Board of Taxation

Review of International Taxation Arrangements

KPMG Submission

31 October 2002

Contents

This submission is provided to the Board of Taxation as part of its consultation process with respect to the Commonwealth Government's review of international taxation arrangements. The submission is provided for the purposes of furthering public policy discussion and deliberations, and should not be relied upon as advice.

KPMG welcomes the opportunity to discuss further the contents of this submission with the Board of Taxation.

For further details, please contact David Stevens, Partner – Tax Strategy & Policy, on 03 9288 5555 or davidstevens@kpmg.com.au

.

1 Introduction & Summary of Recommendations

Introduction

KPMG welcomes the opportunity to contribute to the Commonwealth Government's review of Australia's International Taxation Arrangements. The consultation process being undertaken by the Board of Taxation provides the business and professional community and the government with a unique opportunity to work together to develop international tax rules that should enhance the competitiveness of Australia.

Australia's review of its international taxation arrangements is being undertaken in an environment of increased international competition for foreign investment. Foreign governments, with an appreciation of the importance that taxation and regulatory rules have on the attractiveness of their jurisdictions as places of investment opportunity, have been aggressively pursuing reforms to their international and domestic tax rules for much of the past ten years.

Australia's ability to successfully pursue growth in foreign markets, and to attract an increased share of foreign direct investment, will be impacted by the Commonwealth's ability to introduce international tax reforms that eliminate distortions in investment decisions created by our international tax rules *and* by the interaction of these rules with domestic tax rules.

The review will not be successful if Australia fails to be as innovative as some of our European and Asian competitors who have aggressively pursued reforms to their international and domestic taxation arrangements in recent years. These competitor countries have introduced reforms that have made their economies more attractive for multi-national company structures and have eliminated or mitigated biases against domestic entities pursuing offshore expansions. The principal focuses of these reviews have been on the elimination of taxation on foreign and domestic inter-corporate dividends, capital gains tax relief for group companies, and a closer alignment of the tax treatment of international and domestic income. Many of the reviews also produced rules that have reduced the tax administrative burdens of companies with international interests.

The tax reforms instituted by our competitors have been bold. Our Asian competitors, particularly Singapore and Malaysia, have regimes that are almost entirely focussed on the attraction and creation of multi-national companies. Neither country imposes withholding taxes on dividends, foreign source income derived by companies is generally not subject to domestic tax, neither country has CFC rules, there is no capital gains tax on business assets, and both countries have aggressively reduced their income tax rates (Singapore's company tax will be 20% by 2004, while Malaysia's is 28%). Singapore also utilises an exemption and credit arrangement for the treatment of foreign source income derived by shareholders, effectively eliminating, in most instances, any domestic tax bias for domestic source income by allowing shareholders an effective tax credit for foreign tax paid on foreign source income.

Another Asian regime that is focussed on promoting inward and outward investment is Hong Kong. That jurisdiction has an exceptionally competitive 16% corporate tax rate, exempts all dividends and capital gains from tax, and exempts foreign source income from tax.

The EU countries have also encouraged international investment opportunities through their participation exemption regimes. The regimes operate to eliminate or limit taxation on intercompany dividends and capital gains, whether foreign or domestically sourced. In addition to the participation exemption regimes used by all EU members, some of the countries have other measures available to enhance their attractiveness for international investment beyond the EU. These include: Germany, which effectively exempts from tax dividends and capital gains on shares (whether foreign and domestic) received by companies, and exempts 50% of all dividends and capital gains income on shares (whether foreign and domestic) received by individuals; France, which has a territorial system (albeit not a pure one), the effect of which is that active foreign source income derived by French companies is generally not subject to French tax; Ireland, which has reduced its corporate tax rate to a very competitive 12.5%; the UK, which has a lower rate on dividends and has introduced a partial imputation with a fixed credit for corporate tax paid, whether foreign or domestic; and the Netherlands, which does not impose withholding tax on interest and royalties remitted offshore.

Australia's major trading partner, the United States, is also presently considering significant changes to its rules for the taxation of foreign source income [1] with a view to enhancing the competitiveness of the United States in a global market. The US Congress is presently exploring a variety of options to exempt foreign source income from taxation, including replacing the United States' present worldwide scope of taxation with a territorial model.[2]

KPMG considers that Australia's review of its international tax regime must produce bold and innovative solutions if Australia and Australian businesses are to be able to compete effectively in a business environment where international borders are becoming less relevant.

Principles of international tax reform

The recommendations for reform of Australia's international taxation regime made in this submission are based on the following principles:

- Australia's tax system should aim to ensure that individuals or businesses in similar circumstances should be taxed in similar ways (horizontal equity or 'neutrality'). It should avoid discriminatory or distortionary taxation;
- Domestic taxation arrangements should ideally ameliorate "double taxation" of foreign source income, and at the least not accentuate it. This principle should apply not just at the corporate level but also through multiple entity chains and to the ultimate shareholder level;
- Taxation arrangements should provide similar effective taxation for shareholders that invest directly in foreign entities to those that invest indirectly through a domestic entity;
- Consistent with Australia's scope of tax - that taxes residents on their worldwide income, but limits the taxation of non-residents to only Australian source income - non-residents should not be subject to Australian taxation consequences (either directly or

[1] The catalyst for the present debate in the United States concerning reforms to its international tax rules was a recent WTO finding that the United States' Foreign Sales Corporation/Extraterritorial Income regime was in contravention of international agreements. The regime, in broad terms, permitted exporting entities to elect that foreign source income from their export activities be exempt from US tax. The Bush Administration, while emphasising that the United States will honour its international obligations, stressed that the US should enhance the competitiveness of its international tax rules.

[2] Proponents of a territorial tax system include Rep. Dick Armey, the House Majority Leader and Rep. Bill Thomas, Chairman of the House Ways and Means Committee.

indirectly) on foreign source income that merely passes through Australia, i.e. conduit income flows. Income in this context should also include capital gains;

- Australia's tax regime should not provide special tax incentives for non-residents over residents, e.g. "ring fenced" regimes, but equally, it should not provide disincentives that discriminate against foreign investment and distort investment decisions;
- Australia's tax regime should provide simplicity and certainty for all investors. Australia's tax system should be based upon clear principles, reflected in legislation. Taxpayers should be able to understand simply and comply easily with their tax obligations. There should be certainty for taxpayers, with uniformity and consistency in the application of the law. The costs of compliance and administration should be minimised where possible. Complexity of tax laws should be minimised or avoided where feasible; and
- Australia's tax system should be internationally competitive in its rates, structure and administration.

The submission addresses in detail all the above principles and develops recommendations based on those principles.

The KPMG submission responds to the issues raised in the Treasury Consultation Paper and comments on most options therein.

It specifically develops proposals in three key areas:

- Foreign source income ("FSI") domestic shareholder dividend relief;
- The scope of the FSI rules for attribution; and
- The development of a 'participation exemption' model.

The combined impact of these three systemic reforms would fundamentally improve Australia's international taxation arrangements – consistent with both the direction of the Consultation Paper and global taxation trends.

The other measures we address would also enhance either the focus or operation of various elements of the existing rules.

Summary of recommendations

The recommendations below follow the format outlined in the Treasury Consultation Paper. Therefore, chapter two of this submission relates to the issues and options in chapter two of the Treasury Paper.

Chapter Two Recommendations

- Action is needs to be taken to fundamentally address the bias against foreign source income at the domestic shareholder level. Failure to do so may significantly impair the international competitiveness of Australian businesses and especially their capacity to expand offshore (Option 2.1);
- The preferred mechanism for further development to address the bias would be a partial exemption model (as outlined above) as it has the greatest systemic capacity to facilitate improvements to international taxation arrangements – not just for domestic shareholders. Failing the adoption of a partial exemption model a partial credit of no less than 1/3rd and preferably 3/7th (to equate to full franking) be developed (Option 2.1, also interacts with Options 3.3, 3.9, 3.11); and
- Option B to permit streaming of foreign source income to foreign shareholders without adverse impact on franking be permitted so as to enhance corporate flexibility. This option should be adopted in conjunction with the domestic relief mechanism above. (Option 2.1).

Chapter Three Recommendations

- Support providing a general exemption from the FSI rules for income derived in "comparably taxed" jurisdictions:
  - As a first step, provide the general exemption for income sourced in BELCs. This measure should apply from 1 July 2003;
  - Extend the FSI general exemption to *all income* sourced in countries on the initial (BELC) list. That means that Australia would be relying on that country's foreign source income and related anti-avoidance rules to provide the integrity and comparability to that which would be expected under Australia's rules; and
  - Examine, and extend, the FSI general exemption to other countries considered to have "comparable tax arrangements" to the initial seven on the BELC list.

- (The above recommendations have implications for Options 3.1, 3.2, 3.3, 3.4, 3.10 & 4.1, 4.2, 4.3 - to the extent they relate to investments in BELCs).
- Consider adopting a participation exemption model for foreign source income, including specifically capital gains and dividends. This should be undertaken in conjunction with an expansion of the FDA to handle all exempt foreign source income. (Relates to Options 3.1, 3.9, 3.10, 3.11);
- Align the roll-over relief available through the CFC rules, with that available under the domestic tax law of the country of residence of the CFC, especially in respect of broad-exemption listed countries (Option 3.1);
- Subject to the first recommendation in this section not proceeding, a process should be established to define “comparably taxed” jurisdictions and then add them to the BELC (Option 3.2);
- Reconsider the concept of “tainted rental income” for purposes of the “passive income” definition to ensure that active property businesses do not continue to be inappropriately labelled as “passive” (Option 3.2);
- Amend tainted services rules to exclude income derived from related parties that occur within the same type of country (e.g. BELC, LELC or unlisted) (Option 3.3);
- Provide an exemption for service companies (at least for those residents in limited-exemption listed countries) where the active business of the CFC is solely the provision of such services to related entities (Option 3.3);
- The definition of “associate” for the purposes of determining amounts constituting tainted services income should be further clarified and greater explanation provided to taxpayers (Option 3.4);
- Consideration should be given to extending the relief from the application of the transfer pricing provisions depending on residency (Option 3.4);
- Clarify the implications of consolidations regime’s interaction with international tax provisions (Option 3.4);
- Clarify the Government’s position in relation to the interactions of the debt / equity provisions with CFC legislation (Option 3.4);
- Clarify the attributable income status of notional exchange gains and loses (Option 3.4);

- Exempt capital gains derived through CFCs (Option 3.4);
- Exempt CFCs from Australian CFC rules where they operates in a comparable CFC regime (Option 3.4);
- Treat a company that is non-resident for treaty purposes as a non-resident for all purposes of the Australian tax law (Options 3.4 & 3.13);
- As advanced in the US/Australia DTA Protocol, support the reduction of the withholding tax rates in treaty negotiations (Option 3.5);
- Due to the compliance difficulty in taxing non-residents on the disposal of non-resident interposed entities with underlying Australian assets do not support this measure (Option 3.6);
- Consider and concentrate upon DTA negotiations with MFN countries before seeking to identify other potential DTAs to be negotiated or renegotiated. (Option 3.7);
- Support a dedicated consultative body should be established in relation to the negotiation of tax treaties (Option 3.8);
- Support the abolition of the limited-exemption list for foreign non-portfolio dividends received, plus **foreign branch profits and capital gains** (Option 3.9);
- Subject to acceptance of the first two recommendations for this section, support further examination of a conduit regime designed to allow the flow-through of foreign source income and certain gains to foreign investors (Option 3.10);
- Support a more flexible, effective and broader definition of income than the present FDA (Option 3.11);
- Support clarification of the company residency test so as to provides greater certainty in relation to when a business will be considered to be carried on in Australia, including the interaction of this requirement with the central management and control requirements (Option 3.12); and
- Support the proposal to treat a company that is non-resident for treaty purposes as a non-resident for all purposes of the Australian tax law (Option 3.13).

Chapter 4 Recommendations

- Exclude, from the FIF regime, FIFs which are resident in "broad exemption listed countries" ("BELC"), as defined in the proposed

CFC rules (refer the section dealing with CFCs, and relates to Option 4.1);

- Support the replacement of the current FIF regime in the medium term (Option 4.1). In particular, the following principles and issues should be addressed:
  - Support the concept that the FIF regime should apply only to FIFs which carry on a passive investment activity;
  - Support amendments that exclude, from passive investment activity, investing in real property and hedge funds (Options 4.1 & 4.2);
  - Eliminate the need for the current definition of "eligible activity" (Option 4.1);
  - Exclude, from the Australian FIF regime, FIFs which are otherwise subject to a comparable or an acceptable FIF accruals type tax regime in a foreign country (Option 4.1);
  - Exclude, from the FIF regime, FIFs which distribute a certain portion of its income within a minimum period of time to its Australian (Option 4.1);
  - Support amendments whereby an interest in a FIF would be defined to exclude any entitlement to acquire that FIF (Option 4.1);
  - Support amendments whereby any allowable FIF deductible loss should not be quarantined on a FIF by FIF basis and should be allowed against any other type of foreign income of the same class (ie passive) (Option 4.1);
  - Support amendments whereby any unrealised losses in respect of "taxable FIFs" should be allowed as a deduction against **any** FIF income including FIF income **previously** brought into account (Option 4.1);
  - Support amendments whereby any foreign taxes relating to FIF income (to the extent that the foreign tax has been paid) should be allowed as a credit against that FIF income (Option 4.1);
- Support a study being undertaken with a view to replacing the de minimus balanced portfolio exemption threshold of 5% with a method which appropriately exempts genuine balanced portfolios rather than the use of an artificial threshold number (Option 4.2);
- Support the exclusion from the FIF regime of complying superannuation funds, plus **other funds management entities**

such as life companies and registered managed investment schemes (Option 4.4);

- Support amendments whereby foreign investors be exempted from CGT or any withholding tax on any trust income to which it is presently entitled to the extent that the income is attributable to capital gains on disposal of assets (whether held directly or indirectly) which do not have the necessary connection with Australia (Option 4.6 and 4.7);
- Amend the CGT rules so that a distribution of income to which a non-resident is presently entitled, but which is not assessable because the income has a foreign source (or a CGT exempt gain that arises from Option 4.6) does not reduce the non resident investor cost base in a unit trust (Option 4.8);
- Support proceeding with the recommendations of the Review of Business Taxation rationalising the application of current rules to foreign trusts (Option 4.9); and
- Support amendments whereby the trust provisions in Division 6 and 6AAA ensure that any foreign trust income which was derived by the foreign trust prior to the time a non-resident becomes a resident is exempt from Australian tax (relates to Option 4.10).

Chapter 5 Recommendations

- Not proceed with measures in RBT recommendation requiring residents departing Australia to provide security for deferred CGT liability (Option 5.1);
- Review Australia's domestic taxation regime dealing with the taxation of employee share options and employee shares (Option 5.2); and
- Not proceed with the RBT recommendation to treat ceasing to be an Australia resident as a cessation event for the purposes of Division 13A (Option 5.3).

2 Attracting Equity Capital for Offshore Expansion

2.1 Introduction

Australian companies investing offshore commonly rely upon equity from Australian investors to finance such investments. The cost of capital for offshore investments can often affect the competitiveness and the viability of Australian companies in foreign markets. If shareholder returns are negatively impacted by the Australian tax treatment of investing in an Australian company with foreign interests, then the cost of capital for such investments should theoretically be increased. Australian companies with a higher cost of capital than their foreign competitors may be less competitive and ultimately less viable.

Australia's tax system should ensure that Australian shareholders are not prejudiced to invest in Australian companies with domestic source income, over Australian companies with foreign source income, as this may increase the cost of capital for Australian companies investing offshore. Further, any distortion in investment decisions caused by Australia's present treatment of foreign source and domestic source income may breach the key tax principle of horizontal equity or neutrality in decision-making.

2.2 Current Law

Australia effectively "double" taxes foreign source dividends. This happens because the underlying overseas profit has been subjected to tax in the source jurisdiction (i.e. where it was earned) and then upon repatriation to Australia at the shareholder level it is again taxable as if no tax has been paid (allowing for the foreign tax reducing the value of the income returned). This classical type of taxation of foreign source dividends is in stark contrast to the treatment of domestic source taxed dividend which carry franking credits (for the tax paid) through to the shareholder level as a tax credit. In other words, domestic profits are ultimately taxable once at the shareholder level, while foreign profits are taxed at the foreign profit level (with possible foreign withholding tax) and then also taxed again at the shareholder level.

