# REVIEW OF INTERNATIONAL TAXATION ARRANGEMENTS

*ACCI SUBMISSION*
*TO THE*
*BOARD OF TAXATION*

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**Background**

The Australian Chamber of Commerce and Industry (ACCI) is the peak council of Australian business associations. ACCI's members are employer organisations in all States and Territories and all major sectors of Australian industry.

Through our membership, ACCI represents over 350,000 businesses nation-wide, including the top 100 companies, over 55,000 enterprises employing between 20-100 people, and over 280,000 enterprises employing less than 20 people. This makes ACCI the largest and most representative business organisation in Australia.

Membership of ACCI comprises State and Territory Chambers of Commerce and national employer and industry associations. Each ACCI member is a representative body for small employers or sole traders, as well as medium and large businesses.

## Executive Summary

*Importance of Improving International Tax Environment*

As international investment flows become more important, changes to Australia's current taxation system becomes more urgent and necessary. ACCI therefore welcomes the open and transparent process the Board of Taxation has developed for submissions into International Taxation Arrangements.

In order to remain competitive in a globalised environment businesses must not be prevented from developing and employing the best business structures, finance, people or opportunities available to them.

### Tax System as an Inhibitor of Growth

The tax system, by its nature, discourages certain forms of activity and encourages others. Activity will flow towards areas where the *after-tax* returns are the greatest, and in an important sense earning the greatest after-tax returns includes an understandable reluctance to become entangled with complex arrangements and high compliance costs. To the extent, therefore, that the Australian tax system needlessly adds to business costs or lowers profitability then to that extent Australia is penalising itself by limiting the potential for greater growth and higher living standards.

The increasing relevance to Australia of foreign direct investment (FDI) has generally not been reflected in changes to the tax system that improve the processes involved. If Australia is to engage in a more globalised world economy then such changes need to take place as soon as possible. Indeed, a trend towards more open financial borders will continue to change and influence the vitality of economic markets.

### Removing the Bias Introduced by Imputation System

The introduction of the imputation system in Australia has largely helped to develop and maintain one of the highest share ownership rates in the world. To that end the system has largely been successful.

Returns to shareholders derived from foreign source income are, however, currently subject to double taxation. This double taxation of shareholder income in turn affects the cost of capital paid by firms. The lack of credits for foreign company tax paid to shareholders produces a situation where the pre-tax return for foreign investments must be higher than domestic investments in order to attract investors. In essence, the imputation system has led to a preference towards investing in firms with domestic income only, rather than in firms that earn both international and domestic income.

There therefore exists at the shareholder level a bias towards domestic firms. To what extent this affects the cost of capital is the important question that has required detailed examination. Obtaining answers to these questions is made all the more precarious because of the difficulty of accurately measuring the benefits to the economy overall from removing such a bias.

If the cost of capital were not influenced by the current imputation system then the associated costs to government revenue and the benefits to shareholders would not necessarily dictate change. The Government's primary focus must be to maintain economic conditions conducive to growth and this should be its overriding concern.

The use of franking credits for Dividend Withholding Tax (DWT) to reduce the bias may in theory work. It would not, however, adhere to ACCI's principle of trying to remove such forms of taxation through negotiation with Australia's trading partners. Given that this principle is currently being applied by the Government credits for DWT this is an issue that will become less relevant over time.

Allowing for dividend streaming of foreign source income only benefits companies with non-resident shareholders which is generally not the case for small or expanding companies. The full benefits of streaming are only derived when the proportion of foreign income to non-resident shareholders is equal, a situation unlikely to exist in many Australian firms and therefore streaming is unlikely to be fully effective.

Given these problems, ACCI recommends that if any of the options listed is chosen then its preferred option is that a foreign dividend credit be given to shareholders. The amount of the credit, if this option is adopted, should form the basis for further discussions. However, this should only occur following a study which has shown that the costs of providing this credit are greatly exceeded by the future flow of benefits to the Australian economy overall.

*Controlled Foreign Company and Foreign Investment Fund Rules*

Reducing the compliance cost and uncertainty associated with investing internationally will produce tangible gains. The Australian taxation system has in place an array of different measures to reduce tax avoidance thereby ensuring the integrity of the tax base. These are measures which business fully supports.

It is the anomalies that increase both unnecessary complexity or are revenue raising in nature which add to business's frustration and reduces their competitiveness internationally. Australia's Controlled Foreign Company (CFC) and Foreign Investment Fund (FIF) rules are examples of tax measures whose high level of complexity businesses which are investing offshore must contend with in their daily operations.

Because of the current anomalies in the taxation system Australian firms are being disadvantaged in terms of being able to use capital and labour resources effectively. The taxation of conduit income has led to Australia being avoided as a location to set up regional headquarters. The same system also acts to discourage skilled workers from taking up employment positions that add to the overall productive capacity of Australia.

**Residency Tests and Treaty Negotiations**

Other issues of importance to the future development of tax policy are the current form of Australia's residency test and treaty negotiations. The residency test while being understood by business has been unable to adapt to changes in technology and therefore makes it difficult to ascertain when residency applies. This adds further uncertainty for businesses due to the ambiguity created by the residency test in determining where jurisdictional tax boundaries lie.

The Australia-US treaty negotiations process has generally been successful, especially with respect to dividend withholding tax. This process should continue with the aim of making Australia a more competitive place to invest for international companies. Another aspect that needs change is the lack of information for business about the negotiations. Furthermore, business should strive to be a part of the negotiation process given that such developments may substantially affect the business community.

