has to achieve a higher pre-tax rate of return than its land-locked Australian competitors.

The consultation paper asserts that many larger Australian companies have access to global capital markets as well as the Australian market. As non-residents place little value on imputation credits, the bias mentioned above may not have a significant impact on the cost of capital. However, in our view, only a precious few Australian-based multinationals can currently access global equity markets in any meaningful way. This means that, for the time being at least, most Australian multinationals must continue to consider the needs of the Australian capital market and the continued appetite of that market for franking credits.

Evidence

We agree that further work needs to be carried out to identify or quantify the impact on an Australian based multinational's cost of equity capital caused by the bias discussed above. The impact on the global competitiveness of Australian business as a result of removing tax-based distortions also needs to be researched.

Solutions

The consultation paper examines three options. We have set out below our comments on those three options as well as outlining some alternative options that also merit consideration.

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Option A - Dividend Imputation System to remain with added domestic shareholder relief for unfranked dividends paid out of foreign source income

We recognise that shareholder relief of this character should, by reducing the level of double taxation suffered by Australian shareholders on foreign profits, encourage investment by Australians in Australian companies seeking to invest offshore.

However, in our view, the suggested credit of $1/9^{th}$ is almost certainly too low to meaningfully impact on shareholder behaviour. If attitudes to foreign investment were to be influenced significantly, this rate would need to be increased to say $3/7^{th}$ so as to align the credit with the payment of a franked dividend.

The consultation paper asserts that the standard credit needs to be low since it does not depend on source and dividends may be sourced from low tax jurisdictions. However, it is stated elsewhere in the consultation paper that some 95% of non-portfolio dividends are currently sourced from comparably taxed jurisdictions. While it is conceded that the introduction of an increased credit might theoretically provide an incentive to shift business operations from higher to lower tax jurisdictions, it should be remembered that any low taxed income will be subject to the CFC rules and will be attributed (ie, subject to Australian tax) unless the CFC satisfies the ‘active income’ test. This should very actively discourage the shifting of ‘mobile’ forms of foreign income to low tax jurisdictions purely for the benefit of Australian shareholders.

If there was concern with a flat credit being introduced that is significantly higher than the suggested $1/9^{th}$, then the higher credit might be limited to dividends paid by companies resident in comparably taxed countries (at a minimum, broad-exemption listed countries). This is likely to increase compliance costs and add some complexity to the required legislation.

This option would also cause a significant additional compliance burden as companies would be required to identify all taxed foreign income for the purposes of calculating the credit and trace the new shareholder credits through company chains.

Option B - Dividend Streaming of Foreign Source Income

We support further consideration of this option as it directly addresses the issue of preserving scarce franking credits for Australian resident investors who place most value on them. The option also mitigates the inefficiencies caused by the current inability of companies to stream Foreign Dividend Account (FDA) credits - a welcome development.

It is pointed out in the consultation paper that maximum benefit will only occur when the proportion of non-resident shareholders roughly equals the proportion of foreign source income derived by the company. This means that the option would only currently assist in a few cases. However, the option is still worth pursuing as more and more Australian companies may benefit in future years. However, it should be implemented in conjunction with other measures.

Option C Providing franking credits for foreign dividend withholding taxes

In our view, this option will be ineffective in addressing the imputation system bias discussed above. The availability of a franking credit for any withholding tax suffered on dividends repatriated back to the Australian parent will tend to lose importance as withholding tax rates (hopefully) continue to

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drop in line with the recently negotiated Australia-USA treaty and subsequently triggered most favoured nation clauses. Moreover, this option does not mitigate the cash cost to Australian companies of profit repatriations that are subject to withholding tax.

FURTHER OPTIONS FOR CONSIDERATION

Dividend Exemption

This option would involve a full exemption being granted to Australian shareholders receiving dividends paid out of foreign source income (in the same way as the FDA regime currently applies for non-residents). This model would encourage significant repatriation to Australia from foreign stores of profits as well as simplifying the tax system. Compliance costs for the investor and the company would be significantly reduced. Of course, there would be a significant impact upon tax revenues.

Partial Exemption

This option would address the revenue concerns arising under a full dividend exemption model as Australian shareholders would include a proportion (say 20%) of unfranked dividends sourced out of foreign taxed profits in their assessable income (in a similar fashion to the recently introduced 50% CGT exemption). The progressiveness of the tax system would be retained in respect of the 'top up' tax.

Thought would need to be given as to the proportion of such dividends that would be assessable. Naturally the revenue impact of this option would need further investigation.

Non-resident shareholders would receive full exemption on such dividends as they currently do under the FDA regime.

Preferred Options

We are of the view that dividend streaming should be implemented. Moreover, further work should be undertaken to explore the relative merits of the shareholder credit model as compared with the full or partial exemption model. In the case of the shareholder credit model, we strongly favour a higher level of credit across the board than is proposed in the consultation paper.

Priority

This issue should be given a high priority.

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CHAPTER 3: PROMOTING AUSTRALIA AS A LOCATION FOR INTERNATIONALLY FOCUSED COMPANIES

PART 1 - THE CFC RULES

INTRODUCTION

The CFC rules are, in essence, intended to preserve the integrity of the Australian tax system by preventing the accumulation of “passive” income outside Australia, while at the same time not creating unnecessary taxation impediments for Australian businesses that operate internationally.

It is more than 10 years since the rules were first introduced. In that time changes to the international business environment, as well as changes to the rules, have caused the balance between tax integrity and operational simplicity to slip out of alignment with the result that the rules now present unwarranted obstacles to Australian businesses wishing to operate internationally. This would be a potentially acceptable cost of doing business internationally if Australia’s principal international business competitors were equally constrained. However, as a general rule, the current operation of the rules places Australian business at a commercial disadvantage internationally.

The CFC rules are undoubtedly complex, and effective reform of the rules will be a challenging exercise. In our view, a stepped approach to reform is to be strongly preferred. As a start, there are a number of discreet issues where significant improvements to the law can be made without particular difficulty. A more comprehensive conceptual review of the system (with the aim of making it better able to cope with future changes to the international tax and business environment) can then follow.

The balance of this part of our submission contains some comments on the possible shape of a comprehensive review and more detailed discussion of those key areas in the CFC rules and associated rules dealing with foreign dividends and capital gains that should be immediately reviewed.

A COMPREHENSIVE REVIEW

Our preferred framework for the building of a fully revitalised CFC regime is to focus in the short term on dealing with the major problems in the current rules and to undertake the more comprehensive review with the benefit of the knowledge obtained from that work. This process is to be preferred for two reasons:

- it will ensure that material improvements are made to the system in the event that the comprehensive review fails to identify a new and clearly better system;

- it will improve the likelihood of the comprehensive review producing a successful outcome, by removing unnecessary distractions (problems that have been solved through the earlier work), and focus attention on conceptual “re-thinks” that provide the best chance for the rules to be reformed in a comprehensive manner.

If the recommendations for immediate reforms of the rules are adopted, we will have a CFC regime that operates with wide-ranging attribution rules constrained by relatively flexible exemptions. Such a regime is probably not optimum, but would represent a substantial improvement over the existing system (wide-ranging attribution, with limited and arbitrary exemptions).

However, the existence of this more flexible regime would enable the comprehensive review to consider whether, for instance, it is possible to create a set of rules that reverse the current approach – that is, provide wide-ranging exemptions with limited but targeted attribution rules. A focused approach such as this provides the best framework within which a comprehensive review would occur.

Finally, we submit that a review that focused on re-writing the rules in order to produce, in essence, a "simplified" version would be an entirely futile exercise. In all likelihood, the outcome would be no simpler, and nothing will have changed.

IMMEDIATE REFORM RECOMMENDATIONS

We believe the following reform recommendations should be given priority in the more immediate CFC reform process.

