SUBMISSION TO REVIEW OF INTERNATIONAL TAXATION ARRANGEMENTS

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The following Submission is confined to the following Options for Consultation listed in *Review Of International Taxation Arrangements*, *A Consultation Paper, Commonwealth Department Of Treasury,* Canberra, August, 2002 ('The Treasury Consultation Paper'):

Option 2.1

Option 3.4

Option 3.9

SUBMISSION IN RELATION TO OPTION 2.1

SUMMARY

None of the alternatives discussed in the Treasury Consultation Paper in relation to this option will be adequate to prevent the further migration of Australian resident companies with significant offshore direct investment income. None of the proposals adequately removes the bias at the underlying resident shareholder level against investing in a resident company with significant offshore income. The following submission discusses: (i) how capital import neutrality could be achieved at the natural person shareholder level while retaining the s23AJ (in an expanded form) and s23AH exemptions and the existing foreign tax credit system that applies to corporate income not within the s23AJ and s23AH exemptions; and (ii) how capital export neutrality could be achieved at the natural person shareholder level under the same conditions.

The submission develops a 'marginal rate exemption' system for allowing the s23AJ and s23AH exemptions and foreign tax credits to pass through to natural person shareholders. This approach will produce capital export neutrality at the natural person shareholder level except where the foreign taxes paid on the foreign source income are more than the Australian tax that would be payable at the natural person shareholder's marginal rate on that income. In that situation the marginal rate exemption system developed in this submission allows an exemption equal to the foreign income less foreign tax actually paid. In the absence of this limitation the presence of excess exemptions combined with the full refundability of imputation credits would mean that, in effect, Australia would be refunding foreign tax paid. In any event revenue and integrity considerations would mean that excess exemptions should neither be deductible nor converted into a credit and

refunded. If excess exemptions are prevented from arising the marginal rate exemption approach should mean that capital export neutrality is produced at the shareholder level in all cases except where the foreign taxes on the foreign income exceed what would be the Australian tax on the natural person shareholder's marginal rate on that income. In that situation the marginal rate exemption approach with a non-deductible, non-refundable exemption will produce capital import neutrality at the natural person shareholder level.

The submission then considers how the proposed marginal rate exemption system would apply in situations where the foreign tax credit system has applied to the foreign source income of an Australian company which redistributes it as a dividend to resident shareholders. Under the proposal the total foreign taxes paid, even when in excess of Australian tax at the corporate rate, would be taken into account in determining the portion of the redistribution that would be exempt at the underlying shareholder level. Again, where total foreign taxes exceeded Australian tax otherwise payable at the underlying shareholder's marginal rate on that income the exemption would be limited to the foreign income less the foreign tax actually paid. In situations where the foreign tax was less than the Australian tax payable by the company on the foreign income, Australian tax payable because of the foreign tax credit system would be treated as if it were a payment of foreign tax. This would mean that the payment of Australian tax would not generate a franking credit but would be taken into account in determining the portion of the redistribution that was exempt to the underlying shareholder. Once again this treatment produces capital export neutrality at the underlying resident shareholder level in all cases except where the total foreign taxes on the foreign income exceed what would be the Australian tax at the underlying resident shareholder's marginal rate on that income. In that situation, as noted above, the marginal rate exemption system will produce capital import neutrality at the underlying shareholder level. In the case of portfolio dividends received by an Australian company and redistributed to shareholders foreign underlying tax would not be taken into account in calculating the exempt portion of the dividend on redistribution. This treatment does not produce capital export neutrality at the underlying shareholder level. However, unlike the current treatment, it does produce neutrality between a natural person resident who invests in an Australian company which receives foreign source portfolio dividends and a natural person resident who receives foreign source portfolio dividends directly.

The submission identifies additional compliance costs likely to be associated with the adoption of the marginal rate exemption system and compares these with the alternative of allowing a non-refundable indirect foreign tax credit at the underlying resident shareholder level. The conclusion of this analysis is that the marginal rate exemption approach would involve additional compliance costs at the Australian non-portfolio corporate investor level. However, these are likely to be less than and be more manageable than the additional compliance costs at the underlying resident shareholder level associated with extending a non-refundable indirect foreign tax credit to those shareholders. If, as discussed in the submission in relation to Option 3.9, the s23AJ exemption were extended to cover all non-portfolio (and possibly portfolio) dividends

received by Australian companies where the CFC and FIF rules were not applicable, there would be an offsetting saving in compliance costs.

As an alternative to the marginal rate exemption system the submission then develops a limited exemption system which, for natural persons, limits the exemption by reference to the top marginal rate plus Medicare levy. This approach would be likely to have lower compliance and revenue costs than the marginal rate exemption system but would only produce capital export neutrality for natural person resident shareholders on the top marginal rate. For natural person resident shareholders on marginal rates lower than the top marginal rate this approach would produce a result between capital export neutrality and capital import neutrality.

Where dividends were paid to other resident companies the exemption would be limited by reference to the corporate rate and would equal the foreign income minus the foreign tax paid. Where dividends were paid to resident superannuation funds the exemption would be limited by reference to the 15% rate applicable to superannuation funds.

It is submitted that the limited exemption approach produces a more acceptable result than allowing s23AJ or s23AH exempt income to be fully exempt on redistribution. Under the limited exemption approach no resident underlying shareholder is in a better position by investing in a resident company that derives exempt foreign source income as compared with investing in a resident company that derives domestic source income. The limited exemption approach would also produce neutrality between a resident natural person shareholder investing in a resident company with foreign portfolio dividend income and one who derives a foreign portfolio dividend directly.

The submission in relation to Option 2.1 is divided into the following sections:

1. Assessing Current Treatment Against Benchmarks

- *1.1 Capital Import Neutrality Benchmark*
  - 1.1.1 Examples 1.1 to 1.3
- *1.2 Capital Export Neutrality Benchmarks*
  - 1.2.1 Examples 2.1.1 to 2.2.3
- *1.3 National Neutrality Benchmarks*
  - 1.3.1 Examples 3.1 to 3.3
- *1.4 Assessing The Current Australian Treatment*

2. How May Capital Import Or Capital Export Neutrality Be Achieved At The Resident Shareholder Level While Retaining The s23AJ Exemption At The Company Level.

- *2.1 Achieving Capital Import Neutrality At The Shareholder Level While Retaining The s23AJ and s23AH Exemptions*
  - 2.1.1 Where s23AJ or s23AH exemptions apply at corporate level

2.1.2 Where underlying FTCs apply at corporate level
2.1.3 Where direct FTCs apply at corporate level
2.1.4 Foreign Tax Paid Tracking Requirements
2.1.5 Ordering Rules
2.1.6 Examples 4.1 to 4.3
2.1.7 Problems with pursuing CIN at underlying shareholder level

2.2 Achieving Capital Export Neutrality At The Shareholder Level While Retaining The s23AJ and s23AH Exemptions

2.2.1 The marginal rate exemption approach
2.2.2 Examples 5.1.1 to 5.2.3
2.2.3 Problems associated with determining the appropriate marginal rate
2.2.4 Implications for the scope of the s23AJ and AH exemptions and for the scope of the CFC and FIF rules
2.2.5 Ordering rules for distributions
2.2.6 Consideration of integrity concerns raised in Treasury Consultation Paper
2.2.7 Comparison with compliance costs associated with extending indirect FTCs to underlying resident shareholders
2.2.8 Application of marginal rate exemption approach where underlying foreign tax credits have applied at the resident corporate level
2.2.9 Application of marginal rate exemption approach where direct foreign tax credits have applied at the resident corporate level
2.2.10 Examples 6.1 to 6.3
2.2.11 Examples 7.1 to 7.3
2.2.12 The limited exemption approach
2.2.13 Example 8.1

1. ASSESSING CURRENT TREATMENT AGAINST BENCHMARKS

This section assesses the current Australian tax treatment of foreign non portfolio dividends received by an Australian resident company and distributed as a dividend to resident shareholders. The analysis extends the examples in Tables 2.7 to 2.11 in the Treasury Consultation Paper.

1.1 Capital Import Neutrality Benchmarks

In these examples a capital import neutrality benchmark can be established by treating the foreign source dividend as if it were derived by the Australian resident natural person

or superannuation fund shareholder via a direct holding in the foreign company. To achieve capital import neutrality no Australian tax should be levied on the dividend as it flows to the Australian resident shareholder. Thus, to achieve a capital import neutrality objective the dividend would be exempt from Australian tax when derived. The result is shown in the following examples.

Where

Y = domestic source taxable income

P= domestic source distributable profits

F= foreign source income before foreign taxes

t = total foreign taxes paid on foreign source income

c = domestic corporate tax rate

m = shareholder's marginal tax rate

s = complying superannaution fund rate

1.1.1 Examples 1.1 To 1.3

Example 1.1

Australian company

Taxable income	$1000	Y
Australian company tax paid	$ 300	Yc
Tax preferred Australian income	$ 40	P-Y
After income	$ 740	Y-Yc + P-Y

Australian 48.5% m rate natural person resident shareholder

Dividend	$740	P-Yc
Franking credit	$300	Yc
Grossed up dividend	$1040	P
Tax @ 48.5%	$504.40	Pm
Less franking credit	$300	Yc
Net Tax	$204.40	Pm -Yc
After tax dividend	$535.60	P– Pm
Exempt foreign source dividend	$ 90	F-t

After tax income	$625.60	P-Pm + F-t

The capital import neutrality benchmark for an Australian resident complying superannuation fund is shown in Example 1.2.

Example 1.2

Australian company

Taxable income	$1000	Y
Australian company tax paid	$ 300	Yc
Tax preferred Australian income	$ 40	P-Y
After income	$ 740	Y-Yc + P-Y

Australian Resident Complying Superannuation Fund Shareholder

Dividend	$740	P-Yc
Franking credit	$300	Yc
Grossed up dividend	$1040	P
Tax @ 15%	$ 156	Ps
Less franking credit	$300	Yc
Impuation refund	$ 144	Yc - Ps
After tax dividend	$884	P - Ps
Exempt foreign source dividend	$ 90	F-t
After tax income	$974	P-Ps + F-t

The capital import neutrality benchmark for an Australian resident 31.5% marginal rate taxpayer is shown in Example 1.3.

Example 1.3

Australian company

Taxable income	$1000	Y
Australian company tax paid	$ 300	Yc
Tax preferred Australian income	$ 40	P-Y
After income	$ 740	Y-Yc + P-Y

Australian 31.5% m rate natural person resident shareholder

Dividend	$740	P-Yc
Franking credit	$300	Yc
Grossed up dividend	$1040	P
Tax @ 31.5%	$ 327.60	Pm
Less franking credit	$300	Yc
Net Tax	$ 27.60	Pm -Yc

After tax dividend	$712.40	P– Pm
Exempt foreign source dividend	$ 90	F-t
After tax income	$802.40	P-Pm + F-t

If the foreign source income is looked at in isolation then for capital import neutrality to be achieved at the Australian resident natural person shareholder level it must pass through to the Australian resident natural person shareholder without any additional Australian tax being levied. Hence if the foreign source dividend were received directly by an Australian resident natural person shareholder who did not receive an additional domestic source dividend the position would be:

Foreign source dividend	$90 F – t
Exempt portion	$90 F - t
Foreign source dividend after Australian taxes	$90 F - t

1.2 Capital Export Neutrality Benchmarks

To establish what the capital export neutrality position is it is necessary to determine what the after tax dividend would be to a shareholder who obtained dividends through an Australian resident company whose income was wholly Australian source. To correctly convert the foreign source dividend into pre-tax Australian corporate income we need to gross up the foreign source dividend for foreign corporate tax assumed to be paid. The corporate tax assumed to be paid can be calculated by multiplying the after tax foreign source income $100 by f/1-f where f is the assumed foreign corporate rate. The following examples assume first a foreign corporate rate of 15% and then a foreign corporate rate of 25%.