2.2.1 Problem

The taxation of foreign source profit is "double" taxed if remitted to shareholders. This acts as a disincentive for Australian shareholders to pursue offshore profits unless much higher rates of return can be generated to overcome the additional tax imposition.

The bias against foreign profits puts Australian companies at a disadvantage to domestic companies without foreign source profits and to overseas competitors whose tax regimes do not impose the same penalty on earnings derived by their shareholders.

The existence and extent of the bias requires Australian based companies with large international earnings to go to great lengths to assiduously manage their capital ratios, dividend payout ratios, domestic franking capacity and remittances so as to minimise the impact of the bias on their Australian shareholders. This task unnecessarily increases the compliance costs to Australian based companies and also complicates the management and ownership structures that they operate under.

2.2.2 Evidence

The evidence clearly shows that there is a bias in the current system against foreign source income at the shareholder level. Table 2.1 of the Treasury Consultation Paper on p.14 illustrates the bias on direct investment offshore. Indeed, the only scenario that doesn't show a bias is that involving the Low Tax Country Individual, where the corporate tax rate is 15% and there is no dividend withholding tax imposed on the foreign profit. No OECD or Asia-Pacific country fits that Low Country Scenario. Hong Kong and Ireland have the lowest company tax rate at the moment at 16%, which would still show a small bias.

For further discussion of the bias see also KPMG's International Comparative Study for the Business Council of Australia dated July 2002. That study showed not only the extent of bias in Australia – as Table 2.1 does – but also that when compared to most comparable overseas countries that the existence of the bias results in amongst the most regressive taxation of foreign source income in the comparison (14 countries).

While corporates may be able to provide specific or generic examples and evidence of the cost of capital impact of this distortion, KPMG is not in a position to provide this information or analysis. Notwithstanding this, we believe - from experience - that this is a very real issue for corporate Australia and logically cannot be otherwise.

The existence of such a (significant) bias can only act as a disincentive and impediment to Australian businesses expanding offshore. It places our businesses at a competitive disadvantage versus other countries that can access their local capital markets without this tax penalty. In particular, jurisdictions that tax income without creating a bias, from a tax perspective, for domestic or foreign source dividends, may make investment decisions based on commercial considerations, unaffected by distorting domestic tax influences.

2.3 Options

2.3.1 Retention of imputation system for domestic income

While supporting measures to overcome the bias against foreign source income under the present Australian taxation arrangements, KPMG – in the context of the current review of international taxation arrangements - does not support the abolition of the imputation system (including the refunding of excess franking credits) for providing relief from double taxation of domestic income. We believe that system broadly achieves its stated purpose and any change would involve significant disruption. Therefore, any options to alleviate foreign dividend taxation should not come at the expense of imputation system for domestic income, but rather sit alongside it.

Notwithstanding our current support for the retention of the imputation system for the time being, we believe that options to address the bias with foreign source income should not be dependent on that system, as that system may require revisiting in the not too distant future, and we would prefer adopting a system for addressing international tax concerns that can withstand scrutiny and possible future modification of the domestic imputation system.

2.3.2 Domestic shareholder relief

At the corporate level comparably taxed foreign source income is generally treated as exempt from further Australian tax. This exemption relieves double taxation at the corporate level. However it is currently not permitted to flow through to the shareholders, i.e. it is treated as unfranked income and subject to full taxation. This creates an incentive not to pay these dividends.

Consultation Paper options to address / ameliorate this problem.

The Treasury Paper canvasses two main domestic shareholder relief options, the third option (Option B) on "streaming" is considered independently below:

- Option C proposes franking credits for foreign dividend withholding tax (DWT). This option only provides relief where DWT is paid.

  Given that many of Australia's major trading partners do not impose withholding tax on the remission of non-portfolio dividends, this measure would not be particularly effective.

  Under the recently renegotiated US-Australia double taxation agreement there will be no dividend withholding tax on dividends paid to an Australian company, provided that company has at least 80% control of the US payer; the United Kingdom, Hong Kong and Singapore do not impose a withholding tax on dividends; and most members of the EU provide an exemption for dividend withholding tax on distributions to related entities resident in comparably taxed regimes. Given that the United States, the United Kingdom, Hong Kong and Singapore received 76.9% of Australia's direct investment offshore in 2000-01, the measure would be most influential in encouraging investment into markets which are presently not as vigorously pursued by Australian companies, but would result in no positive benefit for non-portfolio investments into Australia's most popular markets.

- Option A proposes to grant a partial (non-refundable) tax credit. The example used is 1/9th (no reason is given for why this small credit was selected).

  On an underlying tax rate of 30% a credit of perhaps 3/7th would be appropriate. The 1/9th seems to have been set to compensate for a 10% DWT but not any underlying tax.

  This level of the credit raises the inherent problem with providing arbitrary credits, namely that setting the rate determines whether it has a positive impact or not. Plus a new credit mechanism - separate from imputation credits - will add complexity to administration and compliance.

  Presumably the credit could be passed down a corporate chain in which case a typical corporate with offshore income would be required to maintain an imputation account for domestic franking, a foreign dividend account for exempt foreign income, plus a new foreign credits account (plus a fourth account in a NZ imputation account if the Trans Tasman proposals are adopted).

A modest credit is unlikely to result in any behavioural change and have a very limited impact on cost of capital concerns (because a significant bias would still continue).

For a partial credit approach to be effective in addressing the problem, a more substantial credit value (that roughly equates to the foreign tax that was likely to have been paid) would be necessary, for example 3/7th (which implies a 30% rate of tax, i.e. the Australian rate) would be preferable. Failing that, we contend that a rate of at least 1/3rd (equivalent to a 25% effective tax rate) would be necessary to deliver any fundamental impact and behaviourial change.

In two sections below we discuss alternative approaches to overcome the concerns with these options and more effectively addresses the problems they seek to rectify.

2.3.4 Foreign shareholder relief

The problem in overcoming double taxation of foreign income is also accentuated by Australia's rules on dividend franking. The effect of which is to "waste" franking credits on dividends paid to non-residents that could otherwise be exempt under the FDA rules.

These rules also have the effect of denying Australian corporates the ability to maximise the utilisation of taxation benefits that may be available in foreign jurisdictions for the benefit of shareholders in those jurisdictions (e.g. under staple stock arrangements).

The Treasury Paper canvasses the option B of permitting the "streaming" of foreign source income to foreign shareholders as a means of addressing these concerns.

Rather than being seen as an alternative to the other options (A&C) in the paper, this option could be adopted to complement either of those other options. That is, while Options A & C are alternatives, Option B can be undertaken with either of those.

While this option may directly be seen as benefiting foreign shareholders it also indirectly benefits domestic shareholders by preserving franking credits for domestic dividend purposes.

The key criteria for a company to benefit under this Option is the requirement to have a reasonable foreign shareholder base and preferably a foreign shareholder profile that is similar to your foreign earnings profile. Without a foreign shareholder base this option is of no benefit.

A secondary consideration in this option is its ability to provide Australian based companies with the opportunity to deliver similar dividend tax outcomes to non-resident shareholders as a Dual Listed Company (DLC) structure may possibly provide.

Accordingly, Option B is supported in conjunction with domestic shareholder relief.

2.3.5 Alternative approaches for domestic shareholder relief

In addition to a more comparable uniform (partial) credit, two other alternatives have not been canvassed directly in the Consultation paper. They are:

- Providing franking credits (up to the permissible maximum in Australia) to the value of foreign taxes (underlying and withholding); and
- An extension of the current exemption system through an entity chain to partial exemption at the domestic shareholder level.

The table below provides a summary of the key features – positive and negative – of the three alternative approaches.

<u>Table: Alternative Approaches to Domestic Shareholder Relief</u>

Tax & Credit model, with franking provided for foreign taxes paid and credited (to 30% maximum)	**Partial Exemption model**, with top up tax payable on only a proportion of FSI dividend, say 20%	**Uniform Credit model**, with the non-refundable credit available for all FSI dividends, say at $3/7^{th}$
Purity with franking approach and integrates into system, I.e. Relies on imputation system	Stand alone from franking system	Similar, but separate, to franking system
Complicated for entities	Simplicity for shareholders and entities	Simple for entities

High cost (especially with refunds of excess)	Lowest cost	High (est ?) cost (especially where credit is provided when no tax had been paid)
Progressive, same as imputation	Progressive	Progressive
Benefits all, more lowest taxed MTRs	Benefits all, more higher taxed MTRs	Benefits all, more middle MTRs
Eliminates bias most	Reduces bias	Reduces bias
	Facilitates conduit income best	May generate tax benefits greater than tax paid (unless tracing rules are adopted)
Does not favour lower taxed foreign income (as top up)	Favours lower taxed foreign income	Favours lower taxed foreign income

Note: the existing treatment of foreign source income, where foreign taxes are effectively deducted and then the balance is subject to tax at full marginal tax rates provides greater relative benefits for higher MTRs than lower ones. This current treatment is the most appropriate benchmark against which to make comparison of the alternative approaches.

We note that all three models are alternative mechanisms for delivering a similar policy outcome on this issue – that is, addressing the bias against foreign source income.

The tax and credit model is similar to the treatment of foreign income (at a company level) to the regime in place before the 1990s. It was regarded as a complex model. Notwithstanding this point, it does have the potential to most purely align the treatment of foreign source income with domestic income and, if considered desirable, fully integrates into the franking system.

The partial credit model is discussed in the Treasury Paper and above. Suffice to say, that a reasonable level of credit is necessary for it to be effective.

Given the potential elegance, simplicity and attractiveness of a partial exemption model, we have chosen to focus on its further development for consideration. The following section includes a detailed discussion on the partial exemption model.

2.3.6 Extended partial exemption model

Australia, like most developed jurisdictions, uses an exemption model to alleviate double taxation of foreign source dividends (at least from listed countries) received at the corporate level. The use of the exemption model is considered to be much simpler than the alternative tax and credit approach used by a few countries (most notably the USA – albeit subject to many modifications and Australia prior to the 1990s).

The exemption approach is also adopted in Australia for the Foreign Dividend Account (FDA) mechanism. The FDA is intended to allow foreign source dividends to be paid to non-residents exempt from any further Australian tax (including withholding tax).

This approach would also be consistent with a broad theme of many options proposed in the Treasury Consultation Paper - that is, a greater utilisation of the exemption model to address concerns with both compliance and competitiveness issues with respect to Australia's international tax arrangements.

Therefore a relatively straightforward option would be to adopt a partial exemption model for foreign source income such that it allows exempt dividend income to flow through a chain of entities to the ultimate shareholder (either resident or non-resident). The ultimate shareholder would then be subject to tax under a partial exemption approach if they were a resident, and full exemption if they were a non-resident (or possibly also superannuation funds and tax exempt bodies).

This approach would significantly lessen the current additional tax layer that occurs when the foreign sourced income dividends are treated as unfranked and subject to full Australian tax at the shareholder level.

This option would be adopted for those (currently called listed exemption countries) presently exempt foreign source dividends (and possibly capital gains, royalties, etc) with the current tax and credit model continuing for taxable remittances. [This distinction would be removed in light of other possible FSI changes, e.g. exempting all FSI dividends remitted (Option 3.9).]

This option would encourage the distribution of foreign source income back to Australia and through to shareholders as the return to shareholders would not be so adversely impacted by an additional layer of taxation (without offsetting foreign tax credits) in Australia. From our experience, at present, very little offshore income is remitted to Australia as dividends because of this additional "tax cost" to the shareholder.

This approach would also have the benefit of encouraging greater use of Australian based entities for offshore investment as the cost of capital would be lower and foreign dividends would be taxed more comparably to domestic income derived dividends to most shareholders.

From an administrative perspective this option would also be relatively simple. Companies would maintain an exempt foreign income account (similar to the present FDA and could be expanded along the lines of the proposed FIA) alongside their franking account.

This option could also be adopted in concert with the "streaming" option to permit maximum flexibility of use of foreign tax benefits to foreign shareholders. Albeit the importance of streaming would be reduced by this measure.

Under this approach, exempt foreign source dividends received by an Australian corporate could be distributed as exempt dividends through a chain of entities to the ultimate shareholder as partially exempt. The use of an exempt dividend account, such as the FDA, would be necessary to track the dividends but otherwise no restriction (outside the present rules) is proposed on eligibility for exemption.

Benefits

This type of exemption approach has the following benefits:

- It is simple and certain;
- Low cost of compliance,
- Addresses the bias issue systematically;
- Can sit alongside imputation without upsetting or complicating it (but also is not reliant on it);

- Also works well with non-residents (assuming no WHT is imposed as per the FDA rules) – see further discussion below concerning "conduit" issues;
- Does not allow arbitrage of tax benefits as credit options might;
- Addresses double taxation in a manner consistent with much overseas practice (i.e. as an alternative to tax and credit approaches);
- Is consistent with the general direction in the Treasury Consultation paper and recent overseas reforms of addressing problems through use of the exemption approach;
- Provides an internationally competitive regime for raising equity capital;
- Is consistent with OECD and WTO practice;
- Maintains progressive taxation of dividends to individual shareholders (albeit at lower overall tax rates than the present arrangements);
- Can be easily supplemented with "streaming" if that option is pursued;
- Will potentially unlock a large reservoir of offshore profits to be repatriated to (and through) Australia; and
- Can comfortably handle an expansion of the FDA concept to other foreign source income, e.g. the FIA option, or exemptions for capital gains or other foreign income options.

Costs

The full exemption model raises the following costs as issues:

- Cost to Government revenue (before taking account of behavioural responses, e.g. higher remittances, and economic benefits from lower cost of capital);
- Foreign source income derived and remitted from countries with lower tax rates than Australia could be more beneficially treated than taxed Australian sourced income under the franking system. Note: not many countries have lower corporate tax rates than Australia, notwithstanding that Australia's corporate tax rate is around the average (as are most others);
- The ability to offset foreign withholding tax would be lost (as it largely is now), particularly at the individual shareholder level; and

- Unless entities did not participate, they would be required to maintain a separate account for this exempt foreign source income that may require modest additional compliance.

Proposed example

- At the individual shareholder level a deemed Australian taxable component would be introduced, say at a 20% (or could be some other modest) proportion. Given the low tax rate of superannuation funds, it is not proposed that they (or tax exempts) be subject to this deemed taxable component. That means that resident individuals would be the target of such a measure. Tax would be payable at the shareholder's marginal tax rate on 20% of the cash dividend received;
- For example, with a 20% taxable component (i.e. an 80% exemption), a top marginal tax rate shareholder would pay $9.70 on every $100 of exempt cash dividend, while the lowest marginal rate shareholders would pay only $3.40 tax. This tax is effectively in addition to the underlying and/or withholding tax that would have been paid on the profit and its repatriation to Australia;
- Shareholders would also be entitled to offset deductions against this income. This approach of deeming an amount for Australian tax would be relatively simple and avoid the need for complex calculations, credits or refund mechanisms; and
- In fact, the changed system proposed may lead to revenue being collected at the shareholder level that was not previously collected as the current system is a major disincentive to distribute foreign source profits as dividends. Given that the underlying profits will have been subject to offshore tax, plus this additional progressive Australian tax, the proposal provides an equitable solution to addressing the current tax bias, while at the same time providing sufficient incentive to remit offshore profits.

2.3.7 Interactions and Issues to consider

Conduit income flow

The exemption model through a chain of companies/entities would provide an ideal arrangement for coping with conduit income flows as dividends paid to non-residents that were made up from this exempt foreign source dividend income would also be exempt. Special rules to cope with conduit income would not be necessary under this model (assuming capital gains would permitted through the FIA).

Branches FSI

As branch profits are akin to subsidiary profits they would also be treated the same as dividends.

Treatment of FSI capital gains, royalties and interest

This matter would be determined by whether the FDA was extended to cover these other types of income. Certainly from a consistency point capital gains that are distributed should be treated the same as dividends (as they are merely an alternative form to repatriate the profit).