TAKING CURRENT BROAD-EXEMPTION LISTED COUNTRIES OUTSIDE THE CFC RULES AND/OR EXPANDING THE LIST

Existing law

Where a CFC is resident in a broad-exemption listed country, its potentially attributable income is far more limited than is the case with CFCs resident in other countries. Essentially, the attributable income is confined to untaxed capital gains on tainted assets and concessionally taxed interest, royalties and certain offshore income, as well as income or profits dealt with under tax concessions that are specified in the Regulations to the 1936 Act.

There are currently seven broad-exemption listed countries: the US, UK, France, Germany, Canada, Japan and New Zealand. This has been the case since amendments creating the broad-exemption list category were introduced in 1997. Prior to that time, the limited attribution regime applied to approximately sixty countries, including most countries in Europe and the Asia-Pacific region.

Problems with the existing law

The original listing approach in the CFC rules was designed on the basis that the sixty or so countries that were listed had a tax rate and a tax system broadly comparable to that of Australia. To make the system relatively simple to operate, it was presumed that income derived by a resident of a listed country had been fully taxed and should therefore not be subject to tax again in Australia by way of attribution. It was nevertheless recognised that some significant tax deferral opportunities existed in a number of these countries, and the rules allowed for those concessions to be specified in the Regulations so that attribution would occur where profits were sheltered from foreign tax under those concessions.

The 1997 amendments were the result of concerns by the ATO and Treasury that it was not possible to effectively monitor the tax deferral opportunities in so many countries. Consequently, the majority of countries were moved off the list.

The removal of those countries from the list has meant that Australian-based multinationals with CFCs resident in those countries are required to make attribution calculations under rules that were designed solely to deal with attribution from tax havens or low-tax jurisdictions. This has fundamentally compromised the design of the whole system.

This has created excessive compliance requirements and needless attribution of income, without any material benefit to the Australian revenue base:

- in many instances, the attributed income has been subject to foreign tax at a rate equal to or higher than the Australian corporate tax rate;

- attribution of untaxed or lower taxed income more commonly occurs only where taxpayers are commercially unable to avoid it.

Even where CFCs are resident in the broad-exemption listed countries, the rules require Australian businesses to constantly review their operations in these countries from an Australian tax compliance perspective. A common problem, for example, is that reorganisation transactions that occur tax-free in these countries sometimes do not qualify for relief under the CFC rules, and attribution would result in the event the transaction was undertaken. This is generally a needless constraint, as the foreign reorganisation relief would only result in a deferral of foreign tax.

Evidence

CFC tax compliance under the post-1997 rules involves such complexity that it is difficult, if not impossible, for investors to manage their tax position in a simple and cost-effective way. Australian businesses that are expanding outside Australia tend to commence their expansion in the Asia-Pacific region. They therefore mostly carry on business in non-broad-exemption listed countries and have to apply “tax haven” designed compliance measures to their foreign operations. Such businesses rarely have the resources to manage this effectively.

Larger Australian corporations have greater resources to devote to CFC management and tend to have the majority of their investments in broad-exemption listed countries. However, given the focus of these groups on international supply chain processes and centralised service centres, there is also a large volume of intra-group transactions that take place between broad and limited-exemption listed and unlisted countries, and the added complexity of their operations means that CFC compliance management is excessively time consuming.

Australian businesses operating internationally cannot, without risking unwarranted attribution, simply absorb the general thrust of the rules and not focus on their detailed application. That is, they cannot take the position that they are only undertaking “active businesses” internationally and should therefore not have any material CFC concerns. In our experience, where this has been done CFC exposures have inadvertently been created. This can be the result of such simple things as lending funds between two businesses in different jurisdictions without charging interest, or having a CFC provide services to an unrelated third party on behalf of its Australian parent, rather than under direct contract with the third party.

This in itself would not be a problem if it were possible for clear guidelines to be drawn up that could be used by the CFC personnel to avoid these kinds of pitfalls. This is, however, rarely achievable given the complexity of the CFC rules. And the difficulty is compounded by the fact that foreign personnel may not use English as a first language, will often not be "tax literate" and may treat guidelines (once their complexity is apparent) with amused contempt.

Thus, as advisers:

- we cannot give general CFC clearances to companies seeking to operate internationally even where their international operations are confined to a few countries and their businesses are, in commercial terms, entirely "active"; and

- we are compelled to provide guidelines that may be too complicated or constraining to enable CFC compliance to be managed in an appropriately cost-effective manner.

Solutions

It should be possible for a working group to determine a short-list of additional countries that have the potential to be classified as broad-exemption listed countries. Priority should be given to those countries that are attracting or have the potential to attract the largest share of Australian outbound investment, excluding those whose tax systems are self-evidently not comparable to the Australian system.

It must be stressed that there are no clear or decisive criteria that can be used in the selection process. But CFC rules inevitably involve a compromise between integrity and simplicity/clarity. Intelligent, practical, assessments can be made, and changes to tax rules can be managed without undue claim on ATO or Treasury resources.

We believe the following criteria would be relevant in the selection process:

- the degree of access to information by the ATO and Treasury as to tax concessions in those jurisdictions that are potentially applicable to passive income or tainted income;

- the stability of the foreign tax system;

- the constraints that the country faces in granting significant new passive income tax concessions.

Ultimately, a practical assessment will need to be made. The original design of the system recognised this fact, by allowing countries to be included on the list with their potentially offensive rules excluded through the Regulations.

The assessment process should be an ongoing one. An annual review of the list, and consultation with taxpayers should not, we believe, be unreasonably costly.

Finally, we believe there is a case for the view that the current partial exclusion of broad-exemption listed country CFCs from attribution can be extended further without damage to the integrity or intent of the CFC rules, particularly if it proves impossible to materially extend the list of such countries.

By being included on the list, those countries are known to have a highly comparable tax system to the Australian system. It is likely that a relatively small amount of income is or will be attributed from these countries and Australians do not invest in those countries in order to defer Australian tax on passive income.

We would therefore recommend that CFCs resident in countries on the broad-exemption list be entirely excluded from the attribution rules.

If this were done it would be necessary to build integrity measures into the extended exemption to ensure that CFCs in these countries are not used as conduits for entry into non-broad-exemption listed countries so as to take advantage of the exemption. For example, the UK Excluded Countries Exemption operates to exclude outright from attribution CFC income where:

- the CFC is resident in a relevant comparably taxed country; and
- the CFC derives the majority of its income from sources in that country (in essence, non-local income must not exceed 10% of "commercially quantified profits").

This change would mean the elimination of the active income test for CFCs resident in broad-exemption listed countries, as it would become redundant.

Priority

We believe that this is a relatively straightforward change that should be given a high priority, with the aim of introducing changes by 1 July 2003.

MODIFY THE "TAINTED SERVICES INCOME" RULES

Existing law

Services income that is classified as "tainted services income" derived by a CFC resident in an "unlisted" or "limited-exemption listed" country gives rise to attributable income that is potentially subject to Australian taxation on a current basis. All but seven countries (the US, UK, Canada, New Zealand, France, Germany and Japan) are within these categories.

Tainted services income is, with some minor exceptions, any income from the provision of services by such a CFC to any Australian resident or to any associated entity, wherever that associated entity is resident.

Exceptions are provided for:

- services provided by a CFC to another CFC which is resident in the same foreign country, provided certain additional conditions are met;
- the provision of food, accommodation, entertainment, recreation or instruction;
- the provision of services that are related to goods sold by the CFC where the goods were substantially altered by the CFC or created by the CFC; and
- certain services provided by CFC subsidiaries of Australian financial institutions.

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Problems with the existing law

There are three fundamental problems with the existing definition of tainted services income:

1. it causes attribution of income that is, essentially, "active" business income and thereby hinders the growth of Australian-based service and knowledge companies;

2. it inhibits the establishment of shared services centres outside Australia by Australian-based multinationals, needlessly restraining their operational efficiency and, in this respect, placing them at a disadvantage when compared to their major international competitors, as foreign CFC rules generally treat services income far less severely;

3. it creates excessive tax compliance obligations on Australian-based businesses.

