Submission to the Board of Taxation

REVIEW OF INTERNATIONAL TAXATION ARRANGEMENTS

Telstra Corporation Limited

31 October 2002

Telstra is an Australian resident listed company with substantial foreign investments and operations. International growth is one of Telstra's key strategic elements and in this regard our focus is predominantly in our Asian region.

It is critical to ensure that our growth strategy is supported by an appropriate international taxation policy founded on sound economic, commercial and practical principles reflecting an appreciation of the need for Australian companies to be and remain internationally competitive and relevant in the global market.

This submission makes four principal recommendations:

1. Redesign the tainted services income rules;

2. Redesign and redraft the accruals regime generally;

3. Redesign the tax residence definition; and

4. Improve the process of design, implementation and maintenance of tax policies.

1. REDESIGN THE TAINTED SERVICES INCOME RULES

Under the current CFC rules, income from the provision of services is considered tainted where the services are provided to associates or to Australian residents, even where the services are essentially "active" in nature or are part of the conduct of an active business.

This treatment creates a bias against Australian companies operating in service industries; in particular the telecommunications industry, and is therefore an impediment to growth into offshore markets.

The current law also creates a taxation bias against the provision of shared services within multinational groups, as those services will inevitably be "tainted", notwithstanding their commercial basis.

Lastly, the current rules impose a considerable, and we consider unreasonable, compliance burden and associated cost on Australian outbound investing companies.

These impacts are a consequence of developments in international business since the CFC rules were introduced. The concept of "tainted income" was originally intended to limit the application of the CFC rules to income that can be moved comparatively easily from Australia to a more tax-advantageous jurisdiction. This can be contrasted with "active income" that is less mobile because it represents the revenue of a business. To move active income requires moving the entire business and its attendant assets, functions and risks.

This is made clear in the Explanatory Memorandum to the *Taxation Laws Amendment (Foreign Income) Bill 1990* which briefly describes the purpose of the active income test:

The new Part contains provisions to:

> determine whether a company is predominantly engaged in active business and therefore eligible for the active income exemption;

The Explanatory Memorandum also indicates that:

> With limited exceptions, shareholders in a company that passes the active income test because it has substantial business operations will be exempted from Australian accruals taxation.

Income from the provision of telecommunications services clearly has much more in common with active income than with the various kinds of mobile income that are treated as "tainted income". Most obviously, telecommunications income arises from the conduct of an active business. It also arises from substantial business operations that involve the use of significant infrastructure assets to provide services to large numbers of customers. Significant amounts of the resulting income will inevitably be derived in the countries in which the infrastructure and the customers are located. It is very difficult to move either the infrastructure or the customers so as to render the resulting income mobile.

When the CFC rules were first introduced, the Australian and worldwide telecommunications market was heavily regulated and still largely closed to competition. It is therefore not surprising that the rules made no special provision for telecommunications services. However, we believe that if the industry had been in its current state there would have been strong grounds for expressly excluding telecommunications services from the definition of "tainted services income".

Indeed, the Explanatory Memorandum to the *Taxation Laws Amendment (Foreign Income) Bill 1990* implies that the legislation was mainly targeted at personal services:

> The performance of technical, managerial, engineering, architectural, scientific, industrial, transport, commercial,

agency or other professional or similar work would generally qualify as services.

Restrict the scope of tainted services income to services provided to Australian resident associates

In our view, there is no justification for applying the CFC rules to income earned by a CFC from services provided to third party customers. Tainted services income should therefore be limited in scope to services provided by CFCs to Australian resident associates. This amendment would make the treatment of tainted services consistent with the current treatment of tainted sales income.

As far as integrity is concerned, the Australian transfer pricing rules (together with the Schedule 25A reporting obligations) have become significantly more robust since the CFC rules were introduced and would continue to provide protection against the erosion of the Australian tax base by ensuring that transactions with offshore-related parties (including CFCs) are conducted on arm's length terms.

Introduce an active business exemption

In addition to the reform of the tainted services income definition, we also recommend the introduction of an exemption from CFC attribution for income from services provided by a CFC (including services to Australian associates) where those services are part of an active business. The drafting of an active business exemption could be based on the concepts contained in the Foreign Investment Fund provisions.

The addition of an active business exemption would help to ensure that the CFC rules are appropriately targeted towards passive, as opposed to active, income. We consider that, given the transfer pricing rules and reporting obligations, there is a valid argument for the removal of tainted services income from the CFC rules altogether where there is an active business carried on.

