3 February 2003

Mr Richard F E Warburton
Chairman
Board of Taxation
C/- The Treasury
Langton Place
Canberra ACT 2600

Dear Dick

Review of International Taxation Arrangements

We are writing to provide additional information to the Board of Taxation in support our submission to the Review of International Taxation Arrangements.

Attached at Appendix A are case studies that provide anecdotal evidence of the impediments Australian companies face when dealing with our international tax regime. These case studies have already been provided to the Board separately.

The case studies also provide indicators of further behavioural effects which might arise from the reforms, namely that Australia might see an increased volume of inbound employment-creating investment into headquarter activities which are currently located in Europe and Asian countries.

Implications of US proposed changes to the double tax on corporate earnings

Recent proposals by the US Administration to permit a corporation to distribute tax-free dividends to its shareholders to the extent that those dividends are paid out of previously taxed income will have significant implications for Australia and Australian corporates if implemented. Copies of the relevant US Treasury press release are attached.

Currently, under US law, corporate earnings can be subject to tax both at the corporate level and at the shareholder level. The US Administration acknowledges that when a corporation is taxed on its income and then pays dividends that are taxable to shareholders, this effectively results in the same income being taxed twice and this double taxation of corporate earnings distorts business decision making and is inefficient.

To eliminate distortion and inefficiency, the US Administration is proposing that dividends should be excluded from income if the dividend income has been taxed at the corporate level. This will be where the amount paid out in dividends has been subject to either US or foreign tax, as we understand that the proposals are intended to apply to dividends paid by US domestic companies out of foreign profits that have been subject to foreign tax.

The US Administration is introducing these measures in recognition of the fact that the double taxation of corporate profits creates severe economic distortions, including:

- creating a bias in favour of debt compared to equity because payments of interest by the corporation are deductible while returns on equity in the form of dividends are not;

- encouraging corporations to retain earnings rather than distribute as dividends, thereby distorting investment returns and decisions by lessening the pressure on corporate managers to undertake only the most productive investments.

If these US proposals are implemented, the US will become extremely competitive for headquarters and investment and this will make Australia even less competitive in the global structure than it currently is. In the context of the current review of our own international taxation arrangements, it is highly relevant that these proposals would avoid creating the sort of bias against foreign earnings that Australia's tax system currently suffers from.

These developments place a higher imperative on effecting changes to our current international tax regime in relation to the double taxation of foreign profits to ensure that the gulf between US and Australian corporates, in particular those with international activities and a mix of local and foreign shareholders, does not continue to widen.

Please do not hesitate to contact us on the following numbers if you require any further information:

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Tony Burke	Australian Bankers Association	02 8298 0409
Su McCluskey	Business Council of Australia	03 9610 4222

Yours sincerely

APPENDIX A
Case Studies

CASE STUDY 1

Company X is one of the largest companies in Australasia with almost 1 million shareholders.

Company X considers that it is at a significant disadvantage when compared to domestic competitors. Company X has a bigger skew of income that is foreign yet the average and marginal investors are considered to be Australian. Therefore, Company X cannot afford to ignore the domestic market.

With a skew towards Australian investors, this has an impact in relation to the extent to which dividends are franked in Australia. Company X contends that the franking of dividends has a considerable value, as past experience shows the declaration of unfranked dividends attracts high attention from the media. Shareholders continue to query the franking rate, clearly indicating that they attribute value to the credit.

Thus, domestic investors are important to Company X with franking credits clearly valued by these investors. As these investors judge their investments on an after tax basis, Company X has to generate higher pre-tax rate of returns than that of their domestic competitors.

A $3/7^{th}$ shareholder credit would enable Company X to offer instruments at a lower price, thereby increasing shareholder returns.

A $3/7^{th}$ shareholder credit would also mean that Company X is more likely to repatriate profits. There is an expectation by Company X that there would be greater scope to repatriate profits from the UK and return this income to shareholders.