These problems largely arise as a result of changes in the global business environment since the introduction of the CFC rules (in particular, the dramatic growth in the services industry and the growth in importance of shared services centres and "centres of excellence" for multinational groups). The problems created by these developments were greatly compounded by the 1997 amendments to the CFC rules that replaced "listed" countries with "broad" and "limited" exemption lists.

As a result, the tainted services rule has become increasingly misaligned with international business practice and is constraining international business activity by Australian enterprises.

Moreover, the initial premises on which the rules were based are thus no longer entirely valid. In particular:

- a review of the services industry would disclose that it is often capital-intensive and far less mobile than was assumed to be the case in the 1980s when the CFC rules were being drawn up; and

- Australia's transfer pricing laws have, in practice, been significantly strengthened during the 1990s, providing a far stronger basis for regulating inappropriate profit-shifting involving the provision of services.

Evidence

The existing definition of tainted services income has the potential to cause attribution in a wide range of situations where it would seem inappropriate for this result to occur:

- CFCs that assist their Australian parent to perform contracts between that parent and non-Australian resident third parties will derive tainted services income. They will not do so where the contract is executed directly with the third party, although this may not be a commercially desirable approach. The CFCs are almost invariably undertaking an active business, and are established without any tax-planning motivation.

- Shared services centres are an increasingly common feature in larger multinational groups that, not unreasonably, are focused on improving efficiency and obtaining cost-savings. Such services centres, if operated through a CFC, frequently generate tainted services income.

- Telecommunications ventures are in many instances not highly mobile due to their investments in significant tangible assets (cables, networks etc). It is often commercially essential for these ventures to provide their services to associated foreign entities or to Australian third party customers. Where this is done, tainted services income can be generated.

The current definition thus draws active businesses into its ambit and provides a needless obstacle to internal cost-saving and efficiency generating measures within multinational groups.

Solutions

The problems caused by the existing tainted services rule can be largely alleviated by amending the definition of tainted services income in two ways:

- confining its operation to services provided by CFCs to Australian resident associates; and

- adding an exemption that excludes from attribution all services provided by a CFC to Australian resident associates where the CFC is undertaking an active business of providing those services to, or directly for the benefit of, non-associates.

This change should be relatively simple to draft. While the "active business" test element of the proposal would require detailed consideration, it may be possible to draw on similar exemptions already provided in the FIF rules.

This proposal should not give rise to any material integrity concerns:

- the measures are targeted to provide relief to active businesses;

- many of those businesses are not in any event "highly mobile"; and

- the measures do not provide an opportunity for Australian based businesses to merely shift internal support functions – which are highly mobile - offshore in order to defer Australian tax.

Priority

This should be given a high priority. The drafting measures are not particularly complex and a start date of 1 July 2003 for the measures should be achievable.

EXPAND CFC ROLLOVER RELIEF

Existing law

Transfers of "tainted assets" by CFCs qualify for CFC rollover relief only where the transfer is between CFCs that are part of a 100% owned group and where one of the following additional conditions is met:

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- both companies are resident in the same broad-exemption listed country, or the recipient company is resident in Australia;
- the transferor is resident in a broad-exemption listed country, the recipient is resident in a non-broad-exemption listed country and the asset was used by the transferor in carrying on business in a non-broad-exemption listed country; or
- both companies are resident in a non-broad-exemption listed country.

In the case of CFCs resident in broad-exemption listed countries, CFC rollover relief also extends to:

- disposals of assets involving the loss, destruction or compulsory acquisition of the assets, provided certain conditions are met;
- transfers of assets to a 100% group company resident anywhere, provided the transfer will immediately or ultimately give rise to a tax liability for the transferor in the broad-exemption listed country; or
- cancellation of shares, rights and options and issuance of replacement shares, rights and options in the same company, provided certain conditions are met.

Problems with the existing law

As with other complex international organisations, Australian-based multinational groups continually need to undertake or contemplate reorganisations of their asset holding structures to deal with their changing environment. These reorganisations do not result in any realisation of a gain to the group. Any material Australian costs will therefore normally prevent such reorganisations occurring.

CFC rollover relief is so narrowly confined that many reorganisations cannot be undertaken because of the Australian CFC attribution cost. This severely restricts the ability of Australian-based multinationals to rearrange their offshore holding structures in the most commercial and tax efficient manner. Major international competitors are generally far less constrained in this regard.

Evidence

We have found there to be problems for our clients in a wide range of situations:

- Where joint ventures are proposed to be established: Many joint venture transactions will, under the current CFC rules, generate attributable income upon their inception;
- Where tax free reorganisations are undertaken in broad-exemption listed countries: While these countries have tax systems that, under our CFC rules, are recognised as being fundamentally similar to the Australian system, this recognition does not extend to rollover relief. Those countries sometimes allow for rollover relief in situations where it would not be provided under the Australian rules.

- Where CFCs undertake scrip for scrip transactions: These transactions will in most instances not qualify for CFC rollover relief, despite the fact that the transactions merely involve the exchange of one economic interest for a similar economic interest having the same value.

Where these problems occur, Australian businesses are often required to forgo the opportunities that the reorganisation offers.

Solutions

A focused expansion of the existing CFC rollover provisions can alleviate a large percentage of the problems facing Australian-based multinationals wishing to restructure. This can be done without compromising the overall integrity of the CFC rules. In particular, rollover relief should be extended to cover the following situations (in order of priority):

- where a CFC resident in a broad-exemption listed country undertakes a transaction that qualifies for rollover relief under the taxation laws of that broad-exemption listed country;

- where a CFC transfers shares to another CFC or to a non-CFC in exchange for shares;

- where an Australian resident transfers shares in a CFC to another CFC, where all companies are members of the same wholly owned group; and

- where a CFC transfers assets to another CFC where they are part of the same wholly owned group.

These proposals should ultimately be revenue neutral from the Australian tax perspective. All assets that are the subject of the proposals remain within the Australian CGT net.

The changes will require careful thought and legislative planning in order to ensure that the objective of ultimate tax neutrality is achieved. They are thus more complex than the proposals outlined above dealing with tainted services income and changes to the broad-exemption country list. In particular, it will be necessary to focus on measures to ensure that:

- no unwarranted tax-free cost base uplifts are made available as a result of the introduction of new scrip for scrip rules; and

- the provision of wholly owned group rollovers regardless of the residence of the CFCs does not result in a material cost to the revenue.

In addition, amendments to s. 47A of the 1936 Act may be required to allow for some of the proposed rollovers.

In view of this (relative) complexity, it may be necessary for the new rollovers to be introduced on a phased basis. (The removal of the broad-exemption listed countries from the CFC rules would speed up this process, by eliminating the need for the first of the above proposed additional rollovers.)

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Priority

This proposal should be given a high priority.

ADDITIONAL PROPOSALS THAT SHOULD BE CONSIDERED PRIOR TO, OR IN LIEU OF, A COMPREHENSIVE REVIEW OF THE CFC RULES

The adoption of the above three proposals would result in significant improvements to the CFC rules. However, much more can be done, short of a comprehensive review of the rules, to make them simpler and fairer in their impact. We set out below some of additional proposals that should be considered for implementation in the short to medium term.

The first of these proposals suggests the introduction of an additional "safe harbour" provision into the rules, and is, in our opinion, the most important additional proposal to consider. It will, by itself, produce a wide-ranging improvement in the provisions. The remainder of the proposals are more narrowly focused, but will provide some additional and necessary relief for Australian businesses.

Introduce an "active business" safe harbour exemption into the CFC rules

Where a CFC is resident in a broad-exemption listed country, CFC attribution occurs, in essence, when the CFC derives certain narrowly defined categories of income or gains that are subject to concessional tax treatment in that country.

Where a CFC is resident in any other country, attribution occurs, in essence, when the CFC derives a far wider class of income or gains, regardless of whether or not that income or those gains are subject to tax in that country.

