TAX SERVICES

OCTOBER 2002

Review of International Tax Arrangements

Submission to the Board of Taxation

ERNST & YOUNG

FROM THOUGHT TO FINISH.™

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Executive Summary

Ernst & Young strongly supports the Government's commitment to review aspects of Australia's international tax arrangements.

As noted in the Government's *Securing Australia's Prosperity* policy statement, in an increasingly competitive global environment an internationally competitive tax regime is an essential ingredient to ensure that:

- Australian companies are able to attract and retain the equity capital and skilled labour they need to expand their operations offshore to successfully compete on the global stage while remaining based in Australia; and
- foreign companies are not deterred from setting up their regional headquarters in Australia.

In order to develop such an internationally competitive tax regime, it is important to:

- review the current tax system to identify those aspects that may be inhibiting the expansion of Australian companies offshore and the establishment of regional headquarters in Australia; and
- identify and evaluate alternative options for reform, particularly those approaches that other countries have been using to address those problems. The problems Australia is experiencing with its international tax regime are certainly not unique. Rather, other countries are experiencing much the same problems and have been introducing a wide range of reforms over the last two decades to address those problems. Nevertheless, Australia should determine solutions for its particular set of problems and not necessarily copy those employed elsewhere.

It is important to evaluate options for reform not only from the point of view of their ability to reduce the domestic cost of capital, but also to minimise other adverse effects of taxation on multinationals, including the extent to which the tax system:

- deters Australians from saving and investing, and distorts their patterns of investment;
- reduces Australia's ability to attract and retain skilled labour;
- discourages foreign companies from choosing Australia as the location for their Regional Headquarters; and
- imposes significant compliance on taxpayers and administrative costs on government.

Options for reform should not be dismissed simply because they would not reduce the cost of capital in Australia. Rather, their ability to reduce these other adverse effects of taxing income from capital also needs to be assessed.

Equally important, if Australia is to maintain an internationally competitive tax system, the Government also needs to make a commitment to implementing an ongoing process of review and reform of the Australian tax system.

Maintenance of an internationally competitive tax system in a rapidly changing global environment demands a much more pro-active and ongoing process of tax reform than has been practiced in the past.

As a result, it is unrealistic to expect the current review of the international tax regime to identify and resolve all of the problems with that regime given its limited scope and tight timeframes.

Rather, it is preferable to regard the current review as the first step in an ongoing process of review and reform aimed at improving the international competitiveness of Australia's tax system.

Ernst & Young's comments in respect of the 'Review of International Tax Arrangements' Consultation Paper (RITA) can be summarised as follows:

Consultation Paper Options	IMPUTATION	Ernst & Young Submission Reference
	The current provisions create two main problems. First, the inability of Australian shareholders to claim a credit for foreign taxes when they invest indirectly offshore through an Australian multinational company creates a bias at the shareholder level against investment in Australian companies expanding offshore. Second, the current franking credit and foreign dividend account rules mean that flows of foreign source income through an Australian multinational company to a foreign shareholder (i.e. conduit income) have the adverse effect of reducing: ▪ the value of imputation credits the company can attach to the Australian source dividend income it distributes to Australian shareholders (i.e. flows of conduit income 'burn' some of the imputation credits that should have been paid to Australian shareholders); and ▪ the value of exempt dividends that can be paid out of the foreign dividend account to foreign shareholders (i.e. flows of conduit income 'burn' some of the exempt dividends that should have been payable to foreign shareholders).	2.2
2.1 A 2.1 C	Options A and C that have been raised for consultation need to be considered alongside the approaches other countries have been pursuing in order to reduce personal tax rates, the disincentive to save and invest, and the bias in favour of domestic investment. In particular, the following alternative options for reform need to be evaluated in detail in the medium term: • Reduce the top rate of personal income tax while maintaining imputation. • Apply a lower rate of tax to income from capital, particularly dividend income. This could be achieved through a range of options including the implementation of a dual income tax system, a split rate tax system, or a UK style notional tax credit regime. In particular, consideration needs to be given to abolishing the current imputation system and replacing it with a UK style notional credit approach. This would provide shareholders with a credit equal to some proportion of the value of the dividend, regardless of the amount of company tax paid on that income or its source. We recognise that this evaluation would take some time. In the meantime it is important for Australia to reduce the bias against the derivation of foreign source income that is contained in the imputation system. For this reason we recommend immediate action in respect of the options proposed for action, as follows:	2.4

Consultation Paper Options	**IMPUTATION**	Ernst & Young Submission Reference
	Implement option A, which involves the application of a UK style notional tax credit to the foreign source income that Australian shareholders earn from listed countries, while maintaining imputation in its current form. However, the level of notional credit needs to be significantly larger than the one-ninth mentioned in the Consultation Paper. Similarly option B needs to be considered in conjunction with the other options for providing conduit relief outlined in Chapter 3, including the implementation of a conduit holding company (CHC) regime.	
2.1 B	Option B should not be regarded as an alternative to either option A or option C. Rather, it is an option for clarifying the source of dividend income and ensuring that conduit income flows through Australian companies do not have adverse tax effects for either foreign or Australian shareholders. As such, it needs to be considered in conjunction with the other conduit reforms outlined in Chapter 3. Option A also needs to be considered in conjunction with option B as a means of relieving conduit income from tax when it flows through a number of Australian companies before it is repatriated offshore.	2.5
	Regardless of the Government's decisions relating to option A, we recommend that the Government should implement either option B or a Conduit Holding Company regime that would enable conduit income to flow through Australian multinational companies without adverse tax consequences for either Australian or foreign shareholders. Such conduit relief would: • reduce the effective tax rates imposed on the dividend income of Australian shareholders in Australian multinational companies with significant foreign investments and foreign shareholders, thereby reducing the current bias in favour of direct investment offshore; • potentially reduce the cost of capital for those companies by reducing the effective tax rate imposed on the dividend income of foreign shareholders in Australian multinational companies; and • reduce the disincentive for foreign multinational companies to set up their Regional Headquarters in Australia.	2.7

Consultation Paper Options	**CONTROLLED FOREIGN COMPANIES**	Ernst & Young Submission Reference
3.3	Simplification in the legislative drafting of the Controlled Foreign Company rules, though desirable, will not achieve the reform	3.1.1

Consultation Paper Options	CONTROLLED FOREIGN COMPANIES	Ernst & Young Submission Reference
	necessary to allow a more competitive environment for Australian multinationals. This will only occur if the overall policy is re-examined. Ernst & Young is concerned that re-examining the basis of the Controlled Foreign Company rules and a consequent general rewrite of the legislation (after the necessary consultation with interested parties) will be a protracted process.	
	Because Ernst & Young are mainly concerned here with the larger policy issues, despite option 3.3 for consultation, we have not set out in detail the myriad of technical issues under the Controlled Foreign Companies measures. This does not suggest that these issues are not important. However, many (if not most) of these issues are already known to both the Australian Taxation Office and the Treasury and it is understood that these have been made available to the Board.	
3.3	**Limitation of attribution from broad-exemption listed countries**	3.2.1
	Under the existing Controlled Foreign Company measures as they apply to a Controlled Foreign Company resident in a broad-exemption listed country, as a practical matter there are only three basic categories of income and gains that may be subject to attribution: • interest and royalty income that is subject to a tax concession • capital gains that are exempt from tax • income from a branch outside that country that is not subject to tax	
	The existing provisions have the effect that the Controlled Foreign Company measures impose non-neutrality compared to a non Controlled Foreign Company operating in the same jurisdiction, in circumstances where the risk to the Revenue is minimal.	3.2.2
	The simple solution is to accept that no attribution would arise where a company is resident in a broad-exemption listed country.	3.2.3
3.4	**Extension of the list of broad-exemption listed countries**	3.3
	Even if the attribution of income from a Controlled Foreign Company resident in a broad-exemption listed country is to be eliminated or severely restricted, there is scope to extend the list of broad-exemption listed countries and reduce the compliance burden of the Controlled Foreign Company rules without affecting their integrity.	
3.4	**Taxation of shares in a company with predominantly active assets**	3.4.3
	An exemption should be provided for any profit or gain on disposal	

Consultation Paper Options	CONTROLLED FOREIGN COMPANIES	Ernst & Young Submission Reference
	of a company with active assets where a profit on the disposal of the underlying assets would not be subject to attribution under the Controlled Foreign Company measures and any dividend paid out of those profits would be exempt income. Any capital gain on the disposal of shares in a company that is not a Controlled Foreign Company immediately prior to the disposal would not be exempt. The exemption would only be applicable for corporate attributable taxpayers.	
3.1	**Expansion of roll-over relief under the Controlled Foreign Company measures**	3.5
	To deal with the most pressing needs of business but still prevent any significant scope for tax leakage, we suggest that there is a staged approach to the extension of rollover relief. The first stage should not await a full review of the Controlled Foreign Company measures and would consist of the following. • Full rollover relief based on the relief provided by the broad-exemption listed countries of residence of the Controlled Foreign Company • Full rollover relief for the transfer of assets within a wholly owned group • Partial relief for scrip for scrip transactions held companies	
3.2	**Services income**	3.9
	We believe that 'tainted services' as a category within the Controlled Foreign Company regime should not exist as a category, or should only exist to bolster transfer pricing from Australia (other categories such as tainted royalty income encounter similar problems). On this basis, contrary to the statements in the Paper, changes in the definition of tainted services income will not impact any other option for consultation.	3.9.5
3.9	**Taxation of non-portfolio dividends**	3.10
	The exemption of all non-portfolio dividends should be considered as part of a more general review As outlined in the Paper, the exemption of all non-portfolio dividends derived by an Australian company will considerably simplify the taxation of dividends. There will no longer be any need to determine the source of the underlying profit of a foreign company and then determine from which of these profits the dividend has been paid. In addition, much of the complication surrounding the foreign tax credit system could be removed. One of the major benefits will be the simplification of the rules that are intended to prevent the shifting of profits from unlisted to listed	3.10.4

Consultation Paper Options	CONTROLLED FOREIGN COMPANIES	Ernst & Young Submission Reference
	countries.	

Consultation Paper Options	CONDUIT INCOME – PROMOTING REGIONAL AND INTERNATIONAL HEADQUARTER SERVICES COMPANIES	Ernst & Young Submission Reference
	The present Government has acknowledged, by including it as part of RITA, that the encouragement of a "Headquarter Services" sector is in Australia's interest. It has done so for good reason since the existence of a strong Headquarter Services sector has important implications for maintaining a vibrant business community. A strong Headquarter Services sector entails with it the necessary human infrastructure conducive to a robust entrepreneurial community of directors and business executives, along with a competitive business advisory and capital markets sector, with all the implications that has for the promotion of other related services, such as marketing, communications, travel, finance, legal, human resources, etc. The promotion of a vibrant Headquarter Services sector essentially relies on two outcomes. First, maintaining in Australia the functions that Australian based multi-nationals currently conduct. Second, attracting the regional Headquarter functions of foreign based multi-nationals. The issue covered by the Paper which most directly impacts on Australia's ability to attract Regional Headquarter companies, is the issue dealing with improving Australia's conduit income arrangements. A revision of how Australia taxes conduit income and capital gains as proposed in the Paper, whilst an important step forward, goes solely to the issue of the scope of our tax system. It does not assist in the other important issue of dealing with effective tax rates imposed on both individuals and companies and the impact this has on conducting regional headquarter activities in Australia. For this reason it is important both to address the conduit issue and to consider whether incentives which impact on the effective tax rates imposed on headquarter services are appropriate.	4.1
	The Paper suggests that conduit relief might be provided where a foreign group establishes a Conduit Holding Company to act as a regional or similar international holding company • and that Conduit Holding Company disposes of an interest in a	4.2

Consultation Paper Options	CONDUIT INCOME – PROMOTING REGIONAL AND INTERNATIONAL HEADQUARTER SERVICES COMPANIES	Ernst & Young Submission Reference
	foreign company; and/or	
	• where the foreign investor disposes of an interest in the Conduit Holding Company that has foreign assets.	
	In our view, conduit relief should be provided in both situations.	
	The Conduit Holding Company regime, of its own, does relatively little in sending a positive message to foreign companies who may consider Australia as a regional Headquarter location compared to some of the incentives offered by our regional neighbours. A simple Conduit Holding Company regime offering respite from Australian Capital Gains Tax compares relatively poorly in this context with what our regional competitors have to offer, most of which do not have a Capital Gains Tax to start with.	4.2
	What should be considered, in addition to the Conduit Holding Company relief, is a comprehensive International Headquarter Company tax regime that has a "jobs based" incentive rather than simply a legal structure or holding company incentive. A "jobs based" incentive is consistent with some of the incentives currently available for Research and Development spending where a greater than 100% deduction is allowed for qualifying Research and Development spends in Australia. It is also consistent with qualifying expenditures on producing films in Australia, whereby a 12.5% rebate on actual expenditure in Australia broadly is available as an incentive. Historically, such an incentive is consistent with incentives available in the infrastructure (development allowances) or manufacturing (investment allowance) sectors.	
	A considerable amount of work is required in this area in order to properly define and design an appropriate incentive for an International Headquarter Company regime. It is naïve to think that a properly designed and targeted incentive can be arrived at without the benefit of a thorough working study of the topic.	

Consultation Paper Options	AUSTRALIA'S TAX TREATIES	Ernst & Young Submission Reference
	Corporate Residency Rules	
3.12	The current Central Management and Control test is confusing and unclear. However we do not support Option 3.12 suggesting clarification to the test of company residency so that exercising central management and control alone does not constitute the carrying on of a business.	5.1
	The test for corporate residency relying solely on the place of	

Consultation Paper Options	AUSTRALIA'S TAX TREATIES	Ernst & Young Submission Reference
	incorporation test would simplify the issue significantly and should be adopted. Concerns about an incorporation only test in our view already exist or can be dealt with separately.	
3.13	In view of our recommendation in regard to reliance on a place of incorporation residency test, we consider that the dual residency provisions in the income law should be removed to reduce complications.	5.1.4
	Tax Treaties	
3.5	Ernst & Young is supportive of the option to use the recently negotiated protocol to the Australia-United States of America tax treaty as a "basis" model for future negotiations. At the same time we do not believe that all provisions, e.g. 'limitation of benefits' clause, should necessarily be included in future treaty negotiations.	5.2.4
3.7	Ernst & Young consider that the 'most favoured nations' clauses in some of Australia's treaties will act as a springboard for which future renegotiations may proceed quickly and are therefore supportive of Option 3.7 to consider which countries be given priority in treaty negotiation.	5.2.8
3.8	Ernst & Young believe that increased consultation (as proposed in Option 3.8) is desirable. Whilst this would ensure maximum input from the public, it is also recognised that treaty negotiations in many respects must necessarily be confidential. Therefore this Option should be approached with caution.	5.2.8
3.6	**Capital Gains Tax**	5.3
	Under this option, non-residents will be subject to Australian Capital Gains Tax (CGT) where they dispose of an asset that has the "necessary connection with Australia".	
	The current definition of "necessary connection with Australia" excludes shares in foreign companies (even when those companies have an interest (directly or indirectly) in assets which do have a connection with Australia).	
	A non-resident will not be subject to Australian tax on any profit made on the disposal of shares in such an interposed non-resident holding entity.	
	Conceptually Ernst & Young does not believe that the absence of an 'upstream CGT' regime is a problem. There are a significant number of countries without such a regime and those with it face	

Consultation Paper Options	AUSTRALIA'S TAX TREATIES	Ernst & Young Submission Reference
	significant compliance issues. The mere fact that Australia has a direct taxing position on CGT, contrary to many other countries, is in itself very complex and problematic, so it would seem inappropriate to exacerbate the issue by incorporating 'upstream CGT'.	

Consultation Paper Options	AUSTRALIA AS A GLOBAL FINANCIAL SERVICES CENTRE	Ernst & Young Submission Reference
	The existing Foreign Investment Fund measures should be repealed with effect from the income year ended 30 June 2003, irrespective of whether or not replacement measures can be implemented by 1 July 2003.	6.3
	The FIF measures should be re-written so that they target avoidance and do not have consequential adverse implications for investors that, on an objective basis, are not engaged in deliberate long-term deferral, or conversion of income to capital gains.	6.2.1
4.3 4.4 4.5	Absent the repeal of the FIF measures, all of the options for consultation should be incorporated, as follows: • complying superannuation funds should be exempt • the 5% threshold for the balanced portfolio exemption should be raised to a reasonable percentage after consultation with industry. If this does not occur prior to 30 June 2003, the threshold should be raised in the interim to a conservative percentage, pending finalisation of consultation with industry.	6.4 6.4.3 6.5
	Inbound Portfolio Investment via Australian Unit Trusts	
4.6 4.7 4.8	Each of recommendations 4.6, 4.7 and 4.8 should be implemented as outlined in the Paper. In addition, the Board should consider recommending amendments to the taxation law so that revenue profits arising from the sale of the assets that are exempt from capital gains tax under recommendations 4.6, 4.7 and 4.8 are otherwise exempt from Australian income tax. Without this measure, profits exempted from tax under the capital gains tax provisions may inadvertently be subjected to Australian income tax under the ordinary income provisions.	6.6.4

Consultation Paper Options	IMPROVING AUSTRALIA'S TAX TREATMENT OF FOREIGN EXPATRIATES	Ernst & Young Submission Reference
	Ernst & Young is disappointed that the community perception of this issue suggests that the tax disadvantage operates only in	7.1

Consultation Paper Options	IMPROVING AUSTRALIA'S TAX TREATMENT OF FOREIGN EXPATRIATES	Ernst & Young Submission Reference
	relation to chief executive officers and expensive executive imports.	
	Ernst & Young's experience is that Australia's tax disadvantages in relation to foreign expatriates strike at many levels in businesses, and affects significant numbers of middle-income talented people in Australia.	
	Australia's current tax law dealing with foreign expatriates in Australia presents on balance an unfriendly and unwelcoming taxation environment when compared with most other developed countries. Australia's harsh tax regime sends a message to the foreign headquarters that Australia is not serious about attracting foreign investment and not serious about making Australia an attractive environment for business to operate internationally. This is a powerful message of unwelcome when compared with the overt and tax design welcoming messages emerging from other countries in our region, such as Singapore, Malaysia, Thailand, Hong Kong, all of which have tax systems designed to attract multi-national companies and their expatriates to operate in local bases.	
	Of the points raised in the Consultation Paper the most important from an expatriate taxation perspective is the implementation of the previously announced "temporary resident" tax exemptions for foreign nationals working in Australia.	7.1.3
5.1	**CGT Security Deposit Measures**	7.2
	Ernst & Young strongly supports the views expressed in the Paper that the implementation of these measures would be a costly and backward step in tax administration in this country. The measure would effectively eliminate any benefit to the individual in deferring the disposal of a capital asset and avoiding the cash flow impact that such a taxation event would create.	
5.1	**CGT Treatment of Departing Residents**	7.3
	The Paper restated the proposal to deal with double taxation caused by the deemed disposal measures through bilateral tax treaties.	
	In Ernst & Young's view, this approach is both time consuming and unlikely to provide definitive results in the short term. We believe a better approach would be to correct the domestic legislation to provide certainty between destination countries.	
5.2	**Dealing with Cross Border Taxation of Stock Options**	7.4
	The current Australian taxation of stock options (Division 13A) is virtually unworkable in an international context. The inability to clearly establish what is and what is not taxable under the domestic Australian law means that double taxation results are inevitable in	

Consultation Paper Options	IMPROVING AUSTRALIA'S TAX TREATMENT OF FOREIGN EXPATRIATES	Ernst & Young Submission Reference
	the current framework. The proposed use of a treaty-based approach to address the splitting of taxing rights on options is also unworkable for a number of reasons. The following solutions should be considered: First, Australia should remove the taxing point on termination of a temporary resident's Australian-resident status. Second, as noted in recommendation 23 in the BCA discussion paper, Australia should allow the complete exemption from Australian tax of gains from the holding of pre-arrival stock options in order to provide consistency with the treatment adopted in the UK, Singapore and other countries. Third, while not strictly relevant to RITA, Ernst & Young recommends that Australia needs to resolve its domestic tax law through a comprehensive review of the stock option provisions. Such a review would need to focus on: • The interaction of the current Division 13A and the long-term CGT concessions. • Removing the requirement for options and shares to be taxed at cessation where there is no possibility of the employee obtaining an economic benefit for an extended period after termination (thereby effectively removing one of the key double taxation drivers).	
5.3	**Division 13A Cessation Event and Tax Exposure for Employee Share Schemes for a Resident on Date of Departure** Ernst & Young strongly support the recommendation in the Paper to terminate and end discussion on this measure. The issue is all the more problematical when it is understood that employee share schemes are designed by employers as retention strategies and apply to many employees not just the senior executives.	7.5
5.4	**Establishing an ATO Cell for Foreign Expatriates Employees** The current Australian Taxation Office administration of expatriate issues is disjointed due to the number of different sections involved. An expatriate assignment changes virtually every aspect of an individual's tax treatment from Fringe Benefits Tax to superannuation, stock options and capital gains. While the Australian Taxation Office has units dedicated to each of these areas, there is no overarching unit with the authority to deal with expatriate issues that cross over the Australian Taxation Office's	7.6

Consultation Paper Options	IMPROVING AUSTRALIA'S TAX TREATMENT OF FOREIGN EXPATRIATES	Ernst & Young Submission Reference
	various service lines. As such we would welcome the establishment of a specialist cell as a point of reference for all expatriate tax issues.	

