Submission on The Review of International Taxation Arrangements

CPA Australia

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Introduction

As Australia's largest professional finance and accounting body with over 97,000 members, CPA Australia welcomes the opportunity to provide input into the Review of International Taxation Arrangements. Our organisation remains committed to tax reform that meets the government's criteria of:

- optimising economic growth
- promoting equity, and
- promoting simplification and certainty.

We also encourage reform that enhances both Australia's competitiveness in the global community and attractiveness as a place for business and investment.

Our submission is divided into two related parts:

Part A - Key Submission Points

Part A of this paper provides a number of recommendations regarding those issues we believe to be the priority issues to be considered as part of this review. The recommendations are as follows:

- *To address the tax bias identified in Option 2.1 we recommend that a combination of Alternative options A and B be introduced. To ensure the integrity of the revenue base is protected these options should limit the capacity to provide domestic tax relief or dividend streaming to foreign source income from either comparably taxed locations and/or from active businesses.*

- *The alternative suggested at Option C on DWT is unlikely to provide any cost of capital advantage for PHCs and is therefore not supported.*

- *All forms of corporate reorganisation currently permitted by the capital gains tax provisions should be allowed under the CFC rules. This should include but not be limited to the various 100% wholly owned company and scrip for scrip roll-overs. Also as the demerger legislation has now been passed this needs to be considered*

- *An Active Business Test (ABT) be introduced that permits active service business to be performed by CFCs providing they have adequate commercial substance. We also recommend that the definition include adequate mechanisms devised to address any related integrity issues.*

- *CPA Australia is supportive of the proposal to include additional countries on the broad exemption list and to clarify the criteria for inclusion as outlined in 3.3 as an interim step to be pursued prior to a more comprehensive rewrite of the CFC rules in the future.*

- *There is a need for a clear, timely and agreed joint consultative process for identifying and rectifying remaining CFC policy issues.*

- *The provision of a general exemption as proposed in Option 3.9 of RITA for foreign non-portfolio dividends received by Australian companies would simplify the law without any materially adverse impact on the revenue, and is therefore supported.*

- *We support a complete rewrite of the asset CFC rules based on the introduction of an appropriate ABT designed to provide a general exemption for foreign non-portfolio dividends received by Australian resident companies.*

- *We favour the adoption of a specific conduit holding company regime that addresses the current deficiencies outlined over the other alternatives outlined in Option 3.9. A comprehensive approach is required to create a meaningful impact on opportunities that might otherwise pass by as well as to adequately deal with all of the relevant issues.*

Part B – Other comments and recommendations

Part B provides a consideration of some of the other issues/ options raised in the consultation paper.

- *We remain opposed to the introduction of provisions to tax disposals by non-residents of an interest in a non-resident entity that may have underlying Australian assets. Notwithstanding, if this is to be pursued as a matter of government policy, there is a need for significant further discussion and consideration of issues, including that any such measure should only be adopted on the basis that the ATO must first establish that a dominant tax benefit exists before the measure could be imposed*

- *Option 3.12 alone will not remedy the current ambiguity in the area of tests for company residency. In addition, we believe this issue should be dealt with in conjunction with our earlier comments in relation to CFC reform. Also any remedy should also be as consistent as possible with discussions on related issues that are occurring within the OECD*

- *We support the changes proposed in options 4.2 – 4.5 that are aimed at simplifying the existing rules and minimising compliance costs*

- *The four regimes that apply to foreign trusts should be consolidated and codified into a common set of provisions. As part of doing so the need to review the provisions by reference to previous recommendations and the FSI rules should also occur*

- *The RBT proposal that departing residents provide a security against a potential future CGT liability is not supported and should be abandoned.*

Acknowledgments

This paper has been prepared for CPA Australia with extensive input from David Scott - Partner, Ernst and Young, and also members principally via the CPA Taxation Centre of Excellence (TCoE) and the Board Tax Practice Committee. I also acknowledge the work done by both Michael Hay FCPA - Partner, Pitcher Partners and Garry Addison FCPA - Senior Tax Consultant at CPA Australia.