1.2.1 Examples 2.1.1 To 2.2.3

Example 2.1.1

Where the foreign corporate rate is 15% a pre tax dividend of $117.65 would produce an after tax dividend of $100. (ie $117.65 x 15% = $17.65). When the dividend withholding tax of $10 is added the total foreign tax on the dividend becomes $27.65 (ie lower than the Australian corporate tax of $35.30 that would be collected on a pre tax corporate income of $117.65 (ie $117.65 x 30% = $35.30). The average rate of foreign tax on the dividend is 23.50% (ie $27.65/$117.65 x 100/1).

Australian company

Taxable income	$1117.65	Y + F
Australian company tax paid	$ 335.30	Yc + Fc
Tax preferred Australian income	$ 40	P-Y

Dividend	$ 822.35	P + F-Yc - Fc

Australian 48.5% m rate natural person resident shareholder

Dividend	$822.35	P + F-Yc - Fc
Franking credit	$335.30	Yc + Fc
Grossed up dividend	$1157.65	P + F
Tax @ 48.5%	$ 561.46	Pm + Fm
Franking credit	$335.30	Yc + Fc
Net tax	$226.16	Pm + Fm – Yc - Fc
After tax dividend	$596.19	P + F – Pm – Fm

(Note that the wash out of domestic corporate tax preferences on a distribution to a natural person resident shareholder has been assumed. This means that neutrality is not produced between a 48.5% marginal rate taxpayer who earns an addition $1117.65 of income and $40 of tax preferred income and one who derives a dividend from an Australian resident company as shown above.)

If the foreign source dividend were received directly by an Australian resident natural person shareholder who did not receive an additional domestic source dividend capital export neutrality would be achieved by allowing the natural person shareholder a foreign tax credit for both the foreign underlying taxes and the foreign withholding taxes.[1]

Foreign income before foreign taxes	$117.65	F
Foreign taxes	$ 27.65	t
Dividend after foreign taxes	$ 90	F - t
Gross up for foreign taxes	$ 27.65	t
Grossed up dividend	$117.65	F
Tax @ 48.5%	$ 57.06	Fm
FTC	$ 27.65	t
Net tax	$ 29.41	Fm – t
After tax dividend	$ 60.59	F- Fm

Example 2.1.2

Australian company

Taxable income	$1117.65	Y + F
Australian company tax paid	$ 335.30	Yc + Fc
Tax preferred Australian income	$ 40	P-Y

[1] It should be noted that this treatment is simply used here to establish what a capital export neutrality benchmark is. Difficulties associated with establishing the amount of foreign tax paid usually mean that countries do not extend credits for underlying foreign tax to resident portfolio shareholders.

Dividend	$ 822.35	P + F-Yc - Fc

Australian Resident Complying Superannuation Fund Shareholder

Dividend	$822.35	P + F-Yc - Fc
Franking credit	$335.30	Yc + Fc
Grossed up dividend	$1157.65	P + F
Tax @ 15%	$ 173.65	Ps + Fs
Franking credit	$335.30	Yc + Fc
Imputation refund	$ 161.65	Yc + Fc – Ps - Fs
After tax dividend	$984	P + F – Ps - Fs

Example 2.1.3

Australian company

Taxable income	$1117.65	Y + F
Australian company tax paid	$ 335.30	Yc + Fc
Tax preferred Australian income	$ 40	P-Y
Dividend	$ 822.35	P + F-Yc - Fc

Australian 31.5% m rate natural person resident shareholder

Dividend	$822.35	P + F-Yc - Fc
Franking credit	$335.30	Yc + Fc
Grossed up dividend	$1157.65	P + F
Tax @ 31.5%	$ 364.66	Pm + Fm
Franking credit	$335.30	Yc + Fc
Net tax	$ 29.36	Pm + Fm – Yc - Fc
After tax dividend	$792.99	P + F – Pm – Fm

Example 2.2.1

Where the foreign corporate rate is 25% a pre tax dividend of $133.33 would produce an after tax dividend of $100. (ie $133.33 x 25% = $33.33). When the dividend withholding tax of $10 is added the total foreign tax on the dividend becomes $43.33 (ie higher than the Australian corporate tax of $40 that would be collected on a pre tax corporate income of $133.33 (ie $133.33 x 30% = $40). The average rate of foreign tax on the dividend is 32.50% (ie $43.33/$133.33 x 100/1).

Australian Company

Taxable income	$1133.33	Y + F
Australian company tax paid	$ 339	Yc + Fc

Tax preferred Australian income	$ 40	P-Y
Dividend	$ 834.33	P + F – Yc - Fc

Australian 48.5% m rate natural person resident shareholder

Dividend	$834.33	P + F – Yc - Fc
Franking credit	$339	Yc + Fc
Grossed up dividend	$1173.33	P + F
Tax @ 48.5%	$ 569.07	Pm + Fm
Franking credit	$ 339	Yc + Fc
Net tax	$ 230.07	Pm + Fm – Yc - Fc
After tax dividend	$ 604.26	P + F – Pm - Fm

Example 2.2.2

Australian Company

Taxable income	$1133.33	Y + F
Australian company tax paid	$ 339	Yc + Fc
Tax preferred Australian income	$ 40	P-Y
Dividend	$ 834.33	P + F – Yc - Fc

Australian Resident Complying Superannuation Fund Shareholder

Dividend	$834.33	P + F – Yc - Fc
Franking credit	$339	Yc + Fc
Grossed up dividend	$1173.33	P + F
Tax @ 15%	$ 569.07	Ps + Fs
Franking credit	$ 339	Yc + Fc
Imputation refund	$ 230.07	Yc + Fc – Ps - Fs
After tax dividend	$ 1064.40	P + F – Ps - Fs

Example 2.2.3

Australian Company

Taxable income	$1133.33	Y + F
Australian company tax paid	$ 339	Yc + Fc
Tax preferred Australian income	$ 40	P-Y
Dividend	$ 834.33	P + F – Yc - Fc

Australian 31.5% m rate natural person resident shareholder

Dividend	$834.33	P + F – Yc - Fc
Franking credit	$339	Yc + Fc
Grossed up dividend	$1173.33	P + F

Tax @ 31.5%	$ 369.50	Pm + Fm
Franking credit	$ 339	Yc + Fc
Net tax	$ 30.50	Pm + Fm – Yc - Fc
After tax dividend	$ 803.83	P + F – Pm - Fm

1.3 National Neutrality Benchmarks

To achieve National Neutrality foreign tax paid should be treated as a deduction. A benchmark for National Neutrality can therefore be established by treating the foreign source dividend as if it were derived by the Australian resident natural person or superannuation fund shareholder via a direct holding in the foreign company. The foreign taxes paid on the foreign source dividend would be deductible but would not be creditable for Australian tax purposes. No part of the foreign source dividend would be exempt from Australian tax.

1.3.1 Examples 3.1 to 3.3

Example 3.1

Australian company

Taxable income	$1000	Y
Australian company tax paid	$ 300	Yc
Tax preferred Australian income	$ 40	P-Y
After tax dividend	$ 740	Y-Yc + P-Y

Australian 48.5% m rate natural person resident shareholder

Foreign income after payment of foreign taxes	$90	F-t
Dividend	$740	Y – Yc + P –Y
Franking credit	$300	Yc
Grossed up dividend	$1040	Y + P - Y
Taxable income	$1130	Y + P – Y + F - t
Tax @ 48.5%	$548.05	Ym + Pm – Ym + Fm - tm
Franking credit	$300	Yc
Net tax	$248.05	Ym + Pm –Ym + Fm –tm - Yc
After tax dividend	$581.95	F-t + Y–Yc+P–Y–Pm–Fm+tm

Example 3.2

Australian company

Taxable income	$1000	Y
Australian company tax paid	$ 300	Yc
Tax preferred Australian income	$ 40	P-Y

After tax dividend	$ 740	Y-Yc + P-Y

Australian Resident Complying Superannuation Fund Shareholder

Foreign income after payment of foreign taxes	$90	F-t
Dividend	$740	Y – Yc + P –Y
Franking credit	$300	Yc
Grossed up dividend	$1040	Y + P - Y
Taxable income	$1130	Y + P – Y + F - t
Tax @ 15%	$169.50	Ys + Ps – Ys + Fs - ts
Franking credit	$300	Yc
Imputation refund	$130.50	Yc – Ps – Fs + ts
After tax dividend	$960.50	P – Ps – Fs + ts + F - t

Example 3.3

Australian company

Taxable income	$1000	Y
Australian company tax paid	$ 300	Yc
Tax preferred Australian income	$ 40	P-Y
After tax dividend	$ 740	Y-Yc + P-Y

Australian 31.5% m rate natural person resident shareholder

Foreign income after payment of foreign taxes	$90	F-t
Dividend	$740	Y – Yc + P –Y
Franking credit	$300	Yc
Grossed up dividend	$1040	Y + P - Y
Taxable income	$1130	Y + P – Y + F - t
Tax @ 31.5%	$ 355.95	Ym + Pm – Ym + Fm - tm
Franking credit	$300	Yc
Net tax	$ 55.95	Ym + Pm –Ym + Fm –tm - Yc
After tax dividend	$774.05	F-t + Y–Yc+P–Y–Pm–Fm+tm

1.4 Assessing The Current Australian Treatment

When the position of the Australian company in *Examples 1.1* to *1.3* is compared with *Table 2.7* in the Treasury Consultation Paper it can be seen that at the corporate level, where the ITAA36 s23AJ exemption is applicable, the current Australian approach produces capital import neutrality. This is simply because the foreign source non portfolio dividend was exempt from Australian corporate tax. When *Examples 3.1* to *3.3* are compared with *Tables 2.11, 2.9 and 2.10* respectively in the Treasury Consultation Paper it can be seen that at the 48.5% marginal rate natural person resident shareholder level, at the resident complying superannuation fund shareholder level, and at the 31.5% marginal rate shareholder level the current Australian approach produces national

neutrality. This is because the failure to allow either a foreign tax credit or an imputation credit for the payment of foreign tax combined with wash out of corporate preference income when distributed to residents in effect converts the exemption of foreign source non portfolio dividends at the corporate level to a deduction for foreign tax on those dividends at the shareholder level. The James Hardie restructuring shows that this bias at the shareholder level against foreign source corporate income can be enough to cause Australian companies to relocate offshore.

2. HOW MAY CAPITAL IMPORT OR CAPITAL EXPORT NEUTRALITY BE ACHIEVED AT THE RESIDENT SHAREHOLDER LEVEL WHILE RETAINING THE s23AJ AND 23 AH EXEMPTIONS AT THE COMPANY LEVEL

At various points in the Treasury Consultation Paper a clear preference is shown for retaining (albeit in a possibly amended form) the s23AJ non portfolio dividend exemption because of the reduced compliance costs that it brings to Australian companies. The question becomes, if a policy of capital import neutrality is retained for corporate non-portfolio shareholders, how can the after tax position of resident Australian shareholders in Australian companies with exempt foreign dividend income be improved so that it moves closer to capital export neutrality or capital import neutrality.

2.1 Achieving Capital Import Neutrality At The Shareholder Level While Retaining The s23AJ And 23AH Exemptions

2.1.1 Where s23AJ or s23AH exemptions apply at corporate level

Capital import neutrality can be achieved at the natural person resident shareholder level while retaining the s23AJ exemption if the portion of the dividend received by the natural person shareholder that represents a distribution sourced in the s23AJ exempt income is exempt to the natural person shareholder. To achieve this it would be necessary for resident companies to maintain an account that tracked income that had benefited from the s23AJ exemption.

Similarly capital import neutrality at the natural person resident shareholder level is achieved if the portion of the dividend received that represents a distribution sourced in corporate income that has benefited from the s23AH exemption for foreign branch profits is exempt to the natural person shareholder.