**Attracting Skilled Workers from Overseas**

For Australian businesses to remain and become more competitive companies need to develop and have access to skilled workers from around the world. Given the competition that is currently taking place for such individuals, disincentives that make Australia unattractive can have serious consequences in terms of business's ability to compete.

It is, however, important that incentives are not offered to foreign expatriates that exceed those available to domestic employees. This situation would be unacceptable to the business sector and would introduce new biases that did not previously exist.

Australia must act quickly to undertake changes to the current system so that Australian firms have access to the best resources and can compete in international markets.

**Need for Ongoing Review of International Taxation Arrangements**

Improving international tax arrangements cannot, however, be a one-off measure. There is an ongoing need to monitor international developments. There is constant innovation even in tax policy. Australia must ensure its own tax system is world best practice. The processes for reviewing change and seeking comment towards improving the tax system generally should remain high on the Government's agenda. No change should be seen as the final word in tax development since no change is ever likely to be.

**Need to View Tax Measures within Full Budget Context**

There is one final cautionary note that needs to be included. It relates in particular to the issues surrounding the bias in the imputation system but also has a much wider currency to this review. Where measures have a cost to revenue, as many of the recommendations in this submission do, they must be assessed within the context of the entire budget process. Budgets must be kept in surplus and measures which require significantly higher levels of expenditure or reductions in government revenue cannot be looked at in isolation from the budget as a whole.

In regard to the bias introduced into the tax system by the introduction of imputation there are two very large unknowns. There is, firstly, the extent to which removing the bias would increase the growth potential of the Australian economy. But secondly, there is the issue of the cost of any remedy introduced. Both the benefit to the economy and the cost to government revenue have not been adequately estimated making hard and fast recommendations difficult.

It is therefore essential that a proper cost-benefit analysis is conducted before any decision is taken, and then, given that there are large potential costs to revenue, there must be an assessment of the relative importance of correcting this bias in the tax system against all of the other economic measures under consideration at the same time.

## Introduction

### Tax Reform and The Budget Context

From the point of view of living standards, tax systems should ideally be "neutral" in terms of economic choices. In such a framework, the choice of an investment, its financing or its location should not, in principle, be driven by tax considerations. From this perspective, and in an international context, similar investments should not face markedly different effective levels of taxation purely because of their country location. Differences in the effective levels of corporate taxation may in fact imply welfare costs because economic activity may not take place in the lowest (pre-tax) cost location by the lowest cost producers. If the impact of differences in tax regimes favours one location over another, or one producer over another, then goods may be produced at a higher pre-tax cost. Therefore, the size of these tax differentials and dispersions deserve attention.

But while the efficient allocation of resources is a fundamental economic objective improving the taxation system must be seen in the context of other domestic considerations and must not be dealt with in isolation from other significant issues. To the extent that inefficiencies in the tax system do exist their remedies chosen should not place other priorities in jeopardy. The Government must not, in it efforts to address international tax issues neglect sound economic management and should view the changes more to the tax system within the context of other budget imperatives.

The Government has a responsibility to maintain stable fiscal policy. The Government's position of producing surpluses has had a positive effect on the businesses of Australia. Although, we understand the importance of changes to the current international taxation system our overriding consideration is for good domestic policy overall.

### Comments on the Importance of International Taxation to Australia.

*Why is this inquiry important of the members of ACCI?*

This submission is important to ACCI's members because at present Australia maintains an inefficient international tax system. The goal of this submission is to examine ways in which changes to Australia's treatment of international income flows can mature the Australian economy and increase real incomes. It is also about making Australian industry competitive with the rest of the world in attracting foreign capital and skilled migrants.

This submission is not only relevant to large Australian multinational corporations, it is also important to smaller companies wishing to expand offshore either now or in the future. The policies entailed in this submission aim to make Australian business as internationally competitive as possible. Although, the adoption of competitive benchmarks is constrained by practical considerations of compliance and administration, Australia's national interest in protecting its share of taxing rights, and international obligations and consensus (to the extent it exists).

ACCI wishes to bring about positive change at both the corporate and individual level as well as increase Australia's economic activity. This can be achieved through input into changes to Australia's taxation system, which ultimately affects the distribution of capital and labour in this country and how well those resources are used.

*The effects of the imputation system on Australian firms*

Because of the structure of the tax system, large Australian multinational companies that raise the majority of their capital domestically encounter a bias against individuals investing in domestic firms with offshore income. As discussed in the submission the removal of such a bias would encourage multinational companies to maintain their operations and control in Australia. The present system activity discourages their remaining in Australia. The bias towards domestic investment is due to:

> "Australian resident shareholders receive franking credits on dividends paid by resident Australian companies only for Australian company tax paid. Australian resident shareholders do not receive credits for foreign company tax (usually the main tax on a company's offshore investments) paid by a branch or offshore subsidiary of an Australian company."[1]

Multinational companies based in Australia that source the majority of their equity from abroad and have major shareholders, as non-residents, of which there may only be a small number, will not be as affected by the current imputation system.

Any bias of the nature discussed above will generally affect smaller businesses that wish to expand, or continue expanding, into international markets more. These firms are forced to source all

[1] The Treasury "*Review of International Taxation Arrangements: Consultation Paper*", Attracting Equity Capital for Offshore Expansion, Chapter 2 p11.

their funds domestically and therefore require a higher pre-tax return on their investment in order to raise the necessary amount of capital.

**Principles of International Taxation**

*Simplicity and certainty in the taxation system will reduce business compliance costs.*

Parts of Australia's international taxation laws need to be revised in terms of the burden they place on Australian multinational and newly expanding businesses. Simplicity in a tax system allows businesses to allocate resources towards areas that are most productive rather than having to comply with inefficient and wasteful compliance processes.