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Part A - Key Submission Points

Chapter Two – Attracting Equity Capital for Offshore Expansion

Illustration of the Issue

The Review of International Taxation Arrangements Consultation Paper (RITA) identifies the fact that Australia has both significant outbound as well as inbound flows of capital that reflects the growing globalisation of business. In terms of Australian Parent Holding Companies (PHCs), the current dividend imputation system produces a tax bias in favour of them investing in Australian rather than offshore businesses.

One reason for this is the apparent preference shown by Australian resident investors and institutions for receiving franked dividend distributions. Treasury has stated that any proposal to change the existing imputation system to reduce or eliminate the bias needs to address the impact on the cost of capital.

This is a complex issue that relates to the manner in which Australian companies are responding to changes in the global business environment. The issues are made more complex by the fact that Australia has increasingly become a capital exporting location as well as remaining a significant capital importer. A combination of these factors affects the capital structure and ultimately the cost of capital of such businesses. A number of common aspects emerge in discussions with various PHCs such as:

- The Australian market represents a mere 2% of total global business activity.
- As Australian companies reach maximum size in the Australian market place they have no choice but to pursue opportunities offshore
- Where they do so it results in a change to the profile and proportion of offshore business and investors
- Over time, PHCs will accumulate a pool of exempt foreign source income and increasingly need to distribute unfranked dividends to provide shareholders with a return on their investment
- Australian investors in receipt of unfranked distributions by a PHC from foreign source income do take account of the lower relative return in a manner that impacts the cost of capital
- Foreign investors are influenced by the effective after tax cost of a dividend returns from investments made directly in businesses in their country of origin compared to an indirect return via non conduit locations such as Australia
- Foreign investors appear more prepared to invest in debt/note issues made by PHCs. Generally such arrangements are more flexible in terms of matching the profiles of foreign investors with the business activities of PHCs when compared to their current impact of investing in equity issues. There is an obvious difference in the relative cost of capital between debt compared to equity that is in part influenced by the factors mentioned, and

- Dual listed company (DLC) structures provide a solution to the matter only in specific circumstances and are not practical, relevant or viable in every instance.

Discussion of Option 2.1

Option 2.1 considers three alternative options in respect to this matter. They are:

- ***Alternative A***: Providing domestic shareholder tax relief for unfranked dividends paid out of foreign source income;
- ***Alternative B***: Allowing dividend streaming of foreign source income; and
- ***Alternative C***: Providing franking credits for foreign dividend withholding tax (DWT).

We believe that a combination of Alternatives A and B with some modifications should be adopted for the reasons mentioned below.

In the case of both Alternatives A and B it is valid to raise the issue of potential risk to the Australian revenue base of their unfettered application. Subject to our comments in relation to proposals relating to the Controlled Foreign Corporation (CFC) rules later in the paper, we believe this could be adequately addressed by limiting the capacity to provide domestic tax relief or dividend streaming to foreign source income from either comparably taxed locations and/or from active businesses.

We also refer you to our comment below in relation to Chapter 3 in terms of the interaction of the foreign source income rules with changes proposed to the CFC rules.

Alternative A

Alternative A is conceptually sound as a basis for addressing the bias identified. We are also supportive of the credit being non-refundable.

However, a one-ninth credit is unlikely to provide a sufficient normalisation of the existing bias to have an impact on shareholder assessment of the after tax return of such a distribution. For the bias to be adequately addressed we believe the credit should put all domestic shareholders, irrespective of their profile, in an equivalent position to that of receiving franked dividends.

This would also provide a more equitable approach than, for example, providing an exemption. While an exemption approach has the advantage of being simpler, it is biased in favour of shareholders with a high effective tax rate and a greater relative economic advantage than those on lower rates.

Alternative B

We are also supportive of the option of allowing Australian companies to stream the benefits of different income streams to shareholders with different profiles as a means of addressing the tax bias in favour of domestic investment.

The notion that franking credits must be pro-rated amongst all shareholders does not reflect the economic reality of the modern business environment. Further, to suggest it is in accord with the legal interests of shareholders does not reflect that shareholders with different profiles are prepared and frequently do take ownership positions in companies with different economic and ownership rights.

While RITA acknowledges the fact that DLC structures fall outside existing anti avoidance provisions, we refer to our earlier comments as to the application of such structures to specific circumstances.

RITA suggests dividend streaming could take several forms. For example, streaming could occur from the Australian PHC to non-resident investors or from foreign subsidiaries using a stapled stock arrangement.