Consultation Paper Options	OTHER ISSUES NOT ADDRESSED IN THE CONSULTATION PAPER	Ernst & Young Submission Reference
	Venture Capital Concessions to attract foreign equity capital	8.1
	Ernst & Young consider that, apart from dividend imputation there are other factors that are also relevant in setting the attractiveness of Australian companies to investors. Our unworkable environment for venture capital equity, certainly for emerging companies, hampers the supply of foreign equity funds in Australia. One of the unattractive features of the Australian tax environment is the lack of truly viable venture capital concessions, notwithstanding the measures proposed in the RBT report and introduced in 1999. Ernst & Young recognises here the Press Release of the Assistant Treasurer, Senator Helen Coonan, foreshadowing enhanced treatment of venture capital effective 1 July 2002, delivering on the Budget announcement in the May 2002 Budget. The Government is urged to proceed with this measure with the greatest urgency.	
	Australian Treatment of Intangibles and Intellectual Property: A factor in Equity Raising Attractiveness	8.2
	It is considered that, as well as the dividend imputation measures, and the venture capital measures, Australia should address the significance of the treatment of intangibles and intellectual property in making for an attractive capital-raising environment. There is a particular need for focus on two aspects that would make Australia more attractive as a location for the capital raising and holding of global intellectual property in Australia: • the withholding tax environment, which applies to royalties under Australia's double-tax agreements. Australia should adopt a preference for negligible or nil royalty withholding tax rates in its double-tax agreements; and • an enhanced process of achieving an appropriate tax recognition or tax write-off for the cost of intellectual property.	

Consultation Paper Options	OTHER ISSUES NOT ADDRESSED IN THE CONSULTATION PAPER	Ernst & Young Submission Reference
	Amortisation of Intangibles and Intellectual Property Other countries such as the United States of America and more recently, in 2002, the United Kingdom, have mechanisms whereby a broader range of business intangibles is eligible for amortisation. It is suggested that these amortisation techniques make it more attractive for acquisitions to occur by companies located in those countries. As a medium-term objective, Australia should consider an enhanced process for amortisation of business intangibles in the context of acquisitions.	8.3
	Exemption of Non-Australian workdays for temporary residents We note the Treasury's concerns that allowing an exemption for non-Australian workdays of temporary residents will create a tax bias in favour of temporary residents over Australian residents. However with respect to these views, Ernst & Young believes they are misplaced. The idea behind these measures is to increase Australia's international attractiveness as a home of regional head offices. The current Australian tax rules provide no incentive in this respect when compared to our neighbours such as Hong Kong, Singapore, Thailand and Malaysia, who all offer this type of exemption. Therefore, Ernst & Young reiterate the comments in part 10.3.1 and recommendation 21 of the BCA discussion paper that Australia must provide a mechanism for relief from tax of non-Australian source employment income received by temporary residents.	8.4
	Introduction of an Objective Residency Test for Inbound Residents The current "resides" definition of a resident for Australian tax purposes is out of date and out of step with Australia's desire to provide a more definitive tax environment. It is also inconsistent and provides different outcomes for people coming to and leaving from Australia on a temporary basis. Ernst & Young would recommend that an objective residency test be developed. This could be based on days of physical presence and apply to both leaving and arriving international travellers. Such a system would be consistent with the treatment adopted by our near neighbours and would provide greater certainty.	8.5
	Superannuation	8.6

Consultation Paper Options	OTHER ISSUES NOT ADDRESSED IN THE CONSULTATION PAPER	Ernst & Young Submission Reference
	The Consultation Paper notes, and Ernst & Young recognises, the Government's moves to allow temporary residents to withdraw their superannuation contributions following their departure from Australia. However, Australia still imposes additional non-recoverable costs on employers. These issues result from the double coverage of employees under home and host country social security systems. While Ernst & Young acknowledges the efforts of the Government in this area through negotiation of social security agreements, the exemptions allowed in these treaties do not always reflect the commercial substance for the arrangement. Ernst & Young recommends that: A. All temporary residents should be excluded from having to make a contribution to Australia's compulsory superannuation charge in the same way that the "senior executive" exemption operates now. This proposal was outlined at recommendation 22 of the BCA discussion paper. B. Alternatively, if a full exemption cannot be achieved, then an alternative is: o to recognise contributions to foreign social security systems as being equivalent to Australian superannuation for the purposes of companies meeting their minimum support obligations. o to allow Australian employers to claim deductions for contributions to foreign superannuation plans on account of temporary residents. C. Australia should negotiate our treaties to reflect the commercial reality of superannuation contributions for Australian citizens rather than the minimum requirements dictated by the Superannuation Guarantee Charge law.	
4.4	**Foreign Personal Superannuation Funds – need for exemption from FIF difficulties** The Paper recognises at Option 4.4 the need to provide concessions from the Foreign Investment Fund rules for Australian complying superannuation funds. A similar issue arises, however, in relation to foreign personal	8.7

Consultation Paper Options	OTHER ISSUES NOT ADDRESSED IN THE CONSULTATION PAPER	Ernst & Young Submission Reference
	retirement funds. These funds are clearly genuine retirement vehicles that should not fall within the Foreign Investment Fund net. Accordingly, Ernst & Young recommends that they should be included within the list of Foreign Investment Fund exemptions.	

1 Introduction

1.1 Background

In the lead up to the 2001 election, the Prime Minister announced the Government's commitment to an international tax review in its statement on *Securing Australia's Prosperity*:

> If re-elected, the Coalition Government will, as a matter of priority, examine whether features of current taxation arrangements adversely affect the capacity of businesses to remain in Australia. This will be done in consultation with key stakeholders and industry representatives.
>
> Particular attention will be paid to whether Australia's international tax regime acts as an impediment to:
>
> - Australian companies attracting domestic and foreign equity;
> - Australian companies expanding offshore; and/or
> - Holding companies and conduit holdings being located in Australia.

On 2 May 2002, the Treasurer announced that the review would consider at least four principal areas:

- the dividend imputation system's treatment of foreign source income;
- the foreign source income rules (principally comprising the controlled foreign company (CFC), foreign investment and foreign tax credit/exemption rules);
- the overall treatment of 'conduit' income (foreign source income flowing through an Australian entity to non-resident investors); and
- high level aspects of tax treaty policy and processes.

In August 2002, a *Review of International Taxation Arrangements* consultation paper was released by the Treasury, which calls for submissions on a wide range of options for reform to:

- attract equity capital for offshore expansion (option 2.1);
- promote Australia as a location for internationally focused companies (options 3.1 to 3.13);
- promote Australia as a global financial services centre (options 4.1 to 4.11); and
- improve Australia's tax treatment of foreign expatriates (options 5.1 to 5.4).

1.2 Structure of our submission

Our submission is structured in accordance with the recommendations of the Board of Taxation (the Board). In particular, it presents our views on:

- Imputation (section 2);
- Controlled Foreign Companies (section 3);
- Conduit income (section 4);
- Residency and tax treaties (section 5);

- Australia as a Global Financial Services Centre (section 6);
- Foreign expatriates (section 7); and
- Other issues (section 8).

Within each of those sections, we have generally addressed the following issues:

- What is the current law?
- What is the problem?
- What evidence is there of the problem?
- What solutions should be considered?
- How does the problem/solution relate to other options in the consultation paper?
- What priority should be given to resolving this problem?
- What are the benefits from adopting our recommendation?

1.3 Overall comments

Before outlining our views on those issues in detail, however, we want to draw the Board's attention to:

- the importance of international developments to RITA; and
- the need for ongoing review and reform of Australia's international tax regime in the light of those international developments.

1.3.1 Importance of international developments to the Review

As noted in the Government's *Securing Australia's Prosperity* policy statement, in an increasingly competitive global environment an internationally competitive tax regime is an essential ingredient to ensure that:

- Australian companies are able to attract and retain the equity capital and skilled labour they need to expand their operations offshore to successfully compete on the global stage while remaining based in Australia; and
- foreign companies are not deterred from setting up their regional headquarters (RHs) in Australia.

In order to develop such an internationally competitive tax regime, it is important to:

- review the current tax system to identify those aspects that may be inhibiting the expansion of Australian companies offshore and the establishment of RHs in Australia; and
- identify and evaluate alternative options for reform, particularly those approaches that other countries have been using to address those problems. The problems Australia is experiencing with its international tax regime are certainly not unique. Rather, other countries are experiencing much the same problems and have been introducing a wide range of reforms over the last two decades to address those problems.

Perhaps the most significant international tax development over the last two decades has been the trend towards reducing rates of tax on income from capital. Over that period, most countries, including Australia, have been seeking to improve the efficiency of their tax regimes by collecting a greater proportion of their revenue from indirect consumption taxes such as a goods and services tax

(GST) and reducing the rates of tax imposed on income from capital. In comparison with consumption taxes, income taxes are a much less efficient source of revenue since they deter saving and investment.

In particular, in view of the increasing mobility of income from capital, many countries have been reducing the rates of company and withholding tax imposed on the income of foreign investors in order to reduce the domestic cost of capital, increase investment, and improve their international competitiveness.

However, not all international tax reforms have been directed at reducing the domestic cost of capital and increasing the overall level of investment by reducing tax rates imposed on the income of foreign investors. In addition to reducing tax rates on foreign investors, many countries have also been seeking to reduce:

- the extent to which the tax system deters residents from saving and investing, and distorts their investment decisions (eg in favour of investing offshore in foreign companies as opposed to investing offshore via resident multinational companies). Although reducing rates of tax on the income of foreign investors can decrease the cost of capital, in so doing it also increases the effective marginal tax rates imposed on savings[1]. As a result, many countries have been seeking to reduce the rates of personal tax imposed on income from capital, particularly dividend income. For example, many Nordic countries have implemented 'dual' income tax regimes that impose a low flat rate of tax on income from capital, while continuing to subject labour income to an increasing scale of statutory marginal tax rates;
- the extent to which the tax system discourages foreign multinationals from setting up RHs in their countries;
- the compliance and administrative costs associated with dividend imputation regimes;
- the compliance and administrative costs arising from the complex CFC and foreign investment fund (FIF) regimes that seek to reduce the scope for resident investors to accumulate income offshore in low tax jurisdictions; and
- the extent to which the tax system reduces the nation's ability to attract and retain skilled labour.

Indeed, some of the reforms implemented in other countries are directed at multiple objectives. For example, many countries have moved away from the use of dividend imputation regimes and now provide shareholders with relief from double taxation by reducing the rate of personal tax imposed on dividend income. In the United Kingdom (UK), for example, a notional credit is provided to shareholders, which is set at a rate of $1/9^{th}$ of the dividend, regardless of the amount of company tax paid and the source of that dividend income. In effect, this reduces the rate of personal tax applying to that dividend income thereby reducing both:

- the disincentive for residents to save and invest, and any bias against investing offshore through resident multinational companies; and
- the compliance and administrative costs associated with integrating the company and personal income tax regimes.

[1] This is a complex point. It is noted in *Review of Business Tax: an International Perspective,* para 7.54 and illustrated by analysis in chapter 7 of that report.

This highlights the importance of evaluating options for reform from the point of view of their ability to reduce not only the domestic cost of capital, but also the other adverse effects of taxing income from capital, including the extent to which the tax system:

- deters Australians from saving and investing, and distorts their patterns of investment;
- discourages foreign companies from choosing Australia as the location for their RHs; and
- imposes significant compliance on taxpayers and administrative costs on government.

Options for reform should not be dismissed simply because they would not reduce the cost of capital in Australia. Rather, their ability to reduce these other adverse effects of taxing income from capital also needs to be assessed.

1.3.2 Need for an ongoing process of reform

If Australia is to maintain an internationally competitive tax system, the Government also needs to make a commitment to implement an ongoing process of review and reform of the Australian tax system.

In a rapidly changing international environment, the current piecemeal, intermittent process of tax reform is unlikely to ensure Australia's tax system remains internationally competitive.

Rather, it is more likely to result in Australia continually seeking to 'catch up' with international developments to restore Australia's competitive position in relation to other countries pursuing more pro-active and innovative approaches to tax reform.

Indeed, many of the problems currently being experienced with the international tax regime are the result of the numerous uncoordinated, intermittent, piecemeal reforms that have been made to the regime over the last decade.

Maintenance of an internationally competitive tax system in a rapidly changing global environment demands a much more pro-active and ongoing process of tax reform than has been practised in the past.

As a result, it is unrealistic to expect the current review of the international tax regime to identify and resolve all of the problems with that regime given its limited scope and tight timeframes.

Rather, it is preferable to regard the current review as the first step in an ongoing process of review and reform aimed at improving the international competitiveness of Australia's tax system.

2 Imputation

2.1 What is the current law?

Under the current law:

- Australian shareholders are able to claim a credit for foreign taxes when they invest directly offshore in a foreign company. However, when they invest offshore indirectly through an Australian multinational company, the imputation regime does not provide them with credits for foreign tax; and
- when an Australian multinational company pays dividends to its Australian and foreign shareholders, it is required to frank those dividends to the limit of its franking capacity, even though that dividend income may have been partly or fully sourced from foreign income. Similarly, the foreign dividend account (FDA) rules limit the amount of dividends that can be paid to foreign shareholders to the proportion of the foreign ownership interest in the company, even though all of that income may have had a foreign source.

2.2 What is the problem?

These current provisions create two main problems.

First, the inability of Australian shareholders to claim a credit for foreign taxes when they invest indirectly offshore through an Australian multinational company creates a bias at the shareholder level against investment in Australian companies expanding offshore. This:

- increases the effective rate of Australian personal tax imposed on that dividend income, thereby reducing the incentive for Australians to invest in Australian companies expanding overseas. The increase in the effective tax rate will be higher the greater the amount of foreign source income earned by the company and the higher the rate of foreign tax applying to that income; and
- may increase the cost of capital for those Australian companies that are unable to access international capital markets.

Second, the current franking credit and FDA rules mean that flows of foreign source income through an Australian multinational company to a foreign shareholder (i.e. conduit income) have the adverse effect of reducing:

- the value of imputation credits the company can attach to the Australian source dividend income it distributes to Australian shareholders (i.e. flows of conduit income 'burn' some of the imputation credits that should have been paid to Australian shareholders); and
- the value of exempt dividends that can be paid out of the FDA to foreign shareholders (i.e. flows of conduit income 'burn' some of the exempt dividends that should have been payable to foreign shareholders).

This increases the effective rates of personal tax imposed on the dividend income of shareholders in companies with foreign investments and foreign shareholders. The greater the flow of conduit income through an Australian multinational company, the greater the effective rates of personal tax imposed on shareholder's income.

2.3 What evidence is there of the problem?

Under the current tax system, Australian shareholders who invest in companies earning foreign income pay tax (combined foreign and Australian) at a much higher rate than if they invested in companies earning purely Australian sourced income. In addition, Australian shareholders who invest directly in a foreign company receive a credit for foreign taxes paid directly on any dividends received (essentially for any withholding tax), whereas if they invest indirectly offshore through an Australian multinational company, they do not. This means that the effective rate of personal tax imposed on the income that Australian shareholders derive from their equity interests in Australian multinational companies is higher than the effective rate of personal tax applying both to their equity interests in purely domestic companies and to direct investments in foreign companies.

This has the potential to bias patterns of investment by Australian shareholders away from investments in Australian multinational companies.

The impact of that bias on the cost of capital of Australian companies is difficult to determine since it depends on the identity of the marginal investor and the efficiency with which capital markets operate.

In theory, if the marginal investor is a foreign shareholder, such a bias is unlikely to affect the cost of capital. Similarly, if the marginal investor is an Australian shareholder and capital markets are assumed to work perfectly, this bias should have no effect on the cost of capital of Australian companies. This is because, under such assumptions, the cost of capital in Australia is determined by world markets and Australian companies and shareholders are 'price takers'.

In practice, however, this bias does have the potential to increase the cost of capital for those Australian multinational companies that are not able to access foreign capital due to capital market imperfections. For example, with the exception of a few, large, internationally recognised, Australian companies, most Australian companies are not well known to foreign shareholders and, as a result, are likely to have problems raising foreign capital. As a result, such companies have to rely heavily on Australian shareholders to supply their capital (i.e. the existence of such asymmetric information is likely to inhibit the efficient operation of capital markets). Indeed, even large Australian multinational companies can experience difficulties raising the foreign capital needed to finance their investments and have to resort to raising that capital from Australian shareholders.

The extent to which this bias actually increases the cost of capital of Australian multinational companies is hard to determine since it is difficult to estimate the rate of return that those companies would have had to pay in the absence of that bias. Discussions with clients suggest that this bias is likely to have a more noticeable impact on the cost of capital for the smaller, less well known, emerging Australian multinational companies that have to rely heavily on Australian shareholders to provide their equity finance. Nevertheless, it appears to be a concern for a much wider set of companies.

The absence of appropriate conduit relief imposes even greater costs on foreign multinational companies in view of their higher foreign source income and larger number of foreign shareholders (i.e. they have much higher levels of conduit income).

The greatest problems are likely to be experienced by those foreign multinational companies that are considering Australia as a potential location not for foreign direct investment, but for a location to set up their RHs to manage their operations in Australasia.

Appendix 1 details evidence that imputation reduces the cost of capital and that capital markets work at less than optimal efficiency because of information asymmetries.

2.4 What solutions should be considered?

The options A and C that have been raised for consultation need to be considered alongside the approaches other countries have been pursuing in order to reduce personal tax rates, the disincentive to save and invest, and the bias in favour of domestic investment. In particular, the following alternative options for reform need to be evaluated in detail in the medium term:

- Reduce the top rate of personal income tax while maintaining imputation.
- Apply a lower rate of tax to income from capital, particularly dividend income. This could be achieved through a range of options including the implementation of a dual income tax system, a split rate tax system, or a UK style notional tax credit regime. In particular, consideration needs to be given to abolishing the current imputation system and replacing it with a UK style notional credit approach. This would provide shareholders with a credit equal to some proportion of the value of the dividend, regardless of the amount of company tax paid on that income or its source.

We recognise that this evaluation would take some time.

In the meantime it is important for Australia to reduce the bias against the derivation of foreign source income that is contained in the imputation system. For this reason we recommend immediate action in respect of the options proposed for action, as follows:

- Implement option A, which involves the application of a UK style notional tax credit to the foreign source income that Australian shareholders earn from listed countries, but does so in the context of the existing imputation system. We believe, however, that the level of notional credit needs to be significantly larger than the one-ninth mentioned in RITA.
- Similarly option B needs to be considered in conjunction with the other options for providing conduit relief outlined in Chapter 3, including the implementation of a conduit holding company (CHC) regime.

The level of notional credit under option A needs to be set at a level, which substantially eliminates the tax bias against foreign source income. If foreign tax, including withholding tax, has been paid at a rate of 30 percent or more, the credit to provide neutrality would need to be three-sevenths of the dividend. There may be reasons why the effective foreign tax rate is less than 30 percent, eg some tax preferred income or some income earned in low tax restrictions, but these would not be sufficient to take the credit to as low as one-ninth. The vast majority of Australian investment offshore is in jurisdictions with company tax rates of 30 percent or greater. While some additional analysis will need to be done on this by Treasury, we would expect that the credit would need to be at least one-quarter and probably closer to three-sevenths.

2.5 How does the problem/solution relate to other options in the paper?

Option B should not be regarded as an alternative to either option A or option C. Rather, it is an option for clarifying the source of dividend income and ensuring that conduit income flows through Australian companies do not have adverse tax effects for either foreign or Australian shareholders. As such, it needs to be considered in conjunction with the other conduit reforms outlined in Chapter 3.

Options A and C also need to be considered in conjunction with option B as a means of relieving conduit income from tax when it flows through a number of Australian companies before it is repatriated offshore.

2.6 What priority should be given to resolving this problem?

Resolution of these two problems should be accorded a high priority.

Implementation of option B should proceed without delay.

In order to facilitate the evaluation of option A, high priority needs to be given to developing a much better understanding of the extent to which the current bias against investing offshore through Australian multinational companies is increasing the cost of capital of those companies. Such analysis would also help to determine the appropriate magnitude of the notional tax credit that should be provided under option A.

2.7 What are the benefits from adopting our recommendation?

Personal tax rates and income from capital

A reduction in the top marginal rate of income tax is likely to produce the greatest benefits for Australia since it would not only reduce the overall tax disincentive for Australians to save and invest, but also the magnitude of the current bias in favour of direct investment offshore. This is because the efficiency costs of taxing income from capital rise more than proportionately with the tax rate and most domestic saving and investment is undertaken by individuals subject to the top marginal tax rate.

There has been discussion over many years of reducing the top marginal rate. This represents a major reform that should continue to be considered in Australia because of the long-term benefits for savings and investment. This may not be feasible in the current context of international tax reform. If the Government is reluctant to reduce the top marginal tax rate in the near term, consideration should be given to the application of a lower rate of tax to income from capital or dividend income. In particular, we believe the UK style notional tax credit regime warrants much more detailed consideration than it was given in the Paper. Such an approach would:

- be consistent with international trends;
- reduce the overall level of personal tax imposed on dividend income, thereby reducing the extent to which the income tax regime deters Australians from saving and investing;
- reduce the bias in favour of direct investment offshore;
- potentially reduce the cost of capital for those Australian companies that have difficulty accessing the international capital market; and
- provide a simpler method of partially integrating the company and personal income tax regimes than is currently provided by imputation.

Imputation is currently seen as an essential component of the company tax system but it is also an extremely complex method of delivering the benefits that such a system provides. It is possible to deliver essentially the same benefits through a much simpler means. Reforms in other countries, notably the UK, point to how a dual rate system, possibly combined with notional credits, can deliver similar benefits but with considerable simplification. Despite the current attitude to imputation in

Australia, we believe the time may have arrived to evaluate alternative systems. Careful consideration would need to be given to any significant changes to the current imputation system.

As noted by Treasury, however, consideration would also have to be given to:

- the potential revenue costs of such an approach;
- the extent to which it might disadvantage shareholders on low marginal rates of tax; and
- the treatment of current stocks of imputation credits.

We recognise that these issues have a great significance for the relationship of Australian companies and their investors, and the achievement of these types of reforms will take some time.

But Australia needs action to resolve the abovementioned bias against foreign income that is implicit in the imputation system. To act against this bias consideration should be given to the implementation of option A, which involves the application of a notional tax credit to foreign source dividends from listed countries. Implementation of option A has the potential to:

- reduce the disincentive for Australian shareholders to invest indirectly offshore via Australian multinational companies by reducing the effective tax rate imposed on the income that Australian shareholders derive from their investments in listed countries;
- potentially reduce the cost of capital for Australian multinationals that have problems accessing foreign capital markets.