Uncertainty in the tax system is often a result of anomalies through the different treatment of similar economic entities or activities. The use of basic principles in decision-making allows for the treatment of activities to be consistent, transparent and less open to interpretation.

*Integrity of Australia's tax base must be secure in order to ensure our ability to meet domestic obligations*

Australia and other nations have agreed to the principle that a source country (income derived through economic activity carried on in one country by the resident of another) has the right to tax residents and non-residents on their domestic income. However, this system raises the possibility of double taxation whereby the source country exercises its rights to such income and then that income is taxed again in the country of residence of the company or person.

Australia has adopted the principle, however well applied, that when appropriate it should not tax non-residents on income gained through foreign source income. This arrangement adheres to the source principle. This arrangement also provides no disincentive to foreigners wishing to invest through Australian companies while making the creation of domestic holding companies in Australia more attractive. If a country is not involved as either a source or resident of economic activity then income must not be taxed on the way through.

ACCI supports the exclusion of taxation by the Australian Government on foreign source income accruing to non-residents. Nevertheless anomalies still exist within the legislation. This principle often leads to complications in Australia's tax legislation although the underlying principle of not acting to double tax income is sound. Business also supports the right for the government to enforce the integrity of its tax base.

## CHAPTER 2

### Attracting Equity Capital for Offshore Expansion

**Is There an Overall Tax Bias in Favour of Direct Investment Offshore?**

As a general principle, any type of bias in an economy will tend to lead to investments in less productive activities. When a business chooses to expand overseas it requires the necessary equity capital at a reasonable price to remain competitive against its international rivals.

Australian companies that have a higher cost of capital are put at a distinct disadvantage when other international companies are able to obtain capital at a lower price, although it must be proved that this bias caused by the imputation system does produce a higher cost of capital to the firm. If this were not the case then any revenue implications of changes to the tax system for the government would need to be weighed against budget pressures.

Imputation credits are not received for foreign company tax paid. This amounts to the double taxation of income receive as foreign income. Throughout the taxation chain the shareholder of a domestic firm's shares can see that profits are taxed at many different points, for example before repatriation of profits, upon repatriation, during distribution and finally as income. Therefore, imputation bias is only one of a number of elements that affects the price of capital.[2]

There are cases, however, where foreign investment by individuals investing in Australian firms offshore is more tax effective than domestic investment. This situation is just as unreasonable as the first scenario because it distorts investment away from the domestic economy. What is required for an efficient tax system is one that does not favour either domestic or foreign investment over the other and does not change the bias from that of investing domestically to encouraging offshore investment. This allows capital flows to be based on economic criteria rather than tax considerations.

It is imperative to answer the question of whether or not biases in the taxation system raise the cost of capital, as imputation tends to produce a bias at the shareholder rather than the company level. If

[2] The Treasury "*Review of International Taxation Arrangements: Consultation Paper*", Attracting Equity Capital for Offshore Expansion, Chapter 2 p12.

the cost of capital is determined on the international market then current Australian multinational companies will not be disadvantaged due to their ability to raise equity from non-resident shareholders who do not benefit from dividend imputation on foreign source income.

If the cost of raising capital is higher for Australian firms then the Government must address the issue of taxation bias. For smaller companies that wish to expand internationally and do not have access to overseas equity it is important that any bias towards domestic investment is removed. Small companies wishing to expand offshore would be disadvantaged to a greater extent than those companies that already have access to international funds due to the need to maintain higher pre-tax returns.

Australia is a small open economy. As such, it must expand into international markets in order to stay competitive with other larger economies. To achieve this Australian businesses must be competitive with overseas companies in other countries. Therefore, franking of foreign source income may be an important step in helping Australian business to become more competitive internationally.

Smaller companies will rely almost exclusively on sourcing funds from the domestic economy if they wish to expand internationally. These firms are put at a particular disadvantage when competing with larger international firms in a foreign market.

Individual shareholders may of present, if investing through an Australia firm with overseas income, be forced to take income through a capital gain rather than through dividends. This reduces the choice of returns an individual has when investing offshore. Therefore, investors who are unwilling to take only a capital gain with minimal dividends will not invest in Australian companies with offshore income. This will tend to depress earnings and make it harder for a company to raise the necessary funds domestically.

**Reducing Shareholder Level Tax Bias Against Direct Investment Offshore**

Any change designed to reduce the shareholder bias would have to improve prospects for economic growth, not adversely affect the business community or introduce disincentives to investing domestically. Any removal of the imputation system would also need to account for the distortions introduced back into the taxation system.

ACCI does not support the dismantling of the imputation system. The imputation system has improved the allocation of shareholder funds and benefited the Australian economy. It should be retained.

The imputation system does however, produce a bias towards domestic investment. The fact that resident shareholders do not receive a tax credit for foreign tax paid is contrary to the idea that double taxation should be removed from the taxation system.

Any foreign subsidiary of an Australian company that repatriates foreign funds to Australia should be eligible to distribute franked credits to its shareholders to the amount of foreign tax paid. This leaves the return on similar international investments, at the individual level, equal to domestic returns and therefore, the shareholder is indifferent between either types of investment.

Option A involves paying shareholder relief for unfranked dividends out of foreign source income and requires companies to set up a parallel system to the current dividend imputation rules. This would allow resident non-corporate shareholders to receive a non-refundable tax credit when an Australian company pays an unfranked dividend.