We believe that an approach that allows maximum flexibility for PHC to match the profiles of shareholders to sources of income is preferable. Depending on the stage of PHCs' expansion overseas, the location of potential non-resident investors and the extent of the equity interest they may wish to hold, it may be more desirable to stream either from the PHC or from the foreign subsidiary.

That is, we would suggest both scenarios outlined be permitted.

The precise mechanism for how a PHC would stream dividends to non- -resident shareholders would need to be determined. For the reasons mentioned above we believe that mechanism should not result in the erosion of franking credits otherwise available to be distributed to domestic shareholders. Otherwise, some modified mechanism based on a foreign income account would seem appropriate.

Recommendation

To address the tax bias identified in Option 2.1 we recommend that a combination of Alternative options A and B be introduced. To ensure the integrity of the revenue base is protected these options should limit the capacity to provide domestic tax relief or dividend streaming to foreign source income from either comparably taxed locations and/or from active businesses.

Alternative C

In earlier consultation on Alternative C, feedback had suggested that if adopted it would have little effect on the issue at hand. The key reasons identified at that time were that:

- In recent years, foreign DWT has been eliminated or significantly reduced on the payment of dividends
- It has limited potential application for a PHC that has a multi tier offshore ownership structure in that it does not deal with lower tier tax suffered, and
- A change predicated on the PHC first having to suffer foreign DWT is unlikely to accelerate the repatriation of foreign source income.

On that basis we do not believe this is a viable alternative to adopt.

Recommendation

The alternative suggested at Option C on DWT is unlikely to provide any cost of capital advantage for PHCs and is therefore not supported.

Chapter 3 – Promoting Australia as a Location for Internationally Focused Companies

This chapter deals with a number of separate issues that relate to the issue of promoting Australia as a suitable international location for companies. Our response focuses on two particular areas that we feel are critical in this regard, and these are:

- the CFC rules, and
- improving conduit income arrangements.

That is not to say that the other aspects contained in Chapter 3 do not deserve attention. These other matters are dealt with in Part B of this submission.

CFC Rules - Illustration of the Issue

There have been a number of issues associated with the existing CFC rules that have been the subject of concern to PHCs for some time. Many of the issues have been raised individually by companies in submissions to Government in the past as well as via the ATO's National Tax Liaison Group (NTLG) Foreign Source Income (FSI) Sub-Committee.

It is not proposed to restate all such issues here as evidence to illustrate the need for change in this area. However we do make the following general comments:

- Options 3.1 to 3.3 highlight three particular areas that frequently present Australian companies with anomalous or biased outcomes
- Option 3.4 provides a suggestion for dealing with other similar such matters on an ongoing basis, and
- RITA also invites comments as to whether and on what basis the CFC measures should be the subject of a comprehensive rewrite. We have commented further on this issue below.

Discussion of Option 3.1

Option 3.1 considers the expansion of roll-over relief under the CFC rules while maintaining integrity.

In a commercial context, there is often the need to undertake corporate reorganisations due to acquisitions, business combinations, amalgamations, corporate streamlining and/or in advance of divestments. At present there is an inability to do so in a tax effective manner between CFCs other than in relatively limited circumstances where the CFCs in question are resident in the same foreign country.

Conceptually the preferred solution is to allow all forms of corporate reorganisation currently permitted by the capital gains tax (CGT) provisions. This should include but not be limited to the various 100% wholly owned company and scrip for scrip roll-overs. Also as the demerger legislation has now been passed this needs to be considered in this context also.

In terms of the issue of integrity we believe that the existing transfer pricing provisions of Division 13 and the general anti avoidance provisions of Part IVA provide a sufficiently robust regime of integrity measures. That is, if any proposed transaction is undertaken at fair value and with a dominant commercial purpose then the transaction should be permitted.

Recommendation

All forms of corporate reorganisation currently permitted by the capital gains tax (CGT) provisions should be allowed under the CFC rules. This should include but not be limited to the various 100% wholly owned company and scrip for scrip rollovers. Also as the demerger legislation has now been passed this needs to be considered.

Discussion of Option 3.2

Option 3.2 deals with the better targeting of the tainted services income rules.