Aside from the less rigorous attribution requirements applicable to broad-exemption listed country CFCs, there are two "safe harbour" measures in the existing rules:

- a de minimus exemption contained in section 385(4) of the 1936 Act, which prevents attribution occurring in relation to broad-exemption listed country CFCs where, in broad terms, the attributable income for the year is less than $50,000; and

- the "active income test" contained in section 432 of the 1936 Act, which, in broad terms, prevents attribution occurring where the "tainted" (potentially attributable) turnover of the CFC is less than five per cent of its total turnover for the year.

Under the existing law, attribution can potentially occur regardless of whether or not there is any tax saved by the group through earning the income or gains in the foreign country instead of in Australia, and irrespective of the fact that there may have been no relevant purpose of Australian tax-avoidance in relation to the activities of the CFC.

The time spent by Australian businesses investing overseas in managing their CFC compliance obligations has, at least since the introduction of the 1997 amendments to the CFC rules, grown steadily and significantly under the combined pressure of those amendments, the general rigidity of the rules, the lack of simple and focused exemptions, and the growing complexity of international business transactions.

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The introduction of an additional safe harbour measure into the CFC rules would make them more effectively targeted and significantly reduce the compliance burden on Australian businesses that is created by the comparatively indiscriminate approach that underlies the present system. One possible safe harbour measure that should be considered is an "active business" test.

Such a test would involve the introduction of rules that exclude attribution from CFCs that are carrying on activities that are classified as "active" within the terms of the test. Those rules may be modelled on the equivalent test already provided in the FIF provisions, or possibly on the *Exempt Activities* rule contained in the UK CFC provisions.

In essence, such a rule would provide that a CFC is exempt from CFC attribution in a given income year provided its assets are predominantly used to carry on an active business. That business may be defined on an exclusionary basis, so that the following companies would not qualify for the exemption:

- those whose predominant activity is the earning of passive income;

- those who are predominantly engaged in providing services to or trading with an Australian resident controller or a resident associate of that controller.

Companies that are, directly or indirectly, holding companies for subsidiaries that satisfy the active business test would also qualify for the exemption, as may companies that undertake commercial share-trading activities.

Alternatively or additionally, a purpose test (also modelled on equivalent UK provisions) could be considered as a safe harbour measure.

Exclude non-controlled joint ventures from the CFC rules

Joint ventures have become an increasingly common an important means whereby Australian companies invest internationally.

Where an Australian-based multinational participates in a foreign joint venture and holds a 50% interest in that joint venture, all the foreign joint venture companies will be categorised as CFCs under the general CFC definition.

These joint ventures are not "controlled" by the Australian venturer. While that venturer may have an equal say in the running of the venture it cannot treat it like a foreign company in which it has a majority interest. In practical terms, this means that venture is not a vehicle that is easily used to defer Australian tax on passive income.

The application of Australia's CFC rules to those ventures means that the Australian venturer is generally operating under tax laws that are more restrictive than those applicable to the foreign venture party. This creates an impediment for Australian companies seeking to internationalise from an Australian base.

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This joint venture impediment can be substantially removed for Australian investors by modifying the CFC rules so that joint ventures meeting the following conditions are excluded from the definition of a CFC:

- the other joint venturer or venturers are not residents of Australia, nor controlled by residents of Australia; and
- the other joint venturer or venturers are controlled by:
  - residents of broad-exemption listed countries;
  - residents of countries that have comprehensive CFC and FIF-equivalent rules; or
  - entities resident in the country in which the venture is being carried out; and
- the Australian joint venture party holds no more than 50% of the interest in the venture, although the Australian party may have operational management control; and
- the venture carries on an active business.

This proposal should not involve particularly complex drafting measures. In particular, it should be possible to draw in part on the existing “active business” exemption provisions contained in the FIF rules.

A modification to the CFC rules along these lines will not compromise the integrity of the rules (due to the eligibility requirements for the exemption to apply), and will place Australian companies on a more even footing with foreign competitors in building strategic international alliances.

Exclude Australia’s transfer pricing rules from applying where funds are lent interest free between CFCs

Australia’s transfer pricing rules are overlaid on the CFC rules. In making CFC calculations, Australian-based multinationals are required to apply these transfer pricing rules to all relevant related party cross-border transactions undertaken by each CFC.

The existing law approaches the problem of value shifting through transfer pricing in the CFC context in a relatively untargeted manner. The approach essentially requires compliance with transfer pricing measures regardless of whether such compliance is necessary having regard to the objectives of the CFC rules.

The area where this presents the greatest problem is where funds are lent interest-free between CFCs. Such funding is often undertaken for the sake of simplicity and administrative and commercial convenience. The application of Australia’s transfer pricing rules will generally cause CFC attribution to occur on a deemed interest return. However, if interest were actually charged, there would generally be no Australian tax pick-up, as the interest would be taxed in the foreign jurisdiction. Alternatively, CFC attribution could be avoided through the expedient of having funds distributed to Australia as a tax-free dividend and reinvested in another CFC as preference shares.

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The charging of interest when not required to do so by foreign tax authorities or the distribution of funds back to Australia simply generate needless foreign tax or transaction costs and we therefore recommend that the transfer pricing rules not be applied in the CFC context to interest free loans between CFCs.

Ensure that income derived by a CFC is attributed only to taxpayers who are attributable taxpayers at the time the income is derived

The attributable income of a CFC is calculated for the statutory accounting period of the CFC. That attributable income is then included in the assessable income of entities that are attributable taxpayers at the end of the statutory accounting period.

Where a taxpayer buys shares in a foreign company during the foreign company's statutory accounting period, income derived by the foreign company during that statutory accounting period but before its shares are acquired by the taxpayer may be attributed to the taxpayer; in other words, there may be retrospective attribution. That is clearly inequitable. Moreover it will often not be possible for the purchaser and the vendor to adjust the purchase price of the shares appropriately to reflect the retrospective attribution, because the vendor may be resident outside Australia and therefore may be exempt from Australia's CFC rules.

In 1995 the CFC rules were amended to ensure that capital gains made by a foreign company before its shares are acquired by an attributable taxpayer will not be attributed. However, the amendment applies only if the foreign company has not previously been a CFC. If the foreign company has been a CFC at any time before its shares are acquired by a particular attributable taxpayer, the attributable taxpayer may be taxed on capital gains derived by the CFC during the statutory accounting period but before the acquisition by that attributable taxpayer.

We believe that the CFC rules should be amended so that, where shares in a foreign company are acquired directly or indirectly by an Australian resident, only income and gains derived by the foreign company after the acquisition may be attributed to that taxpayer.

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CHAPTER 3: PROMOTING AUSTRALIA AS A LOCATION FOR INTERNATIONALLY FOCUSED COMPANIES

PART 2 – EXEMPTIONS FOR FOREIGN DIVIDENDS AND CAPITAL GAINS ON SHARES IN FOREIGN COMPANIES

EXPAND THE EXEMPTION FOR FOREIGN NON-PORTFOLIO DIVIDENDS AND FOREIGN BRANCH PROFITS

Existing law

Non-portfolio dividends received by Australian companies from foreign companies may be wholly or partly exempt from tax under sections 23AI or 23AJ of the 1936 Act, depending on whether the foreign company paying the dividend is a resident of a listed or an unlisted country.

Where the foreign company is a resident of a listed country, the treatment of the dividend is as follows:

- if any of the foreign company's profit has previously been attributed to the Australian company under the CFC rules, the portion of the dividend deemed to have been paid from the attributed profit is exempt under section 23AI.

- the remaining portion of the dividend is exempt under section 23AJ.

Where the foreign company is a resident of an unlisted country, the foreign company's profits are divided into three baskets, which cover exempting profits, attributed profits and other profits.

To the extent that the dividend is treated as being paid out of exempting profits, it is exempt from tax under section 23AJ. To the extent that it is treated as having been paid out of attributed profits, it is exempt under section 23AI. Finally, to the extent that it is treated as having been paid out of other profits, it is taxable.