**ACCI recommendation**

The preferred option, with qualification, is option A. Attracting equity capital for offshore expansion should be achieved through no great impost on government revenue. These two objectives are dependent, and to some extent interdependent, on the amount of credit given for foreign source income. The final amount as determined must be properly assessed with consultation and input from business.

It is also necessary to understand that the amount of credit given for foreign source income could change the bias from investing domestically to investing offshore. The amount of credit given must not in any way create such an outcome.

The objective for business is to reduce the cost of capital thereby making Australia more competitive internationally, if this outcome cannot be proven either through empirical analysis or illustration any changes to the current approach would need to be seriously considered as to whether they should proceed.

## CHAPTER 3

### Promoting Australia as a Location for Internationally Focused Companies

Australia's CFC and FIF laws are overly complex and represent a significant burden on Australian multinational corporations receiving profits from foreign source income. Although they are based on the principle of anti-avoidance and are designed to maintain the integrity of the Australian Government's revenue, making piecemeal improvements only serves to increase the uncertainty and frustration of the business community.

ACCI would like to see the changes that are necessary take place now rather than at some non-specific time in the future.

CFC provisions in Australia (as everywhere that they exist) are designed to prevent Australian resident entities from sheltering their income, gains or profits from Australian taxation by locating them in a low tax country where they would be taxed lightly, if at all. To counter this, the CFC provisions impose tax on the resident shareholders of the foreign company on the accrued profits made by such companies, whether that profit is distributed in Australia or not. This is known as the attribution process.[3] The CFC rules apply only to companies with Australian resident shareholders who have strict or *de facto* control of a CFC.

Reforms should include reducing the current disincentives that multinational companies face in maintaining holding companies within Australia. The tax system should encourage foreign companies to buy domestic firms as holding companies while maintaining the original firm structure and reducing the complexity of the current laws.

**Option 3.1 for consultation: to consider options to expand rollover relief under the controlled foreign company rules, while maintaining the integrity of those rules.**

It is generally recognised that reforms of the CFC rules need to take place sooner rather than later. The best solution would be to implement changes that reduce the complexity of such laws and

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[3] Jason Gorringe "*Outward Investment from Australia – The Offshore Perspective*", Offshore - Onshore Australian International Tax Site, site accessed on the 21st of October 2002 http://www.lowtax.net/lowtax/html/offon/australia/aus_offshore.html.

allow for Australian multinationals to restructure without incurring unnecessary costs.

ACCI supports the proposal to expand rollover relief. At present the CFC rules provide an obstacle to efficient firm structures due to the costs of restructuring a company. Because of the extension of the capital gains rules, via the CFC rules, to include taxing capital gains that have accrued to a company where that country does not tax capital gains, Australian firms are disadvantaged with respect to their ability to reorganise their firms using the most efficient structure. The current application of the CFC rules acts as a distinctive to keep Australian firms at the centre of any regional subsidiary structure.

A script-for-script transfer will not reduce the Government's income as the company is only swapping one economic entity for another. Therefore, given that the value of the interest is no different, it is reasonable to allow a deferral of the capital gains tax. The new shares will still remain within Australia's taxation system under the existing CFC rules.

ACCI supports the expansion of rollover relief under the CFC rules.

**Option 3.2 for consultation: to consider options to appropriately target the tainted services income rules, while maintaining the integrity of the controlled foreign company rules.**

As economies become more integrated people and companies will derive more income from foreign sources. This is especially true for services and intangible income; therefore, such activities should be seen and taxed as legitimate businesses. If services are produced in this country then as the source country Australia has the right to tax such activities.

Australia's economy has changed since the introduction of the CFC and FIF rules with services having increased as a proportion of overall trade. Some businesses are active and function exclusively in the services arena. Problems arise, when companies that have active business in CFCs do not qualify for relief because they fail the active income test.

Active businesses can be set up as a shared services centre for regional headquarters in offshore subsidiaries. This arrangement may represent the most cost effective structure for an Australian company. These, however, tend to be taxed inappropriately under the current CFC rules.

At present, all service income received by a CFC from an affiliated company or Australian resident is treated as passive income. Passive income is that derived from royalties, interest and services fees. If passive income exceeds 5% of turnover then this income becomes attributable back to Australia.

The consequences of such taxation means that instead of centralising these activities companies will have to use a far less efficient structure such as duplication. Having a centralised services subsidiary will create problems associated with charging fees which amounts to passive income being attributed back to Australia. This provides a disincentive to set up a parent or conduit holding company in Australia with respect to the delivery of cross border services.

We recommend that the tainted service income rules be removed from the CFC rules, as many service providers are now valid active businesses due to there value adding and therefore are genuine active businesses.

**Option 3.3 for consultation: to consider whether additional countries should be included on the broad exemption country list, and to clarify the criteria for inclusion (or exclusion).**

An expansion of the broad exemption country list would enable legislators to simplify the Australian taxation system and therefore reduce compliance burdens on multinational firms operating in different countries.

In broad terms, to be a listed country it must possess the following general characteristics:

(a) a definition of income broadly the same as that employed in Australia
(b) no special tax incentives which encourage international profit shifting
(c) a company tax rate of at least 25 percent[4].

Countries that are placed on the broad exemption list should not allow for tainted income to be taxed at lower levels than is presently the case in Australia. The ability to access such schemes would mean different treatment between taxpayers. Where the same income can be attributed back, the same amount of taxation should apply to either person. These types of arrangements would also

[4] Accessed on the 12th of October 2002 http://www.pc.gov.au/ic/inquiry/53offshore/finalreport/chapter05.pdf.

undermine the Australian tax system, which allows governments to undertake domestic commitments.