Capital gains tax on FSI

For individuals, capital gains tax is payable on the sale of foreign assets under the 50% discounted concept (subject to meeting the eligibility requirements). This makes individuals prefer foreign income through this form over "double taxed" foreign dividends. While there is no evidence to suggest this has a major influence on investing behaviour (at least for non-controlling shareholders), equally a rebalancing of the respective treatments of foreign source dividends versus capital gains would be unlikely to generally result in a major behavioural change with respect to how the foreign profits are realised.

Apply to portfolio and non-portfolio dividends?

Chapter 2 only talks about direct investments through an Australian company and not portfolio ones – either indirectly or directly. This issue requires expanded consideration under any option. In principle, direct or indirect investment should be treated equally, which means any withholding tax that is not creditable at the entity level should not be creditable at the individual shareholder level either.

Linkage to changes in FSI rules, exemption listings

An issue for further exploration is the breadth of exemption proposed, outside the listed countries. And also the linkage with possible reforms in Chapter 3 to create a general exemption from FSI rules for certain jurisdictions. Pending work on general exemption approach the interactions will require further consideration.]

Interaction with Simplified Imputation and "streaming"

Under the existing dividend rules a proportional approach would be adopted for exempt FSI dividends. However, consideration would need to be given to whether discretionary dividends of just exempt FSI income would be permissible, and also how "streaming" options would interact, if that option is also allowed.

2.4 Priority

Given the pressure of globalisation, removing impediments to Australians expanding overseas must be regarded as an imperative priority.

2.5 Recommendations

1. Action needs to be taken to fundamentally address the bias against foreign source income at the domestic shareholder level. Failure to do so may significantly impair the international competitiveness of Australian businesses and especially their capacity to expand offshore.
2. The preferred mechanism for further development to address the bias would be a partial exemption model (as outlined above) as it has the greatest systemic capacity to facilitate improvements to international taxation arrangements – not just for domestic shareholders. Failing the adoption of a partial exemption model a partial credit of no less than 1/3rd and preferably 3/7th (to equate to full franking) be developed.
3. Option B to permit streaming of foreign source income to foreign shareholders without adverse impact on franking be permitted so as to enhance corporate flexibility. This option be adopted in conjunction with 2.

3 Promoting Australia as a Location for Internationally Focussed Companies

Introduction

Overall, Australia's taxation system as it applies to foreign source income ("FSI") should assist in promoting Australia as an attractive jurisdiction for Australian-based multinationals and regional holding companies without distorting the taxation treatment applicable to domestic Australian investors. Whilst it is acknowledged that tax legislation alone will not achieve this objective, it is imperative that tax laws complement other Government initiatives that are in place to achieve this objective.

Clearly this objective needs to be achieved whilst retaining an appropriate balance between compliance and other costs to Australian business with the quantum of revenue collected by Australia.

The successful implementation of appropriately designed measures to achieve these purposes should ultimately raise Australia's international competitiveness and strengthen Australia's continued economic growth by attracting global business, capital and managerial skills to Australia.

Current Law

Whilst KPMG support in principle the proposals being canvassed by Treasury, we note that the proposals appear to provide a short to medium term solution. Given the relative complexity of Australia's accruals taxation regime compared to other broad-exemption listed countries (countries such as Germany and the UK have recently introduced amendments to their respective accruals taxation regime), it is strongly submitted that a substantial reform to Australia's accruals taxation regime is ultimately required in order to allow Australian multi-national companies ("MNCs") to remain competitive in the global economy.

Australia's controlled foreign company ("CFC"), foreign investment fund ("FIF") and transferor trust regimes were introduced over a decade ago, during which time significant reform has occurred to Australia's taxation system and there has been substantial growth in both inbound foreign investment capital and offshore capital investment by Australian entities. Accordingly, it is submitted that any substantial reform that occurs to Australia's accrual taxation regime should proceed on the following basis:

- The reform process should define the particular mischief that is sought to be addressed by the accrual measures. For instance, the original accruals taxation system initially intended to prevent Australian taxpayers from escaping tax on passive investment income by shifting investments to low tax countries. This issue remains an important area, which must be addressed by any accruals taxation system that is introduced;
- However, a subsidiary purpose of the current accruals taxation system seems to be to support Australian transfer pricing measures (which incidentally, apply through the CFC provisions) to exclude offshore profit shifting by including tainted services and tainted sales income within attributable income. It is arguable that the tainted sales and tainted services provisions are no longer required in their current form due to the increased level of review and policing that has been undertaken by the ATO and foreign revenue authorities of transfer pricing provisions. Further, for transactions that occur wholly outside Australia, it is questionable whether the Australian taxation system should be attempting to regulate for inefficiencies contained within the transfer pricing regimes of foreign countries; and
- Once the particular areas of mischief have been identified, a detailed consultative process should be entered into for the purposes of designing accruals taxation measures that address the substantive areas of mischief without resulting in undue complexity or compliance obligations for taxpayers. Future development of a new accruals taxation regime will require substantial consultation with Australia's business community and their professional advisers.

As part of the substantial reform process, or failing substantial reform, as an independent option for this review, the treatment applied to broad-exemption listed countries under the CFC rules should be reviewed. At present, the CFC rules only apply to a limited range of eligible designated concession income and those countries that are currently included in the list of broad-exemption countries impose corporate tax upon nearly all of these types of income (with the exception of New Zealand, which does not have a general system for taxing capital gains and the UK which has recently introduced the "substantial shareholder exemption").

Accordingly, it is submitted that, as a first step, the accruals taxation measures should be amended to exclude Broad-Exemption Listed Countries from any application of these provisions given the relatively minor amount of revenue collected from CFCs resident in these jurisdictions and the highly complex nature of the provisions (which impose a significant compliance cost on Australian business).

In addition, the concept of "tainted rental income" for purposes of the "passive income" definition needs to be reconsidered to ensure that active property businesses do not continue to be inappropriately labelled as "passive".

We consider this a unique opportunity for Australia to embark upon genuine reforms to tax laws that have previously placed Australian business at a real competitive disadvantage to entities operating within our major trading partners. Whilst Australian tax is but one of a myriad of issues facing MNCs and foreign entities looking to locate regional headquarters ("RHQ"), the Australian tax system has a significant impact on the decisions.

Framework for major overhaul of Foreign Source Income regime

General exemption from FSI rules for comparably taxed jurisdictions

The Treasury Consultation Paper has not canvassed options to fundamentally/systemically overhaul the application and operation of Australia's FSI rules. While we acknowledge there are many sensible options for addressing specific issues with the rules, they are all offered within the context of the present architecture holding form.

We support consideration of more fundamental approaches to realign the FSI rules to meet their intended purpose while being aimed at systematically addressing the complex FSI rules, i.e. CFC, FIF, etc.

Under this proposal the objective is to "push down", i.e. realign, the FSI rules to only apply to income and jurisdictions that are providing tax haven type benefits to Australian investors overseas. In other words, to recast the rules as the anti-avoidance measures they are intended as and relieving others from their burden.

This proposal does not in itself go into a redefinition of the specific application of those rules (which is certainly a necessary but separate exercise – **see below**), but nonetheless, it does provide the opportunity to dramatically improve the position of a very large component of Australia's offshore investment.

This proposal could be implemented in a staged approach to ensure concerns regarding tax planning and integrity are not compromised. A staged approach would also permit urgent and immediate action in implementing the first stage, while a process to investigate and complete other stages occurred.

Three staged approach

Stage 1 would be to provide a general exemption from the FSI rules for income **sourced** in the current Broad Exemption Listed Countries (BELC).

That is, income derived in any of the seven countries would not be subject to compliance with the FSI rules and possible attribution in Australia. The general exemption should cover CFC and FIFs rules at least.

This approach is based on the fact that these countries are all broadly comparable and income sourced in those countries (we believe) will have/should have been subject to comparable tax to Australia.

This stage alone has the potential to address about 75% (by value of investment) of Australian FSI issues. This stage can be implemented quickly, perhaps from 1 July 2003.

We understand that FSI attributable from the BELCs is very small and therefore any cost to revenue would be minimal – especially when compliance savings are offset.

As this approach relies on a foreign income-sourcing rule, we recommend a modest de minimus rule for non-locally sourced/taxable income would also be appropriate, at say 10%. A modest de minimus rule would reduce compliance costs to business and also tolerate a very minor income from non-BELCs.

Stage 2 would be, subject to completion of examination, an extension of the general exemption to *all income* sourced in countries on the initial (BELC) list.

That means that Australia would be relying on that country's foreign source income and related anti-avoidance rules to provide the integrity and comparability to that which would be expected under Australia's rules. Relying on a comparable jurisdiction's rules would provide a significant compliance cost saving for Australian companies and avoid duplication with similar attribution rules in those countries.

While those countries may not have an exact replica of our rules, the key question is whether they have integrity and are an appropriate substitute. This decision should be based on a practical assessment.

Stage 3 would be to examine and extend the general exemption to other countries considered to have comparable tax arrangements to the initial seven on the BELC list.

In undertaking this assessment and analysis objective criteria should be established for listing countries on the BELC list.

Criteria for comparable tax may include: corporate tax rate, foreign source income rules, transfer pricing rules, anti-avoidance rules, source rules and special conduit or other preferential tax regimes.

This extension may apply to income covered under Stage 1, or may extend to Stage 2 income as well (depending on the Stage 2 outcome).

Stages 2 and 3 should occur simultaneously to avoid unnecessary delay.

A process should be established to define "comparably taxed" jurisdictions and then add them to the BELC.

Participation Exemption Approach for foreign source dividends and capital gains

Participation exemption models are being increasingly used by jurisdictions to facilitate cross-border investments and promote multi-national holding company structures by mitigating the effects of domestic tax rules on cross-border flows between related parties.

The European Union, in an effort to facilitate an efficient common market, has pioneered the use of participation exemption arrangements. The EC Parent-Subsidiary Directive of 1990, which applies to all EU members, essentially provides that profits distributed between related parties within the EU should be exempt from withholding tax, and that the profits received by the parent should generally be exempt from tax in the parent company's state. (Where an EU member does not grant an exemption from tax for foreign source profits, a credit is available for the foreign underlying tax). The minimum condition necessary to establish a parent-subsidiary relationship for the purpose of the EU participation exemption regime is that the parent must have at least 25% of the issued shares, or voting rights, in the subsidiary.

The EU participation exemption regime also extends to exempt capital gains realised on the sale of shares in respect of corporate mergers.

A number of the EU members have more generous participation regimes than the one prescribed by the EU. For example, the Netherlands' participation exemption regime extends to entities in non-EU countries (providing the subsidiary is subject to a national income tax in its jurisdiction), and only requires the parent to hold at least 5% of the nominal paid-up capital of the company (provided the shares are not held as a mere inventory). In addition, capital gains on the disposal of shares by a parent in its subsidiary are also tax-exempt. In addition, UK has recently extended its participation exemption regime to exempt from tax capital gains arising from the disposal of shares in related entities, whether foreign or domestic; and, Germany exempts from taxation all dividends and capital gains derived by a Germany company, irrespective of the source of such profits, or the level of shareholding by the recipient company.

Many regional countries also have regimes that effectively operate in the same manner as participation exemption regimes. For example, Hong Kong exempts all domestic and foreign source dividends and capital gains from taxation, regardless of the level of shareholder ownership; Malaysia exempts all foreign source dividends from taxation (other than those derived by financial institutions, insurance companies, and aircraft and shipping companies); and Singapore exempts all capital gains from taxation and has a tax and credit regime for foreign-source dividends which, because of Singapore's low 22% rate of corporate tax (reducing to 20% in 2004), effectively results in most foreign source dividends being exempt from corporate tax (and personal tax).

There are several advantages to a participation exemption regime:-

- It should eliminate most double taxation at a corporate level, thereby reducing any bias in a tax system to domestic source profits over foreign source profits;
- It provides for simplicity, certainty and transparency, thereby assisting in assessing investment options, adopting relatively simple corporate structures, and dealing with tax obligations from an administrative perspective;
- It is increasingly used by developed countries to enhance investment flows, increasing the international competitiveness of jurisdictions that adopt it.

The adoption of a participation exemption regime for Australia would be entirely consistent with the worldwide trend of mitigating double taxation, at the corporate level, as an issue for cross-border operations. A participation exemption regime would eliminate the second layer of corporate tax on profits transferred between related parties.

An Australian participation model would be consistent with present rules which exempt from tax dividends from listed countries, but could also be extended to:

- Exempt from tax, capital gains on the disposal of shares in offshore related entities; and
- Exempt from tax, profits received from all related non-resident entities.

This model would also be compatible with providing an exemption from Australia's CFC/FIF regime for related entities in broad exemption list countries, and with the recommendations contained within Chapter 2 of this submission.

For the purpose of consistency a participation exemption regime should also allow for conduit income to be remitted from Australia without withholding tax, for example by the use of an expanded FDA to cover other foreign source income; i.e the FIA recommendation in the RBT (Option 3.11 in the Consultation Paper).

We support the consideration of the development of a participation exemption model for Australia, especially covering capital gains and dividends. A participation exemption model has been proven to be efficient, effective and competitive approach to handling international profit flows.

Interactions and Issues to consider

The general exemption from FSI rules for BELCs ("comparably taxed jurisdictions") together with the participation exemption model are closely related and complement each other.

Specifically these fundamental framework proposals interact with Options 3.1, 3.3, 3.4, 3.9, 3.10, 3.11, 4.1 and 2.1 partial exemption alternative (discussed above).

Additional proposals to deal with specific CFC issues, including those raised in the Consultation Paper follow.

Priority

Given the pressure of globalisation, removing compliance burdens and structural impediments to Australians expanding overseas must be regarded as an imperative priority.

Whilst the following comments are addressed towards the specific options raised within the Review of International Taxation Arrangements Consultation Paper of August 2002, it is our overriding submission that detailed consideration be given to the above comments and the need for substantial reform of the Australian accruals taxation system.

3.1 Option 3.1 Options to expand roll-over relief under the CFC rules

Current law

Domestically, the Australian CGT provisions have been significantly reformed in recent years to provide for a taxation environment that facilitates, rather than hinders genuine corporate reconstructions. Such reforms have included the introduction of the scrip for scrip roll-over measures and the demerger relief provisions contained within the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002*.

Under the existing law, roll-over relief is available to CFCs that conduct a corporate restructure but only under those circumstances which accord with the operation of the domestic roll-over provisions (as modified by the CFC provisions – note that these modifications only deal with Division 126-B rollover). As a result, the current position is that roll-over relief available under the CFC provisions may not align to the type or extent of roll-over relief that is available in a particular foreign country where a CFC may be resident. Further roll-over relief for CFCs will be more restrictive than for domestic companies.

Issues with current law

Whilst the CFC provisions largely incorporate the domestic group asset transfer roll-over relief provisions, there is uncertainty as to availability of more recent CGT relief provisions, such as scrip for scrip roll-over and the proposed new de-merger relief, through the CFC provisions.

There may also be significant differences between the corporate restructure relief available to a CFC in its foreign country of residence and the degree of roll-over relief available under the CFC provisions. Where such differences occur, the limitations of the CFC provisions may operate to restrict the ability of company groups to effect genuine corporate restructures. This would unduly penalise those Australian corporate groups with offshore operations who are competing in foreign markets against local entities or subsidiaries of multi-nationals that are resident of countries, which have no CFC rules, or rules that are less prohibitive than Australia. Thus, the concept of capital import neutrality will be difficult to achieve where the differences between the roll-over relief available in a foreign jurisdiction and that available within the CFC rules result in an additional tax burden for an Australian investor in the foreign jurisdiction.

The CFC provisions also unduly restrict the availability of roll-over relief where assets are transferred between CFCs resident in different countries (Division 126-B roll-over). In this respect, Section 419 imposes quite narrow limitations on the availability of wholly-owned group roll-over based on the country of residence of the originating and recipient CFC. The expansion of this relief should be considered in conjunction with the proposal at Option 3.9 to remove the limited-exemption list.

Examples of existing issues

An Australian multinational may own a significant number of entities in foreign jurisdictions. These entities operate various active businesses. From time to time it is necessary for the Australian multinational to restructure the legal ownership of foreign entities for various commercial or local legal reasons (especially following significant acquisition or divestments).