Exempting profits generally include profits that fall into any of the following categories:

- profit earned by the foreign company from carrying on business through a branch in a listed country;

- a non-portfolio dividend received by the foreign company from a company resident in a listed country;

- a non-portfolio dividend received by the foreign company from a company resident in an unlisted country where that dividend was in turn paid from profits that fall within either of the first two categories.

Because of the third category, where an Australian company owns a chain of foreign companies resident in unlisted countries and receives a dividend from the top company in the chain, the Australian company will generally need to determine the ultimate source of the profits from which the dividend has been paid. It will therefore need to keep a record of the profit earned by each company in the chain, it will need to allocate that profit to each of the three baskets and it will then need to track dividends, within each basket, as they are paid up the chain.

Similarly, where an Australian company owns a chain of foreign companies and income from one or more of the foreign companies has been attributed to the Australian company under the CFC rules, the Australian company will need to keep a record of the amount of profit attributed from each foreign company. The Australian company will then need to track the distribution of that profit up the chain, so that it can ascertain whether dividends received by it have been paid from previously attributed profits.

Similarly detailed information is required to record and track foreign taxes paid in relation to distributions of profits to Australia.

Because non-portfolio dividends paid by companies resident in listed countries to Australian companies are exempt from tax under 23AJ but dividends paid by companies resident in unlisted countries may be taxable, the 1936 Act contains a number of anti-avoidance rules to ensure that profits are not shifted from companies resident in unlisted countries to companies resident in listed countries without those profits being taxed in Australia or in a listed country. The anti-avoidance rules include the following:

- Section 47A – a CFC resident in an unlisted country may be deemed to have paid a dividend if it forgives a debt, makes a loan, acquires shares (or rights or options to acquire shares) in another company, acquires units (or rights or options to acquire units) in a trust, or transfers property or provides services for less than market value.

- Section 457 – a CFC resident in an unlisted country becomes a resident of a listed country or of Australia.

- Sections 458 and 459 – a CFC resident in an unlisted country pays, or under section 47A is deemed to have paid, a dividend to another CFC or to a partnership or trust, and certain conditions are satisfied.

Where an Australian company carries on business through a branch in a listed country, income derived from carrying on business through the branch may be exempt from tax under section 23AH of the 1936 Act. The conditions that must be satisfied to obtain the exemption are, broadly speaking, similar to the conditions that must be satisfied to prevent attribution of income derived by a CFC resident in the particular listed country. Section 23AH is intended to ensure that an Australian company operating through a branch in a listed country is not disadvantaged in comparison to an Australian company operating through a subsidiary resident in the listed country.

Under current law, income derived by an Australian company from carrying on business through a branch in an unlisted country is taxable in Australia. The Australian company will usually be entitled to foreign tax credits for taxes paid on that income in the unlisted country.

Problems with the existing law

The existing law is extraordinarily complex and compliance with the law will often entail considerable cost.

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An Australian company that owns foreign companies resident in unlisted countries must determine, for each of those companies, how much of its profit consists of exempting profits, attributed profits and other profits. That process involves not only determining how much income falls within each basket, but also apportioning expenses and foreign income taxes among the three baskets. Once the amount of each of the three baskets of profits has been determined, the Australian company must track the distributions made from each basket. The Australian company must also track, within each basket, the amount of foreign taxes relating, on the one hand, to profits retained within the foreign company or received as dividends by the foreign company and, on the other hand, to profits distributed by the foreign company. Such tracking requires an Australian company to maintain at least three notional accounts for each of the foreign companies: an attribution account (to record the profit that has been attributed under the CFC rules); an attributed tax account (to record the tax paid on the attributed profit); and an account for exempting profits.

In additional to the complexity of the law, it discourages the repatriation to Australia of profits earned by companies resident in unlisted countries and the investment of those profits in Australia.

Evidence

The problems with the existing law should be clear from the foregoing discussion.

Solution

The exemption in section 23AJ should be expanded to cover all foreign non-portfolio dividends received by an Australian company. Most of the legislative provisions dealing with the treatment of dividends paid by foreign companies to Australian companies could then be repealed.

It is noted in the consultation paper that the granting of such an exemption will increase the importance of having effective CFC rules. This is, however, only true to the extent that the CFC rules operate in an appropriately targeted manner. We see no advantage to Australian taxpayers in having an exemption for foreign dividends in exchange for CFCs rules that contain untargeted measures carrying excessive compliance burdens. Accordingly, we would not support the introduction of a broader foreign dividend exemption in the event that the CFC rules were not reformed.

Priority

The expansion of the dividend exemption should be a medium term priority.

EXEMPT THE SALE OF NON-PORTFOLIO INTERESTS IN FOREIGN COMPANIES FROM CGT

Existing law

Where an Australian company owns shares in a CFC and the CFC sells its assets, the profit derived on the sale of the assets will, with certain exceptions, not be attributed to the Australian company under the CFC rules. In particular, a profit made on the disposal of goodwill will generally not be attributable.

The main exceptions are where the profit is derived from the disposal of intellectual property, tainted

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assets or tainted commodity investments. "Tainted assets" and "tainted commodity investments" are defined in section 317 of the Act.

If the CFC is a resident of a listed country and the Australian company has a non-portfolio interest in the CFC, the profit derived by the CFC from the sale of its assets may be distributed as a dividend that is exempt from tax under section 23AJ of the 1936 Act, even if the profit has not been attributed under the CFC rules.

Problems with the existing law

Where an Australian company makes a profit from the sale of shares in a foreign company, the profit is taxable, even if a profit made from the sale of the foreign company's assets would not be taxable under the CFC rules. There is therefore a disadvantage in selling shares in a foreign company instead of assets of the foreign company. However, in many instances it is commercially desirable to sell shares rather than assets.

Evidence

Refer to the issue discussed above.

Solution

Where an Australian company has a non-portfolio interest in a CFC, a profit made from the sale of that interest should be exempt from Australian CGT, at least in situations where the CFC is carrying on an active business or is a holding company for such company. While a global exemption is preferable, differential treatment for CFCs resident in listed and unlisted countries may be an acceptable interim solution.

Priority

We recognise that a CGT exemption that embraces both unlisted and listed countries would require significant and detailed consideration. As noted immediately above, a stepped approach to this proposal may therefore be necessary. In the short term, consideration should be given to confining the CGT exemption to shares in companies resident in listed countries. The extension of the exemption to all countries should be considered in conjunction with the review of the treatment of non-portfolio dividends discussed above.

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CHAPTER 3: PROMOTING AUSTRALIA AS A LOCATION FOR INTERNATIONALLY FOCUSED COMPANIES

PART 3 – "CONDUIT" ISSUES

PROMOTING REGIONAL AND INTERNATIONAL HEADQUARTER COMPANIES

Existing law

Where a non-resident invests in foreign assets through an Australian holding company, there are essentially three situations where the non-resident is potentially exposed to Australian tax on what are non-Australian sourced profits:

- where the Australian company receives dividends from unlisted countries or derives income from carrying on a business through a branch in an unlisted country;
- where the Australian company derives attributable income under Australia's CFC rules; and
- where the Australian company sells the foreign assets.

While Australia provides a degree of "conduit" relief for foreign investors via the "foreign dividend account" rules, such relief is quite limited.

In the event that a foreign investor established a regional headquarters company in Australia it would be required to apply Australian transfer pricing guidelines in charging for its regional services and would be subject to tax in Australia on any profit thereby derived at the normal company tax rate.

Problems with the existing law

In considering whether to use Australia as a regional holding company destination, non-resident investors note that they will be subject to Australian tax on profits that would not be taxable if they established their holding company outside Australia. They are therefore often reluctant to use Australia as a regional holding company location.

In the case of regional headquarters operations, non-resident investors will generally find other locations in the region more attractive from a taxation perspective. Two of those jurisdictions (Hong Kong and Singapore) offer similar infrastructure facilities to those available in Australia.