In order to consider changes to the current system of broad exemption list we must view the current rules in terms of the changes to company tax that have recently taken place. This could be achieved through the reduction of the company tax rate necessary to be placed on the broad exemption list.

**Option 3.4: to identify technical and other remaining policy issues regarding the controlled foreign company rules and consider options to resolve them either on a case by case basis or as part of a major rewrite of the provisions.**

In combination with the transfer pricing regulations businesses are faced with a large cost of compliance. We would recommend a major rewrite of the provisions not allowing for a case-by-case approach to slow proceedings.

The CFC rules require consideration be given to the longer term where a more comprehensive review is required and to look at the possibilities of their removal from the tax system. They should be viewed in light of the current transfer pricing laws in Australia to evaluate their relevance.

Exempting broad-listed countries from the CFC rules would have a major effect on the compliance costs of business while having little effect on government revenue. The application of these rules on comparatively taxed countries does not help to promote Australian business as an efficient competitor.

With regard to policy issues and the CFC rules it should be discussed as to whether or not companies could lodge an application for exemption on a case-by-case basis from those countries not on the exemption list if they can prove they are carrying on a genuine business.

*Modernising Australia's Tax Treaty Network*

**Option 3.5: to consider whether the recently negotiated protocol to the Australia-United States tax treaty provides an appropriate basis for future treaty negotiations or whether alternative approaches are preferable.**

Australia must negotiate with other countries to remove the current disincentives and inequities faced by foreign investors. The processes of renegotiating the removal of DWT from non-portfolio dividends must continue with other major trading partners.

The goal of Australian tax treaties should be to remove all distortions and impediments to free trade. This must be the overriding objective and the basis upon which any successful treaty is measured. The reduction of taxation on royalties and intangibles should be introduced with treaty members.

The Australia-US treaty does not address the issues of capital gains and only makes use of special provisions with respect to the treatment of pension funds and venture capitalists. The principle underlying such negotiations is welcomed and supported by ACCI although the issue of capital gains must be dealt with in a manner that is more inclusive and conclusive.

**Option 3.6: to consider whether or not to proceed with the Review of Business Taxation proposal to apply CGT to the sale by non-resident interposed entities with underlying Australian assets.**

If this particular proposal were implemented it would create more complexity and uncertainty for the business community. One of the principles of international taxation should be to simplify the law wherever possible and to reduce any disincentives that exist in relation to investing domestically.

Again implementation of this policy must be weighed against the fact that Australia does have a right to tax underlying Australian assets as the source country when that asset is disposed of indirectly. However, this particular use of taxation is another attempt to capture income that does not belong to Australia with the consequence of making Australia a less attractive place to invest.

The taxing of capital gains on underlying Australian assets is consistent with the source country principle and therefore the Government is justified in collecting such taxes. This is subject to the relevant changes capturing people using the interposed entity to avoid tax rather than commercial transactions.

The Board of Taxation has proposed such legislation to avoid this problem:

(a) Australian assets will need to be the principal assets of the entity holding those assets. Determining whether the Australian assets are the 'principal assets' will be made not by reference to a definition but by reference to a set of criteria in the legislation -- such as the market value of the assets and whether the assets produce the majority of the entity's income.

(b) Control of the assets will need to pass from a non-resident entity to another party.
(c) The regime will not apply where the gain on sale of the interposed entity is subject to tax in broad exemption listed countries or would have been subject to tax in such a country except for recognised rollover relief.[5]

ACCI does not believe that the possibility of any extra revenue outweighs the compliance cost faced by business. This proposal should not be adopted.

**Option 3.7 for consultation: to consider which countries should be given priority for tax treaty negotiations, taking into account negotiations underway with the United Kingdom and Germany, the need to update pre-CGT treaties, and countries that Australia may be obliged to approach because of most favoured nation clauses in existing treaties.**

In setting priorities, Australia must negotiate with countries that are able to offer the greatest gains to Australian businesses and the economy. The removal of double taxation from CGT with pre-CGT countries should be a priority balanced against the importance of that country as a trading partner. The importance of a trading partner must also account for inbound investment and not only Australia's foreign direct investment in that country.

**Option 3.8: to consider options to improve consultation processes on negotiating tax treaties.**

The basic principle of improving the consultation process when negotiating tax treaties is supported. In order to produce the best result for the Australian economy in terms of both investment and growth it would be necessary to seek the opinions of those who are most affected by the negotiations.

Opening up the negotiation process to scrutiny allows businesses to be proactive instead of reactive in their comments. If the business community does not see negotiated outcomes as conducive to the goals of taxation policy then these outcomes must be justified in order to ensure the process, if not the outcome, has the confidence of business.

While taking business's wishes into consideration it is important that complexities are kept to a minium. With many competing

[5]Review of Business Taxation "*Foreign investment in Australia*", Taxing gains from the disposal of interposed non-resident entities, Recommendation 21.7, Chapter 21 p647.

interests it is not always possible or desirable to include every such request but the principles expressed by business should nevertheless be taken into account.

This would follow the UK model in which negotiations are publicly announced and public submissions are called for. This would provide transparency and create confidence in the process.

ACCI recommends that the UK model be adopted for future treaty negotiations.

*Treatment of Foreign Non-Portfolio Dividends at the Company Level*

**Option 3.9 for consultation: to consider abolishing the limited exemption country list and provide a general exemption for foreign non-portfolio dividends Australian companies receive and (subject to some existing exceptions) foreign branch profits.**

> "Non-portfolio dividends from companies in listed countries comprise around 95 percent of all non-portfolio dividends Australian companies receive." [6]

The problem introduced by reducing the number of countries listed under a broad exemption is that some countries that taxed company income at a rate comparable to Australia were removed. This leads to the double taxation of income repatriated back to Australia and acts as a disincentive for companies to do so.