In undertaking these restructures, the Australian multinational is required to not only have regard to the CGT roll-over relief available in the relevant foreign jurisdiction, but also the interaction of this relief with the Australian CFC provisions. The reason being that in certain circumstances, the election for roll-over relief in a local jurisdiction can cause attributable income to arise through the CFC rules. Any Australian tax liability arising to the attributable taxpayer will represent an additional cost of the restructure and may become a disincentive to the multinational organising its affairs in that foreign country on a commercially effective or legally prudent basis.

Given that this cost would normally ensure that the restructure does not proceed (or is re-worked), the Revenue collected from this inadequacy is likely to be minimal.

Options

Participation Exemption for capital gains

The participation exemption model outlined above would remove the taxation of capital gains under corporate restructures, and hence overcome this problem.

Aligning CFC roll-over relief with foreign jurisdictions

Australian entities operating active businesses in foreign jurisdictions should not be penalised in Australia for effectively conducting their taxation affairs in overseas jurisdictions (i.e. by electing local CGT roll-over relief where possible). The alignment of roll-over relief available through the CFC rules, with the roll-over relief available under the domestic law of the country of residence of the CFC would reduce compliance costs and ensure the international competitiveness of Australian business.

Aligning the roll-over relief available through the CFC rules, with that available under the domestic tax law of the country of residence of the CFC, especially in respect of broad-exemption listed countries, will significantly reduce the incidence of this exposure, thus allowing the efficient restructuring of the overseas operations of the Australian multinational without requiring unnecessary regard to the Australian CFC rules.

It is recommended that a more detailed investigation be undertaken as to the type and extent of roll-over relief for corporate restructure available within the taxation laws of those foreign countries that are the source of the majority of Australian offshore capital investment (with particular focus on the broad-exemption listed countries and Australia's major trading partners in the Asian region). This investigation should be undertaken to identify areas of roll-over relief available overseas that are not available within the Australian system. Following this investigation, the CFC provisions should be expanded to align the roll-over relief available in the CFC provisions with that available in the key foreign jurisdictions examined.

In relation to roll-over for the cross-border transfer of assets within company groups, Section 419 should be expanded to allow transfers between broad-exemption listed countries.

If the general exemption for Broad Exemption Listed Countries is adopted this would also achieve alignment in those listed jurisdictions.

Aligning CFC roll-over relief with domestic relief

As a bare minimum, the roll-over provisions must be amended to provide parity of Australian tax treatment between domestic and foreign restructures (especially following significant acquisition or divestments).

In order to ensure that roll-over relief available under the CFC rules is aligned with the relief under the domestic provisions, the CFC provisions should be amended to clarify the application of the scrip for scrip, demerger relief (when these measures are enacted) and any other roll-over measures which are available in a domestic context but which there is currently uncertainty as to the availability under the CFC rules.

Priority of issue and benefits of proposed solution

The option to expand roll-over relief would increase Australia's attractiveness as a location to conduct international business by allowing multinationals the ability to restructure operations in a tax efficient manner without a significant cost to the Revenue.

Further, it is considered that the loss to the Revenue would be negligible as the possible CFC tax exposure arising from the existence of this anomaly would generally ensure that a restructure of foreign CFCs does not occur or is re-worked (at substantial cost) to satisfy both the Australian CFC and foreign tax laws. Thus, tax would normally not be payable under the CFC provisions.

Given the increasing level of Australian capital investment overseas (from 9% of GDP to 62% between 1980-81 and 2000-01 as noted in Chapter 1 of the Consultation Paper) and the important implications of this issue for the structure of corporate groups with foreign subsidiaries, it is submitted that this option should be given a high priority in the reform process.

3.2 Option 3.2 Options to appropriately target the tainted services income rules

Current law

Under Section 448 of the existing CFC provisions, for a CFC resident in a non-broad exemption listed country, the tainted services income rules will include in a CFC's adjusted tainted income amounts received by a CFC from providing services to an associate, an Australian resident or the Australian permanent establishment of a non-resident.

Whilst there are particular exceptions for certain types of income from being included within a CFC's tainted services income, it will generally include income received from the performance of a broad range of managerial, technical, commercial and other professional services to associates. By including these types of income within the adjusted tainted income of the CFC, the tainted services provisions were intended to support the Australian transfer pricing rules by preventing profits being shifted to a low tax country via the imposition of service fees. The focus of revenue authorities globally on transfer pricing has significantly decreased the ability to shift profits in this manner.

There is a limited exception under Section 448(6A) where a CFC derives income from the provision of services to an associate that is resident of the same country, the income is taxed in that country at the normal corporate tax rate applicable to that country and the income would not have been in any part a notional allowable deduction of the associated CFC if it were assumed that the CFC had failed to pass the active income test. The drafting of this exception means that in many cases it may be unavailable because the associate CFC must not be able to claim any part of the amount paid as a notional deduction when calculating its attributable income. This requires an intricate examination of the CFC calculations of the payer CFC, which often results in the conclusion that some part of the payment is a notional allowable deduction.

Issues with current law

The current tainted services income rules have the potential to apply to genuine transactions that occur within an offshore business and between associates. In addition, the transfer pricing provisions within Division 13 of Part III to the 1936 Act and similar foreign tax provisions operate to prevent income from being shifted out of Australia through dealings in "property" (which is defined within Section 136AA to include services).

Given that the transfer pricing provisions apply to the supply or acquisition by a non-resident of property in relation to a taxpayer, it is arguable that there is no need for the tainted services income rules to also include dealings between a CFC and an Australian resident or the permanent establishment in Australia of a non-resident. Further, where the provision of services by one CFC to another CFC would also be regulated by the transfer pricing rules within either of the foreign countries in which the CFCs are resident, there is the possibility that the tainted services income rules are unnecessarily duplicating the effect of the transfer pricing rules. The duplication results in an additional burden on an Australian attributable taxpayer.

Whilst Section 448(6A) attempts to resolve situations where same country transactions occur, the current drafting significantly limits the ability to obtain this relief. This is because the tainted services income must be taxed in the receiving CFC and not allowed as a notional allowable deduction (whether in whole or in part) of the paying CFC, assuming that the paying CFC fails the active income test. Thus, as this exception is rarely available, same country transfer pricing can apply to a myriad of circumstances that would never be contemplated in a domestic context.

There is a further definitional issue surrounding the uncertainty of the term "sufficiently influenced" within the Section 318 definition of an associate. Whilst it appears that the use of this term was intended to allow a reasonable amount of flexibility when determining whether two companies are associates, without further clarification of this term it may potentially be interpreted on an overly broad basis.

Examples of existing issues

By way of example, fee income earned from funds management could be regarded as tainted services income where the ultimate parent of the funds management entity has an indirect interest in the managed fund itself. Another example is simply the recharging of holding company shared services for service companies which also provide services to third parties (an active business).

Further, as the tainted services income rules apply to the provision of services between associates, they may apply to inhibit the effective joint tendering or sub-contracting for work on large international projects by associated CFC's which are resident in different countries, e.g. where a CFC resident in one country wins the head-contract for a large project but needs to sub-contract out specialist areas of work, if an associated CFC that is resident in a different country is awarded the sub-contract this may be caught by the tainted services income rules even though the transaction is part of the group's active business. This may limit the scope of services which a company group may provide in the above situation unless a commercially inefficient and costly restructure of the group occurs.

Options

It is submitted that the tainted services rules should at least be amended to exclude income derived from related parties that occur within the same type of country (eg BELC, LELC or unlisted). There is no need to impose a further layer of taxation on transactions between similar types of countries when it is an implicit principle of the CFC provisions that countries within the same classification have reasonably comparable corporate tax systems.

An exemption for service companies should also be introduced (at least for those residents in limited-exemption listed countries) where the active business of the CFC is solely the provision of such services to related entities.

Further, in order to protect the integrity of the CFC rules, and minimise the risk that services income may be shifted to a low tax country, the definition of "associate" for the purposes of determining amounts constituting tainted services income, should be further clarified and greater explanation provided to taxpayers.

Priority of issue and benefits of proposed solution

Modification of the tainted services income rules to clearly remove same type of country transactions from their ambit would reduce the compliance costs of the Australian multinational, as well as making the application of the tainted services income rules more equitable. As a bare minimum, Section 400 (aa) should be expanded to eliminate same country transfer pricing.

The loss to the Revenue would be negligible as any attributable income is normally sheltered from Australian tax by available deductions and foreign tax credits. The rectification of the operation of the tainted services income rules would reduce compliance costs and ensure the international competitiveness of Australian business.

For the above reasons, it is submitted that this issue be given a high priority in the reform process.

3.3 Option 3.3 Whether additional countries should be included on the broad exemption country list and to clarify criteria for inclusion (or exclusion)

Current law

Certain countries with relatively comparative taxation systems to Australia have been designated as broad-exemption listed countries. These countries are the USA, UK, Japan, Germany, France, Canada and New Zealand. A CFC resident in a broad-exemption listed country is not subject to attribution of its tainted income, except for income that is eligible designated concession income.

The broad-exemption listed countries were originally selected in 1997 based on the fact that they have comprehensive accruals taxation regimes for foreign source income, effective tax administration regimes and corporate tax rates similar to Australia. As evidenced by Table 2.3 in the Consultation Paper, broad-exemption countries represent the destination for the majority of Australian direct investment offshore.

For those countries which are not included within the list of broad-exemption countries, they are either treated as limited-exemption listed countries or are unlisted countries.

Issues with current law

This list was complied in 1997 and due to changes in global tax regimes over time, it is possible that other countries should be added to the broad-exemption country list if they are considered to have tax systems similar to Australia's. In particular, as Australia's corporate tax rate has fallen from 36% to 30% since the time when the broad-exemption list was compiled, it is likely that there are now other countries with similar corporate tax rates that may not have previously been considered for inclusion on the list.

It should be noted that out of the seven broad-exemption listed countries, only New Zealand has a similar country "list approach" in determining which CFC's will be subject to tax in New Zealand on passive income. The UK adopts a more simple "percentage" approach. That is, a foreign company must be resident in a low-tax jurisdiction, which is defined as a country having an effective tax rate lower than what it would have been had the company been subject to resident corporation tax.

Examples of existing issues

As the list of broad-exemption listed countries is quite small, there may be scope for including additional countries with relatively comparable tax systems and corporate tax rates. Whilst no specific examples are included within this submission, it is recommended that further investigation occur to identify potentially suitable countries.

Options

As outlined above, our overall submission is that Australia's accruals taxation regime should be the subject of substantial reform, including considering whether to exempting in the first instance Broad-Exemption Listed Countries from the application of these provisions. By completely exempting these (and potentially other comparably taxed) countries from the CFC provisions, this would reduce the level of complexity, tax planning required and structuring issues for investments by Australian companies in our major trading partners.

In this context, it is necessary to reassess the underlying CFC policy to determine whether Australia should endeavour to "police" specific tax concessions that are provided by these largely comparable tax regimes. That is, the availability of these foreign tax concessions should not theoretically impact on the Revenue collected in Australia.

Notwithstanding the above, if the accruals taxation measures are to continue to apply to broad-exemption listed countries, the criteria for expanding the list to include additional countries should be clearly defined. The following factors (which is by no means exhaustive) could be used to determine inclusion in the broad-exemption category:

- OECD countries with comprehensive accruals taxation regimes;
- Countries which have a Double Tax Agreement with Australia (this approach was recently adopted by Germany);

- Countries which comprise most of Australia’s direct investment offshore;
- Australia's major trading partners in the Asian region;
- Countries with comparable entity level tax rates and comparable tax systems i.e. taxation should be based on the concept of “income” or “profit” (and not turnover or production volume), “income” should be defined comprehensively and not given a narrow interpretation and the prevailing corporate tax rate should be at least 25% (similar to the UK requirements); and
- Countries which do not have tax incentives which encourage income/profit shifting.

Where a particular country would broadly satisfy the requirements for inclusion as a broad-exemption listed country but its taxation system has particular features of concern, there is scope for such a country to be included in the list and the Commissioner to make Regulations to include particular types of income derived in that country within its specified eligible designated concession income (refer Schedule 9 to the Regulations).

Priority of issue and benefits of proposed solution

The impact on the Revenue from the expansion of the broad-exemption list should be minimal, as by definition the countries that may be introduced to the broad-exemption list would generate minimal attributable income and substantial Australian tax shelter by way of foreign tax credits.

The expansion of the criteria for inclusion in the broad-exemption country list would provide flexibility for changes in foreign country tax regimes and also reduce compliance costs by not requiring the complex calculation of attributable foreign income that would have been comparably taxed and in circumstances where a significant amount of revenue would not be generated.

3.4 Option 3.4 Technical and other remaining policy issues regarding the CFC rules

Current law

As noted at Option 3.4 of the Consultation Paper, a number of technical issues regarding the CFC rules require consideration and reform.

Issues with current law

The current CFC rules can impose substantial compliance costs on an Australian multinational. Whilst substantial compliance costs exist, only a relatively minor amount of income tax is paid by Australian multinationals as a consequence of the application of the CFC rules (especially once available foreign tax credits are taken into account).

Australia's CFC rules are extremely complex and often have adverse outcomes to transactions, which based on the overriding original policy intent of the CFC rules, were not intended to be covered by the CFC rules.

Examples of existing issues

As noted above, whilst the CFC rules are highly complex and can impose substantial compliance burdens on multinational groups, the actual income tax paid by such groups under the CFC rules can often be relatively minor. Further, when planning genuine commercial transactions between foreign subsidiaries of a multinational group, the CFC rules may often impose additional cost and time requirements in order to prevent unnecessary and, from a policy perspective, unintended adverse consequences that may otherwise arise.

The deficiencies include, but are not limited to, the following:

- Uncertainty in relation to the residency of Limited Partnerships ("LPs") formed in the US and UK (we are aware that this issue is being addressed in a separate forum);
- The treatment of foreign exchange gains and losses;
- The interaction of the CGT and CFC rules when determining the cost base of assets held by CFCs, including inadequacies in the "commencing day assets" concept;
- The application of the transfer pricing rules through the CFC provisions, including same country transfer pricing;
- The interaction between the Consolidations regime and international tax measures; and
- The interaction of the new debt/equity rules with the CFC rules.

Reference should be made to the CFC National Issues Register compiled by the NTLG FSI sub-committee, for a full listing of all relevant issues.

More detailed comments in relation to the specific deficiencies identified above are set out below.

Foreign exchange gains and losses

The taxation treatment of foreign exchange gains and losses has been uncertain since the decision of the High Court in the *ERA Case*. The complexity is compounded when these laws are applied through the CFC provisions.

While we are aware that parallel consultation is being conducted on this issue, it needs to be ensured that the results can be practically applied in a CFC context.

The main benefit derived by Australian multinationals from these amendments is the clarification of the timing of recognition for taxation purposes of foreign exchange gains and losses. This will facilitate investment evaluation and decision making.

CGT cost base for acquired CFCs

In certain situations, where CFCs have been acquired from foreign parents, there may be potential uncertainty in respect of the interpretation of the meaning of the “commencing day” as defined in Section 406. In particular, where an Australian multinational acquires a group of companies from a foreign multinational and that foreign multinational has an Australian subsidiary, all subsidiaries of the foreign multinational are technically CFCs. Accordingly, the “commencing day” of the subsidiaries of the foreign multinational would have technically been at the time the foreign multinational acquired the assets or when the Australian subsidiary was acquired rather than when the Australian multinational acquired the foreign group. This analysis may need to be performed having regard to multiple previous owners. This is clearly an inequitable outcome, given rise to substantial compliance costs and, in many instances, cannot be applied.

To reduce complexity, we recommend that the “commencing day” for this purpose should be deemed to be the date of acquisition by the Australian multinational. To require the Australian multinational to investigate if the foreign vendor had an Australian subsidiary would lead to inequitable results where information is not forthcoming and impossible practical application issues.

Transfer pricing

Section 400 currently ensures that the transfer pricing provisions apply through to all transactions between CFCs, excluding only those transactions between CFCs resident in the same broad-exemption listed country. Consideration should be given to extending the relief from the application of the transfer pricing provisions. This could involve exemptions for:

- Transactions between CFCs resident in the same country;
- Transactions between CFCs that are both resident in a broad-exemption listed country (not necessarily the same one); and
- Transactions between entities where at least one of the entities is resident in a jurisdiction that has a comprehensive transfer pricing regime.