The main disadvantage of such an option is that it could be perceived to be inequitable to the extent that it would provide companies with a credit for tax regardless of the amount of tax actually paid. That is, it would benefit those companies that pay little foreign tax on their foreign source income from listed countries. This disadvantage would have to be weighed up against the reduced compliance and administrative costs associated with not having to determine the amount of foreign tax paid.

If option A was not feasible, we do not believe there would be much merit in proceeding with option C. The main benefit of this option is that it would at least provide Australian shareholders with relief from the foreign withholding tax levied on their dividend income. However, given the changes to the US double tax agreement and its likely flow-on effects, the fact that some countries do not impose withholding tax and the reluctance of companies to incur a withholding tax charge if it can be avoided, we see little merit in the option.

Regardless of the Government's decisions relating to options A, we recommend that the Government should implement either option B or a CHC regime that would enable conduit income to flow through Australian multinational companies without adverse tax consequences for either Australian or foreign shareholders. Such conduit relief would:

- reduce the effective tax rates imposed on the dividend income of Australian shareholders in Australian multinational companies with significant foreign investments and foreign shareholders, thereby reducing the current bias in favour of direct investment offshore;
- potentially reduce the cost of capital for those companies by reducing the effective tax rate imposed on the dividend income of foreign shareholders in Australian multinational companies;
- reduce the incentive for Australian companies to shift their operations offshore;
- reduce the need for Australian companies to set up complex dual listed company structures to stream foreign source income to foreign shareholders and Australian source income to Australian shareholders; and
- reduce the disincentive for foreign multinational companies to set up their RHs in Australia.

3 Controlled Foreign Companies

3.1 General

3.1.1 The context of our submission

For each country that has comprehensive CFC rules our experience is that the measures are invariably a complicated overlay on the tax aspects of cross border business, which are generally already complicated. Nevertheless, reform of the CFC measures is achievable.

Simplification in the legislative drafting of the CFC rules, though desirable, will not achieve the reform necessary to allow a more competitive environment for Australian multinationals. This will only occur if the overall policy is re-examined. Unfortunately, we are concerned that re-examining the basis of the CFC rules and a consequent general rewrite of the legislation (after the necessary consultation with interested parties) will be a protracted process.

Because Ernst & Young are mainly concerned here with the larger policy issues, despite option 3.3 for consultation, we have not set out in detail the myriad of technical issues under the CFC measures. This does not suggest that these issues are not important. However, many (if not most) of these issues are already known to both the ATO and to the Treasury and we understand that these have been made available to the Board.

We have therefore confined our submissions below to those that are of immediate concern to business because they interfere with the ability of Australian multinationals to compete with foreign companies. Most of the submissions set out below can be achieved without a general rewrite of the CFC measures. Given this pressing need to remove the business impediments on Australian multinationals, we believe that the limited ATO and Treasury International Tax resources available be focussed on the removal of immediate business impediments rather than towards a protracted rewrite of the CFC rules. The latter should be attempted in the medium term future not the short term.

3.1.2 Development of the CFC measures

It is important to put the current CFC measures in context.

The problems with the CFC measures, especially the treatment of tainted services income and the application of the measures to CFCs in a wide range of countries, arise because of the ad hoc development of the measures from 1988 to 1997.

By way of background, the CFC measures underwent several policy changes during their development in the late 80's. At their conception, the measures were anti-deferral mechanisms aimed at foreign companies resident in a small number of low tax jurisdictions (irrespective of whether or not the foreign company was controlled by Australians).[2]

However, as a result of consultation the Government modified its approach and proposed that the measures would be anti-avoidance measures rather than pure anti-deferral measures, and the measures would be based on the "entity approach".[3] Under the entity approach, the CFC was to be tested to determine whether it was mainly engaged in activities that would not lead to the minimisation of Australian tax through a range of specified activities (i.e. engaged in "active" business). If the minimisation of tax was present, all of the income, profits and gains of the CFC were to be subject to attribution. If there was no substantial minimisation of Australian tax the income, profits and gains of the CFC would be not be subject to any attribution. Whether a CFC was predominantly engaged in active business was to be measured by reference to the gross non-active income as a percentage of the total income. If the non-active income was greater than 5% of the total income the CFC would fail the test.[4]

This approach was abandoned in the final form of the CFC measures. Rather, it was decided that a "transactional approach" would be used, under which the individual transactions are tested. The identified income, profits and gains are then subject to attribution.

The change from an entity approach to a transactional approach should have resulted in a re-design of the measures. For whatever reason, this did not occur. Therefore, the final form of the CFC measures did not have the cohesive design that they might have had if, from the beginning, they were designed solely as anti-avoidance measures.

The main problem with the change is that a transactional approach requires a more precise analysis of the categories of income, profits and gains that may be subject to attribution.

The income, profits and gains that were taken into account as passive or tainted were not precisely developed. They were merely chosen as items that may indicate that the CFC was not predominantly engaged in active business to determine whether all of the income, profits and gains were to be attributed. The approach was accepted as being imprecise. Unfortunately, this imprecise development of the non-active categories was also used to test the income, profits and gains that might be attributed. Therefore, categories of income, profits and gains designed for one purpose were used for a different purpose. In our view, under a transactional approach the categories of income, profits and gains to be attributed should have been identified with more precision.[5]

The matter was made worse in 1997 with the restriction of the countries that would be treated as comparable.[6] As a result of the extension of the countries to which the full CFC measures will apply the problems with the imprecise categorisation of income that would be subject to attribution were vastly magnified.

In our view it is necessary to re-examine all classes of income, profits and gains that may be subject to attribution to determine whether, in a current economic and business environment, the tax leakage (if

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[2] As proposed in *A Consultative Document*. In effect, deferral of profits derived by a CFC resident in a low tax country was considered to be avoidance of the FTCS.
[3] *Taxation of Foreign Source Income An Information Paper 1989*.
[4] There were a series of other requirements, such as whether or not the CFC had a permanent establishment in its country of residence.
[5] For example, the Treasurer stated that there was no necessity for establishing a foreign company to hold shares in a foreign company (refer para 4.11 of the Information Paper). This statement is commercially unrealistic. This is relevant to whether a profit or gain on disposal of shares in an active company should be attributed.
[6] *Proposed Changes to the Taxation of Foreign Source Income An Information Paper December 1996*

any) is sufficient to warrant the compliance burden and impediments to competition created by the CFC measures.

3.1.3 Inter-relationship of problems/solutions

The existing CFC measures are concerned with the avoidance of tax. By definition it is necessary to first design Australia's international tax system in order to determine the nature and extent of any potential "avoidance". It is only then that the CFC measures can be designed. Therefore, other submissions in the Paper may be relevant to the final form of the CFC measures. The premise of the submissions on the CFC measures is that the measures will not be modified to be other than a tax avoidance measures (that is, the principle of capital import neutrality at the level of the CFC will not be changed).

It is difficult to separately place each option for consultation for the CFC measures in the context of the other options for consultation. Instead, we have attempted to summarise below the various interactions.

- The decision on whether to adopt the options for consultation set out in Chapter 2 or to retain the current system should not impact upon the changes recommended here.
- The decision to adopt Option 3.9 for consultation (taxation of non-portfolio dividends) will significantly impact upon the scope of the CFC measures because the entire policy on taxation of profit movement between foreign countries will be altered.[7]
- The decision not to attribute profits or gains on the disposal of shares in companies carrying on an "active" business can be made irrespective of other options.
- The decision to extend the list of broad-exemption listed countries (BELC) can be made irrespective of any other option.
- The decision to leave CFCs resident in a BELC out of the CFC regime can be made irrespective of other options. To some extent, a decision that profits and gains from the disposal of shares in companies carrying on a "active business" would further strengthen the case for total exclusion of CFCs resident in broad-exemption listed countries.
- Rollover relief for the transfer of assets within a group or for scrip for scrip transactions would be required irrespective of the decision made in regards any other option for consultation. Clearly, the circumstances in which rollover relief would be necessary would be restricted if, for example, attribution only applies to profits or gains on the disposal of shares in companies carrying on a "passive" business.
- Whether or not tainted services income should be removed as a category of tainted income of a CFC, or if not removed restricted, can be considered irrespective of any other option for consultation.

3.1.4 What priority should be given to resolving the problems?

Subject to any specific comments under a particular heading below, we consider that all of the problems should be accorded a high priority.

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[7] For example, this would remove the need for attribution of dividends and deemed dividends provisions. It would also remove the necessity to tax active income derived by a CFC in a listed country from sources in an unlisted country.

3.2 Limitation of attribution from broad-exemption listed countries (Option 3.3)

3.2.1 What is the current law?

Under the existing CFC measures as they apply to a CFC resident in a BELC, as a practical matter there are really only three basic categories of income and gains that may be subject to attribution, as follows. (Several others exist, but they are minor and in our experience, have little practical consequences.)

3.2.1.1 Interest and royalty income that is subject to a tax concession

As far as passive income is concerned, any interest (including amounts in the nature of interest) and royalties are specified in the Regulations. This seems to reflect a view that there would be no tax advantages in shifting operating income into these jurisdictions. Therefore, only the most basic forms of passive income have been addressed.

3.2.1.2 Capital gains that are exempt from tax

Regarding profits or gains of a capital nature, only capital gains from the disposal of an asset are taken into account. The practical effect is that profits and gains on disposal of certain intellectual property (brand names, trademarks, copyrights, etc) as well as gains on disposal of financial securities and shares could all be taken into account.

3.2.1.3 Income from a branch outside that country that is not subject to tax

Where income is derived from sources outside a listed country and is not subject to tax in any listed country, attribution of such income will occur irrespective of whether or not the income is passive income, tainted services income or tainted sales income. The reason for this category of attribution is to protect the dividend exemption. For example, if no listed country taxes the foreign branch income then an Australian company with operations in a low tax jurisdiction could conduct these operations through a company in a listed country and gain the benefit of the dividend exemption.

Further, where a CFC resident in a BELC derives income from sources in a listed country, that income will be attributed if it is passive income, tainted sales income or tainted services income. The reason for this is to prevent the use of the Regulations to shelter amounts derived in a limited exemption listed country that are not designated (for example, tainted sales and services income).

3.2.2 What is the problem?

The problem is twofold.

- First, because of differences in the exact tax treatment of income, profits or gains in different broad-exemption listed countries, an amount may be treated as subject to a reduction of tax even though the treatment is consistent with the country's general tax system, which has already been identified as comparable.
- The second problem is the level of compliance necessary. For example, the general compliance process would be to issue to the foreign subsidiary questionnaires that seek to elicit information on the income,

> profits or gains of the subsidiary. The questionnaires would then be returned to the Australian parent and analysed. Invariably, additional questions would need to be asked. The questions asked would need to accord with the definitions of the various categories of designated concession income, and may therefore need to be explained to the person completing the questionnaire. To make matters worse, that person may not have the necessary English skills to fully appreciate the issue, and the matter may need to be explained several times. The foreign tax treatment would then need to be examined. After all of this, in general no income is attributable. In our experience it is not commensurate with the additional Australian tax.

The combined effect is that the CFC measures impose non-neutrality compared to a non-CFC operating in the same jurisdiction, in circumstances where the risk to the Revenue is minimal.

3.2.3 What solutions should be considered?

The simple solution is to accept that no attribution would arise where a company is resident in a BELC. We have addressed below each category of attribution and can perceive no significant risk of avoidance.

We also believe that where a CFC is resident in a BELC that itself has a comprehensive CFC regime there should be no attribution of the income and gains of any subsidiary CFC, irrespective of whether the CFC is resident in a BELC or a non-BELC. Because the CFC systems of different countries vary widely, this exemption may not be widely applicable. However, certain CFC systems are comprehensive. For example, there should be no significant risk of leakage of Australian tax where the CFC is held through a CFC resident in the US. We suspect that the number of BELCs that would need to be considered and monitored in this context would be small.

3.2.3.1 Interest

Each BELC taxes interest income on the same general principles that apply to the taxation of other domestic source income. There may be some minor exceptions to the basic rule, but in our experience there would be no incentive to divert income to take account of these concessions. For example, certain bonds issued by the US Government may be exempt from tax, but these types of investments carry below market interest rates.

That being the case there will rarely be circumstances where interest will be attributable. Notwithstanding that, it is necessary to go through the compliance burden of identifying all of the interest income (including trade discounts) and then examine that income to determine whether it is subject to a tax concession. This process is time consuming in circumstances where the risk to the revenue is minimal.

3.2.3.2 Royalties

Similarly to interest, all of the broad-exemption listed countries taxes royalties. All of them, similar to Australia, allow amortisation of intangibles to some extent but as far as we are aware no rate of amortisation would warrant moving intangibles to that jurisdiction. Whether or not the income is taxed on exactly the same basis as it is in Australia should not give rise to a concern.

3.2.3.3 Capital gains

Of the broad-exemption listed countries, only New Zealand does not have a general capital gains tax. Other than that, the only significant category of untaxed capital gains in other countries is substantial interests in shares. Therefore, the same considerations as applies to other categories of income should be applicable to capital gains derived by companies resident in those other six countries. That is, since it has been accepted that those countries tax systems are broadly comparable to Australia's, the tax system prevailing in those countries should be left to deal with capital gains.

Concentrating on New Zealand, the main categories of profit or gain that could be attributable under the CFC rules are as follows.

- Gains on financial instruments.

  These will generally be treated as passive income under the CFC measures, although sometimes this would be dealt with under the CFC measures not on disposal but on an accrual basis as "interest".

  New Zealand has a comprehensive financial accrual regime, so that the inherent gains will be taxed on an accrual basis. Any remaining gain on disposal or expiration of the financial asset should be taxed on revenue account. Therefore, it is unlikely that these transactions would in any event give rise to attributable income and the compliance is substantial.

- Gains on disposal of certain land leased may be taxed under the CFC measures.

  The taxation of gains on disposal of land is not consistent with the basic anti-avoidance policy of the CFC measures. In particular, it is difficult to see what avoidance possibilities the investment in land in a foreign jurisdiction raises. Therefore, in our view this category of passive income should not be subject to accruals taxation under the CFC measures. It is our basic contention that a fundamentally immovable asset cannot give rise to diversion of income from Australia.

- Gains on disposal of certain intangibles may be taxed under the CFC measures.

  The scope for shifting such assets to New Zealand is minimal. The income from these intangibles is fully taxed in New Zealand. While a deduction for amortisation of the intangibles is allowed, the level of amortisation is not sufficient to provide tax avoidance opportunities.

  Once again, given the rate of tax in New Zealand on royalties, the fact the regime is conditional and Australia's allowance of amortisation deductions for most intangible assets anyway, the risk of an Australian company transferring its intangibles to a New Zealand company for Australian tax reasons is minimal.

  However, if it is considered that there may be a residual risk, the matter can be easily dealt with as discussed below.

- Gains on disposal of shares.

  These may be taxed under the CFC measures irrespective of the level of shareholding of the CFC in the foreign company.

  For example, while New Zealand does not have a capital gains tax, it still relies on the common law distinctions between items on revenue account and items on capital account. Therefore, gains arising from share trading and gains where the shares are bought for the purpose eof profit making by resale will be taxed in New Zealand. This only leaves as taxable pure passive investments. As a practical matter this will be gains on the disposal of non-portfolio interests (generally, disposal of interests in subsidiaries).

  If capital gains on the disposal of non-portfolio interests in foreign companies are exempt from tax on the basis that the underlying income is active (Option 3.10 for consultation), the scope for taxation of capital gains that may be included in attributable income is further reduced, most likely to the point where the taxing the remaining gains becomes de minimis.

  Again, if you consider that there may be a residual risk, the matter can be easily dealt with as discussed below.

There may be other capital gains exemptions such as the recently enacted exemption from UK capital gains tax for non-portfolio interests. However, we have submitted that there should be an exemption of profits and gains from shares in companies that carry on activities that are predominantly active. The UK capital gains tax exemption requires that the company sold carries on an active business. Therefore, if the submission to exempt from attribution profit and gains from the disposal of shares in an active company was proceeded with, the UK exemption would carry no risk to the Australian revenue.

3.2.3.4 Branch income

Active income that is derived by a CFC resident in a BELC from sources outside a BELC can be attributed under the CFC measures if the income is not subject to tax in a listed country. However, BELCs generally tax income sourced outside the BELC on the same general principles that apply to the taxation of income with a source in the BELC. Therefore, this foreign source of the CFC would usually be subject to comparable tax in the BELC and there would be no need to attribute the amount. Notwithstanding that, it is necessary to go through the compliance burden of identifying all of the income of the CFC derived outside of the BELC and then examine that income to determine whether it is subject to tax. If it is not subject to tax it must be attributed, even though had it been derived from sources in the BELC it would not be attributable.

3.2.3.5 Dealing with the residual risk for capital gains

If it is perceived there is a residual risk for inappropriate non-taxation of capital gains made by a CFC resident in a particular BELC, there could be a more limited system for designating certain types of capital gains as subject to attribution. However, we submit that this approach is unnecessary.

For example, it would be simple to have a very limited list in the Regulations of the relevant BELC and the type of capital gain for that country. For example the Regulations could identify “New Zealand” and designate “capital gains on disposal of shares”.

3.2.4 How does the problem/solution relate to other options in the paper?

As far as we can discern, the solution does not impact on the other options in the Paper.

3.3 Extension of the list of broad-exemption listed countries (Option 3.4)

3.3.1 What is the current law?

As set out in the Paper.

3.3.2 What is the problem?

In many countries, we find there is no or negligible tax impost under the CFC measures because of the local rate of tax is comparable to Australia’s and the comprehensive tax base. Therefore, we believe that there should be a focus on reducing the compliance costs of the CFC measures provided the integrity of the measures is not compromised.

3.3.3 What solutions should be considered?

Even if the attribution of income from a CFC resident in a BELC is to be eliminated or severely restricted, there is scope to extend the list of broad-exemption listed countries and reduce the compliance burden of the CFC rules without affecting their integrity.

We understand that the development of the current list of broad-exemption listed countries was influenced by the relative importance of each of the countries as trading partners. However, it is appropriate to consider extending the list of broad-exemption listed countries without necessarily focussing on major trading partners, for the following reasons.

- The statistics on trade with a country have no necessary co-relation with the level of investment through companies resident in that country. This is clearly shown by the inclusion of Japan on the current list of broad-exemption listed countries. Specifically, notwithstanding the level of trade with Japan, Australian multinationals do not often have a subsidiary resident in Japan.

- The converse is also true in that Australia may not have a significant level of trade with the foreign country, albeit that country is a significant destination for foreign investment.

- Further, a country may be a significant final destination for investment by Australian multinationals, but this may not be apparent from the available empirical evidence. For example, as far as we are aware, the data on Australian investment in foreign countries only discloses the immediate destination of the capital, not the final destination.

- The historical pattern of trade (and also investment) does not fully reflect the growth of trade in new markets and the increase in investment in particular countries. It is therefore a static measure of the importance of a jurisdiction.

In extending the list, we believe there are several conditions that would need to be fulfilled.

- The country must have a headline corporate tax rate approximately equal to, or greater than, Australia's. We suggest that a rate of at least 80% of the Australian rate would be sufficient. The 80% test provides a margin for small movements in headline rates. Further, it is unlikely that a 20% saving on tax would influence a person to divert income to a foreign company.

- The country must have suitable transfer pricing rules.

- The country should have a comprehensive income tax base. However, the country need not have a tax on capital gains or have a CFC system. Further, no regard should be had to particular concessions that are commonly available in Australia (eg R&D incentives, film incentives etc)

- Australia and the country must have entered a DTA. The existence of a DTA means that Australia is already reasonably comfortable that the country is not a tax haven. Further, and more importantly, the DTA ensures a level of sharing of information between the countries so that changes in the tax rules of the country can be readily assessed initially and on an on going basis. As we understand, it is already the case that Australia's treaty partners annually advise Treasury of the changes that occur in their country's tax system.

- As far as is possible, political considerations should be avoided in the decision on whether or not to include a company on the list of broad-exemption listed countries. We do not believe this should be a significant factor in any decision to move to a broader list.

  The listing approach in 1990 may have been influenced by political concerns. However, no concern should arise for the distinction between BELCs and other listed countries. A narrower list of BELCs would not imply that a country is a tax haven, but rather that the level of comparability between that country's and Australia's tax systems is not sufficient. Provided the factors to be taken into account for inclusion were clear, the non-inclusion of a country would be able to be justified in a public and transparent way.

In any event, as a pragmatic matter, it is doubtful that many countries pay particular attention to Australia when developing their CFC measures. To the extent that particular countries raise objections, those will need to be dealt with on a case-by-case basis.

The listing rules should provide also for the foreign country tax environment to be determined not only using its generic income tax environment but also looking to specific taxation regimes in place for foreign investment. In particular we note that many countries which have somewhat undeveloped tax environments have introduced strong and specific tax regimes for foreign investment into the oil and gas and minerals industries, which are highly developed and comparable-tax regimes. These specific regimes (often drafted by lawyers or tax advisers from developed countries like Australia, UK or US and modelled on their home country rules) provide for a high level of coverage and anti-avoidance rules.

For example, we are aware of a company conducting business in a branch in Tunisia. The corporate tax rate is 35% in Tunisia, however pursuant to the oil exploration permit issued to the company by the Tunisian Government, the company must pay income tax in Tunisia at approx 50% in relation to its entire income.

This illustrates our proposition that the criteria and processes for the listing of countries need to have sufficient flexibility to deal with varying tax practices in the countries where Australian companies might operate.

3.3.4 How does the problem/solution relate to other options in the paper?

As far as we can discern, the solution does not impact on the other options in the Paper.

3.4 Taxation of shares in a company with predominantly active assets (Option 3.4)

3.4.1 What is the current law?

Under the existing provisions, most assets used by a CFC in carrying on business will be outside the scope of the CFC measures. However, the sale of shares will generally be within the scope of the CFC measures.