2.1.2 Where underlying FTCs apply at the corporate level

Consideration also needs to be given to the situation where the foreign tax credit system has applied to the foreign source income of the Australian corporate non-portfolio shareholder. Capital import neutrality can be achieved at the underlying Australian shareholder level where the Australian resident corporate non-portfolio shareholder has received a direct and indirect foreign tax credit on foreign source dividends and in relation to branch profits, interest and royalty income that have been subject to a direct

foreign tax credit. In these cases where the total foreign taxes paid are equal to or greater than the Australian corporate tax payable on the dividend grossed up for the foreign withholding tax capital import neutrality is achieved at the underlying resident shareholder level if a redistribution of the dividend is tax exempt to the underlying shareholder. Under this approach excess foreign tax credits would remain quarantined in baskets at the company level. Where the total foreign taxes paid on the foreign source income is less than the Australian corporate tax on the foreign source income grossed up for the foreign taxes, additional adjustments would be necessary to achieve capital import neutrality at the natural person shareholder level. Refunding tax payable under the foreign tax credit system would be inconsistent with the rationale behind the basket system of foreign tax credit limitation. Inappropriate results would also arise if the redistributed dividend were tax exempt to the underlying shareholder if the payment of Australian corporate tax on receipt of the foreign source dividend generated franking credits. As franking credits are currently refundable for most taxpayers the combined effect of the exemption and the refundable franking credit could effectively be to refund some of the additional tax payable under the foreign tax credit system. The point may be illustrated as follows:

Foreign income	$100	F
Foreign tax	$ 25	t
Dividend	$ 75	F – t

Australian company (non-portfolio shareholder)

Dividend	$75	F-t
Gross up	$25	t
Grossed up dividend	$100	F
Australian corporate tax	$ 30	Fc
FTC	$ 25	t
Net Australian tax	$ 5	Fc – t generates fr cr of $5
After tax dividend	$70	F - Fc

Australian resident 40% m rate natural person shareholder

Dividend	$70	F - Fc
Exempt	$70	F- Fc
Franking credit	$ 5	Fc - t
Grossed up dividend	$ 5	Fc – t
Tax @ 40%	$ 2	Fcm – tm
Refund of excess credit	$ 3	Fc – t – Fcm + tm

A more acceptable result would be produced in the payment of additional corporate tax consequent on the operation of the foreign tax credit system were added back in determining the exempt amount of the redistribution and did not generate a franking credit. If excess exemptions were neither refundable nor able to be carried forward no

direct refund of foreign tax arising through the operation of the foreign tax credit system would occur. This operation of this approach may be illustrated as follows:

Foreign income	\$100	F
Foreign tax	\$ 25	t
Dividend	\$ 75	F – t

Australian company (non-portfolio shareholder)

Dividend	\$75	F-t
Gross up	\$25	t
Grossed up dividend	\$100	F
Domestic source income	\$100	Y
Taxable income	\$200	F + Y
Australian corporate tax on F	\$ 30	Fc
FTC	\$ 25	t
Net Australian tax on F	\$ 5	Fc – t
Australian corporate tax on Y	\$ 30	Yc generates fr cr of \$30
Total Australian tax	\$ 35	Yc + Fc - t
After tax income	\$140	F – Fc + Y - Yc

Australian resident 40% m rate natural person shareholder

Dividend	\$140	F – Fc + Y - Yc
Exempt	\$75	F- t
Taxable	\$65	Y- Yc – Fc + t
Franking credit	\$30	Yc
Grossed up dividend	\$95	Y – Fc + t
Tax @ 40%	\$38	Ym – Fcm + tm
Imputation credit	\$30	Yc
Net tax	\$ 8	Ym – Fcm + tm – Yc
After tax dividend	\$132	Y – Ym + F – Fc + Fcm – tm

Total Australian corporate and shareholder tax \$43

If a comparison is made with direct derivation of the foreign source dividend by a 40% m rate shareholder (assuming that foreign source portfolio dividends were exempt) it can be seen that the above treatment falls short of CIN. The difference represents the amount that would have been refundable if the foreign tax paid by the Australian company had generated franking credits and if the foreign source dividend (after net Australian tax of \$5) had been exempt on redistribution to the natural person shareholder.

Foreign source dividend	\$75	F-t
Domestic source dividend	\$70	Y-Yc
Franking credit	\$30	Yc

Grossed up dividend	\$100	Y
Tax @ 40%	\$40	Ym
Imputation credit	\$30	Yc
Net tax	\$10	Ym-Yc
After tax income	\$135	Y-Ym + F- t

Total Australian corporate and shareholder tax \$40

That is the excess Australian tax payable over the CIN position \$3 = Fc + Fcm – tm - t

Alternatively if the foreign source dividend net of Australian tax of \$5 is exempt and the \$5 payment of Australian tax does not generate a franking credit the result is as follows:

Australian resident 40% m rate natural person shareholder

Foreign source dividend	\$70	F- Fc
Domestic source dividend	\$70	Y-Yc
Franking credit	\$30	Yc
Grossed up dividend	\$100	Y
Tax @ 40%	\$40	Ym
Imputation credit	\$30	Yc
Net tax	\$10	Ym - Yc
After tax dividend	\$130	F – Fc + Y - Ym

Total Australian corporate and shareholder tax \$45. This treatment produces a result that is \$5 or Fc – t short of capital import neutrality.

2.1.3 Where direct FTCs apply at the corporate level

Consideration also needs to be given to the situation where an Australian corporate shareholder is only entitled to a direct foreign tax credit for dividends received (for example in the case of portfolio dividends). Here the failure to credit underlying foreign taxes means that under the current underlying foreign taxes are effectively treated as deductions and the treatment of the Australian corporate shareholder moves towards national neutrality. Limitations on the availability of the indirect foreign tax credit are primarily due to the inability of portfolio shareholders to obtain adequate information about underlying foreign taxes paid. The position of the corporate shareholder could at least be largely preserved at the underlying shareholder level by treating a distribution sourced in foreign source income that has been subject to a direct foreign tax credit as exempt on redistribution. For reasons stated above Australian tax payable as a result of the operation of the foreign tax credit system should be treated as a payment of foreign tax for these purposes. This means that it should not generate a franking credit but would be taken into account in determining the portion of the dividend that was exempt on redistribution.

2.1.4 Foreign Tax Paid Tracking Requirements

With one exception a company's existing FDA account tracks the precise items that need to be identified if the treatment of foreign source dividends at the Australian corporate level is to be permitted to pass through to natural person shareholders using the approaches discussed above. The exception is that payments of Australian tax as a consequence of the foreign tax credit system, adjusted to reflect the keeping of the FDA account on an income minus tax paid basis, would also need to be credits in the account rather than in the franking account as is the case at present. If the treatment of foreign source income at the corporate level were to be allowed to pass through to natural person shareholders using the approaches discussed above track would need to be kept of all after tax foreign source corporate income. This would be consistent with recommendations by the Review of Business Taxation that the FDA account be changed to a Foreign Income Account (FYA). Hence the imposition of a requirement that income benefiting from s23AH, s23AJ and FTCs for foreign source dividends be tracked should not impose significant additional compliance burdens on Australian resident companies.

2.1.5 Ordering Rules

Characterising a distribution as being sourced in part in exempt foreign source income would require a different Ordering rule to that presently used in the Australian dividend imputation system. The effect of the benchmark franking rule is that a company can frank a dividend to a level which means that, in effect, the entire distribution is regarded as being sourced in taxed income. If exempt foreign income is to be permitted to pass through to underlying shareholders then a more appropriate franking rule would be to pro rate the franking credits between distributed and undistributed profits. Under this approach the amount to which a dividend should be franked would be determined using the following formula: FD/P where F is the balance in the company's franking account at the time the dividend is paid, D is the amount of the dividend, and P is the distributable profits of the company at the time the dividend is paid. A similar formula could be applied to determine the extent to which a dividend was regarded as being sourced in a company's exempt foreign source income. The appropriate formula would be ED/P where E is the balance in the company's (converted to reflect foreign income minus foreign tax paid – check what FDA account tracks in its current form – would need a FY account anyway) FDA account at the time the dividend is paid. D is the amount of the dividend, and P is the distributable profits of the company at the time the dividend is paid.

2.1.6 Examples 4.1 to 4.3

The following Examples demonstrate that this treatment produces capital import neutrality at the natural person shareholder level.

Example 4.1

Australian company

Taxable income	$1000	Y
Australian company tax paid	$ 300	Yc
Tax preferred Australian income	$ 40	P-Y
After tax income	$ 740	P - Yc
Exempt foreign dividend	$ 90	F-t
Distributable profit	$830	P-Yc +F- t

Australian 48.5% m rate natural person resident shareholder

Dividend	$830	P-Yc + F-t
Exempt portion	$ 90	F- t
Taxable portion	$740	P - Yc
Franking credit	$300	Yc
Grossed up dividend	$1040	P
Tax @ 48.5%	$504.40	Pm
Less franking credit	$300	Yc
Net Tax	$204.40	Pm -Yc
After tax income	$625.60	P-Pm + F-t

Under the current system the after tax income of a 48.5% marginal rate shareholder would be $582. Under option A in the Treasury Consultation Paper the after tax income of the a 48.5% marginal rate shareholder would be $587.10. Under option B in the Treasury Consultation Paper the after tax income of a 48.5% marginal rate shareholder would also be $587.10.

Example 4.2

Australian company

Taxable income	$1000	Y
Australian company tax paid	$ 300	Yc
Tax preferred Australian income	$ 40	P-Y
After tax income	$ 740	P - Yc
Exempt foreign dividend	$ 90	F-t
Distributable profit	$830	P-Yc +F- t

Australian Resident Complying Superannuation Fund Shareholder

Dividend	$830	P-Yc + F-t
Exempt portion	$ 90	F- t
Taxable portion	$740	P - Yc
Franking credit	$300	Yc
Grossed up dividend	$1040	P
Tax @ 15%	$ 156	Ps

Less franking credit	$300	Yc
Imputation refund	$144	Yc - Ps
After tax income	$974	P + F-t - Ps

Under the current system the after tax dividend to a complying superannuation fund would be $960.50. Under Options A and B in the Treasury Consultation Paper the after tax dividend to a complying superannuation fund would be $969.

Example 4.3

Australian company

Taxable income	$1000	Y
Australian company tax paid	$ 300	Yc
Tax preferred Australian income	$ 40	P-Y
After tax income	$ 740	P - Yc
Exempt foreign dividend	$ 90	F-t
Distributable profit	$830	P-Yc +F- t

Australian Resident 31.5% Marginal Rate Shareholder

Dividend	$830	P-Yc + F-t
Exempt portion	$ 90	F- t
Taxable portion	$740	P - Yc
Franking credit	$300	Yc
Grossed up dividend	$1040	P
Tax @ 31.5%	$ 327.60	Pm
Less franking credit	$300	Yc
Imputation refund	$ 27.60	Yc - Pm
After tax income	$802.40	P + F-t - Pm

Under the current system the after tax dividend to a 31.5% marginal rate taxpayer would be $774.10 Under Options A and B in the Treasury Consultation Paper the after tax dividend to a complying superannuation fund would be $780.90

2.1.7 Problems with pursuing CIN at underlying shareholder level

A major objection to pursuing a policy of capital import neutrality at the underlying shareholder level is that, for natural person shareholders on marginal rates above the foreign tax rate it means that investment in Australian companies deriving foreign source income would be favoured over investment in Australian companies deriving domestic source income. Conversely, for shareholders on marginal rates below the foreign tax rate it means that investment in Australian companies deriving domestic source income would be favoured over investment in Australian companies deriving foreign source income.