Interaction of the Consolidations regime and International Tax

There is currently limited, if any, information available as to the interaction between the Consolidations regime and international tax measures.

This is a significant issue for Australian multinationals given that the Consolidations regime potentially applies from 1 July 2002. Accordingly, it is difficult to determine the exact profile of some direct offshore investments and transactions, given the lack of certainty.

It will create a significant benefit for Australian multinationals for this interaction not only to be clarified during the development of the remaining portions of the Consolidations regime, but clarified as soon as possible.

The interaction of the new debt/equity rules with the CFC rules

The new debt/equity rules which characterise an interest as debt or equity do not apply to CFCs. However, at the time the debt/equity rules were introduced it was stated in the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Act 2001 that the application of the debt/equity rules through the CFC rules would be revisited as part of the Review of International Taxation. Accordingly, this issue should be addressed.

Clarification of the Government's intention in this regard is required in order to provide certainty to Australian multinationals in conducting their business affairs.

Options

Australian multinationals would obtain a significant benefit from an overall reconsideration of the CFC rules in light of the initial policy intent of the measures, which should ensure that the rules do not impede genuine business operations.

As noted in our preliminary comments, it is our overriding submission that the CFC provisions are substantially reformed to achieve simplicity of compliance and greater alignment with their initial purpose. It is acknowledged that this may be a time consuming process and should also incorporate reform to the other aspects of Australia's accruals taxation regime.

Accordingly, in the short term, consideration should be given to correcting the numerous technical deficiencies contained within the CFC rules. These deficiencies limit the ability of Australian multinationals to undertake direct offshore investment with low compliance costs.

Priority of issue and benefits of proposed solution

Currently, Australian business is required to navigate a maze of complex international tax measures, most particularly the CFC rules, when undertaking direct offshore investment. A clear set of international tax measures, consistent with the initial policy intent of imposing Australian tax on lowly taxed, passive, foreign income, would reduce compliance costs and ensure the international competitiveness of Australian business.

A substantial reconsideration of the CFC rules in light of the original policy intent of these measures would ensure that Australian businesses are not unduly penalised for genuine commercial investments.

Given the combined importance of simplifying the CFC regime, it is submitted that the issue of substantially reforming the CFC provisions be given a very high medium-term priority. In the short-term, it is submitted that the combined importance of the issues outlined above should warrant a high priority.

Notional foreign exchange gains

The current CFC rules is unclear as to whether "notional" foreign exchange gains is assessable as a capital gain when a CFC disposed of an asset for no profit if calculated in local currency but, if calculated in accordance with Australian CGT rules, would give rise to a capital gain (simply due to movement in exchange rates). It is clear that such a disposal should not give rise to any assessable capital gain given that, in effect, no profit has been derived by the CFC nor has the foreign exchange gain been realised. Yet, the Commissioner has taken the view that such a disposal can give rise to an attributable income under the CFC provisions. The law must be clarified to ensure that such a disposal will not give rise to attributable income.

Capital gains derived by CFCs

Currently, capital gains derived by CFCs may be attributed under the CFC provisions. In line with our comments on the participation exemption for Australian investors, we recommend that an exemption be provided for capital gains derived through CFCs.

If this is not accepted, the law should, at a minimum, be amended so that capital gains attributed under the CFC provisions retain their character as capital gains. This will align the treatment of the CFC with domestic taxpayers. In our view, the current position whereby capital gains are converted to revenue gains is untenable and inconsistent with the philosophy underpinning the structure of CFC provisions, i.e. that CFCs be taxed as if they were resident companies.

Concept of "EDCI"

If our proposal for a blanket exemption for BELCs does not proceed, then we strongly recommend a redesign of the EDCI concept. The current definition gives rise to uncertainty and difficult to apply in practice, in particular, the concept of "subject to a reduction of tax".

Special industry issues

The CFC provisions should also take into account peculiarities pertaining to certain industries such as insurance and banking. We believe that the current exemptions are inadequate in dealing with such industries. In summary, any gain or income derived by a CFC carrying on an insurance or banking activity should be exempt from attribution where they are derived in the ordinary course of that business or are attributable to different stakeholders (e.g. foreign policy holders) or are implemented on an arms length basis (regardless of whether the counter party is an associate, e.g. loans to related parties).

Double tax

The CFC provisions, in some cases, do not adequately provide a credit for foreign taxes relating to the same income (especially involving FIF income derived by CFCs). This is clearly inequitable and should be eliminated as a priority.

Reconciliation with foreign CFC regimes

In addition, we recommend that an exemption from the CFC rules be provided for CFC which are subject to a comparable CFC regime of another country. THe current exemption in Section 456A is too narrow and difficult to apply in practice.

3.5 Option 3.5 Whether the recently negotiated Protocol to the Australia – United States tax treaty provides an appropriate basis for future treaty negotiations

Current law

Australia has entered into a variety of Double Tax Agreements ("DTAs") with other countries for the purposes of allocating residency and source taxing rights. These DTAs have been negotiated at various times and some have been revised from their initial form by the introduction of amending Protocols to the DTAs. However, at present there remain 19 DTAs which were entered into prior to the introduction of the CGT provisions that have not been revised.

Issues with current law

Given the large time disparity between the various DTAs, there exist certain differences in the items governed by the DTAs. These differences are reflective of both the different approaches to negotiating DTAs that have been adopted over time and also the outcome of negotiations with individual countries.

The recently negotiated Australia-USA Protocol represents a significant new model by which certain existing and new DTAs could be negotiated to achieve reduced taxation barriers to the cross-border flow of capital and investment.

Options

We support the proposed initiative that Australia should pursue the process of renegotiating tax treaties that currently lead to inequitable results for foreign investors.

In order to foster closer economic relations with Australia's major trading partners, as a general proposition, the reduction of the dividend withholding tax rates on non-portfolio dividends would enhance cross border capital flows, and investment into Australia.

Certainly it seems to be the trend in recent months that the Australia-USA Protocol has been used as a model for renegotiation of the Australia/Canada and Australia/Malaysia DTAs. As a result, foreign dividend withholding taxes on income flowing to Australia are reduced to between 0% - 5%, with a corresponding reduction of Australian dividend withholding taxes on unfranked dividends to foreign investors.

As a general principle, we support renegotiation of across the board lower withholding taxes by both treaty partners.

Notwithstanding the comments above, each renegotiation of a DTA should depend on the particular circumstances of each treaty partner. As Australia is a net importer of capital with reference to our major trading partners, any renegotiation process should consider Australia's economic and trade relationships with the particular country and the potential costs to the Revenue of reducing withholding tax rates where the net dividend or interest outflow from Australia to a country are significantly greater than the dividend and interest inflows from that country. This can then be evaluated against the benefits obtained from the relaxing of withholding tax rates.

Priority of issue and benefits of proposed solution

The renegotiation of treaties would foster trade and enhance Australia's economic growth. The reduction of dividend withholding tax rates would significantly enhance the capital import neutrality position for investors by reducing the impact of this level of taxation on the repatriation of returns on foreign investment capital.

Given that the Australia-USA Protocol appears to have already been used in negotiations with Canada and Malaysia, it is submitted that this model is continued to be used in those future DTA negotiations where the costs to the Revenue of reducing the rate of withholding taxes for the particular country are not significant in comparison to the economic benefit obtained from providing this reduction.

This issue should be given a medium level of priority as it has already been successfully employed in prior DTA negotiations.

3.6 Option 3.6 Taxing non-residents on the disposal of non-resident interposed entities with underlying Australian assets

Current law

Following the introduction of the CGT regime in 1985, each DTA entered into by Australia has allowed for the taxation of capital gains arising from the disposition of property by the country of source for the gain. These DTAs allow the Commissioner to apply the Australian CGT rules to non-residents. However, there currently remain 19 DTAs that were entered into by Australia prior to the introduction of the CGT regime that do not comment on the rights of Australia to impose CGT on non-residents. There is significant uncertainty in relation to whether the Commissioner may apply the CGT provisions to capital gains arising to non-residents under these pre-CGT DTAs (notwithstanding the Commissioner's view that tax can be imposed in these instances).

Further, under the existing CGT provisions, non-residents may effectively avoid the operation of the Australian CGT provisions by interposing a non-resident holding entity between the relevant CGT asset. In order to address this issue, Recommendation 21.7 of the Review of Business Taxation: A Tax System Redesigned Report (issued July 1999) stated that legislation should be introduced to "deal with the avoidance by non-residents of Australian capital gains tax by disposing of an interposed entity holding Australian assets rather than the assets themselves".

Issues with current law

The ATO has stated in *Taxation Ruling TR 2001/12* that Australia's right to tax capital gains in Australia under the CGT regime is not limited by the pre-CGT DTAs. The ATO reaches this conclusion on the basis that the pre-CGT treaties do not discuss Australia's taxing rights in respect of capital gains and that the CGT regime is not a tax to which the pre-CGT DTAs apply.

Despite this position adopted by the ATO, which is confirmed as the Government's position in the Consultation Paper at Option 3.6, there are strong arguments that the pre-CGT treaties do limit the right of Australia to impose the CGT provisions on non-resident investors. Very broadly, this argument includes the proposition that the CGT provisions do not form a separate tax but are part of the income tax to which the pre-CGT treaties apply. This is also a key issue where the view of the ATO in relation to the application of a particular pre-CGT treaty differs from the position adopted by the revenue authority of the other country.

Accordingly, even though the ATO has expressed its position in *TR 2001/12*, the issue is potentially open to future challenge and should be further clarified through the courts.

In relation to the application of the CGT provisions to non-resident investors that use an interposed non-resident holding entity, there are practical issues involved with introducing such a measure. First, the introduction of amending legislation which unilaterally amends the double tax treaties may not achieve the desired outcome. Australia's ability to tax non-residents on disposal of interposed non-resident entities with Australian assets would need to be negotiated with relevant treaty partners. Query whether any treaty partner would agree to such an arrangement.

Second, there would be significant practical difficulties in administering such a regime involving collection of tax on a transaction between two non-resident entities. The requirement to prepay Australian tax prior to realisation of Australian assets and increased compliance costs may be a deterrent to international investment in Australian assets. In addition, if no foreign tax credits are available to the non-resident disposing entity in their home country, then this measure will result in global double taxation, being a significant deterrent to directing investments through Australia.

Examples of existing issues

Non-resident investors may currently seek to avoid the application of the Australian CGT provisions by interposing a non-resident holding entity between any Australian CGT assets. When the non-resident decides to dispose of their interest in the asset at a later date, they may do so by selling their interest in the interposed entity, which is outside the scope of the Australian CGT regime.

Options

We believe that this option is difficult to implement and may act as a disincentive to attract foreign capital. We also note that this option is inconsistent with global trends regarding taxation of non-residents. Accordingly, we do not support taxing non-residents on disposal of non-resident interposed entities with underlying Australian assets.

3.7 Option 3.7 Which countries should be given priority for tax treaty negotiations

Current law

Presently, Australia is involved in different stages of negotiation and renegotiation of DTAs with numerous countries. Given that some DTAs are dated as far back as 1967, it is imperative to update our DTAs with such countries to reflect current economic climates and taxation issues, including Australia's taxing rights over capital gains and rates of withholding tax.

Most Favoured Nation ("MFN") clauses in some treaties may also affect negotiations because these clauses will require Australia to renegotiate certain treaties upon the agreement between Australia and a third country to certain specified tax treatment, i.e. the entry into force of the recently negotiated Australia-USA Protocol will trigger MFN clauses in certain existing treaties.

Issues with current law

The recently negotiated Australia-USA Protocol will impact significantly upon Australia's treaty negotiation program by triggering the MFN clauses in Australia's tax treaties on withholding tax rates with countries such as France, Switzerland, Norway, Finland, the Netherlands, Austria, Italy and the Republic of Korea.

As noted at Option 3.7 of the Consultation Paper, current negotiations with the United Kingdom over the existing DTA may trigger MFN clauses in other DTAs that Australia has agreed with foreign nations. Given the renegotiation obligations imposed by the various MFN clauses and the need to update Australia's pre-CGT DTAs (refer to comments under option 3.6 above), an issue has arisen regarding which countries Australia should prioritise for DTA negotiations.

Options

As Australia is currently negotiating with the UK and Germany, these countries should be given immediate priority. Following this, it would be in Australia's economic interests if tax treaty negotiations were to occur with our other major trading partners.

However, due to the operation of the MFN clauses within our existing DTAs, the prioritisation of the tax treaty negotiations will be subject to the obligations of Australia to renegotiate with MFN countries following the entry into force of the US Protocol (and possibly the outcome of the UK negotiations).

Accordingly, given the lengthy process of such negotiations, it would be prudent to firstly consider and concentrate upon the negotiations with MFN countries before seeking to identify other potential DTAs to be negotiated or renegotiated. However, after the MFN DTAs have been renegotiated, it is submitted that Australia should then focus on renegotiating any remaining DTAs with significant trading partners before addressing any outstanding pre-CGT treaties.

Priority of issue and benefits of proposed solution

This issue needs to be undertaken concurrent with any other proposal that arises from this Review. Initially this will be dictated by triggering of the MFN clauses.

3.8 Option 3.8 Options to improve consultation processes on negotiating tax treaties

Current law

Previously, the consultative process on negotiating tax treaties has been limited. We agree that effective consultation arrangements should be implemented to ensure the successful and timely negotiations of tax treaties.

Options

We agree with all of the proposed options in the Consultation Paper to improve the consultation process for negotiating DTAs.

In order to improve the transparency of the consultative process, a dedicated consultative body should be established in relation to the negotiation of tax treaties. Alternatively, the role of the Tax Treaties Advisory Panel could be expanded so that it takes a wider role in facilitating consultation with the community.

This approach has been successfully employed in other areas of law, for example with the introduction of the Consolidations legislation, where a key tool used in the consultative process for the Consolidations legislation was the role taken by the Board of Taxation.

If the Tax Treaties Advisory Panel were to adopt a broader consultative role, in order to ensure that it could conduct this role on an independent and transparent basis, the Panel would need to be transferred from under the ATO's authority to be covered by the ambit of the Board of Taxation or to be established as an independent body of its own. The wider role of the Tax Treaties Advisory Panel should include directly consulting with those companies that have significant interests in the other country, as members of the business community are likely to have had significant practical experience with the Revenue authorities of the other country.

This approach would be consistent with ensuring that the tax treaty protects Australia's taxing rights whilst at the same time, creating a competitive tax regime for international investment. Directly approaching members of the business community could be by way of a survey in the first instance, with follow-up interviews and appointment to the Tax Treaties Advisory Panel, if appropriate.

Priority of issue and benefits of proposed solution

It is submitted that this issue be given medium priority as the improvement of DTA negotiation consultation arrangements could have significant benefits for both Australian investment offshore and foreign investment into Australia. Improved consultation measures could also benefit the resolution of Options 3.5 and 3.6.

As the process of negotiating and renegotiating tax treaties is lengthy and highly complex in nature, the benefits of any additional consultative process will be measured against the time taken to negotiate the tax treaties and the efficiency of the treaty negotiation process.

3.9 Option 3.9 Abolishing limited exemption list and provide general exemption for foreign non-portfolio dividends received and foreign branch profits

Current law

Currently, income derived by an Australian taxpayer in the form of a non-portfolio dividend or foreign branch profits may be exempt from tax provided that certain conditions are fulfilled. Broadly, in order to obtain the exemption the income that comprises the non-portfolio dividend must have been sourced and taxed in a listed country (even if the income is derived by a company resident in an unlisted country) or for branch profits, the foreign branch must have been derived in a listed country.

Where an Australian taxpayer receives a non-portfolio dividend from an unlisted country, the dividend will generally be taxable to the taxpayer and a credit for foreign tax may be available.

Issues with current law

By providing an exemption from Australian tax for non-portfolio dividends and certain foreign branch profits, there is a reduced compliance burden to the relevant Australian taxpayers. The exemption also has the same broad effect as if these amounts were taxable with foreign tax credits being available to the Australian taxpayer (on the basis that the listed countries have reasonably comparable corporate tax rates to Australia).