3.4.2 What is the problem?

This issue has been discussed in the conduit context in considering whether or not to provide an exemption from the taxation of capital gains made by an Australian resident on the disposal of a non-portfolio interest in a foreign company. However, in the CFC context this is a different issue.

In the CFC context, the problem is that the taxation of shares is not consistent with the taxation of underlying assets. This can create a preference for asset sales over share sales, a bias that is not appropriate. This issue has been the subject of significant consultation. Further, we are aware that it has been the subject of an independent consultant's report commissioned by the Treasury and / or the ATO.

3.4.3 What solutions should be considered?

An exemption should be provided for any profit or gain on disposal of a company with active assets where a profit on the disposal of the underlying assets would not be subject to attribution under the CFC measures. The exemption would only be applicable for corporate attributable taxpayers.

Where a CFC disposes of shares in another CFC, that other CFC may not have second tier subsidiaries. In that case, the exemption would be reasonably simple to design. At least three basic approaches could be taken.

- The test could be designed so that the profit or gain on disposal of the shares would be exempt if the accrued profit on the underlying active assets was more than a specified percentage of the total profit on disposal of the shares. For example, if the profit or gain on the underlying assets was at least equal to (say) 50% of the profit or gain that would otherwise be included in the attributable income. The advantage of this approach is that it more closely follows the logic for providing the exemption. That is, if the underlying assets were sold the profits on the active assets could be remitted exempt from tax, which would reduce the gain on the disposal of the shares.

- Alternatively, the test could be designed so that the profit or gain on disposal of the shares would be exempt if the gross value of the underlying active assets is more than a specified percentage of the total assets (for example, 50%). The advantage of this approach is that it would better follow the process of selling a company. In particular, in determining the value of a company no regard would be had to the profit or gain on an individual asset. Rather, the value of the assets would be taken into account. Therefore, this approach is likely to cause less compliance difficulties.

- Like any bright line test, there will be transactions at the margin that, objectively, should not have been subject to the CFC measures (or conversely should have fallen within the CFC measures). Setting a line of demarcation should be achievable. However, an all or nothing approach as set out above may be considered arbitrary. If it were decided that a bright line test were not appropriate, the exemption could be allowed to the extent that the profit on disposal of the shares in the CFC is referable to profits attributable to the underlying active assets. This approach may be more equitable but is likely to fail the simplicity test.

The exemption becomes more complex where the CFC disposes of shares in a CFC that has an interest in lower tier CFCs. However, the fundamental policy is the same – that is, the sale of shares should be exempt where the underlying assets are "active". There are two obvious approaches to the problem.

- The shares in each subsidiary could be treated separately. How this would be achieved mechanically would be dictated by the approach taken above. That is, if the exemption was on the basis of assets, the gross value of the shares in the lower tier CFC would be ignored; if the exemption was on the basis of profits, the profit on the shares in the lower tier CFC would be ignored, etc.

- The group sold could be analysed on a consolidated basis and the relevant test applied.

All of the above is intended only to indicate that there is a range of different approaches. At present, we have no firm recommendation on which of these alternatives would be preferable, or whether a different approach would be more attractive.

3.4.4 How does the problem/solution relate to other options in the paper?

The exemption for a profit or gain on disposal of shares in a CFC by a company resident in a listed country has no implications for other areas of the Paper.

3.4.5 What priority should be given to resolving this problem?

Resolution of this problem should be accorded a high priority

3.5 Expansion of roll-over relief under the CFC measures (Option 3.1)

Option 3.1 for consultation raises the possibility of modifying or extending the present provisions that allow for a deferral of tax where a CFC transfers an asset. Irrespective of the decisions made regarding other options for consultation, restrictions on rollover under the CFC system may remain a significant impediment to offshore restructures.

Given the different types of rollover, we have separated our comments into the following categories of deferral of the taxation of an attributable taxpayer.

- Rollover relief according to the tax law of the BELC of residence of the transferor CFC.
- Rollover relief for the transfer of assets between companies in the same wholly owned group.
- Rollover relief for the transfer of shares in a company in exchange for other shares in a company (scrip for scrip relief).
- Rollover relief for the divestiture of shares in a subsidiary to its shareholders (de-merger relief).

While there is a pressing need for wider rollover relief in the CFC context, there is also a wide range of different circumstances where unrestricted scrip for scrip or de-merger relief could apply, and some of these may lead to tax leakage.

To deal with the most pressing needs of business but still prevent any significant scope for tax leakage, we suggest that there is a staged approach to the extension of rollover relief. The first stage should not await a full review of the CFC measures and would consist of the following.

- Full rollover relief based on the relief provided by the BELC of residence of the CFC.
- Full rollover relief for the transfer of assets within a wholly owned group.
- Partial relief for scrip for scrip transactions

This whole area of rollover relief is a difficult issue, but we believe that a suitable balance between the needs of business and the protection of the revenue is achievable. We have therefore later in the submission set out a brief consideration of the issue. However, the matters are too difficult to deal with in full in these submissions. Therefore, we suggest that a working party of Treasury and interested parties be established that would report back to the Government. This process should be given a short time frame and would need to make firm recommendations. This will ensure that the issues are properly considered but at the same time the issue is dealt with as a priority.

The second stage would consist of consideration of the provisions of wider rollover relief for scrip for scrip transactions, or any other rollover that would provide Australian multinationals greater scope to reorganise to engage in competition in foreign markets, including de-merger relief. Depending on the timing of the general review of the CFC measures and the expected time it would take to complete that review, the second stage could occur in conjunction with any general review.

3.6 Rollovers allowed in a BELC (Option 3.1)

3.6.1 What is the current law?

Under the current law, rollovers are recognised in two circumstances.

The first type of rollover is allowed where the CGT provisions apply in the calculation of the attributable income of a CFC. This was fashioned on the rollover under domestic law and can apply to a CFC resident in any foreign country. It is relevant once a profit or gain on the disposal of an asset that needs to be taken into account under the CFC measures has been identified. The purpose is to allow for the deferral of the attribution of that gain.

The second type of rollover is available where a CFC is a resident of a broad-exemption listed county. This rollover is used to identify whether there is a profit or gain that needs to be taken into account in the calculation of the attributable income of a CFC. That is, it identifies whether the gain is to be treated as eligible designated concession income. In this case too, the rollover is only allowed where both companies are resident in the same wholly owned group.

3.6.2 What is the problem?

In order to restructure operations and enter joint ventures and so compete with local business on a level playing field, the restructure relief available under the local law should be allowed. It is difficult to see why the deferral of the tax on a capital gain that is allowed under the tax law of a country that has a tax system comparable to Australia's should not be acceptable.

3.6.3 What solutions should be considered?

Where a CFC in a BELC disposes of an asset and there is rollover relief under the relevant domestic jurisdiction, there should be no attribution of a capital gain irrespective of whether there is a similar rollover relief in the domestic Australian context. This would reduce significantly the amount of compliance costs for taxpayers and ensure economic gains are not taxed until realised.

3.6.4 How does the problem/solution relate to other options in the paper?

This issue directly relates to the extension of the list of broad-exemption listed countries and to the exemption for all income and gains in that BELC.

3.6.5 What priority should be given to resolving this problem?

In our view this should be part of the first stage review in conjunction with the consideration of the extension of the list of broad-exemption listed countries and the exemption for all income and gains derived by a CFC resident in that BELC.

3.7 Rollover of assets within a wholly-owned group (Option 3.1)

3.7.1 What is the current law?

Under the current law, rollovers are recognised in two circumstances.

The first type of rollover allowed is in the notional application of the CGT rules in the calculation of the attributable income of a CFC. This was fashioned on the rollover under domestic Australian law. Those provisions are then modified to restrict their application.[8] The restriction operates as follows.

	Same BELC	Another BELC	Limited	Unlisted	Australia
BELC to	Yes	No	No	No	Yes
Limited to	n/a	No	Yes	Yes	Yes
Unlisted to	n/a	No	Yes	Yes	Yes
Australia to	n/a	No	No	No	Yes

Second, where a CFC is a resident of a BELC, there is a rollover under the Regulations that determines whether a profit or gain is taken into account as eligible designated concession income.[9] The rollover is only allowed where both companies are in the same wholly owned group. The purpose of the current restrictions on the rollover of assets by a CFC is described as being "to protect integrity of the CFC rules and to prevent non-portfolio dividends from companies resident in unlisted countries being routed through a listed country".[10]

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[8] The rollover was fashioned on s 160ZZO of the ITAA 1936 and now operates by reference to s 126-B of the ITAA 1997. Their application is restricted in the calculation of the attributable income of a CFC by s 412 of the ITAA 1936.

[9] Refer reg 152E to 152G of Part 8A of the *Income Tax Regulations 1936*. The provision operates only where the broad-exemption listed country allows the rollover. Where no rollover is allowed under the tax law of the broad exemption listed country, an attributable taxpayer could rely on the rollover under s 412 (for example, for the disposal of an asset by a CFC resident of New Zealand).

[10] Page 57 of the Paper.

3.7.2 What is the problem?

Regarding a disposal where the transferee is a resident of a non-BELC, we expect that the existing "integrity" concern is as follows.

- A CFC resident in a non-BELC could transfer an asset to a CFC resident in a BELC free of foreign tax.
- The tax law of the transferee's BELC of residence could provide that the transferee CFC would have a cost for foreign tax purposes equal to the cost of purchasing the asset.
- Provided that an arm's length amount was given as consideration for the purchase of the asset, on subsequent disposal of the asset the amount of the gain that would be subject to tax would be limited to the gain arising after the time of the transfer (that is, there would be a step up in basis)
- Although the gain accrued to the time of the initial disposal would be effectively free of tax, the actual gain on subsequent disposal of the asset would be subject to tax in the listed country and would not fall within the Regulations as a capital gain that is exempt from tax.
- The accrued gain would therefore not be subject to foreign tax or Australian tax.

The same concern would arise for a transfer of an asset by a CFC resident in one BELC to a CFC resident in another BELC. In terms of the underlying policy this outcome might be inappropriate. Rollover relief was also precluded where the transferee was resident in an unlisted country. In the case of a CFC resident in a BELC transferring an asset to a CFC resident in a non-BELC, it is not clear what integrity concern arises.

In our view denying a rollover as a method of dealing with the potential tax leakage is inappropriate.

3.7.3 What solutions should be considered?

Even if a decision is made not to extend the list of broad-exemption listed countries or to limit the attribution for those countries, there is no reason to restrict wider rollover relief for the transfer of assets within a wholly owned group. Rather, it is an issue of ensuring that on the subsequent disposal of an asset the gain is dealt with under the CFC measures.

Basically, if the transferor and the transferee CFCs are 100% group companies, the attributable taxpayer will be subject to attribution in respect of both companies.

Consistent with the general approach for inter company transfers, the accrued gain on subsequent disposal of the asset by the transferee CFC would need to be taken into account in the calculation of the attributable income of the transferee, or be subject to tax in a BELC.

In essence, the accrued gain would be deferred and subsequently recognised and subject to attribution if it were not taxed in a BELC.

3.7.4 How does the problem/solution relate to other options in the paper?

As mentioned in the background, the intra-group rollover has no implications for other area of the Paper.

However, the circumstances in which the disposal of the asset would be taxed (and therefore the scope of this relief) would be reduced if no income, profits or gains of a CFC resident in a BELC were to be taxed. Further, even if this is not the case, if rollover relief were allowed consistent with that of the BELC of resident of the CFC, the scope of the issue would be somewhat reduced.

3.8 Rollover of assets under a scrip for scrip transaction (Option 3.1)

3.8.1 What is the current law?

A taxpayer can choose to obtain rollover relief when interests held in one entity (the original interests in the original entity) are exchanged by the taxpayer for replacement interests in another entity (the acquiring entity).

The acquiring entity must enter into a single arrangement with the holders of interests in the original entity to acquire voting shares. As part of the offer, the acquiring entity must exchange replacement interests that are similar to the taxpayer's original interests. In consequence of the exchange, the acquiring entity must acquire at least 80% of the voting shares. For closely held companies, the parties must also deal at arm's length.

The effect of the rollover is to:

- defer any capital gain arising from the exchange of the original interest for the replacement interests as part of the takeover or merger. Any capital gain is deferred until a CGT event occurs in respect of the replacement interest; and
- ensure that the cost base of the replacement interest is determined on the basis of the cost base of the original interest.

Scrip for scrip rollover is not available if the taxpayer and the acquiring entity were members of the same wholly owned group just before the exchange.

The scrip for scrip measures can already apply to the calculation of the attributable income of a CFC. Originally, the rollover was available in the same way as it would be available for any resident taxpayer. Subsequent to the enactment of the scrip for scrip rollover, the law was amended to limit the rollover available in the calculation of the attributable income of a CFC. The reason for the amendment was described as follows.

> "Currently, scrip for scrip Rollover is available for arrangements involving a non-resident original company and a non-resident acquiring company. Allowing Rollover for these arrangements could, however, facilitate the tax free repatriation of low taxed profits under the exemption for foreign dividends (section 23AJ of the ITAA 1936)." [11]

However, it is noted:

> "In Treasurer's Press Release No. 74 of 11 November 1999, it was announced that a comprehensive review would be undertaken of the foreign source income rules. It is proposed

[11] Refer para 11.51 of the EM to the *New Business Tax System (Miscellaneous) Bill (No. 2) 2000*

that the application of the scrip for scrip rollover to arrangements involving non-resident companies be further considered as part of that review."[12]

3.8.2 What is the problem?

As discussed above, the inability to restructure without a tax impost under the CFC measures can place Australian companies at a competitive disadvantage when compared to non-residents operating in the same jurisdiction.

For example, this could arise because those competitors can take advantage of scrip for scrip rollover relief in their jurisdiction. Consequently there would be no cost of the competitor converting to a more efficient structure or combine with other players without a tax cost.

Even if there is no local relief, Australian multinationals could be placed at a disadvantage if the Australian multinational needs to establish a critical mass in the foreign jurisdiction to compete against other companies that have already achieved that critical mass. The Australian multinational's attempts to combine with another player in the market may be hampered by the Australian tax impost.

3.8.3 What solutions should be considered?

The solutions to be considered may be different depending mainly on the circumstances of the transferee. There are three categories for the transferee.

- The transferee might be a CFC resident in a BELC.
- The transferee might be a CFC resident in a non-BELC.
- The transferee might not be a CFC.

Further, the asset might be shares in either a CFC or shares in a non-CFC.

3.8.3.1 CFC transfers shares in a CFC to a CFC resident in a BELC

Unrestricted scrip for scrip relief should apply where the CFC exchanges scrip in a company for scrip in a CFC resident in a BELC.

In this case, the concern would be that any profit or gain on the subsequent disposal of the shares in the target or the acquirer would not be subject to attribution because the BELC did not tax the accrued gain. This is the same as the concern expressed above for rollover relief for the transfer of assets within a wholly owned group. The same requirements could be inserted here. That is, it would be simple to provide that the accrued gain would be deferred and subsequently recognised and subject to attribution if it was not subsequently taxed in a BELC.

Otherwise, there should be no tax leakage on the following bases:

- After the scrip for scrip transaction the attributable taxpayer would have an attribution interest in the acquirer. Any profit or gain on subsequent disposal of the shares in the target company would be included in the attributable income of the acquirer CFC.

[12] As above

- The cost base of the shares in the acquirer would be the same as the transferor's cost base of the shares in the target company.
- The cost base of the shares in the target company would be the same as the original cost base to the transferor. This assumes that the transferor CFC and the acquirer are linked, which should be the case since the acquirer is a CFC. If there were any concern here, the cost base for the acquirer would need to carry over from the transferee.
- Prior to and after the scrip for scrip transaction the target company may be a CFC and there may or may not have been attribution of the income of the target company. It is therefore arguable that the nature of the target company's income and assets is relevant. However, after the scrip for scrip transaction the attributable taxpayer would still have an attribution interest in the target company, albeit the attribution interest may be smaller. Ostensibly, this could give rise to a reduced attribution of any profit the income or gains of the target company or any profit or gain on the subsequent disposal of the shares in the target by the acquirer. However, this is mitigated in that the interest in the assets of the transferee is likely to be of a similar nature.

3.8.3.2 CFC transfers shares in a CFC to a CFC resident in a non-BELC

Where the CFC exchanges scrip in a CFC for scrip in a CFC resident in a non-BELC the same scrip for scrip relief should apply. This should give rise to no concerns since:

- After the scrip for scrip transaction the attributable taxpayer would have an attribution interest in the acquirer company. Any profit or gain on subsequent disposal of the shares in the target company would be included in the attributable income of the acquirer CFC.
- The cost base of the shares in the acquirer would be the same as the original cost base to the transferor.
- The cost base of the shares in the target company would be the same as the original cost base to the transferor. This assumes that the transferor CFC and the acquirer are linked, which should be the case since the acquirer is a CFC. If there were any concern here, the cost base for the acquirer would need to carry over from the transferee.

3.8.3.3 CFC transfers shares to a non CFC

Where the CFC exchanges scrip for scrip in a non-CFC the same scrip for scrip relief should apply.

At the level of the transferor the transaction is merely the exchange of one economic interest for a similar economic interest and the values of the interests are no different. At this level (subject to the comments above regarding the acquirer being resident in a BELC) there will be no detrimental effect, since the new shares received by the CFC will still be attributable under the CFC measures.

The only additional concern would be that the disposal of the shares in the target would not be subject to attribution and (if the acquirer is resident in a listed country) it may be possible to remit the profit or gain to the Australian attributable taxpayer free of Australian tax. This is likely to be one of the concerns envisaged when scrip for scrip relief was limited. It should not be difficult to alleviate this concern. First, in blatant cases the general anti-avoidance provision would apply. Second, the issue is not so much that the shares in the target may subsequently be sold but that this may occur within a short period. This concern may be alleviated by, for example, providing that the rollover can be reversed where an acquirer resident in a listed country does not satisfy a minimum holding period.

Otherwise, the result should not cause tax leakage on the basis that the cost base of the shares in the acquirer would be the same as the original cost base to the transferor.

3.8.4 How does the problem/solution relate to other options in the paper?

As mentioned in the background, the intra-group rollover has no implications for other area of the Paper.

However, the circumstances in which the disposal of the asset would be taxed (and therefore the scope of this relief) would be reduced if no income, profits or gains of a CFC resident in a BELC were to be taxed. Further, even if this is not the case, if rollover relief were allowed consistent with that of the BELC of resident of the CFC, the scope of the issue would be somewhat reduced.

3.9 Services Income (Option 3.2)

3.9.1 What is the current law?

Tainted services arise where the CFC derives income from services provided to a resident or an associate. This amount might then be attributed to an Australian shareholder in proportion to the shareholder's interest in the CFC.

Apart from a same country exemption and some minor exclusions income from services provided to a resident of Australia or to an associate will be attributable.

This can be distinguished from tainted sales income. First, tainted sales income only applies where there is a purchase from or sale to a resident of Australia who is an associate of the CFC. Second, there is an exclusion from tainted sales income for substantial manufacture, alteration or production.

The same considerations as apply to the treatment of tainted services income are relevant to the treatment of passive income. In particular, the royalty income that is treated as passive income is confined to royalties paid by associates and other royalties where the CFC developed or substantially modified the intellectual property.

3.9.2 What is the problem?

The issues have already been substantially identified in the Paper. We also note that the issue does not relate solely to tainted services income. Other income that is considered to be passive in nature can also give rise to attributable income where, due to the expansion of Australian multinationals offshore, the activities giving rise to the income are properly located offshore (tainted royalty income is an example of this issue).

As noted in the history of the development of the CFC measures, the definition of tainted services income was developed for a different purpose. Further, to a large extent it seems that it has been lifted from the definition of tainted income in the US Sub-Part F. Therefore, it is not clear that tainted services income was examined with any great degree of precision. However, there were some clear effects of the definition tainted services income.

First, a significant purpose of the CFC provisions was generally (not merely for services income) to act as quasi transfer pricing provisions. This rationale (for both sales and services income) is less relevant, given the development of the administration of transfer pricing rules since 1990.

Beyond the transfer pricing element of the provisions, there was a non transfer pricing element associated with the diversion of activity from Australia where Australian tax advantages could be a major consideration in the decision to relocate the activities.

In the case of tainted sales income, exclusions from tainted sales income for manufacturing (and later alteration and production) accepted that the risk to the Revenue from relocating profit-generating activities outside Australia was small. As mentioned in the Paper, foreign tax considerations may influence the location of the activities but would not drive the decision to locate activities offshore.

As a result of consultation, it was also accepted that often a foreign manufacturing CFC located in one country might need a distribution company in another foreign country. To apply the CFC measures here would impact normal commercial arrangements. Last, even where an Australian resident was part of the supply chain, it was accepted that no income could be diverted from Australia unless an Australian associate was involved in the supply chain.

In the case of tainted services income, the potential revenue leakage was seen as greater. In this case there was a policy assumption that Australian tax considerations would be a significant driver in the decision to establish activities outside Australia. Therefore, there could be tax leakage any time that services were provided to an Australian resident. Further, the thinking was that there might have been some difficulty in formulating a test that would distinguish between "active" and "tainted" services. It is important to note that there was never a policy rationale that dictated that services provided by a CFC to a third party were inherently the subject of tax avoidance. It was subsequently recognised that services provided to an associate in the same jurisdiction were not inherently the subject of tax avoidance and these services were excluded from tainted income.

Attached to this there might have been a perception that services provided by Australian multinationals from offshore were not a significant part of the economy and the location of such services offshore, while sometimes justifiable, would not be generally justifiable.

We are not aware that any empirical or anecdotal evidence was provided during the original consultation that supported the assertion that services provided to an associate were the subject of tax avoidance.

3.9.3 What evidence is there of the problem?

The evidence of the problem is merely anecdotal. However, we have set out below some obvious examples of the shortcomings of the current operation of the CFC measures.