A further objection is that achieving (or, where a foreign tax credit has applied at the corporate level, approximating) CIN at the natural person shareholder level would not produce neutrality between a natural person who invested in a resident company that derived foreign portfolio dividends and one who made a portfolio investment directly in the foreign company. In the latter situation the position of the natural person investor may be illustrated as follows where k represents the foreign corporate tax rate and w represents the foreign withholding tax rate.

Foreign income	$100	F
Foreign corporate tax	$ 25	Fk
Foreign withholding tax	$ 5	Fw - Fkw
After tax dividend	$ 70	F – t

Australian resident 40% m rate natural person shareholder

Foreign source dividend	$70	F - t
Gross up	$ 5	Fw - Fkw
Grossed up dividend	$75	F – t + Fw - Fkw
Tax at 40%	$30	Fm – tm + Fwm - Fkwm
FTC	$ 5	Fw - Fkw
Net tax	$25	Fm – tm – Fwm – Fkwm – Fw + Fkw
Domestic source div	$70	Y-Yc
Franking credit	$30	Yc
Grossed up dividend	$100	Y
Tax at 40%	$ 40	Ym
Imputation credit	$ 30	Yc
Net tax	$ 10	Ym - Yc
Total net tax	$ 35	Ym – Yc + Fm – tm – Fwm – Fkwm – Fw + Fkw
After tax income	$105	F – t + Y – Ym – Fm + tm + Fwm + Fkwm + Fw - Fkw

Total Australian corporate and shareholder tax $65

Problems in identifying underlying foreign tax paid mean that it not practical to extend indirect foreign tax credits to portfolio shareholders. Reverting to exemption treatment for taxed foreign income for natural persons would be likely to result in substantial diversions of the investments of high wealth individuals and their closely held entities to low tax jurisdictions with consequent revenue losses. Applying a policy of CIN to redistributions of the foreign source income of companies would have to be subject to CFC and FIF rules at least in the case of closely held entities. Even with such restrictions on the pass through of the corporate exemption being in place radically different treatment would still be given to direct natural person portfolio shareholders in foreign companies (which were not subject to the CFC of FIF rules) when compared with natural person shareholders in Australian companies that derived portfolio foreign dividend income (other than income attributed by the CFC or FIF rules). Furthermore the treatment of natural persons who had foreign source interest or royalty income would, in certain circumstances, differ from the treatment of those who invested in Australian

companies deriving foreign source dividend income. It would be possible to extend the CFC and FIF regime to all low tax or passive investments of all residents and to exempt all foreign income not falling within the CFC or FIF rules. Such treatment, however, would appear to impose quite unreasonable compliance burdens on natural person residents.

For these reasons it is submitted that pursuit of a policy of capital import neutrality on redistributions of foreign source income to resident shareholders, while technically feasible, is not desirable.

2.2 Achieving Capital Export Neutrality At The Shareholder Level While Retaining The s23AJ And s23AH Exemptions

2.2.1 The marginal rate exemption approach

Except where total foreign taxes on foreign source dividend exceed tax on that source at the shareholder's domestic marginal rate, capital export neutrality can be achieved at the natural person shareholder level while retaining the s23AJ exemption if a portion of the dividend calculated as foreign tax paid grossed up to reflect after tax income as if tax had been paid at the shareholder's marginal rate is exempt when distributed to a resident shareholder as a dividend.[2] Expressed algebraically the exempt portion would be:

$$t\,(1\text{-}m/m) = t\text{-}tm/m$$

The portion that was not exempt would be taxable to the shareholder as an unfranked dividend and hence would be taxed at the shareholder's marginal rate. Hence the taxable portion can be expressed algebraically as:

$$F - t - (t\text{-}tm/m)$$

Tax payable on this portion at the shareholder's marginal rate would be:

$$Fm - tm - m(t\text{-}tm/m) \text{ which becomes}$$

$$Fm - t$$

---

[2] This approach is derived from a recommendation made by Professor A C Warren in *Integration of the Individual and Corporate Taxes, Reporter's Study Of Corporate Tax Integration*, American Law Institute, 1993. Proposal 11 in the Study was:

> Foreign Income
>
> A U.S. corporation with foreign income will add to the exempt income account described in Proposal 3(a) an amount equal to its taxable foreign source income, reduced by the associated creditable foreign taxes. That addition will be limited to the foreign taxes multiplied by (1–c)/c, where c is the U.S. corporate tax rate. The foregoing treatment will be available only as part of a tax treaty.

The assumption behind Professor Warren's proposal was that that United States would continue to maintain a basket system of foreign tax credit limitation. The proposal was also made in the context of other proposals that the top marginal rate for natural person resident taxpayers should be the same as the corporate rate. The approach would not produce capital export neutrality at the underlying shareholder level where an exemption similar to s23AJ is retained at the corporate non portfolio shareholder level.

Hence the after tax dividend will be:

$F – t – (Fm – t)$ which is

$F - Fm$

Where $t > Fm$ this approach means that the shareholder will have an excess exemption equal to $t – Fm/m$ In this situation capital export neutrality would require that the excess exemption either be converted to a refundable credit by multiplying it by m or be carried forward and deducted against future income However, providing a domestic refund for a payment of foreign tax would leave the Australian revenue at the mercy of foreign treasuries, and would be open to abusive tax planning. Not refunding an excess exemption is consistent with the treatment of excess foreign tax credits in foreign tax credit systems. If the excess exemption were to be carried forward as a deduction it would be possible to limit the revenue costs associated with the carry forward and to protect the integrity of the Australian tax system by quarantining the deduction so that it was only able to be used against domestic dividends funded from the FDA or FYA account. This treatment would involve additional compliance costs at the shareholder level.

Additional difficulties arise where the dividend is funded in part from exempt foreign source income and in part from domestic source income use of the marginal exemption approach at the shareholder level would mean that, in situations where $t > Fm$. Here the exemption could result in the taxable dividend income of a resident shareholder being less than $Y – Yc$. This in turn could mean that, particularly where the shareholder was on marginal rate less than the corporate rate, refunds of Australian corporate tax might be made to the shareholder through the operation of the dividend imputation system. In effect, payments of foreign tax would be refunded to resident shareholders through the interaction of the marginal exemption system and the dividend imputation system. For the same reasons as discussed above in relation to converting excess exemptions into refundable credits, this result might not be thought to be acceptable. The simplest way to prevent this result from occurring would be to limit the marginal rate exemption to F-t even where calculation of the exempt amount using the t-tm/m formula would have produced a larger exempt portion. Limiting the exemption in this way will mean that excess exemptions will not be produced. This will mean that the marginal rate exemption system will produce CEN at the natural person shareholder level up to the point where $t = Fm$. At the point where $t = Fm$ it will produce both CEN and CIN. Where $t > Fm$ it will produce CIN. As there would be no excess exemptions in the system there would be no need to consider whether excess exemptions should be deductible, carried forward, or converted into credits.

When the exemption is limited to F-t, then where $t > Fm$, foreign taxes (t) should be substituted for the shareholder's marginal rate (m) in the exemption limitation formula. The result is that the exempt portion in this situation becomes:

$t\ (1-t/t)$ which is

$1-t$

Hence the taxable portion of the dividend becomes

$F - t - (1 - t)$ which is

$F(1 - t) - (1-t)$ which is

Zero

Hence the exempt portion of the dividend under this approach will be

$F - t$ which produces capital import neutrality.

Hence under this approach capital export neutrality will be produced at the natural person shareholder level in all cases where t has a positive value except where $t > Fm$. Where $t > Fm$ this approach will prevent domestic refunds being made in respect of foreign tax paid, will mean that foreign tax paid is not offset against domestic tax liabilities and will produce capital import neutrality at the natural person shareholder level.

Under this approach companies would need to maintain an account that tracked: (i) foreign tax paid (on s23AJ and s23AH exempt income); (ii) foreign tax paid on income subject to FTCs; and (iii) (for reasons discussed subsequently in this submission) domestic tax paid on foreign source income due to the operation of the foreign tax credit system. Foreign tax paid on foreign source dividends is already tracked in the FDA account. Foreign dividends received that are within the s23AJ exemption are already tracked in the FDA account. As the s23AJ exemption is contingent on either Australian tax being paid on the foreign income or on tax being paid on the foreign income in a limited exemption listed country, in effect, there is a requirement to track foreign tax paid on s23AJ exempt income already. To protect the integrity of the system it would be possible to make the taking of a payment of foreign tax into account in the 1-m/m formula contingent on satisfying substantiation requirements. It is submitted that the compliance costs associated with maintaining this account would not be significantly greater than those associated with the existing FDA account and would be considerably less than those likely to be associated with reintroducing a full foreign tax credit system for corporate income.

2.2.2 Examples 5.1.1 to 5.2.3

The operation of this approach is illustrated in the following examples.

Example 5.1.1

Assuming foreign corporate tax rate was 25% and that $33.33 of foreign corporate tax was paid. Total foreign taxes, including $10 DWT, are therefore $43.33. The exempt portion of the dividend would be calculated by multiplying total foreign taxes by 1-m/m. Where the shareholder is on a 48.5% marginal rate the exempt portion of the dividend is calculated as $43.33 x 51.5/48.5 = $46.01.

Australian company

Taxable income	$1000	Y
Australian company tax paid	$ 300	Yc
Tax preferred Australian income	$ 40	P-Y
After tax income	$ 740	P-Yc
Exempt foreign dividend	$ 90	F - t
Distributable profit	$830	P-Yc +F - t

Australian 48.5% m rate natural person resident shareholder

Dividend	$830	P-Yc+F-t
Exempt	$ 46.01	t-tm/m
Taxable	$783.99	P-Yc + F- t –(t-tm/m)
Franking credit	$300	Yc
Grossed up taxable component	$1083.99	P+ F –t – (t-tm/m)
Tax @ 48.5%	$525.74	Pm +Fm –t
Franking credit	$300	Yc
Net tax	$225.74	Pm+Fm- t - Yc
After tax dividend	$604.26	P + F – Pm – Fm

Under the current system the after tax income of a 48.5% marginal rate shareholder would be $582. Under option A in the Treasury Consultation Paper the after tax income of the a 48.5% marginal rate shareholder would be $587.10. Under option B in the Treasury Consultation Paper the after tax income of a 48.5% marginal rate shareholder would also be $587.10. As shown in Example 2.2.1 the capital export neutrality benchmark under these assumptions is $604.26.

Example 5.1.2

Assume the facts in *Example 5.1.1* with the variation that the shareholder is a Superannuation fund. Assume also that the exemption is limited to F – t.

Australian company

Taxable income	$1000	Y
Australian company tax paid	$ 300	Yc
Tax preferred Australian income	$ 40	P-Y
After tax income	$ 740	P-Yc
Exempt foreign dividend	$ 90	F - t

Distributable profit	\$830	P-Yc +F - t

Resident Australian Superannuation Fund shareholder

Dividend	\$830	P-Yc+F-t
Exempt	\$ 90	F-t
Taxable	\$821	P-Yc
Franking credit	\$300	Yc
Grossed up taxable component	\$1121	P
Tax @ 15%	\$ 168.15	Ps
Franking credit	\$ 300	Yc
Refund of excess credit	\$ 131.85	Yc - Ps
After tax dividend	\$961.85	P- Ps+ F - t

Example 5.1.3

Assuming foreign corporate tax rate was 25% and that \$33.33 of foreign corporate tax was paid. Total foreign taxes, including \$10 DWT, are therefore \$43.33. The exempt portion of the dividend would be calculated by multiplying total foreign taxes by 1-m/m. Where the shareholder is on a 31.5% marginal rate the exempt portion of the dividend is calculated as \$43.33 x 68.50/31.50 = \$94.22. As this greater than the after tax foreign income of \$90 the exemption at the underlying shareholder level would be limited to the after tax foreign source income of \$90.