The current amount of taxation collected under this regime is understood to be relatively small compared with the compliance costs incurred by business. A general exemption would reduce compliance costs associated with doing business in limited exemption list counties and is supported by ACCI. Administration of the 'tainted' income rules would be simpler for business if the ATO also designated what constituted such income and if that particular income was subject to a reduction in tax.[7]

As an extension of the process serious consideration must be given to removing investment in broad exemption listed countries from the CFC rules. This is in light of the small amount of revenue raised by the government and the large compliance cost faced by business.

[6] The Treasury "*Review of International Taxation Arrangements: Consultation Paper*", Promoting Australia as a Location for Internationally Focused Companies, Chapter 3 p42.

[7] Anderson Consultation Paper, "*Removing Tax Barriers to International Growth*", Controlled Foreign Company measures need Reform, chapter 5, p74.

The recommendation to abolish the limited exemption list and provide a general exemption is agreed to although any changes must be viewed in light of changes to the CFC rules.

*Improving conduit income arrangements*

**Option 3.10 for consultation: to consider options to provide conduit relief for Australian regional holding and joint-venture companies, including considering the benefits and costs of introducing a general conduit holding company regime; providing an exemption for the sale of a non-portfolio interest in a foreign company with an underlying active business; and providing conduit restructure relief.**

The adoption of a conduit relief policy should be supported, with an exemption from capital gains tax on the disposal of non-portfolio interests in a foreign company with an underlying active business. This support is subject to the complexity of eligibility conditions, which will potentially increase a company's compliance cost and negate any real benefits from change.

Due to the current taxation laws in Australia, a foreign company that takes control of an Australian company will remove all the subsidiaries under its control so as to avoid CFC, FIF and other tax obligations. This has resulted in Australia not being used for regional holding companies in Asia. Therefore, any changes to the current tax law would not represent a reduction in revenue for the government and would encourage firms to use Australia to set up regional holding companies.

As a principle, Australia should not tax foreign owned Australian holding companies on capital gains that were derived from foreign subsidiaries with underlying assets. This principle is analogous to Australia's principle of not taxing non-residents on foreign source income.

Such arrangements mean that tax will not be accrued as income passes on the way through different jurisdictions. We support Australia's right to be included in a small part of international trade although presently Australia's position is to get as much revenue as it can at the expense of other forms of income. Conduit relief should remove the disincentives faced by foreign companies under our taxation system.

When compared with arrangements currently in place in Asian countries such as, Singapore, Hong Kong and Thailand, Australia's tax system is complicated and onerous on business's wishing to set up holding companies.

An increase in the number of regional companies setting up in Australia has the advantage of attracting highly skilled employees to Australia to manage such enterprises. Increased employment will indirectly increase taxes collected by government through GST and wages.

Holding companies may have the added benefit of assisting the development of capital markets within Australia. This occurs by increasing the flow of funds through Australia by developing a competitive regional holding company tax system. Any reduction in the amount of tax faced by non-residents and foreign companies will make Australia a more attractive destination.

Conduit relief must not represent a serious threat to the Government's revenue base. Any attempts by domestic firms to create structures that appear as foreign firms must not be allowed to happen.

The principle of a general conduit holding company regime is supported by ACCI.

**Option 3.11 for consultation: to consider whether to proceed with the foreign income account rules recommended by the Review of Business Taxation, and whether to allow the tax-free flow-through of foreign income account amounts along a chain of Australian companies, subject to Option 2.1.**

> "That the current foreign dividend account (FDA) be replaced by a foreign income account (FIA) that extends relief from Australian dividend withholding tax (DWT) on non-portfolio dividends to all types of foreign source income passing to non-resident investors."[8]

The taxation of foreign source income flowing through an Australian entity to non-resident investors is an adverse arrangement which reduces the attractiveness of such entities to foreign investors. The principle of not taxing foreign source income should apply to all types of income received by a non-resident in order to avoid double taxation of that income.

This structure, as stated in the Review of Business Taxation, would also remove the DWT on all types of income such as portfolio

[8] Review of Business Taxation "*Foreign investment in Australia*", Limiting Australian Tax on Income Flowing through Australia, Chapter 21 p647.

dividends, foreign branch profits and capital gains and will reduce the amount of tax paid by non-resident investors as income flows through Australia. As such, it acts to reduce taxation on conduit income that reduces the attractiveness of investing in Australia.

This recommendation is supported in principle.

**Option 3.12: to consider options to clarify the test of company residency so that exercising central management and control alone does not constitute the carrying on of a business.**

> "Australia asserts its right to tax Australian residents on their statutory and ordinary worldwide income, and to tax an entity that is not an Australian resident on ordinary and statutory income derived from Australian sources or included in assessable income on some basis other than source. It is therefore essential to know whether or not an entity is an Australian resident for the purposes of determining the extent of Australia's jurisdiction."[9]

Australia's system for determining residency does not adhere to the principle of simplicity and as currently structured creates uncertainty. However, after having worked with them for a substantial period already, the rules of residency are generally well known by the business community. However, the problem lies with the advent of technologies such as video and call conferencing, where the question of company residence can become more uncertain.

Currently Australian taxation rules apply to an overseas company if its central management or control is located in Australia. This test applies standards in order to determine the question of residency:

(a) the company must be carrying on business in Australia
(b) if it is, then its central management and control must be located in Australia.[10]

Case law[11] has determined that if a company's management and control are based in Australia then the company must be carrying on business in Australia. This is far too broad a definition and companies would incur severe costs through the rearrangement of affairs if such laws were administratively followed.