2. REDESIGN AND REDRAFT THE ACCRUALS REGIME

The *Review of Business Taxation – A Tax System Redesigned (July 1999)* stated at page 688:

> Substantial redrafting and redesign of the international tax legislation is required as part of the simplification strategy. Such redrafting and redesign is necessary as the relevant provisions were not dealt with by the Tax Law Improvement Project. This strategy should be cognisant of the Review's international tax recommendations, and the recommended comprehensive review of the foreign source income rules. It should also be conducted in consultation with affected parties

Telstra supports the Review's recommendation that the international tax legislation, and the accruals regime in particular, should be redesigned and then redrafted. In our view this recommendation should be implemented as follows:

1. The accruals regime should be amended as a matter of urgency to remove a number of features that limit the ability of Australian companies to compete globally; and

2. A more comprehensive redesign and redrafting project should be undertaken to reduce the scope of the accruals regime and simplify both its language and the compliance obligations and associated cost it imposes on taxpayers.

The accruals regime contains some of the most complex provisions in the tax legislation. These provisions are complex in two senses: they reflect complex design principles and they have been drafted in a very complex manner. In our view it would be almost impossible to simplify the provisions without addressing the design principles first and the drafting approach second.

Telstra submits that the redesign project should focus on reducing the scope of the accruals regime to its original policy objective, ie. discouraging taxpayers from diverting passive income into offshore tax havens. The scope of the accruals regime currently extends beyond this objective and consequently introduces unwarranted complexity and cost in each of three areas:

1. The accruals regime assesses income that a taxpayer has not diverted into another jurisdiction.

The following are some examples of the complexities that arise because the accruals regime attempts to assess income that a taxpayer has not diverted into another jurisdiction:

- ***Definition of "controlled foreign company"***

  If a foreign shareholder owns 90% and an Australian shareholder holds 10% of the shares in a foreign company then in some circumstances the foreign company can still be classified as a controlled foreign company ("CFC") even if there is no relationship between the foreign and Australian shareholders and no attribution under the Foreign Investment Fund provisions. This anomalous outcome arises from the consequences of having a definition of associate that is too wide. The Australian shareholder will be subject to the attribution of profits from a "controlled" foreign company over which it has no actual control.

  The Australian shareholder must nonetheless rely on financial information provided by the foreign company in order to comply with the accruals regime. However, in many instances the foreign company will be unable or unwilling to provide the

required information. The Australian shareholder will then be unable to properly apply the regime and it is difficult to see how the Australian Taxation Office will be able to properly administer it.

The need to obtain and consider this information can also delay acquisition transactions and disadvantage the Australian shareholder during negotiations relating to such transactions.

- ***Purchase of a CFC***

  The Australian purchaser of a CFC can be taxed on profits that the foreign company earned before the date of the purchase (and for which the purchaser has effectively paid). These profits may include capital profits from pre-sale restructuring transactions directed by the vendor and about which the purchaser remains unaware. It should be noted that the negotiated purchase price will usually be based on a multiple of pre-tax earnings and will therefore not normally reflect such Australian tax costs.

  The scope of an Australian purchaser's tax due diligence process must be expanded substantially in order to properly address these exposures. The purchaser will also often be required to educate its foreign tax advisers on the complexities of the accruals regime so that they can identify these exposures in the course of their work.

  In some instances the Australian purchaser may be able to mitigate its exposure by arranging for the foreign company to elect for a notional capital gains tax rollover. However, the need for such an election can both delay the purchase transaction and disadvantage the position of Australian shareholder during negotiations relating to the transaction.

  In our experience tax indemnities and warranties to cover these Australian tax exposures are difficult to obtain and even more difficult to enforce.

- ***Tax cost base of a CFC's assets***

  For the purposes of calculating a notional capital gain, the cost base of assets owned by a company that became a CFC after 30 June 1990 is the greater of the asset's actual cost base and its market value when the company first became a CFC. However, the time at which a company **first** became a CFC can be impossible to determine because of the CFC definitional issues noted above (eg. it may previously have been owned by an Australian company or by a foreign company with an Australian subsidiary).

In addition, the use of tax cost bases to determine the amount of any attributable income can require the generation of CFC-specific financial information (eg. the recalculation of substantial depreciation schedules back to when the foreign company first became a CFC).