Australian company

Taxable income	\$1000	Y
Australian company tax paid	\$ 300	Yc
Tax preferred Australian income	\$ 40	P-Y
After tax income	\$ 740	P-Yc
Exempt foreign dividend	\$ 90	F - t
Distributable profit	\$830	P-Yc +F - t

Australian 31.5% m rate natural person resident shareholder

Dividend	\$830	P-Yc+F-t
Exempt	\$ 94.22	F - t
Taxable	\$735.78	P-Yc
Franking credit	\$300	Yc
Grossed up taxable component	\$1035.78	P
Tax @ 31.5%	\$ 326.27	Pm
Franking credit	\$ 300	Yc
Net tax	\$ 26.27	Pm - Yc
After tax dividend	\$803.73	P – Pm + F - t

Under the current system the after tax dividend to the underlying shareholder would be $774.10. Under both Options A and C in the Treasury Consultation Paper the after tax dividend to the underlying shareholder would be $780.90. As shown in Example 2.2.3 is $803.83.

Example 5.2.1

Where the foreign corporate rate is 15% a pre tax dividend of $117.65 would produce an after tax dividend of $100. (ie $117.65 x 15% = $17.65). When the dividend withholding tax of $10 is added the total foreign tax on the dividend becomes $27.65 (ie lower than the Australian corporate tax of $35.30 that would be collected on a pre tax corporate income of $117.65 (ie $117.65 x 30% = $35.30). The average rate of foreign tax on the dividend is 23.50% (ie $27.65/$117.65 x 100/1). The exempt portion of the dividend on redistribution would be calculated by multiplying total foreign taxes of $27.65 by 1-m/m. Where the shareholder's marginal rate is 48.5% this would mean that $29.36 of the dividend would be exempt on redistribution.

Australian company

Taxable income	$1000	Y
Australian company tax paid	$ 300	Yc
Tax preferred Australian income	$ 40	P-Y
After tax income	$ 740	P-Yc
Exempt foreign dividend	$ 90	F - t
Distributable profit	$830	P-Yc +F - t

Australian 48.5% m rate natural person resident shareholder

Dividend	$830	P-Yc+F-t
Exempt	$ 29.36	t-tm/m
Taxable	$800.64	P-Yc + F- t –(t-tm/m)
Franking credit	$300	Yc
Grossed up taxable component	$1100.64	P+ F –t – (t-tm/m)
Tax @ 48.5%	$533.81	Pm +Fm –t
Franking credit	$300	Yc
Net tax	$233.81	Pm+Fm- t - Yc
After tax dividend	$596.19	P + F – Pm – Fm

Under the current system the after tax income of a 48.5% marginal rate shareholder would be $582. Under option A in the Treasury Consultation Paper the after tax income of the a 48.5% marginal rate shareholder would be $587.10. Under option B in the Treasury Consultation Paper the after tax income of a 48.5% marginal rate shareholder would also be $587.10. As shown in Example 2.1.1 the capital export neutrality benchmark in this situation is $596.19.

Example 5.2..2

Same assumptions as in Example 5.2.1 but with variations that underlying shareholder is a complying superannuation fund and that the limit of the exemption is F-t.

Australian company

Taxable income	\$1000	Y
Australian company tax paid	\$ 300	Yc
Tax preferred Australian income	\$ 40	P-Y
After tax income	\$ 740	P-Yc
Exempt foreign dividend	\$ 90	F - t
Distributable profit	\$830	P-Yc +F - t

Australian Resident Complying Superannuation Fund

Dividend	\$830	P-Yc+F-t
Exempt	\$ 90	F - t
Taxable	\$740	P-Yc
Franking credit	\$300	Yc
Grossed up taxable component	\$1040	P
Tax @ 15%	\$156 Ps	
Franking credit	\$300	Yc
Imputation refund	\$144 Yc - Ps	
After tax dividend	\$974 P – Ps + F - t	

Under the present system the after tax dividend to the shareholder would be \$960. Under both Options A and B in the Treasury Consultation Paper the after tax dividend to the shareholder would be \$969. As noted in Example 2.1.2 the after tax dividend under the capital export neutrality benchmark under these assumptions is \$984. As shown in Example 1.2 the capital import neutrality benchmark for a complying superannuation fund is \$974.

Example 5.2.3

Assume the facts in Example 5.2.1 with the variation that the underlying shareholder is on a 31.5% marginal rate. The exempt portion of the dividend on redistribution would be calculated by multiplying total foreign taxes of \$27.65 by 1-m/m. Where the shareholder's marginal rate is 31.5% this would mean that \$60.13 of the dividend would be exempt on redistribution.

Australian company

Taxable income	\$1000	Y
Australian company tax paid	\$ 300	Yc
Tax preferred Australian income	\$ 40	P-Y

After tax income	$ 740	P-Yc
Exempt foreign dividend	$ 90	F - t
Distributable profit	$830	P-Yc +F - t

Australian 31.5% m rate natural person resident shareholder

Dividend	$830	P-Yc+F-t
Exempt	$ 60.13	t-tm/m
Taxable	$769.87	P-Yc + F- t –(t-tm/m)
Franking credit	$300	Yc
Grossed up taxable component	$1069.87	P+ F –t – (t-tm/m)
Tax @ 31.5%	$337	Pm +Fm –t
Franking credit	$300	Yc
Net tax	$ 37	Pm+Fm- t - Yc
After tax dividend	$793	P + F – Pm – Fm

Under the current system the after tax dividend to the underlying shareholder would be $774.10. Under both Options A and C in the Treasury Consultation Paper the after tax dividend to the underlying shareholder would be $780.90. As shown in Example 2.1.3 under these assumptions the capital export neutrality benchmark would be $792.99

2.2.3 Problems associated with determining the appropriate marginal rate

There would be some additional compliance burdens associated with calculation of the exempt portion of the dividend. These could be minimised requiring companies paying a dividend to advise shareholder's of what the exempt amount of the dividend was for various levels of taxable income. This would mean that the same statement could then be issued to all resident shareholders.

Where receipt of the dividend would mean that the shareholder moved from one marginal tax rate to a higher one, in theory part of the exemption should be calculated by reference to the lower marginal rate and part should be calculated by reference to the higher rate. Even this approach would not produce an entirely accurate result as the extent of the exemption itself would affect the marginal rate into which the dividend placed the shareholder. A workable compromise would be to assume that dividends wholly or partly sourced in foreign income were received last by shareholders and to calculate the extent of the exemption by reference to either the shareholder's taxable income prior to receipt of the dividend or by reference to what would have been the shareholder's taxable income after the receipt of the dividend assuming that none of the dividend was exempt to the shareholder. The former approach would normally mean that the exemption was greater than it should be while the latter approach would normally mean that the exemption was less than it should be. Differences between the two approaches would be neutralized somewhat by the rule, discussed above, setting the upper limit for the exemption at F-t.

To apply a rule that limited the exemption to F- t where t was greater than Fm it would be necessary for foreign companies to track both foreign income that was subject to the s23AJ exemption and foreign tax paid on that income. An average rate of foreign tax could then be determined. When advising shareholders of the exempt amount of the dividend the company would indicate that, assuming that the foreign sourced component of the dividend was received last by the shareholder, that for shareholders whose taxable income was below the level to which a marginal rate applied that meant that Fm = t, the amount of the exemption was equal to F-t. Given that foreign income and foreign tax paid is readily tracked by a non-portfolio shareholder (using accounts akin to the FDA account) this approach would not appear to impose undue compliance burdens on Australian companies.

2.2.4 Implications for the scope of the s23AJ and s23AH exemptions

When viewed from the underlying shareholder level, if the marginal rate exemption approach is used, there is no obvious reason to confine the operation of the s23AJ exemption to dividends sourced in taxed profits from listed countries.

As noted above, this approach produces capital export neutrality at the natural person shareholder level except where t = zero or where t > Fm. In the latter two cases the marginal rate exemption approach produces capital import neutrality. This should mean that the resident investor, provided that distribution from the Australian resident company is not deferred, ultimately is no better off by investing in a resident company with foreign source income rather than in a resident company with only domestic source income. To produce capital export neutrality (or where F – t is greater than F – Fm to produce capital import neutrality) at the underlying shareholder level all the marginal exemption approach requires is for the non-portfolio dividend to have borne some foreign tax and for the amount of foreign tax paid to be quantifiable. Indeed even if no foreign tax has been paid and the foreign source dividend has been exempt at the Australian company level, the marginal exemption approach will produce capital export neutrality at the underlying shareholder level. This is because, as t will be zero, no part of the redistribution of the foreign source dividend will be exempt.

To prevent limitless deferral of Australian tax at the underlying shareholder level it would be necessary to continue to confine the s23AJ exemption to non-portfolio dividends that were not distributions of income that had been attributed under the CFC regimes. Similarly the s23AH exemption would need to be structured so that it did not apply to branch profits of equivalent character to foreign subsidiary income that would be attributed under the CFC regime. However, it is submitted that, in an imputation system, where as a general rule non portfolio dividends are tax exempt and foreign branch profits are tax exempt, it may be possible to exclude widely held Australian companies from the operation of the CFC rules and to broaden the de minimis FIF exemption applicable to them. A more detailed submission in relation to the scope of the s23AJ and s23AH exemptions is made in the submission in relation to Option 3.9.

A more detailed submission in relation to the scope of the CFC and FIF rules is made in the submission in relation to Option 3.4.

If this approach were adopted, the scope of the foreign tax credit system as it applied to dividends received by Australian resident companies would be limited to portfolio dividends and to dividends sourced in income that had not borne any foreign tax. Foreign tax credits would continue to apply to income attributed under the CFC and FIF rules. The possibility of extending the s23AJ exemption to portfolio dividends received by Australian companies is considered in the submission in relation to Option 3.9. If this approach were adopted foreign tax credits would not apply to dividends received by Australian companies at all.

2.2.5 Ordering rules for distributions

The extension of the s23AJ exemption in the manner suggested above would mean that low foreign taxed non-portfolio dividends (representing income that had not previously been attributed under the CFC regime) would not bear Australian tax until they were distributed to underlying Australian shareholders. This may amount to a disincentive to distribution in a closely held company. The scope for deferring shareholder level tax by postponing distributions of s23AJ exempt income would be limited if all distributions were regarded as being funded proportionately from the paying company's foreign source income. Under this approach the steps for calculating the exempt amount of any dividend distribution would be as follows:

> The amount of foreign tax regarded as underlying the distribution would be calculated using the formula:
>
> > $t \times D/P$
> >
> > Where t is the foreign tax paid (tracked using an account like the FDA account)
> >
> > D is the amount of the current distribution
> >
> > P is the distributable profits of the company at the time of the distribution
>
> The exempt amount of the distribution would be calculated using the formula:
>
> > $tD/P \times 1\text{-}m/m$
>
> The franking credit attached to a distribution would be calculated using the formula:
>
> > fD/P

> Where f is the current balance in the company's franking account at the time of the distribution.

It should be noted, as has been argued previously[3], that this approach would inhibit dividend streaming by paying dividends franked to different amounts to different classes of shareholders. It would also mean that, in contrast to the present benchmark franking rule, companies would be less able to distribute taxed corporate income and retain untaxed income.

This approach should mean that the disincentives to distribution in a closely held resident company that currently exist in the Australian dividend imputation system (because of the difference between the top marginal rate and the corporate rate and because of the favourable tax treatment of capital gains of natural persons) would not be significantly altered by use of the marginal rate exemption approach. Rules would also be necessary for determining the extent to which a redistribution by the Australian resident corporate non-portfolio shareholder was sourced in taxed foreign income of a particular year. Consistency would demand that a proportional approach be adopted here as well.