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[9] Woellner, Barkoczy, Murphy, "*2000 Australian Taxation Law*", International Aspects Accruals Taxation, Chapter 22-040 p1313.
[10] Ibid p1320.
[11] Malaysian Shipping Co Ltd v FC of T (1946) 71 CLR 156

The residency test when viewed in relation to CFC rules, capital gains tax and transfer-pricing rules is outdated and could be removed without significant risk to the integrity of revenue. The uncertainty with respect to central management and control must be addressed. The US currently relies on a formal test, the place of incorporation which removes all the uncertainty of the Australian system, although this particular solution is not recommended unless problems of tax minimisation encountered in the US can be rectified.

**Option 3.13: to consider whether a company that is a non-resident for tax treaty purposes should be treated as a non-resident for all purposes of the income tax law, as an alternative to the current dual resident company provisions.**

A company that is considered a resident under its own domestic rules while also being the resident of a foreign country under its own domestic rules is generally dealt with under a tiebreaker specific provision.

This question is linked to that of the place of company residence test and therefore, any suggestions would need to account for such a change to the test of residency.

## CHAPTER 4

### Promoting Australia as a Global Financial Services Centre

Foreign Investment Fund (FIF) measures need to be made less complex in order to reduce compliance costs while still maintaining the integrity of Australia's revenue base. FIF measures should not capture investments that are active businesses in foreign countries or be applied to companies that do not pose a significant revenue risk for the government.

Investments in offshore companies or other entities that fall below the threshold for CFC rules are captured under the FIF rules. The FIF rules also deal with portfolio investment as well. And given the increased importance of cross border flows in portfolio investments and managed funds this function assumes a greater importance.[12]

FIF rules are used to prevent abuses of the control and substantial shareholder rules in the CFC. In particular the CFC rules could be avoided through the promotion of portfolio interests in companies in low tax jurisdictions. The realisation then comes through disposal of the interest for a capital gain.

Both the CFC and FIF rules have an active income exception and although their design does differ both are focussed on tainted income. The FIF rules do not have an exemption for comparably taxed income therefore passive income may be subject to double taxation through attribution if derived through a broad exemption listed country.

A FIF is an entity which is either a foreign company or a foreign trust. The result of the current FIF rules is a reduction of investment by non-residents in Australian managed funds. The FIF are complex and require simplification to reduce the compliance burden faced by Australian and international managed funds.

The impact of the foreign investment fund (FIF) rules where these rules apply to shares in foreign companies or units in certain foreign funds held at 30 June each year may affect any unrealised gains, made through an investment, to be liable for annual tax. A number of exemptions are available however, including:

[12] The Treasury, "*Review of International Taxation Arrangements, Consultation Paper*", Promoting Australia as a Global Financial Services Centre, Chapter 4, p57.

(a) selected US mutual funds
(b) selected types of listed companies
(c) selected employer sponsored superannuation funds.

The process of applying such rules to any particular investment is costly and time-consuming. This increases fund managers' exposure to risk associated with incorrectly establishing a person's obligations and therefore any penalty.

The FIF rules while complex are there to ensure the integrity of the Government's revenue base. Any changes to these laws would require a reasonable level of assurance that tax avoidance schemes could be tightly controlled.

**Option 4.1: to give long-term consideration to a replacement of the current foreign investment fund rules to provide a better balance between maintaining the integrity of the tax system while minimising compliance and other costs for taxpayers.**

The government's options for reforms proposed in the *Review of International Taxation Arrangements* are insufficient. It is therefore recommended a complete review and redesign should be undertaken of the FIF rules.

At present there is a danger that the government will only make slight changes to the FIF rules with the real changes required by the business sector being put to one side.

We recommend that the government, with industry input, undertakes a detailed study into the FIF rules and that this study is made a priority with respect to other international taxation issues. ACCI also recommends that the current developments in the UK, New Zealand and the USA be watched carefully so as to implement changes to Australia's FIF rules as and when appropriate.

**Option 4.2: to consider including undertaking detailed case studies in conjunction with industry, increasing the 5 percent balanced portfolio exemption threshold in the foreign investment fund rules.**

The evidence of companies selling down their portfolio assets to achieve the below 5% threshold indicates that this constraint is clearly producing inefficient outcomes through changes to the economic decisions of business.

A change towards a system that does not require the classification of the FIF rules in order to define a balanced portfolio would substantially reduce the need to undertaken end of year sales. This particular solution would also reduce compliance costs associated with classification of FIFs.

In principle the idea of undertaking detailed case studies in conjunction with industry is acceptable and this should occur in the shortest possible time frame.

**Option 4.3: to consider exempting Australian managed funds that follow widely recognised indices from the foreign investment fund rules.**

Managed funds and diversified portfolios may not always follow widely recognised funds due to a “tracking error”. Tracking errors are reported as a "standard deviation percentage" difference. They basically tell the difference between return received and the benchmark the investment fund was trying to copy. This would then require a notion of what are acceptable and unacceptable divergences between actual investment performance and the theoretical investment performance.

This level of divergence or ‘tracking error’ could be legislated by government and should be greater than that experienced by the index funds. The smaller the allowable divergence the more risk adverse managed funds will become.

If less risk adverse funds continue to act as they previously had and fail to gain an exemption from the FIF rules then compliance costs due to the classification process will still present a significant level of burden. The use of widely recognised indices and what that means in a practical sense needs to be further developed. However, the business community would welcome any reduction in compliance costs.

This recommendation is agreed to in principle with the above issues to be clarified.