At present the current law is biased against the conduct of active service businesses compared to other sales or manufacturer based businesses. The law currently reflects the gap between the nature and environment of business in the late 1980's when the framework of the CFC rules was first formulated and the manner in which business is conducted today.

The CFC rules prescribe all related services between related CFCs or with Australian residents (even unrelated parties) to be 'tainted' for CFC purposes. For example, this renders the performance of service activities such as telecommunications, fund management and professional services as tainted in many circumstances where the need to undertake the activities in the relevant manner is due to the way in which the business operates on a global basis.

These are not the only potential situations that arise. It also fetters new service based businesses from competing internationally on an equivalent basis. It even results in circumstances where CFCs will seek external service providers to provide services that could be rendered internally but for the adverse tax consequences.

The ATO in their 1997 report titled, '*Tax and the Internet*' proposed amending the definition of tainted services to an even more prescriptive form. Given the examples described above, a more prescriptive definition is not supported. In fact we believe the direction of change in this area should be a less prescriptive tainted income definition.

We propose that an *Active Business Test* (ABT) be introduced that permits an active service business to be performed by CFCs providing it has adequate commercial substance. We understand that there may be some reservations regarding adopting an ABT due to the difficulty in defining it's parameters. There may also be concerns in circumstances where there is a mix of active and passive business activities. However, we believe that an adequate mechanism could be devised that would address these integrity issues.

The active business test as proposed above combined with the contemporary manner that existing transfer pricing provisions of Division 13 and the general anti avoidance provisions of Part IVA are administered should provide a sufficiently robust regime of integrity measures.

Recommendation

An Active Business Test (ABT) be introduced that permits active service business to be performed by CFCs providing they have adequate commercial substance. We also recommend that the definition include adequate mechanisms devised to address any related integrity issues.

Discussion of Option 3.3

Option 3.3 considers whether additional countries should be included on the broad exemption list and to clarify the criteria for inclusion.

Currently there are seven broad exemption list countries (BELCs). These are the United States, United Kingdom, Japan, France, Germany, Canada and New Zealand. At present it is only limited designated types of income derived by CFCs resident in those locations that are subject to CFC attribution. As such, it is generally accepted that this greatly simplifies the CFC tax compliance obligations associated with a PHC that conducts business in these locations.

We understand that one proposal currently being considered is to 'turn off' totally the operation of the CFC rules in BELCs. Doing so would immediately eliminate some of the anomalous aspects of the current rules. This would also deal with the issue outlined in Option 3.1, at least as it relates to reorganisations as between companies resident in those locations. Over time additional countries would be added as BELCs to further simplify the application of the rules.

We consider this to be a welcome step in the right direction. However, aspects of the criteria and process for subsequent inclusions on the BELC list need to be addressed. In addition, it does not deal adequately with the issues surrounding the service sector outlined earlier. That is, our comments in relation to Option 3.2 should be addressed irrespective of this proposal.

Part of the motive behind the modifications made to the CFC rules in 1997 that resulted in the creation of BLEC countries was the difficulty that the ATO had in needing to continually update the then extensive number of 'listed' countries. This same predicament has the potential to apply to the proposal at hand as more countries are added. To avoid the list becoming outdated we believe there should be an agreed basis for inclusion on such a list with a commitment that it be updated annually.

Subject to better clarification of the precise basis for inclusion, we agree that the factors outlined in RITA are relevant to consider in this regard. At a minimum the list should be extended to include most countries with which Australia has a DTA. Further, we refer to our separate comments in relation to the need to allow active businesses to be able to be conducted unfettered. We suggest this aspect also need to be taken into account in terms of any criteria that deals with how 'tainted' income is taxed by the location in question.

Our comments are also made subject to those below in relation to the need for a comprehensive rewrite of the CFC rules.

Recommendation

CPA Australia is supportive of the proposal to include additional countries on the broad exemption list and to clarify the criteria for inclusion as outlined in 3.3 as an interim step to be pursued prior to a more comprehensive rewrite of the CFC rules in the future.

Discussion of Option 3.4

This option deals with how to identify and rectify remaining policy issues relating to the ongoing maintenance of the CFC rules.

As outlined, many inadequacies of the existing CFC rules have been identified for some time, generally via the ATO's National Tax Liaison Group (NTLG) Foreign Source Income (FSI) Sub-Committee. However, there has never been an adequate process or sufficient resources available for that forum to resolve them. Further it is unclear whether that forum continues to be the most appropriate one going forward in view of the recent transfer of the tax law design function from the ATO to Treasury.