Evidence

International investors generally do not regard Australia as an attractive regional holding company or headquarters company destination.

Solution

Australia's main regional competitors offer highly attractive taxation packages for both regional holding companies and headquarters companies. A solution that offered marginal improvements to the current rules would be of little interest to foreign investors and, consequently, a waste of time and effort.

A holding company regime with potential credibility for foreign investors would require, at a minimum:

- a tax free-flow through of foreign dividends, from whatever source; and
- a CGT exemption for gains on sales of shares in foreign subsidiaries, with associated measures to allow tax-free distribution of that gain from Australia.

For the sake of simplicity, it may be necessary for the conduit regime to apply only to 100% foreign owned companies. The introduction of a tracing test to prevent companies with any underlying Australian investors from taking advantage of the concessions would, in all likelihood, make them unusable. Instead, a simple and focused anti-avoidance provision would be needed.

Such a regime would still be compromised to a material extent by the application of our existing CFC rules. Ideally, they should not apply to CFCs that fall within the conduit rules. Provided, however, those rules were modified along the lines suggested in our submission, they may potentially be retained.

In the case of regional headquarters companies, it would be necessary to exempt those companies from Australia's transfer pricing rules or to provide such companies with a concessional tax rate that was competitive in the region. Whether such an approach is warranted will depend on the expected benefits that would flow from having such companies in Australia. This would require more detailed consideration.

Priority

We believe this proposal, while of considerable importance, should be considered a medium term priority.

CHAPTER 3: PROMOTING AUSTRALIA AS A LOCATION FOR INTERNATIONALLY FOCUSED COMPANIES

PART 4 – "UPSTREAM" CGT

PROPOSAL TO APPLY CGT TO THE SALE BY NON-RESIDENTS OF NON-RESIDENT INTERPOSED ENTITIES

Current law

In broad terms, non-residents of Australia are subject to CGT on the disposal of CGT assets having the "necessary connection with Australia". Shares in non-resident companies are not assets that normally have that connection, so that a sale or disposal by a non-resident of shares in a non-resident company will not give rise to a CGT liability for the seller. This is the case regardless of whether or not the shares in the non-resident company being sold or disposed of give the seller an indirectly held interest in an Australian resident company.

As part of the Review of Business Taxation, it was proposed to introduce a rule treating such disposals as potentially subject to CGT.

Problems with the proposal

The proposal involves an extraordinary extension of Australia's taxing rights and is, we believe, fundamentally flawed:

- In order for the measure not to create havoc for non-resident investors it would need to be extremely carefully targeted. Given the enormous range of situations that would need to be excluded from its operation, this will almost certainly make the measure one of the most complex in our tax system.

- The measure will likely require the deeming of a tax liability in the indirectly held Australian resident entity in order for any tax to be collected. This would:

  - leave any resident shareholder in the company exposed to the burden of the tax in the event that a non-resident chose to sell its interest "up the chain", a matter over which they would normally have no control;

  - leave the Australian company exposed to tax in situations where it may not even be aware that there has been a triggering change of ownership up the chain;

  - place tax risk on the purchaser of the shares in the interposed entity (as well as on any other shareholder in the ultimate Australian resident company) in a situation where they would not expect such risk to exist (as the proposed rule would be contrary to normal international practices), so that they would rarely recognise the existence of the liability in advance;

  - expose the non-resident to double tax, as many countries would deny a credit for Australian tax paid in these circumstances.

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- The rule would likely require valuations to be undertaken in many situations: for instance, where the Australian company held non-Australian assets, or where the interposed foreign company held non-Australian assets.

- The rule would not sit comfortably with Australia's double tax treaties. Such a unilateral extension of Australia's taxing rights would almost certainly be viewed by our treaty partners as unwarranted and would hinder attempts by Australia to re-negotiate treaties on more favourable terms for Australian taxpayers.

- The relative novelty of the rule, and its complexity, will create a very strong impression (in those potential foreign investors who find out about it) that Australia is not a particularly attractive destination for foreign investment.

The proposal would thus create unwarranted complexity in the tax system, cause inadvertent breaches of the law, create hidden tax exposures for unwary foreign and domestic investors and, for probably a relatively small revenue gain, make Australia appear to be a far less attractive investment destination than it otherwise is.

Evidence

Refer to the problems outlined above.

Solution

We strongly urge that the proposal be dropped from the legislative agenda.

CHAPTER 3: PROMOTING AUSTRALIA AS A LOCATION FOR INTERNATIONALLY FOCUSED COMPANIES

PART 5 – TAX TREATIES

WHETHER THE NEW PROTOCOL TO THE AUSTRALIA-USA TAX TREATY PROVIDES AN APPROPRIATE BASIS FOR FUTURE TREATY NEGOTIATIONS

Australia is an active participant at the OECD. The form of Australia's tax treaties is generally consistent with the OECD's Model Tax Convention on Income and on Capital, the current version of which was updated as of 29 April 2000.

The Protocol to the Australia-USA treaty was negotiated in the period between March and September 2001. However, in addition to the consultation and negotiating processes, the legislative and Parliamentary processes can be lengthy and the Protocol is yet to enter into force.

We believe that the Protocol represents a marked improvement in the Australian approach to treaty negotiations. However, it would appear that Australia is still extremely reluctant to surrender source country taxing rights (for instance, CGT and royalty withholding tax) and consequently treaty negotiations involving Australia are inevitably constrained by this attitude. An in-depth review of the merits of this approach is, we believe, warranted.

Moreover, there are still a number of problems that appear in the Protocol to the Australia-USA treaty, including the following:

- while equipment rentals are to excluded from the Royalty definition, we understand that the ATO is considering expanding its interpretation of when such rents can be taxed as business profits;
- there is inadequate definition of the concept of "fiscally transparent entities" in Article 7 of the treaty; and
- the new Limitation of Benefits Article does not fully recognise certain aspects of Australian commercial structures (such as dual listed companies).

CHAPTER 3: PROMOTING AUSTRALIA AS A LOCATION FOR INTERNATIONALLY FOCUSED COMPANIES

PART 6 – RESIDENCE

CHANGING THE COMPANY RESIDENCE TEST

Under current law, a company incorporated outside Australia is tax resident in Australia if it carries on business here and has its central management and control in Australia or has its voting power controlled by Australian resident shareholders.

The statutory test for the residence of a company was introduced in 1936 and it is well established in case law that central management and control is the highest level of management of a company.

Under the definition of "resident" it is possible that the holding of board meetings in Australia could result in a foreign company being deemed to be Australian tax resident, with significant and adverse tax consequences. This can force Australian directors to locate offshore, and, at the least, can mean that Australian executives are required to travel offshore to attend board meetings (when video or telephone conferencing would be a far more practical alternative).

We therefore support the proposal to clarify the existing law and ensure that central management and control alone will not create Australian residency.

We also believe that consideration should also be given to replacing the central management and control test with an incorporation test. Such a test would be simple to apply and would eliminate the unnecessary administrative burdens. There have been concerns expressed that this would lead to Australian companies exiting Australia (along the lines of US "inversions"). However, such strategies would trigger Australian tax costs and we suspect that such concerns are more imagined than real.

CHAPTER 4: PROMOTING AUSTRALIA AS A GLOBAL FINANCIAL SERVICES CENTRE

We are in complete agreement with the views of Treasury set out in the consultation paper that priority should be given to increasing Australia's competitiveness as a global financial services centre. We also agree that attaining this objective will require fundamental revision of the FIF rules and the CGT rules governing investments by non-residents in Australian managed funds.

It is our view that Options 4.1 through 4.11 all merit further exploration.

Specifically, we firmly support the view that the FIF rules should ultimately be replaced (Option 4.1) by a regime that minimises compliance costs and complexity while preserving tax integrity to the extent necessary. The current rules significantly extend beyond their original anti-avoidance ambit and impose an unreasonable compliance burden on taxpayers.