3.9.3.1 Services relating to an active business in the corporate group

It is clear that services will often be provided in connection with a particular activity that is accepted under the CFC measures as being an "active" business. However, it may not be feasible to carry on these services from Australia. For example, management services provided to several manufacturing activities in Asia may be logically provided from one country in Asia (eg Singapore to Malaysia), but could not feasibly be provided from Australia. This is also common where the manufacturing activities are located in China but a company resident in Hong Kong provides the management services.

The rules governing tainted services income then become extremely arbitrary. This can best be displayed by contrasting these situations.

- Under the first scenario, a CFC manufactures in several jurisdictions. Each company is set up in a separate company resident in the jurisdiction in which the company carries on the activities, and the companies are in close geographical proximity. The services necessary to conduct the operations of each company are located in each company. There is therefore no service provided to an associate and no attribution arises.

- Under the second scenario, the same CFCs conducts the same manufacturing activities. However, to avoid duplication of services all of the service providers are employed by the one company. There will be no attribution from the company that houses the employees etc in respect of the manufacturing of that company. There will be attribution of the income derived from the services provided to the other CFCs.
- Under the third scenario, the same activities are conducted in the same location and in respect of the same manufacturing activities, but the services are provided from a separate services company. Nothing has changed from the previous example other than the legal structure. If the CFC providing the services is located in the same jurisdiction as one of the manufacturing CFCs, attribution will occur in respect of the services provided to the CFCs in the other jurisdictions. However, if the CFC providing the services is located in another jurisdiction there will be attribution of all of the services income.

3.9.3.2 Services that can only be provided outside Australia

Some services are inextricable linked to the business carried on outside Australia because (for example) the assets employed in the business are outside Australia. While in some cases this issue might be solved by ensuring the services are provided as part of the activities of the CFC that uses the services (albeit at cost to the corporate group) this is not always possible.

The most obvious example of restrictions on the provision of services from the same company is in regulated industries were activities must be provided by a separate company to the company holding the assets. In this case, the operating company would need to pay for the provision of services and the income would be subject to attribution (note that the issue can also be relevant to tainted rental income royalties).

However, this might apply in any case where separation of the assets and the operating business is a commercial imperative. For example, different parties to a joint venture may contribute assets to the joint venture and the joint ventures may provide services to the joint venture partners or the joint venture part may provide services to the joint venture. Either way tainted services income could arise.

The result is that Australian investors are disadvantaged, perhaps to the point where they must pass up opportunities to their competitors.

3.9.4 What solutions should be considered?

There are at least two solutions to the problem of tainted services.

3.9.4.1 Delete the category of tainted services income

The most obvious and direct solution is to delete the category of tainted services from type of income that may be subject to attribution. This would be the simplest option, given we do not believe there is significant scope for diversion of income from Australia and it would avoid complex definitional issues in identifying active services

3.9.4.2 Restrict the category to certain services provided to certain associates

However, if there is a perception that the CFC measures still need to act as an adjunct to Australia's transfer pricing provisions, the services should be restricted to those provided to an associated

Australian resident. The risk to the revenue of transfer pricing between parties that are not associates is minimal, and if present can be left to the normal transfer pricing provisions. Services between associated non-residents need not be covered because there is no element of transfer pricing from Australia.

In any event, once services are included to any extent in tainted income exclusion should be provided for services provided as part of an active business. In our view the "active" services can be separated into two categories.

- Services that are provided in connection with an active business of the CFC or of another associated CFC.
- Services that, on a stand-alone basis, are part of a business of providing those services.

At the very least, it should be accepted that services will be provided in connection with an active business where the services are provided wholly or primarily to facilitate the use by a CFC, or associate, of plant, machinery, equipment or other assets owned, leased or controlled by an associate. The equipment etc would need to be located primarily outside Australia. Services will also be provided in connection with an active business where the services facilitate the provision, directly or indirectly of sales to non-residents where the sales are not tainted.

In the case where it is the services themselves that constitute an "active" business, it is unlikely that a definitive test can be established. It might be reasonably simple to establish a list of criteria that would need to be satisfied before a CFC (taken together with associates) will be engaged in an active business. However, our preference would be for the Government to identify those areas that it believes are at risk. Other services would then not generate tainted services income.

3.9.4.3 Treatment of royalties

As discussed, like services, intangible may be created offshore for use offshore in a business carried on offshore.

In our view a "same country" exclusion should be allowed for royalties and other payments for the rights to use intangibles. This would, in effect, give royalties the same treatment as tainted services income and tainted sales income.

However, the exclusion should be broader. The current exclusion recognises that the creation of an intangible for a CFC and its licensing to a third party would be part of the normal business of a CFC and would not be motivated by a desire to avoid Australian tax. Further, it is accepted that the CFC creating the intangible third party need not be located in the jurisdiction as its customer. However, it does not accept that there are commercial (non-Australian tax) reasons for licensing the intangible to an associate for the associate's use or licensing the intangible to an ultimate third party user through an associated distribution company. For example, a CFC may be engaged in making and distributing films. A production company located in the jurisdiction in which the film was made would create those films. The film may then be licensed to an associated company in the jurisdiction in which the films are distributed to third parties.

If the production CFC were to license the distributor, the consideration would be royalty income and attributable under the CFC measures. If the film were to be sold to the distributor, the consideration for the sale would not be a royalty but would be consideration for the assignment of intellectual property and would be included in attributable income. In either case the income ultimately derived by the foreign third party would not be included in attributable income

Alternatively, the CFC may purchase the intangible from a non-resident and license it to associates for on licensing or may license it to end-users. This too produces tainted royalty income.

Ernst & Young recognise that the transfer of intellectual property developed in Australia to a CFC located in a low tax jurisdiction where that CFC does no further development of the intangible may provide scope for diversion of income from Australia and minimisation of Australian tax. However, to attribute income from the intellectual property developed offshore or purchased from a non-resident restricts the freedom of Australian multinationals to compete with its foreign competitors on a level playing field.

3.9.5 How does the problem/solution relate to other options in the paper?

Tainted services should not exist as a category, or should only exist to bolster transfer pricing from Australia (other categories such as tainted royalty income encounter similar problems). On this basis, contrary to the statements in the Paper, changes in the definition of tainted services income will not impact any other option for consultation.

3.10 Taxation of non-portfolio dividends (Option 3.9)

3.10.1 What is the current law?

Broadly, a foreign dividend will be exempt if it is paid from a pool of profits that have been subject to tax in a comparable tax country or subject to attribution under the CFC or FIF measures. The law in this area is quite complicated. The practical application of the law creates significant compliance burdens.

Further, the separation means that dividends flowing between companies resident in unlisted countries and a CFC resident in a listed country are subject to tax at the point the dividend is paid. This prevents dividends being routed through listed countries to gain the benefit of the dividend exemption. Additional anti-avoidance rules apply that are intended to prevent profit shifting from a CFC resident in an unlisted country to a CFC resident in a listed country, and these also prevent profits being routed through a CFC resident in a listed country and gaining the benefit of the dividend exemption.

The deemed dividend provisions are also exceptionally complicated. Broadly, they apply where a CFC resident in an unlisted country has profits (or accrued profits) and the CFC:

- provides (directly or indirectly) property to an associated CFC resident in a listed country or to an associated Australian company for less than arm's length consideration; or
- forgives a debt owed by an associated CFC resident in a listed country or by an associated Australian company for less than arm's length consideration.

The provisions can also apply where the CFC resident in an unlisted country capitalises a CFC. In this case, a deemed dividend can arise where there has been any injection of equity by a CFC resident in an unlisted country to a CFC resident in a listed country. However, the provision does not apply where the capital is injected into a CFC in which no associate of the investor has an interest. If the investor ceases to own the shares in the company prior to the return of the injected equity the exception is removed. This will result in an amendment of the previous year's assessment.

3.10.2 What is the problem?

The practical application of the law creates significant compliance burdens to prevent tax avoidance in circumstances where (based on the available data) little tax is being raised.

Further, the deemed dividend provisions affect genuine business activities in circumstances where there is no reasonable prospect of avoidance.

3.10.3 What evidence is there of the problem?

Reliable statistical evidence cannot be determined by the statistics published by the ATO, although it may be possible for the revenue area of the ATO to provide better details of the tax raised from the remittance of non-portfolio dividends to resident companies.

However, some examples of the problem should be sufficient to suggest the extent of the practical problems that the taxation on non-portfolio dividends creates.

3.10.3.1 Deemed dividends and non-arm's length loans

The issue is that the treatment of non-arms length loans under the deemed dividend provisions can create taxation disproportionate to the transfer of economic value associated with the loan.

Where a CFC resident in an unlisted country provides a non-arm's loan to a CFC resident in a listed country, the whole of the loan is deemed to be a dividend to the extent that there are profits in the company. Economically, no profit has been detached - albeit that future income earnings have been limited. Therefore, economically, it is potential future income that has been shifted. This potential income will already be subject to tax under the CFC measures since the transfer pricing provisions would ordinarily apply in the calculation of the attributable income of a CFC. Therefore, a non-arm's length loan cannot, by itself, affect the profits of the company at the time that the loan is made.

For example, in many cases there is no question that the loans will not be repaid. However, in the short to medium term the subsidiary may not have the capacity to service interest on the loan. Further, some emerging countries do not allow the payment of interest on a loan.

3.10.3.2 Restrictions by local country on share ownership

It is common for countries to stipulate that a person cannot have 100% of the shares in a company. It is common for a local company to have restrictions on minimum equity contributions so that separate owners are required. If the group is to make an additional investment in the subsidiary a deemed dividend may result and attribution may occur.

A similar issue arises where the investment requires a local investor - as you may be aware, many Asian countries require a minority interest by a local. Again, the capital injection may give rise to a deemed dividend.

3.10.4 What solutions should be considered?

The exemption of all non-portfolio dividends should be considered as part of a more general review.

As outlined in the Paper, the exemption of all non-portfolio dividends derived by an Australian company will considerably simplify the taxation of dividends. There will no longer be any need to determine the source of the underlying profit of a foreign company and then determine from which of these profits the dividend has been paid. In addition, much of the complication surrounding the foreign tax credit system could be removed.[13] One of the major benefits will be the simplification of the rules that are intended to prevent the shifting of profits from unlisted to listed countries. In the short term, we suggest that several changes need to be made to the deemed dividend provision. Some suggestions are as follows.

3.10.4.1 The temporary solution for non-arms length loans

We suggest the question should not be whether the loan is at arm's length terms (which is appropriate only to applying the transfer pricing provisions) but on whether profits are detached. Provided that the borrower has the capacity to repay and it is reasonably likely that loan will be repaid, there should be no deemed dividend.

3.10.4.2 The temporary solution for equity investments

Bearing in mind that the issue is whether the fund of profits has been detached, this will never be the case unless the equity investment is in an entity with an avenue to repatriate the profits to Australia in an exempt form (i.e. a different class of shares held by a related entity) and the equity investment is made on non-arm's length terms – i.e. a subscription for shares at an overvalue. Therefore, we submit as follows.

- An equity injection should not be treated as a potential deemed dividend if there are no shares owned by a resident of Australia or an associate that is resident in a listed country.
- If there are shares owned by a resident of Australia or an associate resident in a listed country, there should only be a potential deemed dividend if the shares are issued at a premium. This is because only a share issue at excess value would result in a profit shift to a company resident in Australia or in a listed country.
- A subsequent sale of the shares to an associate in an unlisted country should not trigger the retrospective application of the deemed dividend rules.
- A subsequent sale of shares to an associate resident in Australia or resident in a listed country should not trigger the retrospective application of the deemed dividend rules, provided that the shares are transferred for their market value.

3.10.5 How does the problem/solution relate to other options in the paper?

The removal of the dividend exemption has no implications for other areas of the Paper. It is primarily a mechanism for simplifying the law and the associated compliance (and administrative) costs in circumstances where there is little risk to the Australian revenue.

The modification to the deemed dividend provisions does not impact on other areas of the Paper.

3.10.6 What priority should be given to resolving this problem?

We are concerned that in examining the issues surrounding the provision of this exemption the progress of the basic reform of the CFC measures will be impeded. Further, we are concerned that this

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[13] The underlying foreign tax credit provisions dealing with credits against attributed income will still be required. However, a rewrite of the FTCS would be simple if confined to credits against attributable income

reform would mean that the definition of tainted services income would inappropriately not be reformed as outlined earlier.

In the absence of the a total exemption for non-portfolio dividends, the deemed dividend provisions need to be restricted so that they apply only to transactions that have the effect of shifting profits from a CFC resident in an unlisted country to a CFC resident in a listed country or to an Australian resident.

If consideration of the extended dividend exemption will not impede the progress of the basic reform, we submit that the removal of the dividend exemption should be considered as a priority. If the progress of the other issues will be impeded, then we submit that once the direction on the other matters raised in the Paper is known, the matter then be progressed.

4 Conduit Income – Promoting Regional and International Headquarter Services Companies

4.1 What is the problem?

The Background

Over the decades the Australian economy has moved through various stages of development. From a focus on primary production, the economy moved through to manufacturing and now the services sector is looked upon as providing the greatest opportunity for future growth.

Our taxation system has throughout this period supported, by various concessions or other means, the development of each of these sectors. Typically, primary production and manufacturing incentives (e.g. accelerated capital expenditure write-offs, investment allowances, development allowances, infrastructure bonds, etc) have been prominent in the past and have abated as those sectors, or particular industries within those sectors, have grown and become internationally competitive.

In more recent times there has been an attempt via the taxation system to support certain elements of the services sector. Incentives for Research and Development expenditure, Off-shore Banking Units (OBU's) and tax rebates for Film Production are examples of these. These incentives presumably reflect the importance the Nation and its Government place on the encouragement and development of such service industries.

The present Government has acknowledged, by including it as part of RITA, that the encouragement of a "Headquarter Services" (HS) sector is also in Australia's interest. It has done so for good reason since the existence of a strong "HS" sector has important implications for maintaining a vibrant business community. A strong HS sector entails with it the necessary human infrastructure conducive to a robust entrepreneurial community of directors and business executives, along with a competitive business advisory and capital markets sector, with all the implications that has for the promotion of other related services, such as marketing, communications, travel, finance, legal, human resources, etc.

The promotion of a vibrant HS sector essentially relies on two outcomes. First, maintaining in Australia the functions that Australian based multi-nationals currently conduct. Second, attracting the regional Headquarter functions of foreign based multi-nationals.

Many of the issues raised in the Treasury Paper prepared for consideration by the Board as part of RITA, are aimed at, in the main, the first outcome. That is, keeping Australian based companies in Australia. Aspects of RITA that go directly to this include addressing the imputation bias, addressing problems with Australia's CFC rules, reviewing the corporate residency rules, modernising Australia's double tax treaties, and to a lesser extent a review of Australian FIF rules and other rules that may discourage funds management activities being conducted in Australia. The review of Australia's tax treatment of foreign expatriates assists both Australian multi-nationals or foreign multi-nationals who wish to locate expatriates in Australia.

The issue covered by the Treasury Paper which most directly impacts on Australia's ability to attract Regional Headquarter companies, is the issue dealing with improving Australia's conduit income arrangements.

Headquarter Services - Australia's Strengths and Weaknesses

As a provider of services to the region, Australia is perhaps currently facing a window of opportunity, which may close in a decade or so. From a service sector point of view, Australia is blessed to have a highly educated, skilled and productive pool of labour, an education system that appears to encourage entrepreneurship and creativity, low cost infrastructure and a politically and economically stable environment. All this at a time when our regional neighbours, with the exception of perhaps Singapore, face a level of political and or economic instability which major USA and European companies see as a negative in terms of regional Headquarter locations.

On the other hand, Australia faces two important negatives of its own. Namely, its regional geography is not as conducive as a location for RHs as would be other locations in the region. Although, this is somewhat mitigated by modern communication and travel capabilities, this is a particular draw back in respect of "front office" functions (i.e. senior operational and marketing executives) as opposed to "back office" functions.

The other important negative is Australia's tax regime compared to those of our regional neighbours. In this respect, there are a number of negative aspects.

First, high individual marginal tax rates and certain tax aspects arising from the treatment of foreign expatriates (which are dealt with elsewhere as part of the RITA submissions) provide disincentives for both the individual as well as the employer to locate people to Australia.

Second, the corporate tax rate, even at 30% is much higher than the level offered for regional Headquarter style activities by our key neighbours. In particular, Hong Kong (with tax haven status), Singapore, Malaysia, the Philippines and now the city of Shanghai all offer low or nominal effective tax rates for regional Headquarter functions and activities.

Third, the scope of our tax system – encompassing the taxation of capital gains regardless of whether the gain arises on a domestic or foreign asset, as well the taxation of dividends flowing to Australia from low tax countries, make Australia unattractive from a tax point of view to foreign multi-nationals wishing to establish a RH in the region.

A revision of how Australia taxes conduit income and capital gains as proposed in RITA, whilst an important step forward, goes solely to the last of these issues - namely the scope of our tax system. It does not assist in the other important negative aspects of the tax regime dealing with effective tax rates imposed on both individuals and companies from conducting such activities in Australia.

For this reason we believe that it is important to address the "conduit" issue. It is also important to consider whether incentives which impacts on the effective tax rates imposed on headquarter services are appropriate.

One more negative aspect about our tax system that should not be overlooked is one, which goes to the overall perception that foreign companies have when seeking to do business in Australia. It is unfortunate, but nonetheless a reality, that foreign companies to a large part gauge the willingness of a nation and its Government to do business with it by reference to what incentives exist in the tax system for it to do so.

In a region where our key competitor neighbours are offering significant incentives for the establishment of various forms of industry in their countries, foreign companies rarely overlook the fact that Australia's taxation system sends few, if any, positive signals encouraging foreign companies to establish Headquarter style operations in Australia. Indeed, given the complexity of our tax system and problems that we have had in the administration of tax matters generally, the signals that our tax system gives to foreigners are primarily negative ones.

Finally, on the importance of tax as a factor in establishing business operations in Australia, we note that AXISS has done some work recently suggesting that in the context of "back office" operations e.g. call centres, processing centres, etc. the importance of tax is relatively modest and not significant. To us this would appear to make sense since in the case of "back office" operations the profitability mark-ups that can normally be expected are relatively low. As the profitability of such operations is low, tax should not be a significant factor in any decision to locate those operations in or outside of Australia.

However, Australia should be positioning itself not simply to be a location for "back offices" but also a location for high value added operations and "front offices". We discuss below the types of activities that this would include. Typically these activities are high value activities, which command high profit margins. In these circumstances, tax naturally plays a significant role in determining where these activities are located.

Recent Business Trends – The Move to High Value Hubs

Globalisation has led to significant structural changes to the way that multi-national corporations organise and manage themselves. These changes tend to lead to a concentration of common activities undertaken in various countries into special purpose centres of excellence or "hubs".

To date we have seen this primarily occur with respect to "back office" activities such as shared services centres catering for financial, accounting, data processing activities. Other examples are centralised or regionalised treasury functions, R&D hubs, call centres, etc.

The key principle behind much of this rationalisation is that changes in communications and data flows no longer require that each of these activities be represented in each country that a multi-national operates in. Concentration in various "hubs" allows the best performing individuals within the enterprise to come collectively together, adopting best practices to conduct the activity in a more efficient and productive way for a particular region or globally rather than for an individual geographic location.

Recent trends suggest this change in corporate organisational behaviour is not limited to simply "back office" functions. Many USA multi-nationals for example, are now centralising their marketing and sales functions along with executive management into regional "hubs". This is the basis upon which much of the "Supply Change Management" restructuring exercises have taken place in Europe and more recently, in the Asia Pacific region. In Europe for example, Ireland has become a popular place to locate senior sales and marketing and managerial executives for the UK and European business operations of various USA multi-nationals. Typically, such organisational restructuring would be complimented by appropriate tax planning to ensure that profits which commercially reflect these high value functions and risk taking activities are derived in these regional "hubs". Typically, these "hubs" are therefore located in a low tax or tax concessional environment.

There is ample evidence that this method of organising a multi-national's *"modus operandi"* has been carried out extensively by USA multi-nationals in a European context. Moreover, the same phenomenon is now starting to occur in the Asia Pacific region and whilst other countries may from time to time provide some competition to Singapore, Singapore has become the most popular location for USA companies to base their high value regional hubs.

Moreover, there is evidence that in doing so, risks and activities are being moved from various neighbouring countries, including Australia, into the regional hub. There is therefore a naturally occurring loss of revenue to Australia from failing to be competitive from a tax perspective for this type of business.

The problems Australia therefore faces in this context, we believe are as follows:

- First, without a competitive tax regime to attract and or retain high value head office functions encompassing both "back office" and "front office" activities, Australia will struggle to attract many of these activities – especially high value/high margin activities.
- Second, Australia will gradually lose some of the functions and risk taking activities, which occur here already – whether those activities and risks are being undertaken by Australian or foreign owned companies.
- Third, as the respective regional hubs grow and prosper over time, some of the non-tax natural advantages that Australia currently enjoys (i.e. highly skilled work force, low cost infrastructure and possibly political and economic stability factors) may no longer be relative advantages for us.
- Finally, it is also important to remember that the other measures that are being considered as part of RITA (e.g. imputation bias, CFC rules, residency rules, etc) aimed at ensuring that Australian based multi-nationals remain tax competitive and domiciled in Australia, do relatively little to ensure that their Head Office services will remain in Australia.

  Whilst the legal place of domicile might remain Australian for a particular Australian based multi-national, Head Office style services are likely to gradually gravitate into jurisdictions, which geographically and operationally make most sense.

  There has been relatively little evidence to date of Australian based companies moving regional functions and activities out of Australia where the business operations in the region are wholly owned. However, there is ample evidence, and likely to be growing evidence, that where the Australian multi-national becomes a joint-venture partner in a regional operation, the propensity to move functions and risks out of Australia into a more competitive tax location will be high.

4.2 What solutions should be considered?

We believe the solution requires consideration of two aspects.

1. Conduit Holding Company Relief

The first aspect goes to the scope of our tax regime extending to the taxation of capital gains in a conduit context.