Therefore, if future issues are to be dealt with on a case by case basis then there must be a clear, timely and agreed process for addressing the matters identified.

Recommendation

There is a need for a clear, timely and agreed joint consultative process for identifying and rectifying remaining CFC policy issues.

Discussion of Option 3.9

At present the law exempts non-portfolio dividends and branch profits derived from limited exemption list countries by an Australian resident company. However, dividends derived from unlisted locations are subject to tax unless they have been the subject of previous CFC attribution.

Option 3.9 proposes abolishing this position and providing a general exemption.

Subject to our comments regarding the CFC provisions below we believe this would result in a simplification of the current law. Further, as a practical matter no significant amounts of dividends from unlisted locations are repatriated to Australia in any event. As such, it is unlikely that the introduction of the proposed measure would cause any materially adverse impact on the cost to revenue.

Recommendation

The provision of a general exemption as proposed in Option 3.9 of RITA for foreign non-portfolio dividends received by Australian companies would simplify the law without any materially adverse impact on the revenue, and is therefore supported.

Discussion of the Need to Rewrite the CFC Rules

RITA raises the question of whether the CFC rules should be completely rewritten.

There are many reasons that support the need for a complete rewrite, including many of those already outlined in this submission. In particular, the current CFC rules were first conceived in the late 1980's and then modified in 1997. There are a number circumstances where they do not adequately accommodate bona fide commercial business activities. Since the CFC rules were originally introduced the transfer pricing rules and general anti avoidance provisions have been applied in a much more robust manner by the ATO.

We believe these factors in combination suggest that a fresh approach should be adopted in relation to the taxation of CFCs.

Specifically, we believe a new approach centred around an *Active Business Test* (ABT) would be desirable. If the CFC in question conducts an active business then it should not be subject to attribution. However, if this is not the case then the income derived should be attributed and taxed with an offsetting foreign tax credit (FTC). Consistent with the proposal outlined in Option 3.9 a general exemption could then be applied to all foreign non-portfolio dividends an Australian company may receive.

We also refer you to our earlier comments under Option 3.2 regarding an appropriate ABT mechanism to address integrity and other concerns.

It is also relevant to query whether such an approach would give rise to greater compliance costs particularly in respect of BLEC location CFCs. While this would depend on the precise form of the ABT, we believe the compliance costs would be minimised if an appropriate definition of active business was included and an adequate threshold was set for any mix of active and passive income.

Alternatively, a more moderate approach to the issue such as that adopted by the UK CFC rules is more consistent with Australia's contemporary international tax objectives.

Recommendation

We support a complete rewrite of the CFC rules based on the introduction of an appropriate ABT designed to provide a general exemption for foreign non-portfolio dividends received by Australian resident companies.

Improving Conduit Income Arrangements

Option 3.10 seeks consultation as to whether to provide conduit relief to Australian regional holding and joint venture companies. It does so by contemplating the following three alternatives:

- A general conduit holding company regime
- An exemption for the sale of a non portfolio interest in a foreign company with an underlying active business
- Providing conduit restructure relief.

Australia currently has a partial conduit regime via the operation of the Foreign Dividend Account (FDA). This arrangement enables dividends to be paid to non-residents without the imposition of Australian DWT providing the profits in question are derived from exempt dividends received from certain CFCs.

As part of the Ralph recommendations a new Foreign Income Account (FIA) was proposed that would expand the range of exempt profits that would be eligible to be distributed free of DWT as well as changes to the mechanism for maintaining the account. At this stage the FIA rules have been the subject of consultation but have not been enacted.

However, neither of these rules does not provide conduit relief for:

- The CFC consequences of offshore intra group activity such reorganisations; and
- Australian CGT on the disposal of regional subsidiaries or the shareholding in the Australian conduit entity.

This discourages the use of Australia as a regional holding company location due to the comparatively higher tax cost of doing so than compared to using alternative locations. This can be clearly illustrated by the fact that when many foreign multinational undertake an acquisition of an Australian PHC they typically restructure any foreign subsidiaries so that they are no longer owned via Australia. There are many such examples of this having happened over recent years.

