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

Dear Sir/Madam,

This letter is in response to the Board's request for submissions in relation to the Reform of International Taxation Arrangements, in particular the matter of facilitating conduit structures as raised in Chapter 3 of the Consultation Paper prepared by Treasury.

The issue

The attractiveness to multinational enterprises of a particular location for managing and holding operations in a particular region (hereinafter referred to as an "RHQ") is determined by a number of factors, including its tax regime. The Australian scheme of taxing such companies currently includes a number of significant negative features. These include:

- Australian capital gains tax ("CGT") applies on the disposal by an Australian RHQ of any interest in a foreign entity.
- Australian CFC/FIF rules are enormously complex, unnecessarily broad in their scope and very expensive to comply with.
- In the event a foreign Multinational Company ("MNC") sells its Australian RHQ company, that transaction may also be exposed to Australian CGT.
- Relief for income flowing through an Australian conduit is incomplete.
- The vagaries of the residence test for companies can expose foreign subsidiaries of an Australian RHQ to being treated as Australian resident unless considerable care is taken in managing the position. This 'managing' can mean unnecessary costs are incurred.

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Lessons from practice

Individuals practising in tax in Australia and dealing with MNCs will inevitably, throughout a career, encounter situations where Australia is rejected as a situs for an RHQ based mainly on features of the tax regime. This has certainly been true in my own case. Equally, whilst working in Singapore in the mid 1980s, I have seen examples of MNCs setting up RHQs in that country decided significantly on the basis of tax considerations.

Obviously tax is not the only factor which is considered by MNCs in deciding where to establish an Asia-Pacific RHQ: other important factors include proximity to operations, ease of travel to relevant operations, telecommunications networks, relative costs (in this regard the cost of tax-equalisation programs for expatriates is a significant 'minus' factor for Australia), language, culture and even lifestyle options for expatriates.

Australia's rating in comparison to competitors in our time zone will vary in respect of each of the above factors (some good, some less so), however the one area where Australia rates consistently poorly is in the impact of taxes on the RHQ itself. The CGT exposure, CFC regime and the other items listed under 'The issue' section of this letter are the reasons cited by companies in determining not to establish RHQs in Australia, or to move those which already exist here to an offshore location.

Suggested reforms

Many of the proposals for improving the tax situation for RHQs can be simplified if there is some accepted definition for an RHQ. This should not be made too complicated. For example any Australian resident company in which at least 80% of the interests are ultimately owned by non-residents and which owns a minimum of at least one foreign operating entity would qualify as an RHQ if is so chooses.

An RHQ could own interests in Australian resident entities but these (and interests in them) would not receive any concessional treatment.

Having defined the RHQ it is then easier to attribute to it a range of concessions which mean there is no disadvantageous tax circumstance arising in Australia. The suggested concessions include:

- Capital gains made on disposal of interests in foreign subsidiaries where it represents the effective disposal of an operation would be disregarded (disposal of a foreign holding entity would also qualify where it holds one or more operating entities).

- The disregarded capital gain would be included in the foreign income account (see later point).

- The CFC/FIF rules could be deemed not applicable for qualifying RHQs as the operating entity stipulation for its foreign interests would effectively provide a substitute rule.

- Capital gains made on the disposal of interests in an RHQ would be disregarded *if otherwise taxable*. They would be disregarded to the extent that the gain represents gains on non-Australian interests held by the RHQ.

- Entities in which an RHQ holds a qualifying interest could be deemed to be non-resident of Australia provided they are incorporated/established outside Australia i.e. the management and control test would not operate in these circumstances.

- All foreign income and capital gains derived by RHQs from qualifying foreign entities would go into a foreign income account. It would not be necessary to facilitate dividend streaming if the RHQ is directly owned as to 100% by foreign shareholders. In other cases streaming could best be facilitated by accepting a special class of shares to be used for this purpose.

- RHQs would pay company tax at the normal rate (currently 30%). It would be important that RHQs would be able to access fully Australia's tax treaty network.

- RHQs providing services to group non-resident companies should be entitled to avail themselves of a 'safe-harbour' mark-up on fees and charges, probably at cost plus 7.5% as set out in TR 1999/1.

This is a suggested set of special concessions available only to qualifying RHQs. It is by no means a very aggressive set of rules. Many companies would argue that, in order to compete, Australia needs to offer actual tax incentives for the establishment of RHQs. Another option of course would be to change the rules (CGT and CFC in particular) for all taxpayers. The disadvantage of that is that it is likely to be more costly to the revenue while the specific benefits are unlikely to increase; that is, there are only so many potential RHQs for the region. Indeed there is a potential marketing advantage in having specific legislation for RHQs as it focuses attention on them and helps to sell the idea.

Potential benefits and costs

As noted earlier in this letter the current taxation of conduits makes it very unattractive to set them up in Australia. In that context tax concessions are "no cost" as the potential tax liability would rarely have arisen. The tax advantages in attracting RHQs lie in the other taxes which do apply to activities located in Australia, including company and employment taxes and GST.

The real benefits of course lie in attracting economic activity with all the flow-on effects to service providers. These are well documented no doubt in various studies on the subject.

Conclusion

MNCs are aware that various tax jurisdictions around the world are active in seeking to encourage international investment through the provision of taxation incentives of one sort or another. This practice is by no means limited to developing countries and the aggressive entrepot economies such as Singapore and The Netherlands, it extends to highly sophisticated economies throughout the western world. The United Kingdom and USA, for example, allow for amortisation of intellectual property and the situs of IP can be a vital factor in deciding where to locate particular group functions.

The encouragement of the establishment of RHQs in Australia by facilitative tax legislation should be a high priority in the reforms of Australia's international tax arrangements. It is an obvious area of current weakness, the demonstrable benefits of fixing the problem are significant and the revenue cost (if any) is likely to be acceptable.

If members of the Board would like to speak directly to a company with a current tax issues in the area I would be happy to arrange it.

Yours sincerely,

Tony Baxter