Currently, the offshore reinvestment of foreign profits is favoured, in part due to the tax disadvantages of repatriating foreign earnings. A more favourable tax treatment of foreign earnings would allow more balanced decisions to be made as to the use of those earnings (including repatriation), and appropriate source of foreign capital.

While Company X acknowledges that there are a number of factors that affect this decision, tax implications are not an insignificant part of the equation.

A $3/7^{th}$ shareholder credit would enable Company X to more actively manage UK profits. Decisions can be made in relation to the best way of dealing with the profits in the interests of the business and shareholders without being unnecessarily impacted by tax factors.

Case Study 2

Company Y has been in negotiations with an EU company to establish a 50/50 joint venture in Malaysia, China and Thailand. It may expand to other countries in the future.

The EU company has operations in Malaysia, while Company Y has operations in China, Thailand and Malaysia.

Company Y and the EU company would prefer that one joint venture company hold all these interests, rather than owning companies in each individual jurisdiction. This is required as a focal point for proper management of the joint operations. The use of a partnership or unincorporated joint venture was rejected by the EU company. The issue is where this JV company should be domiciled for tax purposes and the following two options have been canvassed.

Option1 - Malaysia as a hub
Dividends from China would flow free to Malaysia, and then again tax-free from Malaysia to Australia and the Netherlands (EU company intermediate holding company jurisdiction). Company Y and the EU company would be no worse off than if they had received dividends directly from China, as there is no Chinese dividend withholding tax (DWT).

Dividends from Thailand would flow to Malaysia after a 10% DWT and then those same dividends could flow out of Malaysia free of DWT to Australia and the Netherlands. Company Y and the EU company would be no worse off given Thai dividends to Australia and the Netherlands also suffer a 10% DWT.

Option 2 - Australia as a hub
Dividends from China and Malaysia would flow free of DWT to the Australian JV company. The Thai dividends would attract 10% DWT, the same as if Malaysia was the hub.

The dividends received by the JV Australian company would be exempt from Australian tax. These dividends could be paid on to the Netherlands free of DWT by utilising the Foreign Dividend Account. However, Company Y will have to pay Australian tax on the unfranked dividends received from the JV Australian company.
Australian capital gains tax would be payable in respect of any gain on disposal of the foreign subsidiaries.

If the three subsidiaries offshore earn any “attributable income” (as defined under Australia’s CFC laws), then the JV Australian company will pay tax in Australia to the extent the Australian rate exceeds the foreign rate on that income.

Conclusion
Owing to Australia's tax on unfranked dividends (albeit sourced from previously taxed foreign income and which was previously tax exempt in Australia), its capital gains tax on sales of foreign subsidiaries, and its CFC laws that top up taxes to the Australian rate on passive and tainted income, a hub in Malaysia is recommended.

CASE STUDY 3

Company Z has provided this background based on its own observations as a multinational . The comments are focused on the tax considerations of holding/owning assets and do not purport to address other investment considerations such as sovereign risk nor the question as to where headquarters should ultimately reside. In this regard we note headquarters can reside separately from where assets are held or owned etc.

A key question for Company Z when new businesses are acquired or to be established, is the ongoing ownership structure. Related to this issue is also the important question of the implications of any ultimate disposal of the investment. The taxation implications of these matters may influence a decision one way or another when weighing up country ownership comparisons. Both these issues place a sharp focus on the extent of dividend withholding tax and the implications of any Controlled Foreign Company regime in the holding/ownership scenario, and the extent of capital gains tax in the exit scenario.

Company Z notes offshore multinationals have a structuring choice. This potentially allows access to more favourable international tax regimes than in Australia - eg UK where there is no capital gains tax on sale of foreign businesses (i.e. disposals of shares or assets).

While Australia is currently leading the world in economic growth, due to the taxes on foreign profits and on the sale of foreign assets we remain unattractive as a regional holding centre, and largely isolated in the eyes of global investors. As a result, Australia is generally unattractive for "flow through" investment which of itself generates positive economic outcomes from service related activity and Australian bound personnel transfers. Company Z is aware that in the UK and the US , companies seeking to conduct businesses in the Asia/Pacific region are advised not to consider Australia as the regional holding company for those businesses, primarily due to its tax regime. This results in business and multiplier effects instead, for example, flowing to places like Singapore and Hong Kong. In fact, Australia is not considered at all as a suitable base from which to establish regional headquarters and, as a result tends, for the most part, to attract only Australian focused subsidiaries of multinationals.