Whilst these exemptions are not currently available in respect of non-portfolio dividends and branch income from unlisted countries (on the basis that the corporate tax systems of these countries are not similar to Australia), there can also be significant differences between the corporate tax regimes within the 56 limited-exemption countries. Further, as outlined at Option 3.9 of the Consultation Paper, non-portfolio dividends from companies in listed countries comprise around 95% of all foreign non-portfolio dividends that Australian companies receive. Accordingly, by excluding unlisted countries from these exemptions, only 5% of such dividends are subject to tax in Australia.

Given the differences that do exist between some of the limited-exemption listed countries and the relatively minor amounts of non-portfolio dividends from unlisted countries, it may be more beneficial from a compliance perspective if the exemptions were extended to non-portfolio dividends and foreign branch profits sourced from unlisted countries. Further, provisions such as Section 47A and Section 458 could be repealed if the general exemption for non-portfolio dividends is made available, thus simplifying the legislation and reducing compliance costs.

Further, as Australia's accruals taxation measures are designed to catch adjusted tainted income derived by a CFC in an unlisted country, it is arguable that there is no need to deny the non-portfolio dividend exemption to dividends paid from the profits of a CFC that is resident in an unlisted country. The reason of this is that the CFC provisions would have already applied to the passive part of the dividend.

In this regard, consideration should be had of the mischief to which the accruals taxation measures were designed to address. Provided that the appropriate types of passive and other tainted income of the CFC are taxed under the CFC regime, there should be no reason for Australia to further tax income derived in the conduct of an active business by the CFC if it has already been taxed in the foreign jurisdiction, being consistent with concept of capital import neutrality. As noted at Option 3.9 of the Consultation Paper, this may require some consideration of the application of the CFC and FIF rules to tainted income that is retained offshore at low rates of tax.

Options

We agree that the abolition of the limited-exemption list, for the purpose of providing Australian companies a general exemption for foreign non-portfolio dividends and foreign branch profits, would simplify the international tax rules in respect of the receipt of such remissions and would also encourage offshore investment (from Australia or via an Australian conduit entity) without significant cost to the Revenue.

To achieve neutrality however the exemption should also be provided for capital gains, which are an alternative mechanism for returning the offshore profit. If dividends and capital gains are exempted then the core elements of the proposed participation exemption as outlined above would be met.

This solution would also improve the capital import neutrality position of Australian taxpayers that receive non-portfolio dividends from unlisted countries because the additional layer of tax within Australia would be removed.

Priority of issue and benefits of proposed solution

Given that non-portfolio dividends from unlisted countries comprise only 5% of total non-portfolio dividends from all countries, then the cost to the Revenue from exempting from Australian tax foreign dividends and foreign profits would be nominal, but there could be significant compliance savings for Australian multinationals.

The abolition of the limited exemption list would also reduce legislative complexity by removing the need for certain anti-avoidance rules, such as those rules within Sections 47A and 458 of the 1936 Act.

As the proposed solution has the potential to significantly reduce legislative complexity and the compliance burden on Australian taxpayers, it is submitted that this issue warrants a high priority.

3.10 Option 3.10 Improving conduit income arrangements

Current law

Very broadly, where a foreign investor holds an indirect interest in a foreign entity through an Australian subsidiary, the foreign sourced investment income may be subject to Australian corporate or withholding tax when paid as a dividend through Australia to the foreign investor. In this regard, the foreign dividend account exemption will only apply to unfranked dividends paid by the Australian subsidiary out of certain non-portfolio dividends. Where the Australian subsidiary receives other forms of foreign income previously received, dividends subsequently paid to the foreign investor will be subject to Australian withholding tax.

A further layer of Australian tax may apply to the foreign investor on any gains made from disposing of either the foreign entity (taxed in the Australian subsidiary) or disposing of the Australian subsidiary.

Issues with current law

As outlined at Option 3.10 of the Consultation Paper, there are significant issues associated with the current law that applies to foreign conduit income. From a policy perspective, the existing CGT and withholding tax rules apply an unnecessary layer of tax on income that is essentially foreign sourced.

Options

Consistent with the principle of not taxing non-residents on foreign profits, a conduit regime could be designed to allow the flow-through of foreign source income and certain gains to foreign investors. Such a regime would encourage the flow of funds between multinational groups with the Australian entities interposed into the group.

However, there are risks that a conduit taxation regime may not attract significant amounts of additional foreign investment through Australia to offset the lost Revenue. Further, there is also a risk that a conduit taxation regime could result in a relative disadvantage for domestic Australian investors when considering foreign investment opportunities if the exemptions offered under a conduit regime would unfairly benefit an Australian subsidiary of a foreign investor.

In light of these risks, this submission does not attempt to include a detailed analysis of the issues or potential solutions for implementing a conduit taxation regime. Rather, it is submitted that further study be undertaken of the likely impact of these risks on the overall net benefit to the Australian economy of a conduit regime. Only if such a study concludes that a conduit regime would provide sufficient net benefits to the Australian economy should further resources be expended on investigation the various options by which conduit relief may be provided.

We note that if a participation exemption regime and a general exemption for BELCs from FSI rules are pursued key elements of the conduit regime would be systematically delivered. Furthermore, the proposed exemption of FSI dividends (canvassed with respect to Chapter 2 options above) at the entity level would also provide an efficient mechanism for a broader conduit income flow of foreign earnings through Australia to non-residents.

As a matter of principle any conduit regime should not be ring fenced (as this could breach international harmful tax practices and is unlikely to deliver any real economic benefit to Australia) and should not be limited to only non-resident owned entities.

Priority of issue and benefits of proposed solution

Subject to adoption of more significant structural reforms to provide an effective conduit mechanism, and given the uncertainty regarding whether the provision of specifically targeted conduit relief would result in a genuine net benefit to the Australian economy and the complexity that would be needed to ensure that the concession is not open to exploitation, it is submitted that this issue (on its own) be given a lower priority.

3.11 Option 3.11 Whether to proceed with the foreign income account rules

Current law

Under the existing foreign dividend account rules, there is a withholding tax exemption for unfranked dividends paid out of non-portfolio dividends received from listed and (to the extent that foreign tax credits are available) unlisted countries. Accordingly, there will generally be no Australian withholding tax imposed on foreign sourced income when it is paid as a dividend to an Australian resident entity (due to the non-portfolio dividend exemption) or on-paid to a foreign parent entity (due to the foreign dividend account rules).

However, the foreign dividend account rules only have a limited application and an Australian taxation exposure may arise for a multinational group in either of the following circumstances:

- An Australian entity derives income from a foreign subsidiary in a form other than a non-portfolio dividend. This may result in the Australian entity paying tax on the income or withholding tax may apply to the income when it is paid as a dividend to the foreign parent (if unfranked); or
- As noted at Figure 3.4 of the Consultation Paper, where an Australian joint-venture company is the direct holding company for a foreign subsidiary and there is a further layer of Australian parent entities before the income is distributed to the ultimate foreign investor, an Australian tax exposure may arise to the Australian parents of the joint-venture company. This effectively negates the benefit of the non-portfolio dividend exemption.

Issues with current law

The withholding tax exemption currently provided by the foreign dividend account is limited in nature and does not provide appropriate relief for foreign income derived by Australian entities being distributed to foreign shareholders. The issues associated with the failure to provide appropriate relief have been discussed as part of our submission on Option 2.1, concerning dividend bias at the shareholder level.

Example of existing issues

We are aware that other comparative tax regimes examined have mechanisms that eliminate or mitigate tax rules that result in inequitable tax outcomes for foreign investments deriving foreign source income. The principal mechanisms applied to achieve this result are:

- The exemption of all dividends from tax (Hong Kong);
- The exemption of companies from tax on dividends received from all sources, with a partial tax-exemption for all dividends received by individuals (Germany);
- The imposition of tax on dividends received by resident individuals from all sources, without credits for foreign or domestic tax (Classical countries);

- A partial tax credit for individuals for dividends received from all sources (UK and Canada); and
- A credit for foreign-tax passing from the domestic company to the individual shareholder (Singapore).

Options

Any decision with respect to the establishment of foreign income accounts needs to be considered in light of the options canvassed for Option 2.1 of the Consultation Paper, a participation exemption and/or Option 3.9.

Notwithstanding the importance of considering the interactions of other Options with this one, a more flexible, effective and broader definition of income than the present FDA would be beneficial and is encouraged.

Priority of issue and benefits of proposed solution

Given the current distortion of treatment between a scenario where the foreign dividend account rules allow relief and the scenario outlined at Figure 3.4 of the Consultation Paper (where there are multiple layers of Australian entities between a foreign subsidiary and the ultimate foreign parent), it is submitted that this issue be given medium priority in order to promote national neutrality for the investment decisions of Australian taxpayers and capital import neutrality for indirect foreign investors.

3.12 Option 3.12 Options to clarify the test of company residency

Current law

Under the statutory definition of an Australian tax resident, a company will be an Australian resident if they are either:

- Incorporated in Australia; or
- If not incorporated in Australia both:
  - carries on a business in Australia; and
  - has either its central management and control in Australia or its voting power controlled by Australian residents.

Issues with current law

As the residency test includes companies that are not incorporated in Australia but carry on a business and are effectively controlled from Australia, the test often includes foreign incorporated companies within the definition of a resident.

The existing definition of a resident causes issues to arise where there is uncertainty as to the degree of Australian central management and control over a foreign incorporated company. This issue may arise for offshore subsidiaries of Australian companies and multinational entities, particularly dual listed companies.

There is also confusion in relation to the separate application of the limbs of the definition to a foreign incorporated company. As noted at Option 3.12 of the Consultation Paper, the ATO applies the residency test so that the "carrying on a business" limb is separately applied to the "central management and control" limb. However, this view may not be consistent with the relevant case law, including the High Court decision in *Malayan Shipping Company Limited v Federal Commissioner of Taxation (1946) 71 CLR 156* ("the Malayan Shipping case"), where the High Court held that the location of a company's business was the same as the place where the central management and control was exercised because this was where the essential business decisions were made.

The existence of this degree of uncertainty in the definition of an Australian resident creates opportunities for companies to structure their affairs for the purpose of bypassing the test of central management and control to obtain a more favourable taxation position.

Options

As noted in the Consultation Paper, the test for corporate residency could be based on a company's place of incorporation only, so that foreign incorporated companies would not be residents of Australia. Australia would still retain taxing rights in respect of the Australian sourced income and assets having the necessary connection with Australia or possibly via the CFC and transfer pricing rules. However, this test is relatively simple and a company could easily circumvent treatment as an Australian resident.

If the residency test retains the requirement for a business to be carried on in Australia by the company, it is critical that the test provides greater clarity in relation to when a business will be considered to be carried on, including the interaction of this requirement with the central management and control requirements. By further clarifying the operation of these tests, the uncertainty surrounding the correct approach to applying the residency test (in light of the Malayan Shipping case) should be resolved.

However, any amendments that are made to the definition of a resident for Australian tax purposes should be consistent with the definitions of residency that are utilised in DTAs. That is, a unilateral decision should not be made by Australia to alter its definition of residency without careful consideration of its impact on the Revenue and the resulting gain from such a definitional amendment.

Priority of issue and benefits of proposed solution

Given the central role of the concept of a company's tax residency status on the application of the Australian tax system and our taxing rights under the various DTAs, it is submitted that clarifying the test of company residency should be given a low priority.

By providing greater certainty to companies on the application of the test, there would be a benefit and reduced costs to corporate groups in organising and operating their foreign investment activities. There would also be a benefit to the Revenue if the test can be clarified to reduce the scope for a company to circumvent the test by deliberately structuring its affairs to be outside the definition of an Australian resident.

3.13 Option 3.13 Companies as non-residents for tax treaty and other income tax purposes

Current law

Broadly, in order for a company to benefit from a DTA that Australia has entered into, the company must be a resident of either Australia or the other nation. However, due to the different domestic tests for residency that may be employed by the various countries, some companies may be considered to be resident in both Australia and the other nation under each of the domestic tests. Where the relevant DTA does not include a tie-breaker provision, these dual resident companies may be denied the treaty benefits.

Where a dual resident company is treated as a non-resident of Australia for treaty purposes, they will still be treated as a resident of Australia for other purposes of Australian tax law.

Issues with current law

As Australia's various DTAs contain different tests for residency, depending on the outcome of the particular treaty negotiations, there are a significant number of treaties where the relevant test for residency is different to the residency test contained within the 1936 Act (as outlined at below).

This inconsistency creates an unnecessary level of compliance for those companies that may be treated as a non-resident for treaty purposes but a resident for other domestic tax purposes.

Options

The proposal to treat a company that is non-resident for treaty purposes as a non-resident for all purposes of the Australian tax law would simplify the compliance obligations and reduce the costs to these companies of conducting business in both Australia and offshore.

Priority of issue and benefits of proposed solution

Given the importance of the residency concept to the Australian tax system and the need to renegotiate several of Australia's DTAs (refer to Options 3.5 to 3.8), it is submitted that this issue be given a high priority.

Appendix 3.1
Summary of Priority

Option No	Description	Priority
	BELC Exemption	Immediate & Very high
	Participation exemption	Very high
3.1	Expand roll-over relief	Priority depending on the above
3.2	Tainted services income	High
3.3	BELC list	High
3.4	Technical corrections	Some very high
3.5	Use Australia/US Protocol as a precedence	Medium
3.6	Non-resident interposed companies	N/A
3.7	Priority in DTA negotiations	N/A
3.8	Improve DTA consultative process	Medium
3.9	Abolish LELC	Very high
3.10	Conduit income	Priority depends on top two options
3.11	Foreign income account	Medium
3.12	Residency	Low
3.13	Non-resident status for DTA	Medium

4 Promoting Australia as a Global Financial Service Centre

4.1 Option 4.1 Replacement of the current foreign investment fund rules

Foreign Investment Fund ("FIF") Rules

In our experience, the FIF regime has acted as a significant hurdle to Australia being a global financial service centre.

In addition, it also has prevented Australian fund managers and investors from competing on a level playing field with global fund managers and investors.

We are of the view that the FIF regime need to be replaced or substantially modified to address these issues. We believe that this would not be a complex project and should be given **very high priority**.

Current law

The current FIF regime:

- Requires significant taxpayer time and costs in determining whether the regime applies to a particular foreign investment;
- If so, requires significant time in calculating the amount of the FIF income;
- Applies to a wide variety of foreign investments which, in our view, do not give rise to the mischief to which the FIF rules were originally intended to target; in other words, it brings into assessable income unrealised gains attributable to such investments;
- Imposes undue limitations on deductible losses arising from FIF investments (there is no "symmetry" in relation to the manner in which unrealised gains are taxed);
- Gives rise to double taxation, in some circumstances, of the same income;
- Is outdated in its approach to exempt FIFs and inconsistent with global trends in FIF regimes and global investment behaviour;

- Acts as a significant disincentive to global investment opportunities being brought to Australian investors;
- Makes Australia less attractive as a regional location for global fund managers;
- Does not allow Australian fund managers to compete on a level playing field with global fund managers.

Why change is needed

Appropriate change, as outlined below, will have the following positive effects.

- Australia's tax laws relating to FIFs will be significantly simplified and workable from the perspective of Australian taxpayers as well as the Australian Tax Office;
- Compliance costs for Australian investors and the cost of administering the system for the ATO will be significantly reduced whilst maintaining the integrity of the tax system and not giving rise to a loss of tax revenue;
- More investment opportunities will be available to Australian investors hence enabling Australian investors to compete with global investors on an equal footing;
- The bias against foreign investment (versus domestic Australian investment) and between different types of foreign investments will be significantly reduced.
- Double taxation of the same income would be eliminated;
- The need for fund managers to sell down their portfolio in order to avoid compliance costs would be significantly reduced, thereby avoiding any distortion to portfolios established on commercial terms.

In designing the FIF rules, we recommend that organisations such as IFSA, IBSA, the ABA and their members be consulted.