RITA suggests that conduit relief might be provided where a foreign group establishes a CHC to act as a regional or similar international holding company.

- and that CHC disposes of an interest in a foreign company ("Interest A"); and/or
- where the foreign investor disposes of an interest in the CHC that has foreign assets ("Interest B").

In our view, conduit relief should be provided in both situations. We address below the various proposals raised in RITA for providing such relief.

Interest A Relief, where CHC disposes of foreign company interest

Conduit Holding Company Regime

Under this option, an exemption would be provided from CGT in respect of gains on the disposal of foreign subsidiaries (and possibly non-portfolio interests in any foreign company) to the extent that the Australian company (the CHC) is foreign owned. RITA raises a number of issues with this option to which we comment as follows:

- Provided the Australian company is effectively wholly foreign owned, the entire gain should be exempted. The exempting company threshold (i.e. 95% plus foreign owned) for foreign ownership would probably be appropriate since any Australian ownership would be minimal.

  This would eliminate some of the practical difficulties with the exemption. Further, since there would be a minimum foreign ownership threshold, only genuine conduit income would be exempted.

- With regard to the practical difficulties relating to the testing of foreign ownership levels, we do not see this as a major difficulty. The key concern would be to ensure that Australian residents were not taking advantage of the exemption by using an interposed non-resident entity.

Conduit Restructure Relief

Under this option, a rollover would be provided to allow an Australian company to transfer a foreign subsidiary to its foreign parent without Australian CGT.

We believe that this option is not preferable because it does not provide genuine relief for regional holding companies.

This option does not provide an incentive for the use of Australia as a regional holding company location because it requires restructuring prior to a sale of the non-portfolio interest to a third party. Such restructures would be likely to raise issues in the local country relating to, for example, transaction taxes and exchange control or foreign investment rules. It may also trigger CFC like rules in the foreign parent jurisdiction.

Therefore, we believe this option should only be considered if other options are rejected.

A General, Non-Conduit Specific, CGT Exemption

This option would provide a general CGT exemption for sales of non-portfolio interests in companies with active businesses.

This option, as the Treasury Paper acknowledges, raises a number of both international and domestic equity issues that would need serious consideration. We believe this would require a detailed analysis of various issues that cannot be adequately addressed in the context of the existing RITA submission process and timeframe.

We would simply add that if this option were chosen, it would be by far the simplest to implement, as well as the option least exposed to criticism on the basis of harmful tax practices.

Interest B Relief, where foreign investor disposes of an interest in a CHC

RITA indicates that such an exemption could be provided where an Australian company (i.e. the CHC) is wholly or partly owned by non-residents.

Such relief would be fairly simple to provide where the exempt (Interest A) gain is distributed to the non-resident. A foreign income account could be used to achieve this.

Where the non-resident sold an interest in an Australian company that had an unrealised or undistributed gain referable to foreign assets, the provision of an exemption would be more difficult.

Further complexity is introduced where the Australian company was only partly foreign owned.

We believe that, notwithstanding the practical difficulties involved, relief should be provided in "Interest B" cases where the Australian company is effectively wholly foreign owned and the non-resident disposes of a non-portfolio interest. Again, the level of foreign ownership could be based on the exempting company rules.

Adoption of either the CHC Relief or General CGT exemption would in our view eliminate the current incentive that exists in the tax system for foreign companies to either avoid using Australia as a holding company location, or alternatively, "dismantling" an Australian takeover target's international holding company structure once the foreign group acquires an existing Australian based corporate group.

This later risk is now more likely to materialise much sooner than previously since the new consolidations tax regime "cascades" the purchase price paid down through the takeover target's corporate chain thereby uplifting the cost base of the target's international subsidiaries. This makes it possible to transfer out these subsidiaries tax-free via an internal reorganisation of the foreign owned group.

2. Additional Relief – International Headquarter Company (IHC) Relief

The second aspect concerns the effective tax rate imposed on international service companies in Australia compared to neighbouring country competitors.

A CHC regime is purely a "legal or structural" incentive, which may encourage the use of Australia as a legal holding company location.

In its December 2001 "Removing Tax Barriers to International Growth" Paper by the Business Council of Australia, (BCA) the BCA recommended a CHC regime, coupled with licensing requirements which would have as a precondition, the migration of substantive job creation activities. The BCA recognised that there is a potential "disconnect" between simply providing a "legal or structural" incentive to establish regional holding companies and actually encouraging the migration and or retention of headquarter services and related jobs.

Our neighbouring competitors, such as Singapore, Malaysia, China (Hong Kong and more recently Shanghai) offer incentives, which provide for low or nominal corporate rates of tax, also coupled with more generous individual tax rates than Australia.

The CHC regime, of its own, also does relatively little in sending a positive message to foreign companies who may consider Australia as a regional Headquarter location compared to some of the incentives offered by our regional neighbours. A simple CHC regime offering respite from Australian CGT compares relatively poorly in this context with what our regional competitors have to offer, most of which do not have a CGT to start with.

What we believe should be considered, in addition to the CHC relief noted earlier, is a comprehensive IHC tax regime that has a "jobs based" incentive rather than simply a legal structure or holding company incentive. A "jobs based" incentive is consistent with some of the incentives currently available for Research and Development spending where a greater than 100% deduction is allowed for qualifying R&D spends in Australia. It is also consistent with qualifying expenditures on producing films in Australia, whereby a 12.5% rebate on actual expenditure in Australia broadly is available as an incentive.

We also believe that a considerable amount of work is required in this area in order to properly define and design an appropriate incentive for an IHC regime. It is naïve to think that a properly designed and targeted incentive can be arrived at without the benefit of a thorough working study of the topic.

Nevertheless, we envisage that some of the attributes of such an "IHC" incentive, would be broadly as follows:

- There would be a minimum dollar threshold of Australian based Headquarter Qualifying Services that would need to be committed to or spent;
- These qualifying services should include both "back office" and "front office" style services rendered from Australia, either for off-shore associates of the IHC or for third parties;
- A rebate style incentive akin to that available for qualifying films based on a percentage of the Australian spend may prove an efficient method of providing the incentive. The film rebate is refundable if there is an overall loss. We do not envisage that refundability would be necessary in this context;
- Consideration should be given to whether the incentive should be "ring fenced" to non-resident owned companies or rather made available also to Australian owned International Headquarter Companies that meet the minimum qualifying dollar threshold and scope of services requirements. The non "ring fencing" of the incentive may be more consistent with the avoidance of harmful tax practices the subject of recent OECD comments. Also by making the incentive available to Australian owned companies, it promotes the growth of such service activities in Australia for Australian resident groups.
- If made available to Australian owned International Headquarter Companies, consideration could be given to whether it should only be available for "new" services. Services of the scope or nature that are currently being made available by either a foreign or domestic owned group from Australia could be disqualified. This could limit the cost to Government by avoiding incentives for existing services. There may be some concerns about defining what are in fact "new" services from old ones, but we believe that this issue should be capable of practical legislative definition.
- An alternate approach is to make the incentive available for all qualifying services, whether new or old. This would be simpler but the cost to revenue would need to be calculated. It

may well be the case that existing services rendered from Australia by both Australian and Foreign multinationals to offshore associates in particular are in many cases low margin or loss services and so the loss to revenue from incorporating existing services may be marginal. Moreover, a high dollar threshold would also assist with revenue leakages from existing service operations. A thorough working study of the incentive should incorporate such concerns and options.

- Charges made by the IHC for services rendered and received should all be within commercial boundaries so that it is not used as a method for charging excessive fees into the region, again mindful of Harmful Tax Practices concerns.
- To the extent that the IHC did own active non-portfolio investments in other countries a CGT exemption should be available for sales of those investments consistent with the CHC relief alluded to above. As this would be available for all qualifying International Headquarter Companies, (IHCs) whether foreign or locally owned, there is no "ring-fencing" of the incentive and therefore no discrimination between resident and non-resident owned IHCs.
- We do not see the CHC Relief and the IHC Relief as being mutually exclusive. There is no reason they could not subsist side-by-side. Since the CHC relief would be limited to wholly non-resident owned CHC's, the IHC regime offers a broader audience (i.e. available to wholly or partly Australian owned IHC's) but with higher "substance" or "jobs" pre-requisites.
- Again, consistent with CHC relief, to encourage the use of IHC's as regional holding vehicles for foreign multinationals, a CGT exemption should be available on the sale of the non-resident's interest in the IHC. In most cases we anticipate this interest would be 100% although a 50% or more interest may apply in a joint venture context. Accordingly, we believe this exemption can be limited to foreign investors in the IHC who have a 50% or more interest. If Australia proceeds to introduce upstream CGT taxing rules for sales of non-resident entities that have indirect ownership of Australian entities, then a further complimentary exemption would be required from these rules.
- Where the IHC holds both Australian and foreign investment holdings, a partial exemption may be required. However, we anticipate that most IHC's would in these circumstances be structured to simply hold the foreign investments with the Australian operations held under a separate legal ownership structure. As a result, whilst a partial exemption based on relative values may be cumbersome, in practice we expect that it would rarely be utilised. Nonetheless, we believe it should be available.
- Consistent with the IHC also being used as a holding company vehicle, we expect that a general exemption would be provided on all non-portfolio dividends received by the IHC. This coupled with Australia's Foreign Dividend Account (FDA) (or expanded Foreign Income Account (FIA) regime) should allow the foreign investor to repatriate such profits from Australia withholding tax free. This FDA exemption should extend to the repatriation of profits made on the sale of any foreign non-portfolio holding.

5 Residency and Tax Treaties

5.1 Corporate Residency Rules

5.1.1 What is the current law?

Section 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) prescribes three alternative statutory tests for determining the residency of companies. These are:

1. Place of incorporation;
2. Place of central management and control if carrying on business in Australia; or
3. Residence of controlling shareholders if carrying on business in Australia.

Incorporation

Under the place of incorporation test, a company will be a resident of Australia if the company was incorporated under the laws of Australia. This test is a bright line test in that it is rigid, formalistic and easily determined.

Central Management and Control

Under the second statutory test, a company is an Australian resident if that company:

- Carries on business in Australia; and
- Has its central management and control in Australia.

The central management and control ("**CM&C**") test is not so easily determined. The determination of where CM&C exists requires an examination of the company's facts and circumstances (i.e. the substance of where the true power of CM&C exists) – of necessity this means that the CM&C test, as with many common law tests, produces much uncertainty and inconsistent results and hence is by no means a rigid or clear-cut test.

Typically, CM&C is in the hands of the directors - the general approach of the Courts is that CM&C is where the directors meet to transact the company's affairs, and the identification of that place will flow as a consequence of locating the persons who exercise that power.

However, there may be circumstances where CM&C does not abide in the place where directors meet if it can be shown that *de facto* control exists elsewhere. For instance, some cases have held that where a board of directors habitually follow the instructions of another person without exercising independent judgement, CM&C is the place where that other person is: *Unit Construction Co Ltd v Bullock* (1959) 38 TC 712; *Koitaki Para Rubber Estates Ltd v FC of T* (1940) 64 CLR 15. On the other hand, *de facto* control has been distinguished from a "strong power to exert influence", which the courts have decided is not where CM&C lies: *Esquire Nominees Ltd v FC of T* (1972) 72 ATC 4076.

Controlling Shareholders

Under the third statutory test, a company is resident of Australia if it:

- carries on business in Australia; and
- its voting power is controlled by persons who are residents of Australia.

Unlike the CM&C test, this test requires a consideration of whether a company is carrying on business in Australia. One must thus look at such indicia as repetition or transactions; continuity and system of organisation; commercial significance of activities and profit motive.

Control of voting power means more than 50 per cent of the voting power being in the hands of Australian residents. Voting power is taken to mean the ability to vote at a general meeting of the company. On the other hand, control is likely to include *de facto* control. This, again, may produce uncertainties and is an issue, which is not clarified by legislation. For instance, will *de facto* control be avoided if an Australian resident shareholder simply refrains from voting or gives a non-resident proxy to vote?

5.1.2 What is the problem?

Problems with CM&C Test

The CM&C test is confusing and unclear. As suggested above, the concept of CM&C and the substance over form approach that courts have adopted to determine *de facto* control of a company is a hard matter of fact and difficult to determine conclusively.

Also, the case of *Malayan Shipping Co Ltd v FC of T* (1946) 71 CLR 156 determined that a company will be carrying on business in Australia if CM&C in Australia is established – effectively, running the two limbs of the CM&C test together.

The classical CM&C test is increasingly becoming outdated as business and trade is becoming internationalised.

Electronic forms of communication such as the telephone, e-mail and video-conferencing is making it very easy for important company decisions to be made without the decision makers being at the same location. Whereas at the time the CM&C tests were formulated, it was impossible for CM&C decisions to be made without collocation of the board of directors, it is now not uncommon for directors meetings to be held via video conferencing. In such circumstances, the existing rules are unhelpful in determining where CM&C lies.

The function of the CM&C rules are in some sense becoming obsolete as they are duplicated by other provisions in the Tax Act such as Australia's attribution rules, transfer pricing rules and CGT regime:

- Under the CFC, FIF and transferor trust provisions, Australian residents who have an interest in offshore entities may be required to be taxed on attribution. The incomes of these offshore entities (through attribution back to the Australian shareholder) are in effect subject to Australian tax upon derivation. Thus, the concept of residency becomes irrelevant under these rules, as Australia is effectively able to tax the Australian resident's share of this entity's income notwithstanding that the entities themselves are non-resident.
- The Income Tax Assessment Acts also contain elaborate transfer pricing rules, which provide Australia with an adequate share of non-resident companies income to the extent that such income is sourced in Australia. To the extent that Australia's sourcing rules are robust, the concept of residency becomes less relevant as Australia may still have jurisdiction to tax non-resident income derived from sources within Australia.
- Furthermore, Australia's CGT regime will assess any Australian shareholder on the incremental gain made when that shareholder disposes of the shares in a foreign company.

The CM&C rules also inhibit the growth of Australian enterprises, both emerging businesses and large established businesses.

It is increasingly the case that small or medium enterprises ("SMEs") that seek to expand offshore would do so via a foreign subsidiary company. However, in order to avoid that foreign subsidiary from being an Australian resident under the CM&C rules (and thus be treated as a dual resident), the foreign subsidiary would have headquarters offshore, would have a majority of foreign directors, office holders and executives and would make major decisions overseas. This is clearly not in Australia's economic interest.

Large companies with foreign subsidiaries wishing to make a dual listing or attract foreign equity capital would act similarly in order to ensure the company is not treated as an Australian resident under the CM&C rules. In the same way, multinational corporations are unlikely to select Australia, as it's international or RHs where the headquarters has foreign subsidiaries.

Option 3.12 of RITA suggests that options be considered to clarify the test of corporate residency so that exercising CM&C alone does not constitute the carrying on a business.

Problems with Controlling Shareholder Test

Perhaps to a lesser extent, the controlling shareholder test is also subject to the uncertainties revolving around the concepts of when a company is carrying on business in Australia and when voting power is controlled by an Australian resident.

Other issues

Australia's DTAs will often include a tiebreaker rule in the event that a company is determined a resident under the laws of more than one state. These DTAs often give residence to the place of effective management while some of Australia's DTAs give residence to place of incorporation.

Where residence of a company is granted against Australia under a DTA tiebreaker rule, the company may nevertheless still be a resident of Australia for the purposes of Australian law. Thus, complicated dual resident modifications are necessary.

The Treasury Paper suggests that a company that is a non-resident under a DTA should also be treated as a non-resident for the purposes of Australian law.

5.1.3 What evidence is there of the problem?

We have evidence from income tax audits of our clients by the Australian Taxation Office (ATO) that the tests of residency cause issues for taxpayers and the ATO. Investigation of such issues involves a significant cost to the community, in terms of time and resources that could be devoted to more productive pursuits.

5.1.4 What solutions should be considered?

We do not support Option 3.12.

The Option suggests that the CM&C test be clarified such that establishing CM&C will not necessarily satisfy the carrying on business in Australia requirement. Yet, as discussed above, the Court in *Malayan Shipping* held that a company, which has CM&C in Australia, would also be carrying on business in Australia. So, clarification of that point alone does not address the problems and concerns discussed above.

The difficulty in applying the CM&C test is not whether a company is carrying on business in Australia. The difficulty lies in when CM&C will be established and the circumstances in which "real" CM&C can be imputed to a place other than where the directors meet i.e. when *de facto* control is established.

Accordingly, we suggest that, as a bare minimum, the Board should recommend Treasury consider options for a more robust and clear-cut statutory test for establishing CM&C.

A "bright-line" test that clearly establishes when a company has CM&C in Australia or otherwise would address the concerns expressed[14].

However, whilst a revised test for CM&C would clarify the problem of identifying the location of CM&C, the Board should recommend to Treasury that it consider further the implications of abolishing altogether the CM&C test and the controlling shareholder test and rather rely solely on a place of incorporation test. A case for this was put forward in the BCA paper, *Removing Tax Barriers to International Growth*.

In our opinion, by relying solely on the place of incorporation test, the test for corporate residency could be immensely simplified. Obviously, the implications of such a change would need to be carefully considered, including any revenue risks and potential for averting Australian residency by changing place of incorporation. However, as Australia has elaborate source based taxation measures, we do not believe that there will be much (if any) revenue risk from such a change.

In relation to Option 3.13, we agree that the dual residency provisions in the Tax Acts should be removed to reduce complications.

5.1.5 How does the problem/solution relate to other options in 'the paper'?

In considering the option to use the place of incorporation test as the sole test for corporate residency, there would need to be a review of Australia's DTAs in relation to the tiebreaker rules.

Moreover, Options 3.1 to 3.4 which are focused on better targeting the CFC rules and improving the integrity of those measures will become more important since the CFC rules duplicate the purpose and function of the CM&C test.

5.1.6 What priority should be given to resolving this problem?

We believe that corporate Australia would see fixing these issues of residency as a high priority to achieving increased certainty out of the International Tax reform process.

5.1.7 What are the benefits from adopting our recommendations?

[14] The Board could use the example of where CM&C lies if board meetings are held via teleconference and the directors are located in different places, as a "self-test" of any new rule.

The Board should see that the benefits of adopting our recommendations are the attainment of certainty and simplicity.

5.2 Australia's Tax Treaties

5.2.1 What is the current law?

Tax treaties are primarily aimed at addressing the problem of international double taxation. They are entered bilaterally between two States and determine, in the case where double taxation arises, which state will withdraw or reduce their tax claim.

As a policy objective, Australia's treaties also aim to promote closer economic cooperation between Australia and other countries by eliminating possible barriers to trade and investment. Tax treaties will reduce or eliminate double taxation of income flows between the treaty partner countries caused by overlapping tax jurisdictions. Treaties therefore establish greater legal and fiscal certainty within which cross-border trade and investment can be carried on and promoted.

Australia's position in respect of source taxation of the income of non-residents, like that of many of our trading partners, is to rely largely on a system of withholding. Broadly, dividends paid to non-resident shareholders are taxed at 0% for franked dividends and 30% for unfranked dividends, reduced to 15% for treaty countries. Royalties and interest withholding is broadly 15% and 10% under the treaties.

5.2.2 What is the problem?

Traditionally, Australia has been a net importer of capital. That is, investment flows tend to be inbound rather than outbound. Accordingly, our historical withholding system ensured that Australia obtained an equitable share of revenue from investments in Australia by non-residents.

It is increasingly the case, however, that Australian residents are directing their investments offshore. Conspicuously, high levels of withholding taxes impose constraints on residents investing offshore.

For instance, in relation to dividend withholding, unlike Australia, many of our trading partners do not have a two-tiered withholding rate that differentiates between dividends paid from taxed or untaxed profits.[15] In many cases, an Australian resident shareholder would receive a foreign dividend, which has already been subject to full rates of foreign tax at the corporate level, and also be subject to a further 15% dividend withholding tax on remission to Australia.

When such dividends come home to Australia, the resident shareholder may not be able to obtain a credit for those taxes because it may be exempt income by virtue of being a non-portfolio dividend or if the foreign taxes paid exceed Australian tax on the dividend.

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[15] This is particularly the case with countries operating on a classical corporate tax system, such as the US.

To this extent, withholding taxes present an additional tax burden on Australian residents investing overseas and are counteractive to the object of achieving capital export neutrality.

Conversely, because our Australian corporate income tax rate has been reducing, the problem also is true for investment inflows. In circumstances where a non-resident invests in Australia and is not able to fully recoup the Australian withholding taxes, the additional tax liability poses a significant constraint for foreign investments in Australia.

As tax treaties operate bilaterally, by reducing rates of withholding, restrictions on capital inflows and outflows are reduced substantially.

5.2.3 What evidence is there of the problem?

We have anecdotal evidence from our clients that the level of withholding taxes imposed by our trading partners has impacted investment and profit repatriation decisions.

5.2.4 What solutions should be considered?

Subject to the qualification noted below, we are strongly supportive of Option 3.5 to use the recently ratified Australia-USA treaty protocol as a model for future treaty negotiation and move towards reducing or eliminating withholding taxes.

Our one reservation is that we do not agree that a limitation of benefits ("LOB") article should necessarily be included in future treaty negotiations. Such an article would, in our opinion, defy the purpose of reducing withholding taxes in order to facilitate free trade and capital. The negotiated reductions in withholding rates would, in many instances, be taken away by virtue of the LOB article.

In this respect, we note that the LOB article was included in the USA protocol under the request of the USA. The LOB article is a measure that the USA (and other countries) has deliberately chosen to counteract the problem of treaty shopping and is prevalent in USA treaties. We also note that a LOB is not the only way of addressing the problem and that Australia needs to approach the issue with caution, bearing in mind that not all of our treaty partners may address the problem in the same way and may not share the same attitude.

Should it be necessary to include an LOB article in treaties that are being renegotiated, or in new treaties, we recommend that such an LOB article contain a carve-out for regional headquarter companies similar to article 16(2)(h) of the USA Protocol. Including a RHQ carve-out is consistent with the Treasury recommendations that are seeking to promote Australia as a location for RHQ companies of multinational corporations.