Further, there is an additional issue as to what passes Australia and goes to other currently more suitable locations. The loss of potential economic activity including the opportunity to augment the critical mass of our financial sector is hard to estimate. However, other locations have benefited from using a conduit tax regime as one important aspect in helping attract such activity.

We favour the adoption of a specific conduit holding company regime that addresses the current deficiencies outlined over the other alternatives outlined in Option 3.9. We believe a comprehensive approach is required to create a meaningful impact on opportunities that might otherwise pass by as well as to adequately deal with all of the relevant issues.

The key features of such a proposal could be as follows:

- Exempt the CHC from CGT on the sale of non-portfolio interests in foreign companies.
- Based on our suggestions in relation to Alternatives A and B of Option 2.1 the exemption need not be proportionate to the level of non-resident shareholding. Rather, the mechanism for distributions of the profits to resident and non-resident shareholders could be made in accordance with those suggestions.
- This would eliminate the need to identify non-resident shareholders at the time of each disposal.
- Otherwise, an exemption proportionate to the level of foreign ownership in the CHC would be required.
- Where the non-resident disposes of the interest in the CHC before the disposal of the foreign shareholding then we suggest allowance be made for a cost base adjustment to the non-residents interest in the CHC.

We also believe that the proposal should not be limited to 100% or 50/50 joint venture arrangements.

By way of example, it is not difficult to conceive of a situation that could arise where an Australian PHC joint ventures on a regional project with say two other parties. Say that one of the other parties is an Australian resident and the other a non-resident. Each of them may hold an equal one third share in the joint venture company. It would seem unfortunate if a genuine bona fide regional project of that kind would not satisfy the requirements of a CHC regime.

Accordingly we believe the non-resident ownership cut off for qualification should not be so arbitrary. Rather, we believe that a level of substantial ownership of say 20% would be a more appropriate threshold.

Recommendation

We favour the adoption of a specific conduit holding company regime that addresses the current deficiencies outlined over the other alternatives outlined in Option 3.9. A comprehensive approach is required to create a meaningful impact on opportunities that might otherwise pass by as well as to adequately deal with all of the relevant issues.

Part B – Other comments and recommendations

Other Chapter 3 Options

The other RITA Chapter 3 options not already discussed can be categorised under the following three topic headings:

- DTA Related Matters (Options 3.5, 3.7 and 3.8)
- The Review of Business Taxation ('BTR') proposal to apply CGT to the sale by non-residents of non-resident interposed entities with underlying Australian assets (Option 3.6), and
- Matters relating to the test of company residency and the current dual resident provisions.

DTA Related Matters – some comments

One of the reasons for adopting a new model DTA in whatever the form should be to ensure that the Australian positions dealt with via tax treaties are reviewed and updated regularly so Australia remains internationally competitive. In recent years various countries, particularly the United States, have adopted new and contemporary aspects when negotiating treaties or protocols. It was reasons of this kind that in part contributed to the desire to renegotiate the Australia/United States DTA.

Option 3.5 proposes adopting the recently negotiated protocol (the protocol) to the Australia/United States DTA as the basis for future negotiations. While we are generally supportive of this proposal we have a number of qualifications that need to be considered. At present the protocol to the Australia/United States DTA would appear the most contemporary for the proposed purpose. However, we believe it is important that future and other changes in this regard be taken into account in ensuring we remain internationally tax competitive.

The second qualification we have relates to the application of the limitation of benefits (LOB) article contained in the protocol. This article was included in the protocol to address the issue of treaty shopping. That is, to prevent, say, an entity resident in Australia being interposed between some offshore location and the United States in such a manner that would create better overall DTA outcomes than if the ownership was made directly from the United States.

However, if applied in an unfettered manner it could render irrelevant the impact of domestic provisions such as those that may encourage Australia as a conduit location. It seems that a more appropriate way of dealing with the genuine need for a LOB article is to ensure that it is a purpose based test that limits its application to circumstances where there is a dominant tax abuse motive.

In terms of preferences for DTA negotiation referred to in Option 3.7 we note that the Most Favoured Nations clauses in some Australian treaties may influence the priority given to renegotiating DTAs. Otherwise, we understand that priority has historically been given to DTAs with countries that have high levels of trade and/or investment links with Australia. We agree with such an approach.