**Option 4.4: to consider exempting complying superannuation funds from the foreign investment fund rules.**

The original goal of the FIF rules was to prevent tax avoidance although superannuation funds are not recognised as tax avoidance vehicles. This makes their inclusion in the FIF rules unnecessary and only serves to increase the cost of compliance and does not increase the revenue base of the government.

If the use of superannuation funds for tax avoidance purposes is low then any funds that hold offshore interests will be unduly affected by the current arrangements.

This solution is supported by ACCI due to the reduction in compliance costs on complying superannuation funds while still maintaining the integrity of the system.

**Option 4.5: to consider amending the foreign investment fund rules to allow fund management services to be an eligible activity for the purpose of the foreign investment fund rules.**

The above option is a small improvement which still relies on the classification system. The movement of some passive income to active business income is part of the improvement process in the tax system.

**Option 4.6: to consider exemption 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.**

The Australian taxation system should not distinguish between unit trusts and direct investment. Currently the treatment of CGT using Australian managed funds deters non-residents from using such businesses to invest in Australian assets or managed offshore investments. This creates a bias between the two forms of investment and diminishes the competitiveness of Australian-based managed funds.

**Option 4.7: to consider the feasibility of exemption 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.**

The phase ‘do not have the necessary connection with Australia’ will need to be fully explored and developed so that Australia does not tax income for which it is not the source country but to also maintain Australian tax rights over transactions that include Australia as the source country.

In principle this option would be supported, as the source principle (income derived through economic activity carried on in one country by the resident of another) does not allow Australia to collect revenue on the way through.

**Option 4.8: to consider 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's cost base in a unit trust.**

No recommendation is made on this proposal.

*Taxing Foreign Trusts*

**Option 4.9: to consider proceeding with the recommendations of the Review of Business Taxation rationalising the application of current rules to foreign trusts.**

This proposal is reasonable as the FIF rules are better than the current foreign trust rules and any measure to simplify the FIF rules is welcomed. The rationalisation of such rules will also reduce the amount of burden faced by managed and superannuation funds.

**Option 4.10: to consider proceeding with the recommendations of the Review of Business Taxation in relation to transferors trusts.**

If these provisions only capture the people using the discretionary trusts for tax avoidance purposes then ACCI supports the *Review of Business Taxation* recommendations.

The conditions of amnesty are also supported.

**Option 4.11: to consider specific tax issues outside the Government's current tax reform programme where the lack of separate entity treatment inappropriately impedes the use of branch structures.**

Any tax issue that inappropriately impedes an Australian business from using the most efficient structure must be immediately reformed. We support the recommendation that the Australian government look at specific issues outside the current reform process.

## CHAPTER 5

### Improving Australia's Tax Treatment of Foreign Expatriates

Australian businesses require highly skilled workers in order to remain competitive with the international community. In addition, it is vital that Australia be viewed as the 'destination of first choice' for skilled migrants. In order to achieve this, disincentives within the tax system for skilled migrants to relocate to Australia must be removed. In making such changes, however, domestic taxpayers should not be disadvantaged with respect to tax payments for government services all people benefit from. Preferential tax treatment for foreign workers in Australia should not be introduced.

At the same time expatriates returning home after working abroad should not be more disadvantaged than a new migrant working in Australia for the first time. The Australian tax system should encourage the return of expatriates in order to increase the skills base of Australia.

The tax system currently produces disincentives for highly skilled foreign nationals to come to Australia and work. These disincentives are generally added onto the cost borne by businesses that wish to employ skilled migrants. These costs take the form of increased wages needed to compensate foreign expatriates for taxes applied by the Federal Government relative to the taxes that would be payable in their countries of origin.

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

This option is not supported and should be withdrawn due to the disincentive it provides to foreign residents for taking up positions in Australia. This particular tax agreement will apply to CGT not yet realised and therefore may require foreign expatriates to sell all or a portion of the asset in order to provide the necessary security. This policy should be viewed as a short-term and inadequate solution to the current problem of attracting world-class workers.

This option will also add to a company's compliance and administrative burden for very little gain. As a cost the company may have to put up the security themselves in order to recruit employees. In the long term, tax treaties must be negotiated and include CGT treatment of skilled migrants with countries where the majority of foreign expatriates derive.

This particular policy goes against the government and business's objective of encouraging skilled migrants to work in Australia. For this policy not to act as a disincentive for foreign nationals it requires that any security is tax deductible in their country of origin. If this is not the case, which is most likely, then it will act as an additional burden on the company employing skilled workers.

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

Optimal taxation regimes require that countries do not undertake double taxation of worldwide income. This situation again acts as a disincentive to highly skilled foreign nationals taking up positions within Australian firms. The appropriate action is therefore to remove any double taxation that occurs on share options through the bilateral treaty negotiation process. These agreements will result in reciprocal arrangements and therefore not provide an advantage over Australian workers in a similar position.

ACCI supports the issue being dealt with through future treaty negotiations.

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

ACCI opposes the recommendation set forward by the Review of Business Taxation to treat individuals ceasing to be Australian residents as a cessation event for the purpose of Division 13A.

There is also the possibility that gains will never be realised and therefore is potentially unfair also using cessation of residence as a cessation event. This legislative outcome would also be administratively complex for business.

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

The current system for dealing with taxation of foreign expatriates is complicated and may require the setting up of a specialist cell.

This will enhance compliance of Australian tax laws and reduce the uncertainty currently faced by foreign nationals. Current types of arrangements increase the uncertainty faced by foreign nationals and may act as a disincentive towards moving between their country of origin and Australia.