Grant Thornton's submission to

The Board of Taxation

November 2002

General Comments

1. A primary objective of any review of our taxation system, and in particular in our international tax system, is to make the system as simple and understandable as possible. Particularly in relation to rules such as our controlled foreign corporations (CFC) and our foreign investment fund (FIF) regimes, it is very difficult for taxpayers to comply with the legislation because it is difficult to understand and as a result revenue collection may ultimately suffer.

   By the way our taxation law is drafted, it seems that insufficient regard has been had to affording businesses some level of economic reasonableness; that is, the legislation seems to go to large extents to cover all conceivable losses of revenue, which is a real negative to doing business; particularly for smaller businesses that may not have the resources to properly understand and comply with the system.

   Therefore, it would be very positive for Treasury, the Parliamentary draftsmen, and the Australian Taxation Office to recognise that a taxation system which is simpler may in the end give rise to economic benefits which out weigh the short term revenue that may be obtained by the application of overly detailed laws. Growing Australian enterprises very often look to overseas markets to expand and generate revenue, given the relatively small consumer market that exists in Australia. Accordingly, it is very important that overseas expansion from Australia is not discouraged by what is, and what is perceived to be, an overly complex and difficult international taxation system.

   In relation to SMEs, the Paper makes the point that as the size of an Australian enterprise reduces, generally the more limited the sources of capital become. While we generally agree with that observation, the difficulty of raising foreign capital is accentuated by the complexity of the Australian taxation system. All relevant government bodies need to recognise that the complexity of our system creates a severe business frustration and has a particularly negative effect on attracting investment from foreigners who also perceive it to be frustrating and burdensome.

2. The point is also made in the Paper that for smaller Australian enterprises, access to international capital markets may be more restricted, and therefore the domestic capital market is an important source of funding. We agree that this heightens the need to ensure that there is no bias levelled against the distribution in Australia of profits arising from foreign sources.

3. The Paper does at times consider options for totally redrafting some aspects of the law. This submission supports the further detailed consideration of a total re-write of some of our laws.

4. Many of our international tax laws are old, but with an increasingly mobile world capital market, Australia has an opportunity to take an initiative in being a leader with reform.

   It is recognised in the Paper that Australia is a net importer of capital - therefore concern must be had to appropriately taxing income and gains based on source. However, given the increasing mobility of capital, caution should be taken not to, for example, impose rates of withholding tax that are comparably high. In relation to withholding taxes, the approach to the recent US Treaty negotiation is encouraging. Broader treaty reforms need to be undertaken with care as they will have a significant impact on our economic development.

Specific Issues

5. Chapter 2 – Attracting Equity Capital for Offshore Expansion

Option 2.1

While the option of exempting part or all of a dividend derived from foreign profits from a shareholder's assessable income is disregarded in the options for consultation, we do not believe it should be rejected. It may not be currently acceptable to Treasury nor be politically attractive. However, it would offer a simple solution, and it would be relevant to assess the revenue impact of it, if that can be done taking into account non-deductible losses or outgoings that may be attributable to the derivation of that income.

Of the options that are considered, option A, providing tax credits for unfranked dividends paid out of designated foreign source income, is supportable, but only if a reasonable level of tax credit is provided. The Paper contemplates a low rate of credit (10%) on the basis that the foreign tax paid off shore *may* be low. However, it may also be high. It may not be possible to apply one rate of credit across all taxpayers. It may be appropriate for companies to determine with more certainty what the average or mixed rate of foreign tax paid in respect of that income.

It would be equitable to allow companies the option to determine the average rate of tax paid in respect of the foreign income, and allow credit at that rate. Naturally, any election would need to be substantiated. However, if there is to be a serious attempt to provide an equitable solution to Australian shareholders, then the setting of a low rate of credit because foreign tax paid offshore *may* be low is totally inappropriate.

Priority: High

6. Chapter 3 - Promoting Australia as a Location for Internationally Focused Companies

We support the recommendation for a total re-write of the CFC and FIF provisions. As they currently stand they are excessively complicated and impractical.

Priority: High

Subject to that, we make the following comments on the various options considered in this chapter.

Option 3.1

With the development of new roll-over reliefs in our domestic system, the CFC rules should accordingly be extended to accommodate similar rules in respect of foreign corporate restructuring.

Option 3.2

The definition of "tainted services income" and "tainted sales income" need not be so extensive in the CFC legislation. For foreign entities providing services or sales to related parties on an arm's length basis, there should be no need for attribution to be contemplated. The paper says that the tainted services income rules partly back up Australia's transfer pricing rules. We would suggest that Australia's transfer pricing rules primarily protect Australia's tax base in relation to international related parties transactions, and the excessive use of attribution under the CFC rules is unwarranted. We note that the paper concedes that attribution for active offshore services income is increasingly inappropriate given the increasing economic importance of the provision of services.

Option 3.3

Additions to the broad exemption list should be considered on a case by case basis, taking into account the other country's administrative integrity and comparative taxation regime, as well as the importance of trading with that country. The consideration needs to take into account broader issues than merely comparative tax rates and available tax concessions in that country. The existence of a double tax treaty with that country should be an influential but not overly persuasive factor.