We note the recently concluded negotiations with the United States and Canada as well as negotiations now commenced with the United Kingdom. We understand that the negotiations in relation to a protocol to the Australia/German DTA have been ongoing for many years. As such we suggest that renewed efforts be made to resolving that negotiation at an early date.

We refer to the invitation to comment per Option 3.8 on the process of consultation in relation to DTA negotiation. CPA Australia participates in the current Treaty Panel established for that purpose. In our experience, we have typically been invited to comment only after the negotiation process is complete or as part of a general discussion of potential issues prior to negotiations.

We are aware of and understand the difficulty associated with the high degree of confidence that is required to be maintained during the process of negotiating a DTA with another country. However, we believe that greater participation in the formative aspects of treaty positions would optimise the degree of commercial input provided.

BTR Proposal in Relation to CGT (Option 3.6)

At issue is the potential risk to revenue of the disposal by non-residents of an interest in a non-resident entity that may have underlying Australian assets. This is an issue that we were invited to consult with Treasury and the ATO as part of BTR. At the time we were critical of how this issue was proposed to be dealt with in the outline provided to us.

It had been suggested that any disposal of an entity offshore where there was significant value in Australian underlying assets would be subject to the rule. Where the ownership structure included both underlying Australian and foreign country assets then it was proposed CGT be imposed proportionate to the relative values involved. Further, it was proposed that the test would be applied without regard to the commercial purpose of the disposal in question.

We believe that this approach does not reflect the practical or commercial realities of global corporate ownership structures. For example:

- it is common for global businesses to organise themselves along regional or other sub ownership structures to provide flexibility to raise capital, joint venture with strategic partners and so on. Introducing new ownership to such a structure at an offshore level is a sensible commercial alternative that would be caught be the proposal previously discussed
- Many business combinations occur these days by mergers or acquisitions of public companies in the foreign parent location. Such a transaction would have the potential to trigger such rules in circumstances where those undertaking the transaction would have had little or no regard for a tax measure of the kind proposed
- Further in certain circumstances, if businesses looking to combine in such a way were to have regard to the potential tax cost it may be sufficient to prevent the transaction, and
- Establishing appropriate values for assets in structures with combinations of underlying assets, some in Australia and elsewhere would be difficult if not impractical in many circumstances

- It is also unclear if such a proposal adopted on a unilateral basis by Australia would be effective or the extent that Australia would have the jurisdiction to collect tax from transactions of the kind mentioned. In earlier consultation there was an acknowledgement that any such rule would also need to be subject to the application of our DTA network. This would limit the extent of any application of the proposed measure.

In this light we question the relevance or need for such a provision, the potential for it to apply to genuine business arrangements and the complexity that would be involved in developing an acceptable form of the measure.

As a minimum we believe that such a proposal requires significant further discussion and that any such measure should only be adopted on the basis that the ATO must first establish that a dominant tax benefit exists before the measure could be imposed.

Recommendation

We remain opposed to the introduction of provisions to tax disposals by non-residents of an interest in a non-resident entity that may have underlying Australian assets. Notwithstanding, if this is to be pursued as a matter of government policy, there is a need for significant further discussion and consideration of issues, including that any such measure should only be adopted on the basis that the ATO must first establish that a dominant tax benefit exists before the measure could be imposed.

Company Residency and Dual Resident Companies

Under the current law a company is considered a resident for Australian tax purposes if it satisfies one of the following three tests:

1. place of incorporation
2. place of central management and control if carrying on business in Australia, or
3. residence of controlling shareholders if carrying on business in Australia.

Of the three tests the one relevant to discussion of Option 3.12 is that of central management and control (CM&C).

Under the place of incorporation test, a company will be a resident of Australia if the company is incorporated under the laws of Australia. This test is a bright line test in that it is rigid, formalistic and easily determined.

In contrast to this the CM&C test is confusing and unclear. The key concept of CM&C was established in the decision in *De Beers Consolidated Mines Ltd v Howe* [1906] AC 455. It suggested that a company has its CM&C where the directing authority is exercised. What is unclear is in precisely what form the directing authority can manifest itself. Depending on the circumstances it is possible to suggest from the case law that the relevant authority can occur via the board of directors or even via the shareholders.