Options

General Principles

We acknowledge that, in some cases, the lack of a FIF tax regime may favour investment in foreign non Australian funds rather than domestic funds. However, this statement holds true only where the underlying investment do not incur a comparable level of taxation and only where the Australian investment provides similar yield and similar opportunities. In many cases, the particular foreign investment is subject to a comparable level of global taxes and provides opportunities simply not available in Australia – This of course is not surprising given that Australia represents a very small percentage of the global market. Some examples of global funds offering investment opportunities not available in Australia include global infrastructure projects, private equity and hedge funds.

In some cases, the FIF regime gives rise to double taxation of the same income (generally due to a lack of tax credit for foreign taxes paid in relation to the same income or gain).

In our opinion, the current FIF tax regime creates an unnecessary bias **against** foreign non Australian investments.

In recognition of the concern that the government may have in relation to loss of revenue, we acknowledge that the government would be reluctant to eliminate the FIF tax regime completely. However, in our view, the FIF tax regime should be substantially modified so that it is clearly targeted at the situations which present the risk of revenue loss. This targeted approach is especially important given that that the FIF regime brings into assessable income gains and income which are not realised and may never be realised, an approach which goes against general income taxation principles.

In principle, the FIF tax regime should not apply to the type of investments or circumstances which are unlikely to be motivated by tax deferral or avoidance or are unlikely to cause a material loss of revenue. Whilst we are not suggesting any motive test, we believe that the approach should be focussed on situations which are likely to be driven by such motives.

In addition, any investment subject to the FIF regime should be taxed in an equivalent manner to an Australian investment, thereby reducing any bias between the two types of investments.

The current FIF regime does not reflect these principles and as such, we propose that the FIF regime be modified. We strongly believe that this modification can be managed so that it maintains the integrity of the tax system (ie not result in a material loss of revenue) whilst minimising significant compliance costs for taxpayers as well as giving rise to the positive results mentioned above.

Approach

In accordance with the philosophy enunciated above, we submit that the current FIF regime should be modified such that the regime provides a wider range of exemptions for investments which are unlikely to "offend" – it is proposed that the regime should the following features (in addition to the current exemptions):

- The FIF regime should apply only to FIFs which carry on a passive investment activity. This is based upon the intention of the provisions to prevent deferral of tax or accumulation of income by Australian investors in low tax jurisdictions. In the main, passive investment activities are really the type of activities that should be targeted given the mobility of such income. We are aware that this is the approach that is being undertaken by the current rules but believe that the current rules also apply to investment which do not come within the intended objective. The approach we therefore propose is to exempt all foreign investments other than those which are truly intended to be caught;
- Passive investment activity in our view should not include investing in real property and hedge funds. We believe this is justifiable on the basis that Australian investors would typically invest in these industries because of the lack of a similar investment opportunities in Australia and/or the reputation of the particular (foreign) fund manager and not because of low underlying tax rates. Hedge fund managers typically have a variety of investment strategies which include activities other than investment in shares. In the main, hedge fund investors do not typically invest in hedge funds as a vehicle into underlying passive long term investments. As such, we do not believe that hedge funds should be classified as a typical passive investment. However, we do acknowledge that more work may need to be done to refine the definition of a hedge fund;
- This approach would eliminate the need for the current definition of "eligible activity". Thus, there will be no need to specifically carve out fund management services as referred to in **Option 4.5;**
- However, if our recommendation above does not proceed, then we recommend that the definition of eligible activities be expanded (as suggested in **Option 4.5**) to include fund management services as well as investment in real property and hedge funds;
- FIFs which are resident in "broad exemption listed countries" ("BELC"), as defined in the proposed CFC rules (refer the section dealing with CFCs), should be excluded from the FIF regime. This feature is already present in the current FIF rules for certain US resident FIFs – subject to certain requirements being met. The BELC exemption should be extended to lower tier FIFs – there should be an ability to trace through the particular FIF investment structure (for example, where the investment is in a "fund of

funds" structure). We appreciate that this rule may need to be subject to exceptions for particular types of entities which are exempt from tax in the BELC;

- FIFs which are otherwise subject to a comparable or an acceptable FIF accruals type tax regime in a foreign country should be excluded from the FIF regime. As an example, where the FIF is resident in the US and has investments in underlying FIFs in countries outside the US which are subject to the US FIF regime, the US FIF should be excluded from the FIF regime. We believe that this would not cause any loss of revenue and ensures that the overall return from the foreign investment is not subject to any risk of double taxation;
- FIFs which distribute a certain portion of its income within a minimum period of time to its Australian investors should also be exempted from the FIF regime. Such FIFs are most unlikely to be motivated by income accumulation or tax deferral. We suggest an acceptable distribution rate may be at least 75% of its total distributable profits within a period of 4 years. More work may need to be done to determine an appropriate range;
- Complying superannuation funds, life companies and registered managed investment schemes should be exempted from the FIF regime. The rationale is that the superannuation funds are subject to a lower tax rate and as such, would have less incentive to accumulate funds offshore. Similarly, life companies and registered managed investment schemes are less likely to be investing offshore for taxation reasons. In order to preserve the integrity of this measure, this exemption should apply even where the superannuation fund, life company or managed fund invests through another Australian trust;
- A study should be undertaken with a view to replacing the de minimus balanced portfolio exemption threshold of 5% with a method which appropriately exempts genuine balanced portfolios rather than the use of an artificial threshold number (5%) which creates compliance costs (in determining whether the portfolio comes within the threshold), transaction costs (when fund managers sell down in order to come within the threshold) and distorts investment behaviour;
- It should be made clear that the FIF regime applies only where the CFC regimes do not apply;
- The FIF regime should take precedence over other regimes which apply to trusts;

- Funds which follow a widely recognised index (such as the FTSE or Dow Jones) should be exempted from the FIF regime – in accordance with **Option 4.3** for consultation. However, more work will need to be done in order to determine, practically, how this exemption is defined;

In order to align the taxation of FIFs and domestic Australian investments, the method of calculating FIF income should reflect the following:

An interest in a FIF should be defined to exclude any entitlement to acquire that FIF, similar to how an entitlement to acquire an interest in an Australian company or share is not taxable;

Any allowable FIF deductible loss should not be quarantined on a FIF by FIF basis and should be allowed against any other type of foreign income of the same class (ie passive);

Any unrealised losses in respect of "taxable FIFs" should be allowed as a deduction against **any** FIF income including FIF income **previously** brought into account. This measure is justifiable on the basis of unrealised losses should be deductible against the unrealised gain that was previously brought into account, hence, mitigating the impact of the taxation of unrealised gains under the FIF regime;

Any foreign taxes relating to FIF income (to the extent that the foreign tax has been paid) should be allowed as a credit against that FIF income. There should be an ability to match the foreign tax against the particular FIF income including an ability to amend prior year tax returns for this purpose. This should be extended to tax paid in accordance with foreign FIF regimes in respect of the same investment or foreign tax paid on disposal of the FIF;

The above principles should be retained whether or not the Australian investor holds the FIF directly or through an Australian resident trust. In other words, an Australian investor investing through an Australian trust should be entitled to the above treatment in respect of any underlying investment which gives rise to FIF income being derived by the trust; and

Any FIF income attributable to capital gains in the hands of the Australian investor should be treated as a capital gain rather than ordinary income.

Priority

Very High

4.2 Option 4.2: Undertaking detailed case studies in conjunction with industry, increasing the 5 per cent balanced portfolio exemption threshold in the foreign investment fund rules.

Refer above.

4.3 Option 4.3: Exempting Australian managed funds that follow widely recognised indices from the foreign investment fund rules.

Refer above.

4.4 Option 4.4 Exempting, complying superannuation funds from the foreign investment fund rules.

Refer above.

4.5 Option 4.5: Amending the foreign investment fund rules to allow fund management services to be an eligible activity for the purposes of the foreign investment fund rules.

Refer above.

4.6 Option 4.6: Exempting from CGT gains to which non resident beneficiaries are presently entitled that relate to assets without the necessary connection with Australia. Whether an asset has the necessary connection with Australia could be determined as if the trustee of the resident trust was a non resident

Current Law

A non resident investor who has holds an interest in an Australian fund (in the form of an Australia resident trust) as a vehicle to make an investment into Australian public companies would incur capital gains tax when the fund disposes of its investment in the public company notwithstanding that the underlying interest in the Australian company is less than 10% of the total paid up share capital in the

Australian public company (hence, is not an asset which has the necessary connection with Australia).

This result equally applies where the Australian fund holds a non Australian investment, i.e. the foreign investor is effectively taxed on any gain on disposal by the fund manager of the foreign investment.

Had the foreign investor invested directly into the foreign investment, or through a non Australian fund, the foreign investor would not have been taxed in Australia at all.

Why change is needed

The Australian tax impact mentioned above is a significant disincentive to attracting foreign investors into Australian managed funds. Consequently, Australian funds are not able to compete with global fund managers and less capital is being invested in Australia.

We believe that an exemption from CGT (or withholding tax) for the foreign investor in the above situation would be revenue positive.

The solution

We recommend that foreign investors be exempted from CGT or any withholding tax on any trust income to which it is presently entitled to the extent that the income is attributable to capital gains on disposal of assets (whether held directly or indirectly) which do not have the necessary connection with Australia.

From a practical perspective, where the Australian fund has also invested into assets which do have the necessary connection with Australia fund managers will be required to calculate the portion of the income which is attributable to the latter. In this scenario, part of the trust income would be subject to Australian CGT in the hands of the investor. More work will need to be done in order to minimise any compliance costs for the fund managers.

Priority

High

4.7 Option 4.7 Exempting from CGT gains on the disposal of a non-portfolio interest in a unit trust that relate to unrealised gains on assets that do not have the necessary connection with Australia

Current Law

A non resident investor who has holds an interest in an Australian fund (in the form of an Australia resident trust) as a vehicle to make an investment into Australian public companies would incur capital gains tax on disposal of its interest in the Australian fund notwithstanding that the underlying interest in the Australian company is less than 10% of the total paid up share capital in the Australian public company.

This result equally applies where the Australian fund holds a non Australian investment, i.e. the foreign investor is effectively taxed on the foreign investment on exit from the Australian fund (the value of the foreign investment is priced into the exit price). Had the foreign investor invested directly into the foreign investment, or through a non Australian fund, the foreign investor would not have been taxed in Australia at all.

Why change is needed

This is discussed above.

The solution

We recommend that foreign investors be exempted from CGT or any withholding tax on disposal of its units in the Australian fund to the extent that the gain is attributable to assets (whether held directly or indirectly) which do not have the necessary connection with Australia.

From a practical perspective, where the Australian fund has also invested into assets which do have the necessary connection with Australia fund managers will be required to calculate the portion of the gain attributable to the latter. In this scenario, part of the gain on exit would be subject to Australian CGT. More work will need to be done in order to minimise any compliance costs for the fund managers.

Priority

High

4.8 Option 4.8 Amending the CGT rules so that a distribution of income to which a non resident is presently entitled, but which is not assessable because the income has a foreign source (or a CGT exempt gain that arises from Option 4.6) does not reduce the non resident investor cost base in a unit trust

Current Law

A non-resident investor in an Australian fund (in the form of an Australia resident trust) and who receives a tax free distribution would have its cost base in the fund reduced.

This effectively subjects the non-resident to Australian CGT on disposal of the interest.

Why change is needed

This is discussed above.

The solution

We recommend amending the CGT rules so that a distribution of income to which a non-resident is presently entitled, but which is not assessable because the income has a foreign source (or a CGT exempt gain that arises from Option 4.6) does not reduce the non resident investor cost base in a unit trust.

Priority

High

4.9 Option 4.9 Proceeding with the recommendations of the Review of Business Taxation rationalising the application of current rules to foreign trusts

Current Law

The taxation of trusts is currently subject to a number of different regimes including Division 6AAA, Division 6 and the FIF provisions. In many cases, it is unclear as to whether the different regimes reconcile. Some of the key issues are highlighted in a publication entitled *"Interests in Non Resident Trusts: A review of the conflicting income tax regimes"* (Australian Tax Research Foundation, Melbourne, 1997) by Burns, L and Krever, R**.**

Why change is needed

The current regimes give rise to significant uncertainty in many cases involving foreign trusts as to their impact, including the issue as to which of the regimes apply, who is the relevant taxpayer in relation to the trust income and what rules are to apply in calculating the taxable trust income.

The solution

We strongly support proceeding with the recommendations of the Review of Business Taxation rationalising the application of current rules to foreign trusts.

Priority

Whilst we acknowledge that any redesign of the trust regimes is likely to involve a reasonable amount of resources, given the current problems and given that the redesign of the FIF regime will need to be reconciled to the trust regimes, we are of the view that this should be given high priority.

4.10 Option 4.10Taxation of undistributed trust income of foreign individual migrating to Australia

Current Law

A non resident who migrates to Australia and becomes an Australian tax resident may be subject to tax on undistributed (foreign) trust income which accrued prior to becoming a resident but is distributed to the individual after migration.

Why change is needed

From a policy perspective, this result is an anomaly and inequitable given that the income is foreign sourced and was derived during a period in which the individual was not an Australian resident.

The current law is a significant disincentive for foreign individuals to migrate to Australia and is also a disincentive for such individuals to bring additional capital into Australia where the capital is currently held as undistributed income in a non Australian trust.

The solution

We recommend that the trust provisions in Division 6 and 6AAA be amended so as to ensure that any foreign trust income which were derived by the foreign trust prior to the time a non resident becomes a resident is exempt from Australian tax.

Priority

Medium

Appendix 4.1
Summary of Priority

Option No	Description	Priority
	General exemption from FSI rules for FIFs income in BELCs	Very high
4.1	Overhaul the FIF regime	Very high
4.2	5% balanced fund exemption	Medium/Low
4.3	Exempting index funds	Priority depending on the first two above
4.4	Exempting complying superannuation funds & other managed funds entities	High
4.5	Allow fund management services as an eligible activity	High
4.6	CGT on non-residents	High
4.7	As above	As above
4.8	As above	As above
4.9	RBT recommendations with respect to foreign trusts	High
4.10	Transferor trusts	Medium
4.11	Branch taxation	N/A

5 Improving Australia's Tax Treatment of Foreign Expatriates

5.1 Option 5.1 Residents departing Australia provide security for deferred CGT liability

Current law

Under the current CGT rules, resident individuals who cease to be an Australian resident for tax purposes on departure from Australia, are subject to a CGT liability on unrealised gains associated with their assets that do not have the "necessary connection with Australia" by way of a deemed disposal for tax purposes. This will include shares in Australian public companies (where the holding is less than 10%), shares in Australian private companies and similar foreign assets.

There is an exception to the deemed disposal rule for an expatriate who has been resident in Australia for less than 5 years during the previous 10 years, in respect of assets owned by the expatriate prior to becoming an Australian resident.

Problems with the current law / examples of problems

Although expatriates assigned to Australia for periods of up to 5 years, can usually satisfy this exception in respect of assets held at the date of arrival in Australia, many expatriates are still significantly impacted by the deemed disposal rule, resulting in an impediment for Australian businesses to attract appropriately skilled foreign labour to Australia as:

- The Australian tax implications of the deemed disposal rule, restrict the investment opportunities for expatriates to Australia. For example if an expatriate invests in foreign shares after arriving in Australia and becoming a resident for tax purposes, those foreign shares are subject to the deemed disposal rules when the expatriate permanently departs Australia, as they were not held at the time the expatriate first arrived in Australia. Expatriates may not be willing to be subject to the deemed disposal (and therefore are less likely to accept a position in Australia), particularly due to the fact that there are:

- potential double taxation issues should their home country ultimately tax them on disposal of the asset; and
- currency fluctuations which in itself can result in a significant difference between the gain that the individual is taxed on at the time of departure, and the gain that is ultimately derived (even in a case where the value of an asset does not change from the time of departure to ultimate disposal).

- Many expatriates take an equity interest in the Australian employer during their time in Australia (which aligns their interests with those of the shareholders and incentivises performance), which are subject to the deemed disposal rules.
- If the employee is unwilling to take on the burden of paying CGT at the time of departure from Australia, they may either not accept the assignment to Australia in the first place or insist that the Australian employer picks up any liability incurred, which increases the cost for Australian businesses to employ the skilled labour in Australia.