2.2.6 Consideration of integrity concerns raised in Treasury Consultation Paper

The limited exemption approach should not raise integrity concerns similar to those expressed at pp23 to 24 of the Treasury Consultation Paper. Because no refunds would be involved at the shareholder level there would be no scope for 'cashing out' foreign dividend withholding tax or foreign underlying tax through conduit companies. As the payment of foreign tax would not generate Australian franking credits there would be no prospect of companies generating additional franking credits through offshore trade in foreign companies. So far as the limited exemption approach applies to dividends funded from s23AJ or s23AH exempt income it would be limited to foreign income on which foreign tax has actually been paid. Income exempt under s23AJ is currently tracked in a company's FDA account and if the FDA account were changed to a Foreign Income Account then s23AH exempt income would be tracked as well. If substantiation of the payment of foreign taxes is a concern then the exemptions (and foreign tax credits) could be made contingent on satisfying substantiation requirements.

2.2.7 Comparison with compliance costs associated with extending indirect FTCs to underlying resident shareholders

Equivalent results to those produced by the marginal rate exemption system proposed above could be produced by allowing foreign tax credits received by Australian non-portfolio investors to flow through in some way to underlying resident shareholders.[4] At

[3] See the discussion in C J Taylor, "Resolving Inequities In Australia's Dividend Imputation System" (1995) 12 *Australian Tax Forum* 267 at 311 to 316 and P A Harris, *Corporate/Shareholder Income Taxation And Allocating Taxing Rights Between Countries: A Comparison Of Imputation Systems*, IBFD Publications, Amsterdam, 1996.

[4] Here the assumption is that a basket system of foreign tax credit limitation would not apply at the shareholder level (ie blending of investments at the corporate level is allowed) but that excess credits at the shareholder level would only be able to be offset against the portion of future dividends that was funded

the non-portfolio shareholder level this would involve: tracking foreign tax paid; tracking foreign source income; identifying the portion of the redistribution that was funded in foreign income and (either through direct identification or through a formula) determining the foreign tax applicable to the dividend. If blending of investments at the corporate level were a matter of concern then it might be necessary for the company to distinguish between high tax and low tax income that had benefited from the s23AJ exemption. At the corporate level these compliance obligations would not differ significantly from those involved in a marginal rate exemption system. In fact the marginal rate exemption system could involve some additional compliance costs at the corporate level associated with determining the exempt portion of the dividend for shareholders on various marginal rates. On the other hand use of the marginal rate exemption system would permit the maintenance and extension of the s23AJ exemption producing offsetting savings in compliance costs. At the shareholder level, use of a foreign tax credit system would involve: quarantining the portion of the dividend sourced in foreign income; grossing the dividend up for the foreign income attributable to it; calculating the average rate of Australian tax on the shareholder's income including the grossed up foreign dividend; determining the Australian tax payable at the average rate on the grossed up foreign dividend; and allowing a foreign tax credit against the Australian tax payable. To produce equivalent results to the marginal rate exemption system excess credits would then need to be quarantined and could only be permitted to be offset against future tax obligations on foreign source dividends. Rules for allocating expenses to the foreign dividend income would also need to be applied at the underlying shareholder level. When compared with a marginal rate exemption system, converting a corporate level exemption to a shareholder level foreign tax credit involves a greater compliance burden at the shareholder level. It is reasonable to expect that non-portfolio investors are better equipped to cope with additional compliance burdens than are underlying shareholders, particularly where the underlying shareholders are natural persons. It is also likely that overall compliance costs under the marginal rate exemption approach would be lower than under an approach that converted a corporate exemption to a foreign tax credit for underlying shareholders. Under the marginal rate exemption approach companies can calculate the amount of the exemption that applies for shareholders on different marginal rates and issue one statement to all shareholders. Under the foreign tax credit approach each shareholder needs to calculate, for foreign tax credit limitation purposes, the Australian tax payable on the portion of the dividend sourced in foreign income grossed up for foreign taxes.

2.2.8 Application of marginal rate exemption approach where underlying foreign tax credits have applied at the resident corporate level

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from exempt foreign source income. If a basket system were to be maintained at the underlying shareholder level the system would become considerably more complex although complexity could be mitigated by rule that taxed corporate income was assumed to be distributed first. See the discussion in A C Warren, *Integration of the Individual and Corporate Taxes, Reporter's Study Of Corporate Tax Integration*, American Law Institute, 1993 at 7.3 (b) Outbound Investment.

Here the position where the Australian resident company receives credit for all foreign tax paid (currently non-portfolio dividends falling outside the s23AJ exemption, income attributed under the CFC regime, income attributed under the FIF regime where actual calculation of foreign tax has been possible, foreign branch income falling outside the s23AH exemption, foreign source royalties and foreign source dividends) needs to be distinguished from the position where the Australian resident company receives credit for less than all the foreign tax paid (currently portfolio dividends, and FIF income to which the deemed rate of return or mark to market methods have applied).

Where foreign tax credits were applicable to non portfolio shareholders (for example in the case of CFC attributed income or foreign passive income or foreign branch income not within the s23AH exemption) allowing the foreign tax actually paid, grossed up using the 1-m/m formula, to pass through as exempt income to a resident natural person shareholder would produce capital export neutrality at the natural person shareholder level. Equivalent results to that proposed for s23AJ exempt income will be produced if, in applying the t (1-m/m) formula excess foreign tax credits are disregarded. That is the whole amount of foreign taxes paid would be taken into account in the t(1-m/m) formula even though t was greater than Fc. Where t is greater than Fm this approach will again mean that there will be an excess exemption at the shareholder level. The comments made above in relation to possible alternative treatments of excess exemptions will also be applicable in this situation. For the reasons stated above, in the situation where t > Fm, the exemption that passes through to the underlying shareholder should be equal to F – t. This treatment will prevent excess exemptions arising at the underlying shareholder level. This treatment would also mean that excess FTCs at the corporate level are, in effect, utilized at the underlying shareholder level on redistribution. Hence it would be appropriate for excess foreign tax credits to be eliminated once they have been taken into account in determining the exempt portion of a redistribution under the marginal rate exemption approach.

Where Fc is greater than t the foreign tax credit system will mean that Australian corporate tax equal to Fc – t will be payable. Under current rules this payment of Australian corporate tax will generate franking credits equal to Fc – t. This will mean that calculating the exemption by grossing up the foreign tax paid using the 1-m/m formula will not produce capital export neutrality at the shareholder level. The simplest solution to this problem is to treat the Australian corporate tax of Fc-t as if it were a payment of foreign tax rather than as a payment of Australian tax. This would mean that it would not generate franking credits but would generate a credit in the company's FDA or FYA account. On distribution the Australian tax paid would be taken into account in determining the proportion of the dividend that was tax exempt using the t (1-m/m) formula. That is the Australian corporate tax of Fc-t paid would be regarded as forming part of t for purposes of the t(1-m/m) formula.

2.2.9 Examples 6.1 to 6.3

These points are illustrated in the following examples

Example 6.1 – Where t >Fc

Australian company

Taxable income	$1000	Y
Tax preferred Australian income	$ 40	P-Y
CFC income attributed	$ 133.33	F
Australian tax on CFC income	$ 40	Fc
FTC	$ 43.33	t
Excess credit	$ 3.33	t - Fc
Australian company tax on Y	$ 300	Yc
Distributable profit	$ 830	P – Yc + F- t

Australian 48.5% m rate natural person resident shareholder

Dividend	$830	P – Yc + F- t
Exempt	$ 46.01	t-tm/m (43.33 x 51.5/48.5)
Taxable	$783.99	P – Yc + F – t - (t – tm/m)
Franking credit	$300	Yc
Grossed up taxable component	$1083.99	P+ F –t – (t-tm/m)
Tax @ 48.5%	$525.74	Pm +Fm –t
Franking credit	$300	Yc
Net tax	$225.74	Pm+Fm- t - Yc
After tax dividend	$604.26	P + F – Pm – Fm

Example 6.2

Where t is > Fm or Fs the exemption would be limited to F-t.

Australian company

Taxable income	$1000	Y
Tax preferred Australian income	$ 40	P-Y
CFC income attributed	$ 133.33	F
Australian tax on CFC income	$ 40	Fc
FTC	$ 43.33	t
Excess credit	$ 3.33	t - Fc
Australian company tax on Y	$ 300	Yc
Distributable profit	$ 830	P – Yc + F- t

Australian Resident Complying Superannuation Fund

Dividend	$830	P – Yc + F- t
Exempt	$ 43.33	F - t
Taxable	$786.67	P – Yc
Franking credit	$300	Yc

Grossed up taxable component	$1086.67	P
Tax @ 15%	$ 163	Ps
Franking credit	$300	Yc
Imputation refund	$ 137	Yc - Ps
After tax dividend	$ 967	P – Ps + F-t

Example 6.3

Australian company

Taxable income	$1000	Y
Tax preferred Australian income	$ 40	P-Y
CFC income attributed	$ 133.33	F
Australian tax on CFC income	$ 40	Fc
FTC	$ 43.33	t
Excess credit	$ 3.33	t - Fc
Australian company tax on Y	$ 300	Yc
Distributable profit	$ 830	P – Yc + F- t

Australian 31.5% m rate natural person resident shareholder

Dividend	$830	P – Yc + F- t
Exempt	$ 94.23	t-tm/m ($43.33 x 68.5/31.5)
Taxable	$735.77	P – Yc + F – t - (t – tm/m)
Franking credit	$300	Yc
Grossed up taxable component	$1035.77	P+ F –t – (t-tm/m)
Tax @ 48.5%	$326.27	Pm +Fm –t
Franking credit	$300	Yc
Net tax	$ 26.27	Pm+Fm- t - Yc
After tax dividend	$803.73	P + F – Pm – Fm

Separate consideration needs to be given to the situation where the total foreign taxes paid are less than Australian corporate tax on the grossed up foreign dividend. Here capital export neutrality is produced at the shareholder level if the net Australian tax generated under the foreign tax credit system does not generate a franking credit but is taken into account in the t(1-m/m) formula in calculating the exemption.

2.2.10 Examples 7.1 to 7.3

Example 7.1

Australian company

Aust source Taxable income	$1000	Y
CFC income net of foreign tax	$ 90	F-t
Gross up for foreign tax	$ 27.65	t

Grossed up CFC income	$ 117.65	F
Australian tax on CFC income	$ 35.30	Fc
FTC	$ 27.65	t
Net Australian tax	$ 7.65	Fc - t
Australian company tax on Y	$ 300	Yc
Total Australian company tax	$ 307.65	Yc + Fc - t
Tax preferred Australian income	$ 40	P-Y
Dividend	$ 822.35	P + F- Yc – Fc

Australian 48.5% m rate natural person resident shareholder

Dividend	$822.35	P + F – Yc - Fc
Exempt portion ($27.65 + $7.65(51.5/48.5)	$ 37.48	Fc – Fcm/m
Taxable portion	$784.87	P + F – Yc – Fc – (Fc – Fcm/m)
Franking credit	$300	Yc
Grossed up taxable portion	$1084.87	P + F –Fc – (Fc-Fcm/m)
Tax @ 48.5%	$ 526.16	Pm + Fm – Fc
Franking credit	$300	Yc
Net tax	$226.16	Pm + Fm – Fc - Yc
After tax dividend	$596.19	P + F – Pm - Fm

Example 7.2

Australian company

Taxable income	$1000	Y
CFC income net of foreign tax	$ 90	F-t
Gross up for foreign tax	$ 27.65	t
Grossed up CFC income	$ 117.65	F
Australian tax on CFC income	$ 35.30	Fc
FTC	$ 27.65	t
Net Australian tax	$ 7.65	Fc - t
Australian company tax on Y	$ 300	Yc
Total Australian company tax	$ 307.65	Yc + Fc - t
Tax preferred Australian income	$ 40	P-Y
Dividend	$ 822.35	P + F- Yc – Fc

Australian Superannuation Fund

Dividend	$822.35	P + F – Yc - Fc
Exempt portion	$200.03	Fc – Fcs/s
Taxable	$622.32	P + F – Yc – Fc – (Fc – Fcs/s)
Franking credit	$300	Yc