Company Z is concerned that focus on the international tax debate has been on outbound investment-perhaps not surprisingly, from the perspective of Australian companies attempting to grow globally. However, we also need to view Australia's international tax regime from the perspective of an inbound investor (which includes multinational companies seeking to invest offshore through Australian based holding companies). While it would be impossible to quantify the amount of international investment that passes Australia by, Company Z remains concerned that if we do not make Australia more attractive by reforming our international tax regime, continuing to ignore inbound investment opportunities will ensure that multinational companies in similar positions will continue to locate their regional service businesses and consequently, their regional holding companies owning investments, outside Australia. This will undoubtedly be due, in part, to both other countries' competitive on-going tax regimes on annual profits combined with their minimal exit tax on foreign investments should this be contemplated.

Company Z disagrees with arguments that there is no need for reform in this area as other structures including the Dual Listed Company structure deal with the tax problems. Those structures do not benefit Australia in the sense of attracting inbound or "flow through" investment. Moreover for Australian companies with outbound investments, there may be no choice but to adhere to an uncompetitive regime.

For inbound multinationals, there is a choice to owning offshore assets. With the current Australian tax regime, that decision will be, in all but exceptional circumstances, likely to favour establishing ownership structures under more attractive places outside Australia ,such as the UK. Interestingly we understand from our US advisors the US Administration is very likely to propose substantial changes in its CFC and foreign tax credit regimes precisely because of a perception that the US (much like Australia) is not a preferred tax regime to be subject to due to the nature of its international tax rules. Comparison in this regard should be made to the UK which last year unashamedly sought to relax its rules to attract companies holding foreign assets.

Therefore, Company Z considers it is vitally important that reforms be considered not only to encourage companies to locate their headquarters/regional headquarters in Australia, but also to be confident that Australia will not seek to tax gains on investments held through Australia, thereby not discouraging ownership of foreign assets held through Australia

Case Study 4

Company A provides taxation and investment advice to Australian and foreign companies operating overseas and seeking to expand globally and Australian companies that also wish to expand globally.

Company A believes that the Australian tax system is not a good advertisement for Australia as a regional location and falls well below the attractiveness of locations such as Singapore and Hong Kong.

Company A suggest there are three different scenarios in relation to a company's decision to locate or invest in Australia.

Scenario 1 – Direct investment
Companies that are looking at direct investment in Australia will base their decision on a number of factors including taxation. The decision to invest in Australia is business driven underpinned largely by commercial objectives. Therefore, while taxation is an important factor, it may not necessarily be the determining factor.

Scenario 2 – Overseas Company seeking to expand into the Asia-Pacific
A Canadian company seeking to expand into the Asia-Pacific region recently sought advice as to the suitability of Australia as a location for a holding company. The company and their advisors were stunned and surprised at the immensely complex and administratively costly tax regime they would need to comply with, particularly in comparison to Singapore and Hong Kong. The company ultimately decided to set up their holding company in Hong Kong.

Company A suggests that overseas companies that consider expanding and setting up a regional headquarters in Australia very quickly seek alternative locations and are advised to consider Singapore or Hong Kong as viable locations, by tax and investment advisors, both in Australia and overseas. The Australian tax system and its administration has achieved an unenviable reputation, so much so, that it is unusual for Australian advisors to be asked to provide this advice, as quite often, the overseas advisors recommend against Australia in the first instance.

Scenario 3 – Australian located companies
Multinational companies with Australian operations that are located and operate in Australia continue to face the complications of our taxation system, however will not necessarily seek to relocate their operations solely for tax purposes. However, the adverse implications for Australia are seen when these companies seek to expand and their experiences with our tax regime reinforce their decisions to expand overseas rather than in Australia.