Although the current tax legislation allows an individual to elect for the deemed disposal rule not to occur as at the date of departure from Australia, meaning that the taxing point is deferred until the time of actual disposal of the relevant assets, many expatriates prefer to disclose the unrealised gain in the tax return for the year of departure, as they would prefer to lodge a "final return" in Australia.

From our experience, the expatriate population in Australia are generally conservative in nature due to their positions of authority within Australian businesses and they are generally keen to ensure full disclosure of taxable income in Australia. Therefore rather than having a taxable capital gain hanging over their head from an Australian tax perspective until they eventually dispose of the asset, whenever that may be, they tend to prefer to allow the deemed disposal to occur in the year of departure.

The big problem with this however, is that there can be a significant cash flow issue for the individual, in that they are required to pay CGT on a gain that is not realised by the end of the income year concerned. Therefore in many cases, the only way that this liability can be paid, is if the employee sells the asset at the time the liability falls due, or the employer agrees to pay the liability on the individual's behalf. This increases the costs of hiring the individual in Australia as this will not only cost the income tax amount but also any Fringe Benefits Tax on the benefit provided. Therefore if a security deposit is required from individuals departing Australia, we do not believe that this will alleviate the underlying problem with the deemed disposal rule for

CGT purposes – all it will do is make the cash flow impact a definite issue, rather than providing the possibility of deferring the taxing point to match the time that any real benefit is derived. It is also likely to remove the possibility of claiming any credit for Australian tax paid on the unrealised gain, in a foreign country that the individual may also be taxed in.

Options

The Government should not proceed with this recommendation.

Such a move should be withdrawn for the following reasons:

- It is a disincentive to highly skilled workers coming to Australia and exacerbates current problems with the CGT treatment of foreign expatriates as in many cases it will force expatriates to sell their CGT assets to enable them to provide the security;
- The cost of administration is likely to substantially reduce any additional tax revenue raised under such an option;
- Any security is unlikely to be tax deductible (or available as a tax credit) in the expatriate's normal country of residence, therefore resulting in a significant cost; and
- The option would be counteractive to Australia's desire to be competitive in the global economy and is against the overall Government policy of attracting highly skilled expatriates to Australia. As the consultation paper recognises, skilled labour is becoming increasingly mobile, and in order for Australia to compete in international markets, Australian businesses must be able to attract appropriately skilled workers, who can bring new ideas, skills and work practices into the Australian economy. The Government has publicly expressed its commitment to reduce costs on Australian employers, however implementation of this option would only increase costs and will be a disadvantage for Australian businesses in attracting skilled employees in the international labour market.

KPMG supports the measures relating to income tax exemptions for temporary residents that were eventually stricken from the legislation in Taxation Laws Amendment Bill (No.4) passed by Parliament in June 2002. The exemptions would have applied to expatriates who are residents of Australia for the first time and enter on temporary residence visas (subject to a 10 year reset rule), and included an exemption for capital gains and losses from assets that do not have the necessary connection with Australia (which excludes portfolio interests in Australian publicly listed companies and unit trusts) regardless of when they are acquired.

In our view, this measure in particular if implemented, would have a great bearing on being able to attract the appropriate international talent into the Australian economy, as it would remove an impediment that either has a substantial financial impact for the individuals personally, or for the Australian business employing the individual, if they are required to pick up any liability that the individual incurs in order to attract them to Australia.

KPMG also supports the progressive renegotiation of Double Tax Treaties with various overseas jurisdictions to clarify the issue of taxing rights over Capital Gains events. The interaction of different jurisdictions' domestic law with the articles of current Double Tax Treaties is an area that has resulted in varying interpretations being adopted, due to the fact that Capital Gains Tax was quite often not taken into account in the original drafting of the Treaties that have been negotiated.

Level of priority

Due to issues and problems as outlined above, option 5.1 should be an extremely low priority in terms of reviewing Australia's International Taxation Arrangements. In fact, we suggest that this option be totally removed from the Treasury's agenda.

However the need for reform of the taxation of foreign expatriates into Australia is an extremely high priority. The original proposals as outlined in Taxation Laws Amendment Bill (No.4) were a positive move in this direction, however since the expatriate provisions of that legislation were dropped, we are aware of numerous examples of multinational companies in Australia either not being able to attract appropriately skilled employees in the global search for talent, or the tax implications being a major hurdle in final negotiations to sign on international executives.

5.2 Option 5.2 Double taxation of employee share options through bilateral tax treaty negations

Current law

The taxation of options is covered by Division 13A of the 1936 Act. Assessable income arising under Division 13A is statutory income (see Division 10-5 of the 1997 Act). Statutory income derived by an Australian resident is assessable whether derived from sources in or out of Australia. Statutory income derived by a non-resident of Australia is assessable to the extent it has an Australian source and where the Act includes it in your assessable income on some basis other than having an Australian source.

The legislation is inadequate in the following ways:-

- It gives no guidance as to whether the discount on employee share options should be treated as employment income
- It gives no guidance on the amount of the discount to be included in assessable income where the relevant employment (assuming the discount will be treated as employment income) occurs only partly in Australia.

Prima facie Division 13A includes the value of the option in the employee's assessable income at the time the option is granted. However, where the option is a "qualifying" option, the taxing point is deferred until, generally, the option is exercised. With a "qualifying" option, only if the employee makes an election will the option be taxed at grant.

It might be expected that most options granted to executives will be qualifying options especially where the company in which the options are granted is a tax resident of Australia.

For an **inbound expatriate**, where the trigger event (ie exercise) occurs in Australia, the employee's assessable income may, arguably include the full discount, regardless of the jurisdiction in which the employment, during the option holding period, was exercised.

This general statement should be qualified in these respects –

- There is an argument for concluding that options issued to a non-resident in an overseas jurisdiction in a company which is a non-resident, will be non-qualifying options. Because of a lack of connection with Australia, the value of these options cannot be taxed at grant and by virtue of section 139C(4) of the 1936 Act they are not taxed on exercise.

- It is not known whether this outcome was not the intention of the legislators at the time Division 13A was introduced.
- A not uncommon practice is to include in an employee's assessable income on exercise, only that part of the discount which relates to Australian employment where the part referrable to non Australian employment is taxed in the relevant overseas jurisdiction. This practice is aimed at achieving a common sense approach but has little direct legislative support. The ATO's attitude to this equitable and common sense approach is not known.
- Amendments introduced in Taxation Laws Amendment Bill (No. 7) 2002, which was recently introduced into Parliament, will result in the discount relating to non-Australian employment being exempt from tax in Australia in the following circumstances for inbound expatriates:
  - The expatriate comes into Australia on a temporary entry visa.
  - The option was issued prior to the expatriate coming into Australia in respect of non-Australian employment.
  - The exercise of the options occurs within four years of the expatriate becoming a tax resident of Australia.

  This measure is applauded and is in line with the general principles underpinning this submission.

For an **outbound expatriate**, it is arguable that the full discount may be included in the employee's assessable income in the year of exercise, regardless of where the relevant employment was exercised. It is likely that a liability will arise, in respect of the discount (in whole or in part) in the country where the employee is working at the time of exercise.

The Australian domestic legislation, as noted above, does not adequately contemplate the situation where, during the option holding period, the employee exercises employment in more than one country.

The preamble to the statement of option 5.2 (see pages 78 and 79 of the Treasury Consultation Paper) succinctly summarises the present situation regarding double tax relief, noting that different countries adopt different approaches to the taxation of options and that to effectively remove double taxation a common approach, or reciprocity, is needed. The paper suggests that it is appropriate to address the double taxation of benefits arising from employee share options on a country-by-country basis through bilateral tax treaty negotiations.

The preamble also makes mention of the OECD approach which is contained in a public discussion draft entitled "Cross Border Income Tax Issues Arising From Employee Stock Option Plans".

Why change is needed

Appropriate change, as outlined below, will have the following positive effects.

- Australia's tax laws will fairly tax the appropriate amount commensurate with the temporal connection of the employee with Australia.
- Australia's tax law will be simplified and bought into line with that of our main trading/ investing partners.
- Australia will become a more open and attractive place for expatriates to come and work.
- Australia will become a more attractive place to locate a regional headquarters with the flow-on benefits of more jobs and a more sophisticated work force.

Options

It is appropriate that the allocation of taxing rights in relation to employee share options is a subject which is dealt with in Australia's double taxation treaties.

However, as a starting point it is submitted that Australia's domestic taxation regime dealing with the taxation of employee share options and employee shares should be reviewed. Such a review would be undertaken with the following purposes in mind:

- To make clear that the discount on employee share options (and the discount on employee shares) is, in the absence of contrary intent, to be treated as employment income.
- To align the way Australia taxes employee share options with the way employee share/stock options are taxed by Australia's major trading investments/partners.

  It might be expected that most cross border issues in this area arise between Australia and countries which are our major trading/investing partners. These countries include the United States, the United Kingdom, Japan, New Zealand, Singapore, Germany, The Netherlands and France. In the Appendix a brief outline of the way in which employee share/stock options are taxed in these countries is provided.

Most countries adopt, as the taxing point, the time when options are exercised and treat any discount at this time as assessable income. Most countries treat any further gain in relation to shares acquired on the exercise employee share options as being subject to the capital gains tax regime.

As noted above, Australia generally treats the discount on qualifying options as assessable income at the time the option is exercised, but also offers the employee the alternative of electing to be taxed on, generally, the formula determined value of the option at the time it is granted. Non qualifying options are taxed at the time the option is granted using, generally, a formula determined value. A value, so determined, is brought to account in the year in which the option is granted as assessable income.

We are not aware of any other country which gives employees the opportunity to determine, by election, the taxing point for employee share options.

As a means of simplifying Australia's taxation regime and as means of bringing it into line with the regimes operating in its major trading/investing partners, it is submitted that the opportunity for an employee to elect to pay tax on the value of the option at the time it is granted should be discontinued.

- It is further submitted that Australia's domestic taxing regime be amended to make certain that:
  - that portion of the discount which relates to employment exercised in Australia where Australia has taxing rights in relation to the resultant salary and wages is assessable in Australia;
  - Australia does not claim taxing rights in relation to that portion of any discount which relates to employment exercised in another country where Australia does not have taxing rights in relation to the resultant salary and wages;
  - the allocation of the discount be determined on a time apportionment basis; and
  - any tax liability arising should arise in the year the option is exercised.

  These recommendations should produce the following results:

  - The implementation of this principle is reasonably straightforward where a resident of Australia for tax purposes leaves the country with stock options and becomes a non-resident. It is similarly straightforward where a non-resident, with stock options, arrives in Australia and becomes a tax resident of this country.

In each case, Australia would claim taxing rights in relation to that portion of the discount which related to the period when the individual was a resident of Australia for tax purposes.

- In a situation where an individual with share options leaves Australia but remains a resident of this country for tax purposes but, by virtue of the Dependent Services Article of the relevant double tax treaty, the overseas country has primary taxing rights in relation to the resultant salary and wages, the portion of the discount applicable to the overseas service should not be subject to tax in Australia.
- Where the employee remains, during a period of overseas employment, a resident of Australia and the relevant salary and wages are not subject to tax in the overseas jurisdiction, the discount applicable to this period of employment should continue to be taxed in Australia in line with the salary and wages applicable to such service.

  Where the salary and wages are subject to tax in the overseas jurisdiction but the rate of tax in that jurisdiction is zero, (and, if the rate were not zero, the overseas jurisdiction would have primary taxing rights) the discount applicable to the overseas employment should not be subject to tax in Australia.

  The aim is to, for the purposes of section 23AG, bring into line the tax treatment of the discount with the tax treatment of the salary and wages relating to overseas employment.
- In circumstances where salary and wages are taxable in an overseas jurisdiction but, for whatever reason, the discount on the share options is not assessable in that jurisdiction, Australia should not seek to tax the discount applicable to the overseas employment.

Incorporation of allocation rules in the domestic legislation would make more simple and more certain the application of the relevant rules and, it is submitted, would overcome the majority of the present problems without resort to the double tax treaty renegotiation.

Double tax treaty negotiation

It is submitted that if the recommendations above were incorporated into Australia's domestic legislation, negotiation of amendments to double tax treaties with our major trading/investing partners would be relatively straight forward as the applicable Australian legislation would be generally in line with domestic legislation in other countries leaving little scope for double taxation and little scope for there being a portion of the discount on which no tax was payable.

It is further submitted that a renegotiated double tax treaty should stipulate Australia's right to collect tax on that portion of the discount which relates to employment activities which give rise to assessable Australian salary and wages.

Negotiation of amendments to double tax treaties is invariably a long draw out procedure. Amendment of Australia's domestic law to bring it into line with the law operating in our major investing/trading partners would resolve quickly most of the double taxation problems in relation to share options.

In circumstances where there are major differences between Australia's domestic legislation and that operating in other jurisdictions the problem should be able to be addressed through renegotiation of the relevant double tax treaties. Because of the time involved in renegotiating treaties, problems with these jurisdictions would remain but if Australia has adopted a best practice domestic regime it would be in a strong position to collect the appropriate amount of tax owing in any matter which required resolution by the applicable competent authorities.

Priority

These changes to domestic legislation should be easy to make, will have substantial positive effects and should be given a high priority.

Renegotiation of our double tax treaties should aim to back up our domestic law and should proceed with appropriate urgency. However, change to our domestic law in the manner proposed will resolve most of the contentious issues in this area.

5.3 Option 5.3 GCT Cessation event

For the reasons outlined in the Treasury Paper's preamble to Option 5.3 for consultation we recommend that the government should not proceed with the Review of Business Taxation recommendation to treat ceasing to be an Australia resident as a cessation event for the purposes of Division 13A.

Other issues which need to be addressed to resolve anomalies in Australia's taxing of expatriates

While not listed as options for consultation, the following issues should be addressed as part of the review:

- Australia's high rate of personal income tax and the low level at which the highest rate cuts in.
- The changes recommended by the Review of Business Taxation relating to the non-taxation of foreign sourced income earned by temporary resident during the first four years they are in Australia should be implemented as soon as possible. We note that these changes are included in Taxation Laws Amendment Bill (No. 7) 2002 which was recently introduced into the Parliament.
- The four year window should be reviewed and extended. It is a major issue for expatriates – often senior people – who would want to stay longer and are skilled people Australia would generally want to stay longer. This could be dealt with by giving the Commissioner a discretion.
- There should be no levy of withholding tax on payment of interest by temporary residents to overseas lenders. (This issue has been addressed in Taxation Laws Amendment Bill (No. 7) 2002)
- Expatriates may experience difficulties in meeting the proof of identity requirements when applying for a Tax File Number ("TFN"). This is because only limited forms of documentation are accepted by the Australian Tax Office ('ATO'). The TFN application process could be simplified by accepting a person's passport as the proof of identity.

All of these changes send a message that Australia is an open, attractive place in which to do business. They align tax legislation with sought-after economic outcomes. They align Australia's tax rules more closely with those of our major trading/investing partners and in the process, simplify our laws.

Appendix

Taxing point re option plans in overseas jurisdictions

Country	At grant	At vesting	At exercise	Deferral of tax	CGT on sale of ESOP shares
USA			X		CGT 20% > 1 year; 18% > 5 years
United Kingdom			?[1]		Yes
Japan			X		Yes, subject to residence rules
New Zealand			X		NZ does not have a CGT
Singapore			X	May elect to defer tax for up to five years if options are issued under certain ESOP schemes, subject to an interest charge	Singapore does not have a general CGT
Germany			X		If shares held > 12 months, then no CGT on sale
The Netherlands		X		Tax may generally be deferred until the date of exercise	NL does not have a general CGT
France			?[2]	If tax is not paid on exercise it can be deferred until sale of shares and may be concessionally treated	No CGT unless gross sale proceeds exceed FF 50,000. Concessional treatment where stock held for > 4 years after grant

Notes:
(1) Tax is not chargeable at exercise if scheme is an “approved employee share scheme”.
(2) Tax is not levied at exercise on qualifying shares if the option exercise price is > 95% of the average stock price over the 20 trading days preceding the grant date. For non-qualifying schemes tax is payable on exercise.

The above summary presents the general position regarding the taxing of stock options in these countries. In almost all jurisdictions there will be variations and concessions in certain circumstances. We would be pleased to provide further, detailed information should that be required.