Again, the law is unable to be applied and administered by the Australian shareholder and the Australian Taxation Office respectively.

2. ***The accruals regime assesses income from the conduct of an active business.***

The following are some examples of the complexities that arise because the accruals regime taxes income from the conduct of an active business:

- ***Tainted services income***

  Please refer to our earlier comments on this point.

- ***Deeming of dividends***

  The funding arrangements for a group of CFCs can also be restricted by the accruals regime. If an unlisted country CFC provides equity funding to an entity other than a wholly owned subsidiary then the transaction can be treated as a taxable dividend to the Australian shareholder.

- ***Sale of foreign operations***

  Profits derived by a CFC from the sale of its business will generally be exempt from attribution. Profits derived by a CFC from the sale of shares in a subsidiary company that carries on the same business will usually be subject to attribution.

  As attributable income, these profits are also unable to be offset against any domestic capital losses of the Australian shareholder group.

- ***Overlay of Australian transfer pricing rules on CFC activities***

  The accruals regime applies the Australian transfer pricing provisions to all transactions between CFCs (subject to a limited exception for transactions between CFCs resident in the same broad-exemption listed country). This is the case even where the transfer pricing rules in the particular foreign country would not require an adjustment. Ignoring the domestic provisions of the relevant country results in an unnecessary compliance burden for both the Australian shareholder and the CFC.

3. ***The accruals regime assesses income derived in jurisdictions other than recognised offshore tax havens.***

The following are some examples of the complexities that arise because the accruals regime attempts to assess income derived in jurisdictions other than recognised offshore tax havens:

- ***Grouping of CFC losses***

  Regulatory or commercial issues often mean that more than one CFC is required to operate a business in a particular country or countries. The accruals regime does not currently provide for the grouping of profits and losses (both revenue and capital) of CFCs (even CFCs in the same country). The regime may therefore assess a taxpayer on the profits of one CFC even though they are partially or wholly offset by the losses of another. The rules also do not permit the consolidation of same country CFC operations for the purposes of calculating the active income test.

  Note that, even if a group of CFCs can elect to be treated as a consolidated taxpayer for domestic tax purposes (eg. New Zealand), the accruals regime will still ignore the domestic law and require financial information to be prepared for each CFC in order to calculate its attributable income (if any).

- ***Tainted services income***

  Please refer to our earlier comments on this point.

The practical result of the current law extending the scope of the accruals regime in the areas outlined above is that taxpayers are effectively forced to recalculate the income of foreign companies under Australian tax rules. Comparatively minor differences between the treatment of a particular item under the foreign and Australian tax rules may then trigger a liability for tax under the accruals regime.

Even if it does not trigger a liability for Australian tax, the recalculation process itself may still impose substantial compliance costs on Australian shareholders and their CFCs. If the taxpayer has no actual control over the foreign company then it may be unable to obtain the required information. If the accounting records of the foreign company are focussed towards its foreign tax and statutory reporting obligations (as is usually the case) then the required information may simply be unavailable.

These issues impose an unnecessary economic and commercial burden on Australian taxpayers and place them at a disadvantage to their international counterparts.

Telstra therefore submits that amendments should be made to the accruals regime as a matter of urgency to

reduce the scope of the accruals regime to its original policy objective. Redesigning and redrafting new legislation to meet this objective can then reduce the complexity in the current regime.

3. REDESIGN THE TAX RESIDENCE DEFINITION

Under current law, a company incorporated outside Australia is tax resident in Australia if it carries on business here and has its central management and control (CM&C) in Australia or has its voting power controlled by Australian resident shareholders.

Case law has established that CM&C generally exists in the location where board meetings are held.

The CM&C test (introduced in the 1936 Act) in today's world raises a number of practical uncertainties, for example:

- Where directors are located in more than one country;
- Where board meetings are held by phone or video conference;
- The implications of the use of circular resolutions, board sub-committees, alternative directors etc;
- The interaction between management and board functions;
- The extent to which commercial activity can constitute a carrying on of business in Australia, and thus residence, where CM&C or voting power is located here.

We understand that current ATO practice is not to treat CM&C alone as synonymous with carrying on business. However, this does not address the problems caused by the inclusion of a carrying on of business element in the residence test.