5.2.5 How does the problem/solution relate to other options in 'the paper'?

Australia's withholding tax policy is vitally important in attracting equity capital for offshore expansion and promoting Australia as a location for internationally focused companies.

There is also an interaction with our imputation system, because an absence of imputation credits for withholding taxes means that shareholders of Australian companies effectively suffer taxation on their income at both the Australian and foreign level.

5.2.6 What priority should be given to resolving the problem?

We are of the opinion that these issues be given a high priority.

5.2.7 What are the benefits from adopting our recommendations?

A system of reduced or nil withholding taxes would substantially improve Australia's capital and investment inflows/outflows.

5.2.8 Other issues relating to Tax Treaties

We are of the opinion that the Most Favoured Nations clauses in some of Australia's treaties will act as a springboard for which future renegotiations may proceed quickly. We are therefore supportive of Option 3.7 to consider which countries to be given priority in treaty negotiation.

In relation to Option 3.8 which suggests options to improve consultation processes on negotiating treaties, whilst be believe that this is desirable as it provides maximum input from the public, we also note that it must be recognised that treaty negotiations in many respects must necessarily be confidential. We are therefore of the opinion that this Option be approached with caution.

We also recommend that where anomalies exist within the law that can be resolved by amendment of domestic tax law this approach be preferred rather than to delay amendments through the treaty renegotiation process.

5.3 Capital Gains Tax (Option 3.6)

5.3.1 What is the current law?

Currently, non-residents will be subject to Australian CGT where they dispose of an asset that has the "necessary connection with Australia" (section 136-25 of the *Income Tax Assessment Act 1997 (ITAA 1997)*).

5.3.2 What is the problem?

The current definition of "necessary connection with Australia" excludes shares in foreign companies (even when those companies have an interest (directly or indirectly) in assets which do have a connection with Australia).

A non-resident will not be subject to Australian tax on any profit made on the disposal of shares in such an interposed non-resident holding entity.

5.3.3 What evidence is there of the problem?

We are unaware of any revenue leakage from the current rules.

5.3.4 What solution should be considered?

As we do not believe that the quantum of the "problem" is significant, and because any proposed solution would be profoundly complex and act as a deterrent to inbound investment, there is no need to address the "problem" in our view.

RITA proposes that CGT should apply to the sale of non-resident interposed entities with underlying Australian assets – we disagree.

Whilst acknowledging that there may be (an unquantifiable) revenue leakage from the current law, our experience is that it is not generally commercially realistic or feasible for non-resident investors to structure their Australian capital investments in such a way as to capture the "so-called tax benefit".

For instance, a non-resident would need to dispose of the entire portfolio of Australian CGT assets that are held by the interposed entity. Otherwise, the non-resident would need to have interposed a separate entity for each CGT asset held. This becomes rather impracticable.

Moreover, the country of residence of the investor will, more likely than not, tax any capital gain on disposal of the shares in the interposed entity.

We also agree, as the consultation paper states, that any measures to tax a non-resident holding entity would be complex and difficult to target appropriately. Specifically, for any such measures to work properly, they will need to address problems such as:

- *Appropriate targeting?* – for the measures to be appropriately targeted, any such measures must include a purpose test, rather than be a blanket integrity measure. In circumstances where the measures are wrongly targeted, they would be detrimental to overseas inbound investment. For instance, in the context of a merger or acquisition of a multinational corporate group that has interests in Australian assets (however small), it would be unreasonable for the international merger or acquisition to trigger Australian CGT consequences.
- *Valuation of gain?* – the proposed measures would more likely than not attribute a deemed capital gain to the non-resident interposed entity. This triggers issues of valuing such gain. The problem is further exacerbated if the interposed entity holds a portfolio of both Australian and non-Australian assets. In these circumstances, we envisage that complex rules for identifying the gain allocable to the Australian assets would be needed.
- *Anti-overlap measures?* – the measures would necessarily have to mesh with other provisions of the Tax Act, specifically in determining if prior gains have already been subject to tax.

- *Administration, information and enforcement*? – as the interposed entity is non-resident, it would be very difficult for the measure to be properly enforced and tax to be collected.

In our opinion, any rules that may act as a deterrent to Australian inbound investment should be discouraged.

5.3.5 How does the problem/solution relate to other options in the paper?

In our opinion, the provision of the CGT relief discussed is crucial to achieving conduit income relief as proposed by option 3.10.

5.3.6 What priority should be given to resolving this problem?

Not applicable.

5.3.7 What are the benefits from adopting our recommendations?

By avoiding complex legislation, Australia's tax regime will encourage foreign investment.

5.3.8 Other issues relating to Capital Gains Tax

There is an ongoing debate between tax commentators and the Australian Tax Office ("**ATO**") concerning whether Australia's tax treaties entered prior to the introduction of the CGT regime offer treaty protection to non-residents from CGT by virtue of the Business Profits and other articles. In our view, there is compelling evidence to suggest that it does.

However, this position should be clarified in future renegotiations of the relevant pre-CGT treaties in order to expressly state Australia's intention to preserve rights to tax capital gains of non-residents.

Australia should also be aware of, and continue to monitor, moves by other jurisdictions to provide CGT exemptions for the disposal of significant shareholdings to ensure that Australia's CGT regime reflects current practice throughout the world and does not make Australia an unattractive investment location.

6 Australia as a Global Financial Services Centre

6.1 Background

Chapter 4 of the Paper has as its predominant focus correcting biases that exist in the Australian taxation system that are generally accepted as impeding the development of Australia as a global financial services centre.

Ernst & Young believes that it is clearly desirable to have a strong financial services centre in Australia. A strong and efficient financial services sector in Australia helps provide capital for Australian businesses, provides directly and indirect employment opportunities for Australians, and helps facilitate savings and wealth accumulation for investing Australians. Another spin-off from a larger, and consequently more profitable, financial services sector in Australia is greater tax collection from the wealth the sector creates.

The relative and absolute size of cross-border portfolio capital flows, and particularly outbound portfolio capital flows, has grown significantly since the relaxation of Australian foreign exchange controls.[16] In recent times, portfolio capital outflows have averaged about 3% of Australian GDP[17], and portfolio outbound investment now comprises approximately 30% of Australian managed funds, most of which is in foreign equities.[18]

The suggested reform measures necessarily focus on both inbound and outbound portfolio investment made through the Australian financial services sector. Ernst & Young believes that the applicable taxation laws should not, without sound reason, discriminate between the taxation of returns to portfolio capital based on its source (domestic vs. foreign) or application (domestic vs. foreign). The proposed reforms are directed at these dynamics.

Somewhat curiously in a chapter directed at promoting Australia as a Global Financial Services Centre, Chapter 4 also raises for consideration recommendations made in the Review of Business Taxation dealing with the interplay and suitability of taxation provisions that deal with interests held by Australian residents in certain foreign trusts. It also raises the prospect of providing separate entity treatment to Australian branches of foreign companies. We support these measures, for the reasons outlined in the Paper, and have not sought to comment on them further in this submission.

Ernst & Young welcome the inclusion of the options for reform in the review of International Taxation Arrangements. However, care is required to ensure that a lot of energy is not wasted directing scare resources to the development of quick-fix solutions rather than moving immediately to a more significant, balanced and reasoned reformation of the applicable taxation rules.

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[16] Australia as a Capital Exporter, Ric Battellino, Assistant Governor (Financial Markets), Address to Conference on 'The Impact of An Australia-US Free Trade Agreement: Foreign Policy Challenges and Economic Opportunities', Canberra, 29 August 2002.
[17] *Ibid*, @ page 2.
[18] *Ibid*, @ page 4.

6.2 Foreign Investment Funds

6.2.1 The policy rationale

The Paper sets the background to the FIF rules, outlining that they, at least in part, are an adjunct to the CFC rules, applying "to significant interests in foreign entities that fall outside the CFC rules"[19]. However, it is significant that the Treasury also state that the FIF rules are "… more than just an adjunct to the CFC rules, and deal with portfolio investments as well."[20]

Emphasising that the FIF rules deal with portfolio investment may be relevant to a revised policy, however, it was not relevant to the original policy, albeit that the existing FIF measures may partially have the effect of limiting deferral in the manner outlined.

Relevantly, when the FIF rules were first foreshadowed (as the passive investment fund rules), they were envisage as purely an adjunct to the CFC measures, operating as an effective anti-avoidance rules aimed at foreign accumulation funds. Even during consultation on the FIF measures, the Treasurer stated that the deferral problems applied to "especially those [investments] yielding passive income".[21]

However, statements made in the Paper go further, asserting that deferral, even if not part of an arrangement for the avoidance of Australian tax, would be:

> "… contrary to the goal of taxing resident individuals on their worldwide income, pose a risk to the revenue base, and favour the use of particular offshore managed funds over Australian managed funds."

Unfortunately, there is no basis in the Paper advanced for any of these conclusions. In our view, any change of policy to eliminate deferral should be open to public debate, and careful scrutiny of identified perceived problems, inequities and potential policy responses. Further, in our view, if it is ultimately determined that the new policy aims are to be pursued, the existing FIF rules are not appropriate to achieve that policy aim.

We support the retention of a form of FIF rules acting as a targeted anti-avoidance measure. However, we do not at this stage support the use of the FIF measures as a means of targeting deferral not linked to avoidance. This requires separate policy analysis.

6.2.1.1 The goal of taxing resident individuals on their worldwide income

We agree that a goal of taxing resident individuals on their worldwide income would be undermined if individual taxpayers could easily defer Australian tax, or convert income to capital gains, by diverting income to vehicles located in tax havens. However, at present the FIF measures go much further.

- They also have the effect of discouraging Australian individuals from diversifying their investment portfolio by including portfolio investments in foreign funds that invest in foreign shares.

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[19] Page 57 of the Paper
[20] Page 57 of the Paper
[21] Para 1.11 of *Taxation of Interests in Foreign Investment Funds An Information Paper 2 April 1992*

- In order to comply with the active business exemption a taxpayer with a diversified portfolio must undertake compliance a disproportionate to the risk to the Revenue.
- Because the exemptions are improperly targeted, the individual whose investment falls within the FIF measures must go through a considerable compliance burden which, given the complexity of the legislation, is again disproportionate to the risk to the Revenue.

6.2.1.2 Risk to the revenue base

We note that the total income declared under the FIF measures in previous years was generally not significant (e.g. for companies in the 1999-2000 income year the amount of FIF income was $13,951,216 from 48 taxpayers and for individuals $25,373,055 for all attributed foreign income from 1,633 taxpayers).[22]

From the statistics we cannot determine the amount of the tax raised. Obviously, this does not show the income declared as a result of selling investments prior to year-end (which could have been influenced by the FIF measures) or the prophylactic effect of the FIF measures. However, it is indicative that the direct revenue raised from taxpayers other than complying superannuation funds is not significant.

6.2.1.3 Favour the use of particular offshore managed funds over Australian managed funds

We have no empirical evidence that this is the case, and the funds management industry would be better placed to comment on this. If the Australian funds management industry feels they can compete with foreign funds without the FIF measures there is little basis for the comment.

However, we would like to make the following points.

- First we would suggest that an investment in a foreign fund that in turn invests in assets that are subject to market risk, the motivation for deferral or conversion of income to a capital gain is likely to be outweighed by the risk / pre tax return.
- In a totally passive fund where the investment carried a set or predictable rate of return and was not subject to market or currency risk, and did not distribute income, there could be a preference for this investment over an equivalent investment in an Australian fund.

6.2.2 Relevance to different categories of taxpayer

There seems to have been an assumption in designing the existing FIF measures that no distinction should be made between different types of taxpayers. However, in a targeted anti-avoidance measure this distinction is invariably made. Analysing the application of the FIF rules on the basis of such distinction demands, at the least, a full analysis of the potential for avoidance.

We believe that the FIF measures can apply in six different circumstances, each of which needs to be examined separately:

- Individuals with ability to accumulate significant non-superannuation savings. These are often identified as those individuals on the top marginal rate of tax (which, given Australia's high rates of personal tax is not indicative of the savings potential) but can also be identified by a set amount of taxable income.
- Individuals without that capacity;
- Companies;

[22] All figures derived from the *Taxation Statistics 1999-2000*, as provided by the Commissioner of Taxation.

- Complying superannuation funds;
- Australian managed investment funds; and
- CFCs.

The Options 4.1 to 4.4 for consultation seem to have (in our view correctly) been based on this premise.

6.3 The FIF rules should be abandoned

Our starting point is that the FIF measures are so flawed that they should be abandoned effective for the 2004 financial year. This would be done pending the introduction of rules that have a coherent policy. We see no basis for the retention of rules that:

- were introduced with a specific policy rationale which is not achieved (i.e. the measures were supposed to be restricted avoidance involving vehicles that were likely to be accumulation vehicles or mechanisms for conversion of income to capital gains); and
- have the effect of implementing a policy never agreed by the Government or the Parliament (i.e. an attack on deferral where the vehicle was not likely to be one used for the conversion of income to capital gains).

However, we have addressed below the options for consultation put forward in the Paper.

6.4 Exemption for complying superannuation funds (Options 4.4)

6.4.1 What is the current law?

Under the FIF measures, complying superannuation funds may be subject to attribution if none of the exemptions is available. The inclusion of FIF income is subject to a primary tax rate of 15%.

There is no exemption from the FIF measures for investments in foreign managed funds even where the underlying investments of the foreign fund would, if held directly by the complying superannuation fund, be exempt from attribution.

6.4.2 What is the problem & the evidence of the problem?

The largest category of taxpayers subject to attribution under the FIF measures are complying superannuation funds as follows:

- $31,837 from 56 taxpayers (1995-96);
- $73,985,223 from 34 taxpayers (1996-97);
- $817,994 from 48 taxpayers (1997-98);

- $17,460,766 from 73 taxpayers (1998-99).[23]

This is to be expected. The foreign investments of funds under management of complying superannuation funds accounts for approximately $100 billion. There is no serious dispute that a significant portion of this must be invested offshore – there is no realistic commercial choice. Further, much of these funds must be investment through managed funds, for which no exemption from the FIF measures is available. Therefore, a significant portion of the offshore investment income of complying superannuation funds can be subject to the FIF measures.

6.4.3 What solutions should be considered?

In the short term, complying superannuation funds should be exempted from the FIF measures. As set out in the Paper, the potential for deferral is substantially less than for a high rate or corporate taxpayer given the primary rate of tax of 15%. Exempting complying superannuation funds from the measures (even if this is only in the short term) would provide significant compliance savings without serious scope for deferral of tax.

6.4.4 How does the problem/solution relate to other options in the paper?

The treatment of FIFs can be dealt with irrespective of the implementation of any other option.

6.4.5 What priority should be given to resolving this problem?

Resolution of this problem should be accorded a high priority.

6.5 Other Exemptions (Options 4.3 and 4.5)

6.5.1 What is the problem?

As discussed, the basic issue is that the FIF measures impinge on investments that by managed funds that, on an objective basis, are not tax avoidance vehicles. This does not merely occur at the margin. If the FIF measures are not abandoned, the only solution is to provide a raft of exemptions to attempt to deal with these unjustified impingements.

6.5.2 What solutions should be considered?

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[23] The figures for 1999-2000 have not been quoted, as they appear to be either anomalous or incorrect.

If the application of the FIF measures is not to be suspended pending a rewrite of the measures, we submit that all of these exemptions outlined in the options for consultation in the Paper should be provided as soon as possible.

6.5.2.1 Raising the threshold for the balanced portfolio exemption

The issue of whether or not the 5% threshold is too low has been raised with the Treasury and the ATO for sometime now. We would expect then that they already have some feel for the number that would be acceptable (subject to determining whether a higher number is required). Consultation with the funds management industry on this matter is essential.

However, unless this can be finalised and legislated prior to 30 June 2003, we submit that the threshold should be raised immediately applicable for the year ended 30 June 2003. The 30 June 2003 date is appropriate for two reasons.

First, it is at the end of the year of income that the managed funds and superannuation funds need to sell down their investments. Therefore, provided the legislation is enacted in a timely fashion the amendment will be for all practical purposes prospective.

Second, the amendment cannot be adverse to any taxpayer and so there can be no issue of inequitably disadvantaging any taxpayer.

6.5.2.2 Exemption of index linked funds

Once again, the current application of the FIF measures to index linked funds shows that the FIF measures were too widely targeted.

6.5.2.3 Exemption of broad-exemption listed countries

Currently, the FIF measures exempt investments companies resident in the US. This is on the basis that the US is likely to tax all investment companies incorporated in the US or taxed as domestic corporations on a comparable basis to Australia. In those circumstances, there is little prospect that the company is used as a deferral vehicle. The same exemption should be extended to companies resident in other broad-exemption listed countries. Once again, it is unlikely that there will be any prospect that (say) a UK resident company will be established to deliberately defer tax or convert income to capital gains.

6.5.2.4 Managed funds

Once again, in our experience foreign managed funds are not accumulation vehicle. However, a suitable definition for the purposes of the exemption can only be developed in conjunction with the funds management industry.

6.5.3 How does the problem/solution relate to other options in the paper?

As discussed, the issues surrounding the FIF measures do not impact any other options in the Paper.

6.5.4 What priority should be given to resolving this problem?

If the application of the FIF measures is not to be suspended pending a rewrite of the measures, consideration of the mitigating the adverse effect of the FIF measures should be accorded a high priority.

6.6 Inbound Portfolio Investment via Australian Unit Trusts

6.6.1 What is the current law?

Under existing law, a foreign investor who holds an investment in an Australian unit trust, that in turn holds Australian investments or foreign investments may be subject to Australian tax on income and gains arising from the investment.

In the context of Australian investments, liability to Australian income tax for the investor can arise in circumstances where that liability would not arise if the underlying investment was held directly by the foreign investor, or by a foreign collective investment vehicle.

The issue is best exemplified in the following circumstances:

- Where a domestic trust holds an investment that, if held directly by a foreign investor, would not be an asset with the necessary connection with Australia. A capital gain arising from the investment would be subject to Australian capital gains tax where held through the Australian trust, but not where the investment is held directly by the non-resident.
- Where a domestic trust holds a foreign investment, a capital gain arising from the investment would be subject to Australian capital gains tax where held through the Australian trust, but not where the investment is held directly by the non-resident.
- Where a non-resident disposes of units in an Australian trust for a capital gain, a liability to Australian capital gains tax can arise in circumstances where it would not where the investment held in a foreign collective investment vehicle, notwithstanding that the fund's underlying investments are not investments that have the necessary connection with Australia.

We note that the issues raised in the Paper, and reform options considered, are limited to capital gains tax considerations. Our concern is that similar issues arise in relation to Australian taxation of revenue profits arising in similar circumstances.

In this regard, we note that revenue profits made by foreign investors are not generally subjected to Australian tax unless the profit has an Australian source, and is made at or through a permanent establishment in Australia (assuming as is typically the case that the investor resides in a country with which Australia has concluded a Double Tax Agreement ('DTA')). Where trustee of a fund in an Australian resident, section 3(11) of the International Agreements Act 1956 deems the investor to have a permanent establishment in Australia, and for any revenue profits associated therewith to be attributable to that establishment.

A taxation bias therefore arises under the current taxation law, since foreign funds are not burdened by this characterisation.

We do not understand the logic of amending the taxation system to remove a capital gains tax bias from the regime, but which retains a bias for revenue gains. If the Australian financial services industry is to reach its full potential, all biases that operate as a disincentive to foreign holders of capital investing via Australian based funds should be removed.

6.6.2 What is the problem?

The examples outlined above show that the taxation system has an inbuilt bias against foreigners investing in Australian unit trusts, the current vehicle of choice in the Australian funds management sector.

From an equality perspective, the existing system has as a problem that it does not appear to be fair. Any regime that has different taxation outcomes for essentially identical investments, should as a matter of principle be rectified to remove the bias.

From a national interest perspective, the problem is that the inbuilt bias is likely to be operating as a disincentive to foreign holders of capital from investing into Australia through Australian managed funds, thereby preventing the sector from reaching its full potential.

6.6.3 What evidence is there of the problem?

The evidence from an equality perspective is that the same investment structured through an Australian trust gives rise to different Australian taxation outcomes than would be the case of foreign direct portfolio investment.

We only have anecdotal evidence from our fund management clients that the taxation regime, and in particular the issues raised above, is retarding the growth of their businesses.

6.6.4 What solutions should be considered?

Each of recommendations 4.6, 4.7 and 4.8 should be implemented as outlined in the Paper.

In addition, the Board should consider recommending amendments to the taxation law so that revenue profits arising from the sale of the assets that are exempt from capital gains tax under recommendations 4.6, 4.7 and 4.8 are otherwise exempt from Australian income tax. Without this measure, profits exempted from tax under the capital gains tax provisions may inadvertently be subjected to Australian income tax under the ordinary income provisions.

6.6.5 How does the problem/solution relate to other options in 'the paper'?

The problem and solutions identified are aligned with the options in the Paper.

6.6.6 What priority should be given to resolving the problem?

We are of the opinion that these issues be given a high priority.

6.6.7 What are the benefits from adopting our recommendations?

The benefits of adopting the recommendations are as outlined in the Paper.

In addition, clarifying the taxation position for revenue profits will ensure any uncertainty about the characterisation of the gains does not arise. Our experience has consistently been that unless investors or potential investors can be provided with certainty regarding their likely taxation outcomes that they will be reluctant to invest.

7 Improving Australia's Tax Treatment of Foreign Expatriates

7.1 Overview

Ernst & Young supports the initiative of the Government in introducing measures to deliver overdue reform in relation to Australia's taxation of foreign expatriates in Australia on temporary assignments. It is unfortunate that the Senate rejected this measure when first introduced.

Ernst & Young recommends that the Board should in its communication in relation to the consultative document, emphasise to Government and in particular to the Opposition Parties and Senators generally, the key economic imperatives flowing from a more beneficial Australian tax treatment of foreign expatriates on temporary assignments in Australia.

