1 November 2002

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

REVIEW OF INTERNATIONAL TAXATION ARRANGEMENTS: SUBMISSION IN RELATION TO FOREIGN DIVIDEND CREDIT PROPOSAL UNDER OPTION 2.1

The purpose of this submission is to comment on the foreign dividend credit proposal outlined in Option A under Option 2.1.

The comments propose certain modifications to Option A to reduce the cost to the revenue and improve economic neutrality.

Option A proposes to allow resident shareholders of Australian companies to receive a non-refundable tax credit of, say, one-ninth of an unfranked dividend paid out of foreign source income. The foreign dividend credit is to be allowed without reference to the foreign tax paid offshore.

Proposed modification one: the foreign dividend credit should not exceed the average rate of foreign tax actually paid on the foreign source income

The foreign dividend credit allowed should be calculated by reference to the average rate of foreign tax paid by the company on the foreign source income from which the unfranked dividend is distributed.

If the credit is to be capped at, say, one-ninth of the unfranked dividend, then the rule should operate by allowing a credit equal to the lower of one-ninth of the dividend or the average rate of tax paid on the foreign source income from which the unfranked dividend is distributed.

The average rate of foreign tax on the foreign source income should be calculated by reference to the total foreign tax paid by the company and by its underlying foreign subsidiaries on the company's total distributable foreign source profit at the time of the dividend. A similar mechanism applies at present under section 160AFC of the *Income Tax Assessment Act 1936* to calculate underlying foreign tax credits on dividends paid to an Australian company from its foreign subsidiaries.

To simply allow the credit without reference to the actual foreign tax paid on the foreign source income will create a bias in favour of companies operating offshore in low-tax regimes, and against companies operating in high-tax regimes.

Further, the actual problem which the proposal seeks to address – namely the current bias against foreign source income in the interaction between the imputation and foreign tax credit regimes – is a problem which is most acute when the company operates in high-tax regimes. It is not a significant problem when the company operates in low-tax regimes. It would be perverse to adopt a measure which most favours those operating in low-tax regimes.

Proposed modification two: companies should not be able to pay unfranked dividends with the foreign dividend credit unless they have no distributable franked or unfranked Australian source profits

There should be an ordering rule which requires companies to first pay franked dividends from taxed profits, then unfranked dividends from Australian source profits, and lastly unfranked dividends from foreign source income which will carry the foreign dividend credit.

The actual problem which the proposal seeks to address – namely the bias between the interaction of the imputation and the foreign tax credit regimes – is a problem which only results in a real cost to shareholders if and to the extent that the Australian company has to make use of taxed foreign source income to service the dividend requirements of its shareholders. The problem remains merely theoretical while a company has sufficient Australian source franked and unfranked profit to service the dividend requirements.

An ordering rule will ensure that the foreign dividend credit only has to be accessed when it is actually required to ensure there is no real cost to shareholders in the company earning taxed foreign income. This will target the measure more effectively, and reduce its cost to the revenue.

Proposed modification three: the rate of the foreign dividend credit should at least equal the rate of the foreign tax credit which the Australian shareholder would be able to obtain if they invested directly in the foreign subsidiaries of the Australian company

The proposal is that the foreign dividend credit be limited to say one-ninth of the unfranked dividend paid from foreign source income. This should be reconsidered.

The rationale of the foreign dividend credit should be that it is tax neutral for an Australian shareholder as to whether they purchase shares directly in a foreign company or purchase shares in an Australian company which owns a foreign subsidiary.

A portfolio investor who purchases foreign company shares directly will normally get a foreign tax credit for the foreign dividend withholding tax on the dividends from the foreign company. Hence, where an Australian company pays an unfranked dividend out of dividends from foreign companies, the rate of the foreign dividend credit for portfolio investors should be at least equal to the average rate of foreign dividend withholding tax paid on those foreign dividends. The proposed foreign dividend credit rate of one-ninth of the dividend approximates the correct rate, but would be a little low for foreign dividends from most countries at present.

A corporate non-portfolio investor who purchases foreign company shares directly will normally get a foreign tax credit for both the foreign dividend withholding tax on the dividends from the foreign company, and the underlying tax paid by the foreign company on the foreign income from which the dividend is distributed. Hence, to ensure investment neutrality for a corporate non-portfolio investor, where an Australian company pays an unfranked dividend out of dividends from its foreign subsidiaries to the corporate non-portfolio investors, there should be an additional foreign dividend credit set at a rate which takes into account the underlying foreign tax paid by the foreign subsidiaries on the foreign income.

This additional foreign dividend credit will be necessary to ensure that corporate non-portfolio investors can use Australian resident companies as holding companies for international joint ventures which will invest off-shore. If this additional foreign dividend credit is not available, corporate non-portfolio investors will be forced to use off-shore holding companies for international joint ventures, to ensure that they get a foreign tax credit for both the foreign dividend withholding tax on the dividends from the foreign company, and the underlying tax paid by the foreign company on the foreign income from which the dividend is distributed

Proposed modification four: the foreign dividend credit should be subject to the same anti-avoidance rules which apply to franking credits

Since the foreign dividend credit is a special form of imputation credit, eligibility for the credit should be subject to the same anti-avoidance rules as franking credits.

Proposed modification five: unfranked dividends carrying the foreign dividend credit should be exempt from dividend withholding tax

Since the foreign dividend credit is a special form of imputation credit, the same exemption from dividend withholding tax should apply to unfranked dividends which carry the credit as applies to franked dividends which carry franking credits.

This will enhance investment neutrality, as foreign investors will obtain the same result investing in an Australian company which earns taxed foreign source income as applies to investing in an Australian company which earns taxed Australian source income.

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