In the interim, we support the other short-term options canvassed in the consultation paper that consideration be given to amending the FIF rules so as to:

- increase the 5% balanced portfolio exemption threshold in the FIF rules (Option 4.2). Current fund practice of selling down before year-end so as to qualify for the 5% exemption simply increases investors' transaction costs;

- exempt Australian managed funds that follow widely recognised indices and complying superannuation funds from the FIF rules (Options 4.3 and 4.4); and

- extend the definition of 'eligible activities' to include funds management services for FIF purposes on the basis that such activities derive active business income rather then income from the holding of passive assets (option 4.5).

We would add a further option to the list of interim FIF rule options. We are of the view that consideration should be given to exempting from the FIF rules all investments made by Australian residents in comparably taxed jurisdictions (including at a minimum all broad-exemption listed countries). This would align the treatment of investments in all broad-exemption listed countries with the current exemption for certain US investments. While the impact on revenue would need to be investigated, there is little doubt that there would be a very significant decrease in the overall compliance burden on taxpayers.

Options 4.6 through 4.8 canvass the possibility of amending the CGT rules as they adversely impede foreign beneficiaries from investing in Australian managed funds that normally take the form of unit trusts. Currently, the CGT rules create a distortion such that foreign investors are encouraged to either invest directly or through an offshore managed fund. We support these CGT options on the grounds that they will remove the inherent tax distortion and therefore encourage foreign investment via Australian managed funds.

We are of the view that the remaining options canvassed in Chapter Four of the consultation paper (Options 4.9 through 4.11) also merit further consideration.

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Priority

We agree that the potential replacement of the FIF regime is a longer-term objective. However, the interim FIF options and CGT options should be given high priority.

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

1. Introduction

In our role as tax agent and tax advisors, we manage the taxation affairs of a significant number of individuals undertaking temporary assignments in Australia. As such, we feel that we are well positioned to critically evaluate the views and recommendations presented in the consultation paper and to assess the impact of these on foreign expatriates and their employers.

We support the views and recommendations outlined in the consultation paper. Our specific comments on the contents of the consultation paper and related items follow.

2. Summary of Proposed Reforms to Date

The consultation paper recognises the importance of attracting highly skilled foreign expatriates in order to ensure Australia's long-term international competitiveness both in industry and in the global labour market.

The consultation paper further recognises that the current tax regime contains many potential disincentives to achieving this objective. This additional tax burden is often transferred to the employer, as many foreign expatriates undertaking temporary assignments in Australia are covered by tax equalisation policies i.e. a guarantee that they will pay no more and no less tax as a result of their international assignment. This can create an additional barrier to sourcing the best international labour talent.

We recognise recent Government proposals to remove some of these disincentives, including the recently introduced Taxation Laws Amendment Bill No 7 ("TLAB 7"), and summarise them in the following tables:

2.1 Measures affecting temporary residents

A "Temporary resident" is to be defined as an individual who:
a) Is a holder of a temporary resident visa;
b) Has not been an Australian resident for more than 4 years since last becoming resident;
c) Has not been an Australian resident at any time in 10 years since last becoming a resident; and
d) Has not applied for permanent residency

	Measure	**Announced**
1	Exemption for foreign source income and capital gains (other than foreign sourced employment income and gains)	B, C, D
2	Deemed capital gain for departing temporary residents to be disregarded (except for employment related assets and certain Australian assets).	C, D
3	Amended FIF attribution rules to allow more generous exemption so that all temporary residents exempt, regardless of length of visa.	B, C, D
4	Removal of 10% interest withholding tax for individuals paying interest (including home mortgage interest) to a non-resident financial institution.	B, C, D

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5	Exemption from Australian tax on employee share/option gains solely in respect of services outside Australia. Apportionment of employee share/option gains granted partly in respect of services outside Australia.	C, D

2.2 Measures affecting departing residents (potentially including departing temporary residents)

	Measure	**Announced**
1	Proposal to include the value of share discounts under an employee share scheme in the year an individual ceases residency.	A
2	Individuals ceasing residency and electing out of the deemed disposal rules to provide security for deferred capital gains liability.	A

2.3 Other measures

	Measure	**Announced**
1	Introduction of a final withholding tax at company rate on non-residents' Australian source salary and wage income	A
2	Consider addressing the double taxation of employee share options through bilateral tax treaty negotiations	A

(A) Ralph Review of Business Taxation ("RBT") – September 1999
(B) Treasurer Press Release No.82 "Taxation of Expatriates" 15/10/01
(C) Taxation Laws Amendment Bill No 4 ("TLAB 4") Schedule 3, 30/5/02
(D) Taxation Laws Amendment Bill No 7 ("TLAB 7")

3 Options for Consultation

Chapter 5 of the consultation paper identifies a number of Options for Consultation in regard to various aspects of the taxation of foreign expatriates. These are as follows:

- CGT treatment of departing residents;
- Removing double taxation on employee share options;
- Division 13A treatment of departing residents; and
- Providing administrative support for foreign expatriates and their employers.

Each of these Options for Consultation will be discussed in detail below.

The consultation paper also highlights some of the recent key reforms and proposals in other tax areas, including:

- Foreign source investment exemption;
- Treatment of foreign workdays;
- Amendment of FIF rules; and
- Superannuation arrangements for temporary residents.

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Where appropriate, we provide some brief comments on these issues.

3.1 CGT treatment of departing residents

Option 5.1 for consultation: to consider whether to proceed with the Review of Business Taxation recommendation that residents departing Australia provide security for deferred CGT liability.

3.1.1 Existing law

Currently, upon ceasing Australian tax residence, an individual is deemed to have disposed of all assets then held for their market value as at that date. Certain assets are excluded from this rule, including:

- Assets acquired (or deemed to be acquired) before 20 September 1985;
- Assets having the 'necessary connection with Australia' e.g. property situated in Australia; and
- Assets held upon commencing Australian tax residence, or acquired by inheritance, provided that the individual was not a tax resident of Australia for more than 5 years in the last 10 years prior to ceasing tax residence.

Individuals may, however, elect to treat all assets otherwise deemed to be disposed of as assets having the necessary connection with Australia. The effect of this election is that no gain/ loss is recognised upon ceasing tax residence, but rather the *entire* actual gain/ loss is reported and taxed in Australia upon the ultimate disposal of the asset. If appropriate, the election should be made in the tax year that the individual ceases Australian tax residence.

3.1.2 Problems with existing law

<u>Where the deemed disposal rules operate</u>

The current deemed disposal rules present a number of problems for departing residents, especially those who have been in Australia for more than 5 years. These include:

- Cash flow problems due to having to pay tax on an unrealised gain;
- Paying tax on a gain which may *never* ultimately be realised (where the asset's value decreases after the individual ceases residence);
- Double taxation on the same gain (where the foreign jurisdiction does not provide credit for the Australian tax paid on the deemed disposal when the asset is ultimately disposed);
- Artificially inflated gains on foreign assets due to temporary fluctuations in exchange rates; and
- Market valuation problems associated with non-liquid assets.

<u>Where the election to avoid deemed disposal is made</u>

Whilst the availability of an election to avoid the deemed disposal rules alleviates many of the problems outlined above, it creates its own set of issues, including:

- The *entire* gain becomes subject to Australian tax, including that portion of the gain that accrued after the individual ceases Australian tax residence, generally without the possibility of foreign tax credit relief;
- An additional Australian compliance burden for the individual; and
- Practical difficulties experienced by the Australian Taxation Office ("ATO") in enforcing the reporting of the gain due to jurisdictional issues following the individual's permanent departure from Australia. It is this problem in particular that led to the RBT recommendation for a security to be provided where the CGT liability is deferred.

3.1.3 Suggested solution/s

It is submitted that the RBT recommendation should be set aside due to the practical and logistical problems associated with selection and valuation of an appropriate security. In addition, this approach does not resolve the problems associated with double taxation of the gain realised upon the ultimate disposal of the asset. We believe that it is this potential double tax impact that should become the focus of any future tax reforms in this area.