At issue is whether the classical CM&C test is increasingly becoming outdated as business and trade is becoming internationalised and if so what may be done to provide more certainty.

For example:

- electronic forms of communication such as the telephone, e-mail and video-conferencing is making it very easy for important company decisions to be made without the decision makers being at the same location. Whereas at the time the CM&C tests were formulated, it was impossible for CM&C decisions to be made without collocation of the board of directors, it is now not uncommon for directors meetings to be held via video conferencing
- the case of *Malayan Shipping Co Ltd v FC of T* (1946) 71 CLR 156 suggested that a company will be carrying on business in Australia if CM&C is in Australia. Option 3.12 suggests that consideration be given to the exercise of CM&C alone not being sufficient to constitute the carrying on of a business and therefore tax residence
- a OECD released in February 2001 (*The Impact of the Communications Revolution on the application of Place of Effective Management as a Tie Breaker Rule)* discussed the difficulties with tests of this kind as well as possible alternative tests.

Against this background we do not believe that the suggestion in Option 3.12 alone will remedy the current ambiguity in this area. In addition, we believe this issue should be dealt with in conjunction with our earlier comments in relation to CFC reform. Further, any remedy should also be as consistent as possible with discussions on related issues that are occurring within the OECD.

Our comments in relation Option 3.13 are made subject to those outlined above.

Recommendation

Option 3.12 alone will not remedy the current ambiguity in the area of tests to determine company residency. In addition, we believe this issue should be dealt with in conjunction with our earlier comments in relation to CFC reform. Also any remedy should also be as consistent as possible with discussions on related issues that are occurring within the OECD.

Chapter Four – Promoting Australia as a Global Financial Services Centre

We have made only limited comments in relation to this chapter. Comments have been made where areas overlap with our earlier comments or relate to matters we have previously provided input on as part of BTR consultation.

Foreign Investment Fund Rules

As indicated in RITA, the Foreign Investment Fund (FIF) rules were introduced in the early 1990’s to complement the CFC rules in circumstances where Australian residents invested in offshore structures that they did not control and that could accumulate essentially passive income that was not regularly repatriated back to Australia.

There is an acknowledgement in the Treasury paper that the current FIF rules are highly complex. Further, the paper also acknowledges the existence of Australian based mirror funds that generally mean a narrower range of passive investment products for Australian portfolio investors.

We agree with the suggestions contained in Options 4.2 to 4.5 that are targeted at minimising compliance and simplifying the rules. In particular, we believe Options 4.3 and 4.4 could be easily adopted and welcomed by investors.

In relation to considering the longer term replacement of the FIF rules we suggest this would need to be dealt with in conjunction with a review and rewrite of the CFC rules. To that end we refer you to our earlier comments in that regard.

Recommendation

We support the changes proposed in options 4.2 – 4.5 that are aimed at simplifying the existing rules and minimising compliance costs

Taxation of Foreign Trusts

As outlined in RITA, Options 4.9 and 4.10 relate to the further consideration of BTR recommendations 20.8 to 20.12. However, as BTR recommendation 20.7 originally stated these measures were being contemplated only as an interim step pending a comprehensive review of the foreign source income rules. Indeed as the Treasury paper indicates, the implementation of these proposals has been deferred until such a review had been undertaken.

It was acknowledged as part of BTR that the current complexity arises partly because there are four regimes within the current law that cover foreign trusts. These are often difficult to reconcile and can produce complex outcomes even in relatively straightforward factual circumstances.

Accordingly we believe the objective in this regard should be the consolidation and codification of the various relevant rules into a common set of provisions. As part of doing so the need to review the provisions by reference to previous recommendations and the FSI rules should also occur.

Recommendation

The four regimes that apply to foreign trusts should be consolidated and codified into a common set of provisions. As part of doing so the need to review the provisions by reference to previous recommendations and the FSI rules should also occur.

Chapter 5 – Improving Australia's Tax treatment of Foreign Expatriates

The RBT proposal that departing residents provide a security against a potential future CGT liability is not supported. We concur with the comments in RITA that such an approach would excacerbate the problems with the current CGT treatment, involve significant compliance and administration costs and may be contrary to the government's current approach.

Recommendation

The RBT proposal that departing residents provide a security against a potential future CGT liability is not supported and should be abandoned.