Option 3.7

While we cannot in this submission give a view on how the likely future treaty negotiations should be prioritised, given the expected activity in international treaty negotiation in the near future, we do believe that it is a very important issue for the Government to carefully negotiate or renegotiate our tax treaties. Open consultation with interested business groups and representative bodies must be encouraged. Issues regarding mobile individuals and executive remuneration require specific attention.

Priority: High

Option 3.9

We agree with the proposal to abolish the limited exemption list and generally exempt all non-portfolio dividends repatriated to Australian company shareholders. We endorse the simplicity of this alternative and the fact that it may encourage repatriation of profits to Australia.

Option 3.10

Broad tax relief for conduit Australian regional holding companies would promote our international attractiveness and should be encouraged. We do not believe that such a system can be dismissed on the basis that it might be complex and have compliance and administration costs, without this alternative being properly developed. As the paper notes, other jurisdictions such as New Zealand have conduit holding company regimes.

In particular, capital gains tax exemption should be introduced for non-resident investors in respect of their interest in Australian conduit holding companies. In addition, the regime should exempt the Australian company from capital gains tax (CGT) on gains from the disposal of foreign subsidiaries subject to the regime.

Encouragement to physically locate business in Australia through these and any other appropriate fiscal incentives should be encouraged in respect of industries that are compatible to Australia.

Option 3.11

We support the development of the current foreign dividend account regime to more broadly encompass exemption for all conduit income that an Australian holding company distributes to non-resident shareholders. We support the development of the foreign income account in lieu of the foreign dividend account, and for exempt foreign income to be able to flow through accounts in any number of Australian entities.

Option 3.12

We support amending the definition of "resident" for companies to specify that having central management and control in Australia does not mean of itself that the company carries on business in Australia. The determination of the place of carrying on a business should be far more specific to the locality of a company's business operations.

Option 3.13

We support Australian residency being determined by treaty tie-breaker provisions where applicable in order to avoid many of the difficult issues arising for dual resident companies under our law. The determination of residency by reference to a relevant treaty in these situations would give simplicity that outweighs any revenue benefit attributable to the present dual resident rules.

7. Chapter 4 - Promoting Australia as a Global Financial Services Centre

Option 4.1

We support a total re-write of the FIF rules, focussing on minimising compliance costs.

In the meantime, broader exemption in favour of interests in funds in comparable tax jurisdictions should be actively pursued, and broader exemption for investments in entities operating in active business industry classes should be introduced.

Option 4.3

In relation to funds management, it seems to us to be unnecessary to subject a domestic widely held managed fund to the current FIF regime at all. The manipulation of investments that, as noted in the paper, currently exists in order to circumvent the FIF rules seems to be a staggering indicator that the FIF regime does not work.

Broad exemption from FIF attribution should be considered for widely held managed funds in Australia.

Option 4.4

Similarly, interests held by complying superannuation funds should be exempted to encourage broader investment by such funds to support retirement policy initiatives.

Often migrating retirees are locked into investments that are subject to FIF rules and there should be broad exemption from FIF measures to attract the significant capital that can and does come to Australia with migrants who see Australia as a good retirement destination.

Options 4.6 and 4.7

These options clearly contemplate amending the law to prevent significant anomalies in our CGT system and are certainly supportable; the issue will be implementing them in a way that does not give rise to unnecessary compliance burdens.

8. Chapter 5 – Improving Australia's Tax Treatment of Foreign Expatriates

Option 5.2

In this area, the law needs dramatic amendment in order to make the Australian system equitable and clear. Division 13A of our 1936 Act does not address residence and source issues, and mobile executives in receipt of options often need advice in relation to their position under Division 13A. Urgent reconsideration needs to be given to the policy behind this division, in the light of OECD treaty deliberations on the taxation of employee share options.

It is noted in the paper that the approach promoted by the OECD is to allocate taxation to the jurisdiction in which share options are exercised. However, there should be a fundamental rethink on how our domestic rules apply.

In our view, the rules should better reflect a jurisdiction to tax based on where the services that gave rise to the shares or options are performed. If, for example, an executive has received options in respect of services performed overseas, and he or she commences residency and then subsequently exercises those options, why should any benefit arising from those options be subject to income tax in Australia? In many cases, foreign services income of an Australian resident is exempt from Australian tax under section 23AG of our 1936 Act. Why would it not be appropriate to treat any benefit or gain arising from the exercising of the options under our capital gains tax regime only; that is, the options would have a cost base based on their market value at the time of the executive becoming an Australian resident. In any event, the current rules need to be amended to make the taxation position of an option holding executive migrating in or out of Australia more clear. There as there are a lot of instances where the Australian tax position for executives is very difficult to determine and often inequitable at present.

Priority: High

Option 5.4

We strongly support the creation of a specialist cell within the ATO to deal with expatriate tax matters; not just in relation to foreign expatriates working in Australia, but also in respect Australians working overseas, so that, for example, consistent and prompt determinations can be given to the application of s23AG of the 1936 Act to an individual's circumstances. In reference to s23AG, we believe that in many cases the ATO is not sufficiently sensitive to the particular facts surrounding foreign employment engagements (and the application of the rules surrounding continuous periods of service) and that this area requires specific attention.

Also, the taxation treatment of migrants to Australia needs to be consistent with Commonwealth retirement incomes policies. For example, relief for the undeducted purchase price of foreign pensions should be available to make the taxation treatment of foreign pensions more consistent with that afforded to lump sum benefits.

Priority: High