Grossed up taxable portion	$922.32	P + F – Fc - (Fc – Fcs/s)
Tax @ 15%	$138.35	Ps + Fs -Fc
Franking credit	$300	Yc
Refund of excess credit	$161.65	Y c - Ps + Fs + Fc
After tax dividend	$984	P + F – Ps + Fs

Cf if F-t is limit of exemption

Dividend	$822.35	P + F – Yc - Fc
Exempt portion	$117.65	F - t
Taxable	$704.85	P – Yc – Fc + t
Franking credit	$300	Yc
Grossed up taxable portion	$1004.85	P – Fc + t
Tax @ 15%	$ 150.73	Ps – Fcs + ts
Franking credit	$300	Yc
Refund of excess credit	$149.27	Yc – Ps + Fcs - ts
After tax dividend	$971.62	P + F – Fc – Ps + Fcs + ts

Example 7.3

Australian company

Taxable income	$1000	Y
CFC income net of foreign tax	$ 90	F-t
Gross up for foreign tax	$ 27.65	t
Grossed up CFC income	$ 117.65	F
Australian tax on CFC income	$ 35.30	Fc
FTC	$ 27.65	t
Net Australian tax	$ 7.65	Fc - t
Australian company tax on Y	$ 300	Yc
Total Australian company tax	$ 307.65	Yc + Fc - t
Tax preferred Australian income	$ 40	P-Y
Dividend	$ 822.35	P + F- Yc – Fc

Australian 31.5% m rate natural person resident shareholder

Dividend	$822.35	P + F – Yc - Fc
Exempt portion ($27.65 + $7.65(68.5/31.5)	$ 76.76	Fc – Fcm/m
Taxable portion	$745.59	P + F – Yc – Fc – (Fc – Fcm/m)
Franking credit	$300	Yc
Grossed up taxable portion	$1045.59	P + F –Fc – (Fc-Fcm/m)
Tax @ 31.5%	$ 329.36	Pm + Fm – Fc
Franking credit	$300	Yc
Net tax	$ 29.36	Pm + Fm – Fc
After tax dividend	$795.99	P + F – Pm - Fm

2.2.11 Application of marginal rate exemption approach where direct foreign tax credits have applied at the resident corporate level

Difficulties associated with obtaining adequate information about underlying foreign tax paid mean that it is not practically[5] possible to produce capital export neutrality at the underlying resident shareholder level where an Australian resident company redistributes foreign source portfolio dividends. Underlying foreign tax paid is treated as a deduction in determining taxable income, in contrast to domestic tax paid which is treated as a credit against the underlying shareholder's personal tax liability. Currently underlying natural person shareholders receiving such redistributions are treated less favourably than natural persons with direct portfolio shareholdings in foreign companies. This lack of neutrality can be eliminated under the marginal rate exemption system by taking into account the creditable amount of foreign tax and the net Australian tax payable (following the application of the foreign tax credit rules) into account as t in applying the t x 1-m/m formula.[6] These points are illustrated by the following examples,

2.2.12 Examples 8.1 to 8.3

Example 8.1 – Current Treatment Of Foreign Source Portfolio Dividends Redistributed By Australian Resident Company To Resident Natural Person Shareholder

Assume that a foreign company has $1,000,000 of pre tax income. It pays foreign company tax of $200,000 and distributes a dividend of $1000 to an Australian resident company that has a portfolio shareholding. Assume that withholding tax of $100 is payable on the dividend.

Australian Company

Foreign portfolio dividend	$ 900
Gross up for DWT	$ 100
Grossed up dividend	$1000
Corporate tax at 30%	$ 300
Foreign Tax Credit	$ 100
Net Australian tax	$ 200
After tax dividend	$ 700

Australian resident 48.5% m rate shareholder

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[5] It would be possible to allow underlying foreign tax credits in the case of foreign listed companies using, for example, a LIFO rule in relation to distributions by the foreign company. Such an approach would appear to impose unacceptable levels of complexity and compliance costs on natural person resident portfolio shareholders. It would also fail to deal with portfolio interests in unlisted companies.

[6] In these circumstances the same result would be produced by allowing the payment of foreign dividend withholding tax to generate a franking credit. This treatment would, however, raise the integrity concerns discussed in the Treasury Consultation Paper.

Dividend	$ 700
Franking credit	$ 200
Grossed up dividend	$ 900
Tax @ 48.5%	$ 436.50
Imputation credit	$ 200
Net tax	$ 236.50
After tax dividend	$ 463.50

Example 8.2 – Current treatment of resident natural person shareholder with portfolio shareholding in foreign company. Assume foreign company's income is as in 8.1 and that it pays a dividend of $1000 to the Australian resident on which foreign withholding tax of $100 is payable.

Australian resident 48.5% m rate shareholder

Dividend	$ 900
Gross up for DWT	$ 100
Grossed up dividend	$1000
Tax @ 48.5%	$ 485
Foreign tax credit	$ 100
Net tax	$ 385
After tax dividend	$ 515

Example 8.3 Treatment Of Underlying Resident Natural Person Shareholder Under Marginal Rate Exemption Approach

Australian company

Foreign portfolio dividend	$ 900
Gross up for DWT	$ 100
Grossed up dividend	$1000
Corporate tax at 30%	$ 300
Foreign Tax Credit	$ 100
Net Australian tax	$ 200
After tax dividend	$ 700

Australian resident 48.5% m rate shareholder

Dividend	$ 700
Exempt portion	$ 318.55 ($100+ $200 x 51.5/48.5)
Taxable	$381.45
Tax @ 48.5%	$ 185
After tax dividend	$ 515

2.2.13 The limited exemption approach

If the compliance and revenue costs associated with the marginal rate exemption approach were thought to be too great an alternative approach would be to use only 3 rates in the t x 1-m/m formula. Where the underlying shareholder was a resident company c would be substituted for m in the formula. Where F- t was less than F- Fc the exempt portion of the dividend would be limited to F-t. Where the underlying shareholder was a resident complying superannuation fund s would be substituted for m in the formula. Where the underlying shareholder was a resident natural person the top marginal rate plus medicare levy could be substituted for m in the formula. This approach would mean that the statement that the company issued to shareholders would only need to calculate the exempt portion of the dividend for each of the three classes of shareholder. It would be possible to add additional classes where a dividend was paid to shareholders resident in DTA and non DTA countries. In all cases the limit of the exemption would be F-t. The effects for Australian resident companies, Australian resident complying superannuation funds and for top marginal rate natural person resident shareholders would be the same was were noted earlier in this submission. The effects for lower marginal rate natural person shareholders are illustrated in the following examples.

2.2.14 Example 9.1

Example 9.1

Assuming foreign corporate tax rate was 25% and that $33.33 of foreign corporate tax was paid. Total foreign taxes, including $10 DWT, are therefore $43.33. The exempt portion of the dividend would be calculated by multiplying total foreign taxes by 1-m/m. Where the shareholder is on a 48.5% marginal rate the exempt portion of the dividend is calculated as $43.33 x 51.5/48.5 = $46.01. By contrast under the marginal rate exemption approach the exempt portion for a 31.5% marginal rate shareholder would be $94..22 which would be limited to $90 using the rule that the exemption could not exceed F-t.

In the following example r represents the top marginal rate plus medicare levy.

Australian company

Taxable income	$1000	Y
Australian company tax paid	$ 300	Yc
Tax preferred Australian income	$ 40	P-Y
After tax income	$ 740	P-Yc
Exempt foreign dividend	$ 90	F - t
Distributable profit	$830	P-Yc +F - t

Australian 31.5% Marginal Rate Resident Natural Person Shareholder

Dividend	$830	P-Yc+F-t
Exempt	$ 46.01	t-tr/f
Taxable	$783.99	P-Yc + F- t –(t-tr/r)
Franking credit	$300	Yc
Grossed up taxable	$1083.99	P+ F –t – (t-tr/r)
Tax @ 31.5%	$ 341.46	Pm +Fm –tm – tm/r – trm/r
Franking credit	$300	Yc
Net tax	$ 41.46	Pm+Fm- tm – tm/r – trm/r - Yc
After tax dividend	$788.54	P – + F – t – Pm – Fm + tm + tm/r + trm/r

SUBMISSION IN RELATION TO OPTION 3.4

In an integrated system of corporate-shareholder taxation the total tax payable on profit flowing through a company to an underlying shareholder should equal tax on that profit at the rate applicable to the shareholder. Even if foreign source corporate income is subject to little of no foreign tax or Australian corporate tax it will (if the marginal exemption system discussed at 2.2 is adopted) ultimately bear the correct amount of (Australian and foreign) tax when redistributed to a resident shareholder. If, as is suggested in the submission below in relation to Option 3.9, the s23AJ exemption is extended to cover all non-portfolio dividends other than those representing income previously attributed under the CFC or FIF rules, the time when any additional Australian tax would be collected would be at the time of distribution to underlying shareholders. Hence in the design of anti-deferral rules in integrated corporate-shareholder tax systems it is important to focus on whether foreign source income is likely to be redistributed to underlying shareholders.

The position in relation to an integrated system may be contrasted with the position under a classical system where deferral involves postponement of tax at the corporate level which is separate from the additional tax levied at the shareholder level on redistribution. In its 2000 Policy Study *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations* the U.S. Department of Treasury acknowledged that the problem of deferral, and hence the need for Subpart F rules, was a product of the combined effect of taxing corporations as separate persons and the use of a system of worldwide taxation of residents.[7] The U.S. Treasury Policy Study recognized that either moving to a territorial system of taxation or treating corporations as pass through entities would mean that deferral would be eliminated. [8] When a classical system exempts non portfolio dividends and/or foreign branch profits it is foregoing the corporate level tax altogether. Hence some U.S. commentators in considering the implications of a shift to an exemption system for the U.S. while retaining a classical system regard it appropriate to exclude highly mobile passive income from exemption treatment because exemption of such

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[7] United States: Office of Tax Policy, Department of the Treasury, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations*: *A Policy Study*, 2000, at 1 – 3.

[8] Ibid at 3 – 4.

income would create an incentive to move assets offshore with potentially large U.S. revenue losses. [9] In a classical system which exempts foreign source income, the concern is understandably with a loss of domestic corporate level tax through diverting corporate income to low tax jurisdictions. A closely held company in a classical system which exempts foreign dividends would thus have an incentive to divert income to low tax jurisdictions thus maximizing the after tax income that can ultimately be distributed to its underlying controllers. A listed company in a classical system with a foreign dividend exemption would also have an incentive to lower its domestic corporate tax by diverting income to low tax jurisdictions with a view to maximizing the after tax corporate income that it has available for either retention or distribution and with a view to maximizing its share price. If a classical system used a blanket exemption of foreign source dividends the result of investment in low tax jurisdictions would be the virtual elimination of the corporate tax in the residence country and a lower level of overall corporate and shareholder taxation. For similar reasons, if domestic tax on foreign source corporate income is able to be deferred, then both listed and unlisted companies will benefit from that deferral. From the revenue's viewpoint any domestic corporate tax that is lost is never recovered when the foreign source income is redistributed to underlying shareholders. Hence, in a classical system, it is logical to structure CFC rules so that at least passive income derived in low tax jurisdictions is attributed and given FTC treatment irrespective of whether or not the domestic company is or is not listed.