From a policy perspective, the current law has the following implications:

- It forces Australian executives to locate offshore in order to avoid the risk that an offshore subsidiary that is majority Australian owned could be considered to carry on business in Australia.
- It forces Australian executives to travel offshore to attend board meetings – even attendance via telephone or video conferences can be a problem.
- It encourages the appointment of non-Australian resident directors and executives to the management and boards of offshore subsidiaries and joint ventures.

- It discourages the use of Australia as a location for the regional or global management of offshore-incorporated companies.

None of these implications are in the long-term interests of Australia as a regional headquarters and/or regional service centre. They also raise concerns about the implications for corporate governance of foreign subsidiaries of Australian companies.

We support the Option 3.12 proposal set out in the Treasury Consultation Paper (August 2002), as a partial solution to the problem, to clarify the residence test to ensure that merely exercising CM&C in Australia does not constitute the carrying on of business. This could be done by way of simple amendment to the legislative definition of residence.

However, we consider that reform should go further than this and should re-examine the continuing appropriateness of a CM&C test. Movement to a place of "effective management" test creates similar definitional issues to a CM&C test and does not address the policy concerns. We therefore need a law improvement that provides clarity and removes any ambiguity.

We would support a residence test based on country of incorporation. Such a test would be simple to apply in practice and would eliminate the administrative burden and the negative policy implications and uncertainty associated with the current test.

Concerns have been expressed recently in the US over so-called "inversions" (basically the interposing of a tax haven holding company over a US company). Any integrity concerns associated with Australian companies choosing to move residence out of Australia can be addressed by reference to existing Australian tax provisions. For example:

- An incorporation test would potentially allow companies to restructure themselves out of the Australian CFC provisions, as has happened in the US. However, such a restructure would normally carry an Australian tax cost in relation to the sale of offshore subsidiaries/assets to the new foreign holding company. In addition, Australian tax would continue be collected on dividends received by Australian resident shareholders and capital gains made on the sale of their shares.

- Much of the concern expressed in relation to US inversions focuses on the potential for the subsequent stripping of US earnings, e.g. via royalties, interest or management fees. These concerns should be addressed by the application of the relevant transfer pricing, withholding tax and thin capitalisation regimes. The CFC rules would continue to operate in relation to companies that migrate but remain controlled by Australian residents (although this would not necessarily be the case for listed companies).

- Another concern expressed by US commentators is that inverting companies could take advantage of favourable treaties to reduce or

eliminate US withholding taxes. This may require examination and possible renegotiation of the limitation of benefits articles in such treaties. Australia's treaties would need to be reviewed in any event for the impact of a change in the residence test on tiebreaker rules that operate based on the place of effective management.

In summary, moving to an incorporation test would remove the practical uncertainties and policy objections inherent in a residence test that relies on concepts of CM&C and "carrying on business" without necessarily creating integrity exposures.

4. IMPROVE THE PROCESS OF DESIGN, IMPLEMENTATION AND MAINTENANCE OF TAX POLICIES

Many of the matters raised above reflect unintended and unreasonable tax consequences that have arisen as Australian business and the global economy has grown and developed over the years since the relevant legislation was introduced. These have been the subject of many representations by taxpayers and associations. Unfortunately the international tax laws have remained largely static – the underlying principles and policies were not subject to any regular review and improvement process to ensure they remained relevant.

This highlights the critical need for international taxation legislation to remain dynamic and for Government to adopt a pro-active and continuous improvement process to ensure the principles, policies and resultant law are relevant to changing economic circumstances. Simplicity, coherence and certainty should underpin such a process to ensure Australian business will be internationally competitive.

The Board of Taxation in its *Evaluation of the Tax Value Method (July 2002),* in particular at paragraph 115, has identified the need...*"for* (a) *more systemic on-going review of the tax system and its operation with a view to identifying and implementing needed change as it emerges..."*. This comment in the context of the current review of the international taxation arrangements is a positive recommendation that is supported.

Closely related to tax system monitoring, maintenance and improvement is the need to ensure that the translation into law properly aligns to the intent of the underlying principles and policy. The original policy underlying the accruals regime of attacking passive income in low taxing countries was translated into complex laws that went beyond, as evidenced by the examples above, the design proposition. In the context of the Review of International Taxation Arrangements, an implementation process that ensures the resultant law is consistent with the underlying principles and policies would be a welcomed extension of the Board of Taxation's proposal in the TVM Report.