Measures to remove this double tax impact were included in the recently negotiated Protocol to the US/ Australia Double Tax Agreement, via detailed rules on the allocation of taxing rights in respect of capital gains. Under the Protocol, US citizens who elect to defer Australian capital gains will, if they ultimately sell the assets after returning to the US, pay tax on the entire gain only in the US. If the gain is realised when the individual is resident in a third country, he/ she will have to pay Australian CGT, but US domestic law provides a mechanism for allowing a credit for the Australian tax in such circumstances.

Where the individual chooses to recognise the deemed disposal at the time of departing Australia, this deemed disposal can be recognised for US tax purposes. In this case, the individual will be considered to have sold and immediately re-acquired the asset for US tax purposes at its market value at that time. This measure ensures the availability of a foreign tax credit for Australian tax paid on the deemed disposal.

It is submitted that such measures provide an equitable result in a practical manner and should be mirrored in the negotiation of similar bilateral agreements.

3.1.4 Priority

High. Problems associated with the current CGT legislation for departing residents are a direct disincentive to the attraction and retention of foreign expatriates.

3.2 Double taxation of employee share options

Option 5.2 for consultation: *to consider addressing the double taxation of employee share options through bilateral tax treaty negotiations and possible consequential changes to Australia's domestic tax law treatment.*

3.2.1 Existing law

The taxation of employee share options in Australia is complicated and largely depends upon whether the options are "qualifying" or "non-qualifying". The discount inherent in a grant of non-qualifying options is subject to tax in the year of grant. Where a qualifying grant is made, the discount is taxable at "cessation" time, unless the taxpayer makes an election to be taxed at grant. "Cessation" time is defined as the <u>earliest</u> of the following events:

a) Exercise of unrestricted options;
b) All restrictions/ conditions ceasing to have effect on restricted options;
c) Disposal of the options (other than by exercise);
d) Ceasing of employment; or
e) 10 years from the date of grant.

Any further gain on the disposal of the underlying share i.e. between "cessation" and disposal or between grant and disposal is generally subject to CGT.

3.2.2 Problems with existing law

Problems arise where foreign expatriates are granted employee share options which relate to service in more than one country. Such grants may become subject to double taxation due to the different approaches to taxing the discount or profit element arising from employee share options. This includes differences in the sourcing, valuation/calculation of taxable amount and timing of derivation of the gain.

To illustrate this point, consider an example where a US expatriate, on assignment in Australia, exercises employee share options (and sells the underlying shares) granted prior to his/her arrival in Australia. For US tax purposes, the stock option gain will generally be sourced to the US based on the proportion of US workdays relative to the total workdays during the period from grant to exercise or vesting. However, for Australian tax purposes, the gain will be computed based on the increase in market value since commencement of Australian tax residence.

Further complications arise where the gain is subject to tax at different points in time. As an example, countries may seek to tax the employee share option gain at any one (or a combination) of the following events:

- Grant of the options;
- Vesting of the options;
- Exercise of the options;
- Disposal of the underlying shares;
- Departure from country; or
- In the case of Australia – a cessation time event.

3.2.3 Suggested solution/s

We support the proposal outlined in the consultation paper that it may be most appropriate to deal with this problem on a country-by-country basis via bilateral tax treaty negotiations. However, these

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negotiations need to be coupled with domestic tax law changes that provide more certainty around the sourcing of employee share option gains.

3.2.4 Priority

High. Employee stock options are an increasingly significant component of foreign expatriate compensation packages. Globally mobile employees encounter significant difficulty funding their retirement due to the lack of recognition between countries of genuine foreign retirement saving plans and accordingly many of these employees seek to build their wealth via employee stock options.

3.3RBT recommendation re residency cessation as ESAS cessation event

Option 5.3 for consultation: *to consider whether to proceed with the Review of Business Taxation recommendation to treat ceasing to be an Australian resident as a cessation event for the purposes of Division 13A.*

It is submitted that the RBT recommendation should be set aside as it will create a number of difficulties, similar to those currently being experienced under the CGT regime for departing residents. These include:

- Cash flow problems due to having to pay tax where there is no corresponding income-generating event. Whilst we recognise that this may also potentially arise for other "cessation" times e.g. exercise of the option, cessation of employment, etc. the individual generally retains an element of control over the income flow in most of these situations;
- Paying tax on a gain which may never ultimately be realised (where the employee share options go out of the money and are never exercised);
- Double taxation on the same gain (where the foreign jurisdiction does not provide credit for the Australian tax paid); and
- Artificially inflated gains on foreign employee share options due to temporary fluctuations in exchange rates.

It is interesting to note that Singapore has recently implemented similar provisions. It may be advisable to wait and see how effectively Singapore is able to enforce such provisions before seeking to legislate similar proposals.

3.4 Specialist ATO group

Option 5.4 for consultation: *to consider the Australian Taxation Office establishing a specialist cell to work with employers to deal with the tax administration concerns of foreign expatriate employees.*

We support and encourage the establishment of a specialist cell within the Australian Taxation Office to deal with the often-complicated tax issues faced by foreign expatriates and their employers. Such a cell should be familiar with common issues/concerns, such as:

- Determination of tax residence status;
- Taxation of foreign income, including FIFs and Foreign Life Assurance Policies ("FLPs");
- Superannuation requirements and exemptions;
- Operation of Double Tax Agreements;

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- Taxation of employee share options;
- Operation of the CGT regime, in particular, the deemed acquisition and disposal provisions; and
- Compliance with related taxes e.g. PAYG, FBT, Pay-Roll tax, Work Cover etc.

3.5 Superannuation Arrangements for Temporary Residents

"SDC agreements ensure that Australian working temporarily overseas or non-residents working temporarily in Australia contribute to one pension or superannuation scheme if contributory social security schemes operate in their home country. They make the cost of doing business in Australia cheaper. SDC agreements also reduce the costs to Australian employers who send employee to work in countries that have agreements with Australia." (page 77)

Whilst we welcome the intention to prevent the double coverage of superannuation/ pension/ social security benefits for temporary assignees, it should be recognised that the current SDC agreements do not provide adequate protection for Australians undertaking temporary assignments offshore.

This is because the SDC agreements only provide dual coverage relief in circumstances where such contributions are mandatory in *both* jurisdictions. As such, relief would only be available for Australian expatriates who remain subject to the Superannuation Guarantee requirements. This is generally limited to those expatriates who remain Australian tax residents for the duration of their overseas assignments. As a general rule, expatriates will only retain their Australian tax status where the assignment period is for 2 years or less.

As such, in order to achieve the stated objective of the SDC agreement, it is submitted that the agreements be extended in order to include circumstances where voluntary Australian superannuation contributions of an equivalent level are maintained during the assignment period.

"In addition, the Government has announced that it is prepared to negotiate reciprocal arrangements with other governments to allow non-residents to transfer superannuation monies to a pension fund in their home country, provided the country has corresponding preservation arrangements." (page 78)

Whilst we support and welcome this measure, we submit that any such transfer arrangements should maintain the integrity of the fund balance accumulated whilst on temporary assignment in Australia i.e. the current 30% withholding tax should not be applied to inter-fund transfers.

3.6 Foreign workdays

The operation of the section 23AG exemption for foreign earnings is discussed on pages 74-75 of the consultation paper.

We believe that the Government should consider revising the operation of the section 23AG exemption such that it also provides relief from Australian tax for expatriates working in Australia with regional responsibilities.

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

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relative to other countries in the region, a taxpayer's total tax burden is typically limited to their Australian rate of tax.

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

* * * * *

We would of course be pleased to discuss any aspects of our detailed submissions with the Secretariat, the Treasury or the Australian Taxation Office. In such event, please do not hesitate to contact Peter McCullough (on (02) 9322 7420), Larry Gafinowitz (on (02) 9322 5841) or Paul Glover (on (02) 9322 7315).

Yours sincerely
DELOITTE TOUCHE TOHMATSU LTD