By contrast, in an imputation system with an exemption for non portfolio dividends (other than dividends representing income previously attributed under the CFC or FIF rules) and which uses a marginal rate exemption system the same overall amount of Australian tax will be collected whether CFC income is attributed and taxed at the corporate level prior to distribution or is exempted at the corporate level and then distributed. Whether or not exemption or FTC treatment of non-portfolio dividends has been used at the corporate shareholder level the after tax dividend received by an underlying shareholder will be either $F - Fm$ (where foreign taxes are lower than the underlying shareholder's marginal rate), $F\text{-}Fm = F\text{-}t$ (where foreign taxes are equal to the underlying shareholder's marginal rate or where blending of investments at the corporate level has produced the result that $t = Fm$) and $F - t$ (where foreign taxes are greater than the underlying shareholder's marginal rate). In the first two situations the underlying shareholder will, ultimately, be no better off in after tax terms by deriving a dividend funded from foreign source dividends than he or she would have been if the dividend had been wholly funded from domestic sources. In the third situation the underlying shareholder will be worse off by deriving a dividend funded from foreign source dividends.

In the case of closely held companies it appears reasonable to assume that resident underlying shareholders would prefer, in the absence of CFC and FIF rules, for low or untaxed foreign income to remain in corporate solution even where all non-portfolio dividends were exempt to an Australian recipient company. The distribution policies of a widely held company, however, are more likely to be governed by competitive pressures

[9] See M. J. Graetz and P.W. Oosterhuls, "Structuring an Exemption System for Foreign Income of U.S. Corporations" 54 *National Tax Journal* 771 at 774 to 775.

for equity funds and by the need to maintain the company's share price. It must be acknowledged, however, that the current system of discounting capital gains of natural persons, trusts and superannuation funds, coupled with the difference between the corporate rate and the top marginal rate appears to represent a tax bias in favour of profit retentions over distributions. However, any bias that exists in favour of retaining rather than distributing tax preferred foreign income is no different in kind from the bias that exists in relation to the retention of tax preferred income generally. In the case of a widely held company it does not appear to be appropriate to use CFC and FIF rules to combat a more general bias against distributions of tax preferred income. As discussed at 2.2.5 the bias against redistribution of tax preferred income could be redressed somewhat by the use of a proportionate distribution rule. As an exemption system means that no deferral of Australian tax occurs at the direct corporate investor level it may be possible to exclude Australian listed companies and their wholly owned subsidiaries from being attributable taxpayers for the purposes of the CFC rules..

Somewhat different comments need to be made in relation to FIF rules. It is assumed, consistently with the submission made in relation to Option 3.9 below, that direct foreign tax credits would continue to apply to portfolio dividends received by Australian companies. Hence net Australian corporate tax would be payable where the foreign withholding tax was less than Australian corporate tax on the foreign dividend grossed up for the foreign withholding tax. Where accruals taxation is used the time at which this additional tax is payable is advanced. However, where the marginal rate exemption approach applies to redistributions the overall level of Australian and the after tax position of the underlying shareholder when foreign dividends are redistributed will be unaffected by whether or not accruals taxation has applied at the corporate level. As the after tax position of listed companies would be improved by deferring receipt of foreign portfolio dividends from low tax countries there would be a case for continuing to apply FIF rules to them. However, if it is accepted that the distribution policies of listed companies are unlikely to be unduly influenced by tax considerations relevant to their underlying shareholders, there may be a case for applying a more generous de minimis exception to listed companies based on a percentage of their global assets. This would mean that listed companies would be able to engage in reasonable management of their fluctuations in liquidity without there being any disincentive for them to repatriate and redistribute income from their foreign portfolio investments.

This submission was written on the assumption that the marginal rate exemption approach discussed in relation to Option 2.1 would be implemented. Similar points to those made in this submission would be able to be made if the limited exemption approach discussed in relation to Option 2.1 were implemented.

SUBMISSION IN RELATION TO OPTION 3.9

In broad terms the s23AJ exemption is currently confined to non portfolio dividends sourced income that has been taxed in a listed country, and that has not previously been attributed under the CFC rules. Foreign tax credits apply to corporate income to which the s23AJ and s23AH exemptions do not apply. Where foreign tax credits apply

Australia collects corporate tax on the difference between the foreign tax paid and Australian corporate tax on the grossed up foreign income.

Currently confining the s23AJ exemption to non portfolio dividends sourced in income that has been taxed in a listed country, and that has not previously been attributed under either the CFC or the FIF rules, limits the scope for FTC planning directed at offsetting excess foreign tax credits on non-portfolio dividend income against net Australian tax payable on non-portfolio dividend income from low tax jurisdictions.

The application of a foreign tax credit to non portfolio dividends received from companies resident in unlisted countries is a disincentive to the repatriation of those dividends although this effect is mitigated somewhat by Australian franking credits generated by the net Australian tax payable.

Currently at the underlying resident shareholder level, the interaction of the s23AJ exemption and the dividend imputation system produces the curious result that investment in listed Australian companies with subsidiaries engaged in active business in listed countries is treated less favourably than investment in a CFC deriving passive income in an unlisted country. At the corporate level the effective inability to offset excess foreign tax credits from active businesses in high tax countries (largely eliminated by the presence of the s23AJ exemption) against Australian tax liabilities arising from active businesses in low tax countries means that Australian companies with foreign business operations or foreign subsidiaries can be treated less favourably than those with wholly Australian investments.

If the s23AJ exemption were to be extended to all non-portfolio dividends (other than distributions of income that had been attributed under the CFC or FIF rules), and if the marginal rate exemption system were adopted, the Australian corporate tax currently collected via the foreign tax credit system would ultimately be collected at the shareholder level when the foreign source income was redistributed. In a listed company, as submitted in relation to Option 3.4, it is likely that competitive pressures for equity funds and the need to maintain the company's share price (and possibly other non tax factors) would be the key determinants of its distribution policies. This coupled with the Ordering rule for distributions discussed at 2.2.5 above, and capital gains arising at the underlying shareholder level to the extent that sale prices reflect the net asset backing of the shares should mean that in relation to listed companies there would be relatively little overall loss of Australian revenue, if any, due to the extension of the s23AJ exemption, the exclusion of listed companies from CFC attribution and the broadening of the de minimis exemption as it applied to listed companies. [10] In relation to closely held companies, untaxed and low taxed passive income would continue, consistently with the submission in relation to Option 3.4, to be taxed under the CFC and FIF rules and would be subject to foreign tax credit treatment. There would be revenue losses in relation to

[10] There is no advantage in deferral where the tax on repatriation is fixed and unavoidable as the tax liability will increase at the same rate would investment of the after tax proceeds. See the discussion in D G Hartmann, "Tax Policy And Foreign Direct Investment" (1985) 26 *Jnl Of Public Economics* 107 and A C Warren, "The Timing Of Taxes" (1986) 39 *National Tax Journal* 499.

non portfolio dividends from currently unlisted countries that were not distributions of previously attributed income. It would be reasonable to assume that redistribution of such dividends would be deferred although this effect would be mitigated somewhat by the Ordering rule suggested at 2.2.5.

If the s23AJ exemption were to be extended to all non-portfolio dividends (other than distributions of income that was attributed under the CFC or FIF regimes) the locational choice of non-portfolio foreign investments by listed Australian resident companies should be unaffected by attempts to offset high tax investments against low tax investments. It may be conceded that, where a company does blend its non-portfolio investments between high tax and low tax countries, the marginal rate exemption system proposed in this submission produces the same effect at the natural person resident shareholder level as blending of investments does at a corporate level in a foreign tax credit system. Hence, in closely held companies it might be expected that the locational choices of non-portfolio foreign investments might exhibit tax motivated blending of investments which would prevent net Australian tax being paid at the underlying shareholder level on investments in low tax jurisdictions. Whether or not this should be a matter of concern is another question. Under the marginal rate exemption approach proposed in this submission optimal blending of direct investments in high tax and low tax jurisdictions means that t = Fm. Where this is the case the marginal rate exemption approach produces both capital import neutrality and capital export neutrality at the natural person shareholder level and prevents there being any refunds by Australia of foreign tax paid and prevents foreign tax paid being offset against a taxpayer's Australian tax liabilities. Consistently with the submission made in relation to Option 3.4, blending of investments in closely held companies would continue to be inhibited by the application of CFC and FIF rules and FTCs (where the CFC or FIF rules are applicable) to those companies.

Consideration could be given to extending the s23AJ exemption to all foreign source dividends other than those representing distributions of previously attributed income. If the s23AJ exemption were only extended to all non portfolio dividends (not being distributions of previously attributed income) blending of investments at the corporate level would continue to be inhibited somewhat by the application of foreign tax credits to portfolio dividends, dividends sourced in income that had not borne foreign tax, foreign income attributed under the CFC and FIF rules and other foreign source corporate income that did not fall within the s23AH exemption. In cases where FTCs were applicable and t < Fc the foreign tax credit system with its existing baskets would mean that Australian tax would be borne at the corporate rate on Fc – t. Although foreign tax credits apply to portfolio dividends irrespective of whether they were sourced in high or low tax countries, the fact that the credit is limited to a direct credit will usually mean that foreign tax will be lower than Australian corporate tax on the grossed up dividend. Exempting foreign portfolio dividends received by Australian companies, other than dividends representing distributions of income previously attributed under the FIF rules, would thus provide additional opportunities for blending of low and high tax foreign share investments at the corporate level. For that reason extension of the s23AJ exemption to all foreign dividends, other than those representing distributions of income previously

attributed under the CFC or FIF rules, might not be thought be desirable. In addition, exempting foreign portfolio dividends (other than distributions of previously attributed income) derived by natural person residents would either produce a lack of neutrality with natural persons deriving non exempt foreign income and with natural persons deriving only domestic income. As discussed earlier comprehensive pursuit of capital import neutrality at the natural person taxpayer level would be likely to result in abusive tax planning through passive investment in low tax jurisdictions. To exempt corporate foreign source portfolio dividends while giving foreign tax credit treatment to natural persons deriving foreign source portfolio dividends would produce a lack of neutrality between the latter class of natural persons and those who invest in Australian companies deriving foreign source portfolio dividends. As the foreign tax credit would be restricted to a direct foreign tax credit this lack of neutrality would be alleviated but not eliminated by use of either the marginal rate exemption or the limited exemption approaches discusses earlier in this submission.

If a blending of high tax and low tax non-portfolio investments by closely held resident companies is regarded as a matter of concern then a basket system approach to the limited exemption could be used. This would involve increased compliance burdens for both Australian companies and their shareholders. Companies would need to keep separate track of foreign taxes paid for each relevant rate of foreign tax. Shareholders would need to be advised of the relevant exempt portions for their applicable marginal rates for each separate basket of foreign taxed dividends. Although compliance costs could be reduced by including a band of rates in each basket and by super stacking the compliance costs of this approach would not appear to be outweighed by the Australian revenue gained Alternatively, if blending is a matter of concern then the s23AJ exemption could continue to be confined to dividends sourced in profits that had been taxed in comparably taxed countries. For this system to be effective, however, the list of comparably taxed countries would need to be confined to truly comparably taxed countries and concessional tax treatments would need to be identified and excluded from the exemption. This would involve administrative burdens and, as suggested in the Treasury Consultation paper, might create difficulties with previously listed countries that were being excluded from the list.

Hence, it is submitted that the s23AJ exemption should be extended to include all non-portfolio dividends other than those representing income previously attributed under the CFC or FIF rules. A corresponding extension would also need to be made in the scope of s23AH. This would mean that in the case of non-portfolio dividends and foreign branch profits there would effectively only be two classes of income: (i) exempt income; and (ii) income that is attributed under the CFC or FIF rules. If, consistently with the submission in relation to Option 3.4, listed companies and their wholly owned subsidiaries ceased to be attributable taxpayers for CFC purposes and the de minimis exemption for FIF rules was broadened for such companies, all non portfolio dividends (falling within the FIF de minimis rules) and foreign branch profits of such companies would be exempt from Australian tax. This would be a considerable simplification and should result in considerably reduced compliance costs for such companies.

This submission was written on the assumption that the marginal rate exemption approach discussed in relation to Option 2.1 would be implemented. Similar points to those made in this submission would be able to be made if the limited exemption approach discussed in relation to Option 2.1 were implemented.