We are pleased to present our response to the Department of Treasury's Consultation Paper on RITA specifically related to Part 5 of the consultation paper dealing with Australia's treatment of foreign expatriates.

The response considers:

- The proposals for taxation of foreign income and assets of temporary residents contained in Tax Laws Amendment Bill (No.4) 2002 (TLAB4) now to be reintroduced as Tax Laws Amendment Bill (No.7) 2002 (TLAB7).
- The options for consultation in Chapter 5 of the consultation paper, being:

  5.1 Capital Gains Tax Security Deposit Measures
  (part of 5.1) CGT Treatment of Departing Residents

  5.2 The Double Taxation of Employee Share Options

  5.3 Taxation of Share Options on ceasing of Australian residence

  5.4 Establishment of an Expatriate Tax Cell within the ATO

- In addition, there are several other issues related to the treatment of foreign expatriates that, in our view, require urgent Government attention. .

  1. Exemption of Non-Australian workdays for temporary residents
  2. Introduction of an Objective residency test for inbound residents
  3. Addressing major inefficiencies in double-Superannuation rules

7.1.1 Why is this issue important?

Ernst & Young is disappointed that the community perception of this issue suggests that the tax disadvantage operates only in relation to chief executive officers and expensive executive imports.

Ernst & Young's experience is that Australia's tax disadvantages in relation to foreign expatriates strike at many levels in businesses, and affects significant numbers of middle-income talented people in Australia. For example, the measures affect:

- chemical engineers in Australia for their contribution to exploration activities and development of new manufacturing processes;
- mineral engineers in Australia because of their unique skills;
- researchers generally who are exposed to Australia to assist in developing our intellectual capital;

as well as emerging business executives in global groups, who are being groomed for upward progression within their companies. Many of these individuals are on middle incomes.

These are the individuals particularly disadvantaged from a comparative viewpoint by Australia's harsh treatment of their overseas assets acquired pre-assignment.

Because of the much stronger international focus of business, it is also common to have middle level and senior executives employed internationally. This arises: -

- For Australian - origin executives who are posted for shorter or longer terms overseas;
- For foreign executives posted to Australia within global companies;
- In relation to Australian companies which need to recruit scarce expertise in order to operate in a global environment

These issues involve a mix of people - from people on middle level incomes to higher-level incomes. These issues affect talented young people, with families and children, as much as they affect senior CEO-level people.

Ernst & Young recognises that the level of personal income tax rates in Australia is a broader economic setting not relevant only to RITA. However, it should be emphasised that:

- The international tax environment for individuals is moving to lower tax rates;
- Like any other workers, individuals who are temporarily resident in Australia have foreign assets that are taxed harshly here.

So, Australia's current tax law dealing with foreign expatriates in Australia presents on balance an unfriendly and unwelcoming taxation environment when compared with most other developed countries. Australia's harsh tax regime sends a message to the foreign headquarters that Australia is not serious about attracting foreign investment and not serious about making Australia an attractive environment for business to operate internationally. This is a powerful message of unwelcome when compared with the overt and tax design welcoming messages emerging from other countries in our region, such as Singapore, Malaysia, Thailand, Hong Kong, all of which have tax systems designed to attract multi-national companies and their expatriates to operate in local bases.

7.1.2 Australia's Harsh Tax Rules Add to Employer Costs and Make Australia Less Competitive

In many cases, where foreign expatriates are brought into Australia on tax equalisation arrangements, the harsh costs arising from the Australian tax settings are borne by the employer. These costs result in significant additional costs, which ultimately cause Australia to be less competitive.

We emphasise that these costs, which operate at the employment-cost line, are costs that affect the pre-tax profit of multi-national enterprises. That is, the divisional and operational employers within corporate groups are dissuaded from using foreign expatriates and their skills.

In many organisations there are many options available. If the foreign expatriates cannot be brought to Australia, they can be brought to other Asia Pacific locations to do similar work. If Australia does not want their managerial or value-added skills, then those managerial or value-added skills can be generated in other countries such as Malaysia, Singapore, Thailand, Hong Kong and China.

As a result those other countries can generate the taxation revenue that flows from the current earnings of the foreign expatriates, as a result of their more neutral treatment of the foreign expatriates' pre-assignment investments.

7.1.3 Temporary Resident Measures

Of the points raised in the Consultation Paper the most important from an expatriate taxation perspective is the implementation of the previously announced "temporary resident" tax exemptions for foreign nationals working in Australia (these are referred to in this submission as "temporary residents"). These measures are contained in TLAB7.

7.1.3.1 The current law and the inherent problems

To recap the Consultation Paper and the original measures, these provisions were designed to relieve foreign expatriates working in Australia from Australian tax on investments held outside Australia for a maximum of four years. This would have included both income tax arising from investments owned prior to arrival and purchased during their time in Australia, as well as any capital gains made from the sale of foreign assets while the person was in Australia.

The measures would also relieve a temporary resident from the deemed disposal measures currently in place where an ordinary resident ends their Australian residency for tax purposes.

The measures would continue to tax, in Australia, any holdings or income generated from Australian investments (e.g. Australian listed stocks). The measures would not affect the existing exemption for non-Australian employment income such as, for periods of service outside Australia, while an Australian resident.

TLAB4 was originally introduced on 30 May 2002 for debate in the Parliament. However, following opposition from the Australian Labor Party (ALP) and the minor parties, the measures were removed from the Bill in order that other important tax measures could be passed.

Ernst & Young welcomes the Government's commitment to these measures as expressed in the Consultation Paper. These measures will be particularly effective in the short to medium term as employees everywhere move from growth based to income stream investments.

The Senate's blocking of the Bill was partly due to concerns raised by the ALP. The Press Release from Senator Bob McMullan on 18 June 2002 asserted that:

(a) the measures will only benefit "wealthy" foreign temporary residents; and

(b) the Government had provided no evidence that the Australian Taxation of foreign temporary residents was uncompetitive in an international context.

7.1.3.2 The problem is not about "Wealthy" Foreign Executives

These measures were not designed to benefit only the "wealthy" executives employed in senior positions in Australian companies and foreign companies in Australia. The reality in respect of this group is that where they are needed to come to Australia, they will come, because the excessive Australian tax on their personal income and investments will generally be borne by their Australian employer under Tax Equalisation arrangements.

So the problem is in fact yet another tax overlay, yet another additional tax cost which operates to make it all the more expensive to bring talented temporary residents into Australia for the development of our businesses.

It is sometime stated that large companies can afford these costs, but it is not just large companies that find themselves in need of overseas talent.

The primary benefit sought from the measures is to make it more tax effective for Australian companies in general to employ lower level foreign talent on a larger scale where the skills required are not available in the Australian market place.

7.1.3.3 The problem adds to cost structure for Australian business

Under current legislation, the combination of the high differential between the Australian and foreign tax rates on salary and investment income has made it difficult, if not impossible, for small Australian companies to hire this talent in order to grow their business both in a national and International context. It has also increased the cost of large infrastructure projects where higher numbers of lower paid but particularly skilled workers are required. This is mainly as a result of the "tax on tax" affect of compensating individuals at the higher Australian tax rates on their personal and, if necessary, employment income.

Example illustrating the costly outcome of the current tax treatment

The following example illustrates how Australia's tax system can multiply the cost of employing even a non-wealthy foreign expatriate in Australia, and how it adds to the cost structure for Australian companies for key skill sets.

Say, a medium sized Australian company wishes to bring a USA chemical engineer to Australia to work on a new product line. In the USA, this engineer earns a regular salary of US$60,000 per annum and has an investment income of US$5,000 per annum. This person will not be considered to be a "wealthy" employee in the USA context.

In order to motivate the engineer to come to Australia, the Australian company agrees to operate a tax equalisation system such that the engineer will only pay a tax liability equivalent to a tax he would have paid, had he remained in the USA. The company will then meet any additional Australian tax obligation imposed as a result of his temporary assignment.

Assumption A: Engineer has no geared or leveraged investments

An employee working in the USA on a taxable income of US$65,000 faces a marginal tax rate of 27.5% at the Federal level. Therefore, the USA tax payable on the $5,000 of personal income will be US$1,375 (equivalent to approximately A$2,750). Under his agreement with his employer this would be the maximum amount that the engineer will be required to contribute towards the Australian tax cost on his personal income.

Under the current Australian system for the taxation of foreign income, the amount of tax that would be payable in respect of this income would be calculated as follows:

Taxable Australian income	A$10,000
Australian tax payable @47%	A$4,700
Less contribution by employee	(A$2,750)
Australian tax payable by company	A$1,950
Add Fringe Benefits Tax gross up *	A$1,836
Total cost to company	A$3,786
Total tax paid on income	A$6,536

*The employer pays Fringe benefits tax because the compensation to the employee for the incremental tax under the equalisation policy is a taxable fringe benefit.

In this example, the company is being required to pay an additional A$3,786 just in respect of this employee's personal income.

So, Australia's higher individual tax rate, which results in marginal costs to the employer, is further escalated by the Fringe Benefits Tax (FBT) to create an exponential "tax on tax" effect.

This tax on tax is in addition to the already high costs of moving an individual to Australia such as providing accommodation, transportation and moving expenses and housing and family benefits plus the tax differential on the employees base salary.

Assumption B: Engineer has a geared investment portfolio

Assume however that the engineer, like many Australian investors, has geared his personal affairs to be tax effective from a USA perspective. For example, a common investment held by many Americans is tax-exempt municipal bonds. These bonds pay interest that is exempt from USA tax (with a resultant lower prime yield) but which is fully taxable to a person on a temporary assignment in Australia under current law.

The USA tax under such an arrangement would be nil. As a result the employee would not contribute the A$2,750 to the cost of the tax under the equalisation arrangement. The full Australian tax cost would have to be borne by the company.

Adding in the cost of Fringe Benefits Tax, the "tax on tax" effect creates a total increase in the company cost of A$9,126 per employee

Therefore, under these types of tax equalisation arrangements (which are extremely common, particularly for individuals coming from the USA) the benefits of the temporary resident measures would not flow to the individual. Rather the saving will flow to the employer company thereby reducing the employer's costs and providing more opportunity for other employment creation projects.

The examples demonstrate the effect if the tax is borne by the employer.

7.1.3.4 The problem makes Australia unattractive for foreign employees

If the employer seeks NOT to run a tax equalisation policy, and to make the employee responsible for the additional tax, the likely outcome is that the potential employee will refuse to come to Australia. This is a frequent occurrence.

7.1.3.5 Uncompetitive taxation contrasts with attractive other-country treatments

With the exception of the current limited exemption from the FIF regime and Medicare Levy for temporary residents, the Australian tax system offers no incentive to individuals to relocate to Australia in respect of their personal income.

This is at odds with the position adopted in many of our major trading partners including the UK, Singapore, Thailand and Hong Kong to name a few. The four countries listed above all operate a "remittance" based system for the taxation of personal income belonging to foreign expatriates working within their borders. While the rules vary from country to country, the general theme is that where a foreign expatriate is working in that country, their foreign personal income will be exempt from tax in that country unless the expatriate chooses to remit (or bring in) the income to that country.

For example, foreign expatriates working in the UK for a period of less than three years will not pay any UK tax on their personal foreign investment income provided they do not bring that income into the UK. This compares to the Australian system where anyone arriving for a period of more than six months will have all of his or her foreign income taxed in this country regardless of whether it was ever brought into Australia.

7.1.3.6 Results of the Problem

The uncompetitive nature of the current Australian system has other undesirable consequences beyond foreign expatriates simply rejecting an Australia assignment, or escalating the costs of bringing in talented people to assist in global projects. These include:

- The tax on tax issue raised above has the unintended consequence of over inflating the reported salaries of foreign workers relative to what the employee actually receives. This can cause problems within the company due to perceived salary differentials that do not actually exist.
- The high cost of bringing in necessary skills from overseas results in some inflationary effects on Australian salaries. We suggest that in some scarce skill areas, Australian employees' salaries are increased due to their being benchmarked against the all-up costs of employing foreign employees with similar skills.
- In a broader context, in creates and exaggerates the impression in the media and the public mind of overpaid foreign executive when the real money is going to the ATO.

7.1.3.7 Solution – illustrating linkages

Ernst & Young suggests that the simple solution would be to reintroduce TLAB7 and for the Senate to pass the rules.

If the Senate continued to consider that TLAB7 was overgenerous we could offer alternative proposals.

7.2 CGT Security Deposit Measures – Option 5.1

7.2.1 What is the problem?

As pointed out in the Consultation Paper this was originally a recommendation of the RBT that will affect Australian residents who do not sell an asset to realise a capital gain or loss at their departure from Australia. The measures would require them to leave "adequate security" in favour of the Australian Government to cover any potential capital gain or loss arising upon the eventual sale of the asset while a non-resident.

Ernst & Young strongly supports the views expressed in the Consultation Paper that the implementation of these measures would be a costly and backward step in tax administration in this country. The measure would effectively eliminate any benefit to the individual in deferring the disposal of a capital asset and avoiding the cash flow impact that such a taxation event would create.

Such a measure would also be at odds with virtually every other country with which Australia has a trading relationship. The original measure was recommended based on a Canadian model for similar initiatives. However, to date the Canadian initiative has only been intermittently imposed and after three years, and Canada still does not have a definitive or easy to use system in order to provide the security.

In addition, the increased administration costs of such a system by the ATO on the large number of Australians travelling overseas (not just foreign temporary residents ceasing their Australian resident status) would mitigate any increase in revenue obtained through dealing with the guaranteed property.

Ernst & Young notes that, after careful policy analysis, the consultation for the TLAB7 temporary resident measures did not even consider this measure for consultation.

7.2.2 What solutions should be considered?

In order to provide certainty to Australian employers and employees, we would seek the Board to provide a firm statement of recommendation to the Government that this proposal be removed from consideration.

7.3 CGT Treatment of Departing Residents

7.3.1 What is the problem?

The Consultation Paper restated the proposal to deal with double taxation caused by the deemed disposal measures through bilateral tax treaties.

In Ernst & Young's view, this approach is both time consuming and unlikely to provide definitive results in the short term. We believe a better approach would be to correct the domestic legislation to provide certainty between destination countries.

Deemed disposal on termination of residence: an uncompetitive measure.

Australia and Canada are the only two countries in the world that operate a deemed disposal system, whereby a resident departing the country who becomes a non-resident is deemed to dispose of all assets which are subject to CGT.

The system effectively punishes people who wish (or who are required) to work in Australia for longer than 5 years by taxing them on gains that have not (and often cannot be) crystallised and which have no value to the taxpayer at an arbitrary point in time.

This tax feature acts to repel temporary residents from Australian postings or extended stays.

It is difficult to see how Australia can justify the position of taxing non-Australian assets that are not in actual fact disposed of by non residents until years after their departure from Australia.

7.3.2 What solutions should be considered?

7.3.2.1 A better approach: Reform Expatriate Capital Gains Tax in General

There is currently a range of piecemeal reforms being considered such as:

- the security deposit
- treaty measures referred to above
- limited-extent exemptions as proposed in TLAB7.

However there is scope to perhaps revisit the approach regarding the whole deemed disposal question and the related taxation of foreign capital gains.

While we welcome the proposal to address these issues through the negotiation of DTAs, this approach would involve:

- lengthy delays – of years (consider for example the fact that the USA treaty has already been finalised)
- ambiguity (as every treaty involves a distinct negotiation process with different tensions and positions).

So this approach will not persuade more people to come to Australia to share their skills.

Therefore we would call on the Government to introduce a domestic legislative resolution to these issues in order to provide certainty and stability for employers and international employees.

Ernst & Young welcomes the introduction by the Government of TLAB7 with a view to alleviating this problem for temporary residents. However, it does not deal with the converse problem for Australian residents departing overseas on working assignments for several years.

TLAB7 is better than the current rules which apply to persons who have been residents for less than “5 out of 10” years. This is a “drop dead date” rule. But the TLAB7 approach can itself be improved.

These issues were discussed in the BCA discussion document “Removing Tax Barriers to International Growth” dated 11 December 2001, prepared by Michael Wachtel and Alf Capito (“the BCA discussion document”).

Ernst & Young supports the general approach to exemption for temporary residents, which is contained in TLAB7.

However we recommend a more structured approach to eligibility for the concession:

A. Ernst & Young proposes that the entire system of deemed disposal should be abolished for temporary residents working in Australia on temporary visas, consistent with recommendations 21, 23 and 25 of the BCA discussion document;

B. Ernst & Young proposes that the entire system of deemed disposal should be abolished also for domestic residents departing on temporary assignments.

C. The tax concessions should be adjusted to allow a tapered concession for residents over a seven-year period. Under the tapered exemption proposal the exemption would operate as follows:

    1. Executives in Australia for periods up to five years would not be subject to Australian CGT on their foreign assets.

    2. This concession would be progressively scaled back for two further years after the fifth year.

Such an approach would alleviate the current compliance nightmare of temporary residents needing to track and distinguish their investments between those acquired prior to arrival and those acquired in Australia. This aspect can cause significant compliance difficulties where individuals are engaging in dividend reinvestment plans.

There are also two further policy issues that need to be considered in relation to these proposals.

1. For how long should a visitor be entitled to such concessions?

   The drop-dead date approach proposed under TLAB7 is a proposed expiry of the concessions after four years' residence. Ernst & Young recommends against this approach, as it does not solve the problem of temporary residents being forced to leave Australia once they reach a certain date (if anything the date of departure is shortened from 5 years under the current rules to 4.

   Ernst & Young prefers the tapered approach outlined above and in recommendation 21 of the BCA discussion document. This avoids the "tax shock" temporary residents would feel upon transitioning to the domestic tax framework on a set day. Under this system, after an initial period, gains that would be exempt under the new regime will revert back to the "standard" CGT rules over a period of two years.

2. The second issue, which was not addressed under TLAB7, is the determination if the date to be used for setting the deemed acquisition value (i.e. the date that the CGT exposure commences).

   Ernst & Young proposes that, if assets are to be subject to Australian tax from a particular date, then the assets should be valued at that date. Put another way, when a the temporary resident ceases to be subject to the temporary resident tax concessions, there should be a deemed acquisition on the same date as the assets transition from one system to the other. This approach would also allow the individual time to move from an investment strategy geared to the home country to one that is effective in Australia.

This issue is not as sensitive if a tapered approach was used although the date to be used for deemed acquisition must still be determined in a logical way. For example, does Australia use the date of first residence, the date when the full exemption ceases (5 years) or the date the taper ceases (7 years)? Ernst & Young would recommend a deemed valuation date being the end of the full exemption period.

7.3.2.2 Alternative Possible Solution: Remittance Basis

Ernst & Young recognises the political problems in the introduction of TLAB7.

If the removal of the repellent features of Australia's taxation of temporary residents could not be achieved by building on TLAB7, the Government might consider a remittance-based system to apportion gains between countries.

Similar to the current practice of the UK, a temporary resident might be exempt from Australian CGT during their temporary resident period, provided that the income from the realisation of the property was not brought into Australia. This is less generous in some ways but perhaps enhanced in removing the "all or nothing" exemption with a drop dead end date as suggested under the TLAB7.

7.4 Dealing with Cross Border Taxation of Stock Options – Option 5.2

7.4.1 What is the problem?

The current Australian taxation of stock options (Division 13A) is virtually unworkable in an international context. The inability to clearly establish what is and what is not taxable under the domestic Australian law means that double taxation results are inevitable in the current framework.

The proposed use of a treaty-based approach to address the splitting of taxing rights on options is also unworkable for a number of reasons:

- Most importantly, these issues need to be resolved today, not in the years taken to negotiate or renegotiate each double tax agreement. Despite the current debate about the future use of stock options, these instruments remain an important and valuable tool for the remuneration of employees. Furthermore, the issues inherent in the international taxation of options become even more difficult when dealing with issues of restricted stock, which are becoming more common.

- Income tax treaties are designed to avoid double taxation of income not to provide a mechanism for Australia to tax everything that another country treats concessionally or neutrally.

  For example, many countries allow a full exemption from tax for stock options granted prior to arrival. This includes both the UK and Singapore, two of our most significant trading partners. As such, if the UK does not want to tax income that is UK sourced at common law, the treaty should not be used as a mechanism for Australia to be able to pick up income tax to which it would not be entitled but for a domestic decision of the UK. This would send a message of Australian opportunism and would be resisted in treaty negotiations.

- Two main countries whose resident individuals arrive in Australia and have tax problems with double taxation of options are the USA and the UK. However the USA treaty has only recently been renegotiated, and reports suggest that renegotiation of the UK treaty is nearly complete. Therefore the ability to further amend the treaties for these two countries, at least in the short term, is extremely limited. As such employees moving between two of the most popular and important locations will remain in a cloud of uncertainty for the foreseeable future.

7.4.2 What solutions should be considered?

First, as noted above, Australia should remove the taxing point on termination of a temporary resident's Australian-resident status.

Second, as noted in recommendation 23 in the BCA discussion paper, Australia should allow the complete exemption from Australian tax of gains from the holding of pre-arrival stock options in order to provide consistency with the treatment adopted in the UK, Singapore and other countries.

This approach is clearer than that in TLAB7. The TLAB7 approach had ambiguity arising from the desire for Australia to tax the options "to the extent" the income relates to Australia. That ambiguity made it only a partial solution.

Third, while not strictly relevant to RITA, Ernst & Young recommends that Australia needs to resolve its domestic tax law through a comprehensive review of the stock option provisions. Such a review would need to focus on:

- The interaction of the current Division 13A and the long-term CGT concessions.

- Removing the requirement for options & shares to be taxed at cessation where there is no possibility of the employee obtaining an economic benefit for an extended period after termination (thereby effectively removing one of the key double taxation drivers).

7.5 Division 13A Cessation Event and Tax Exposure for Employee Share Schemes for a Resident on Date of Departure – Option 5.3

This proposal was originally put forward in The Review of Business Taxation – Ralph Review (RBT).

Again, Ernst & Young strongly support the recommendation in the Consultation Paper to terminate and end discussion on this measure. The arguments against this measure are the same as for those against the deemed disposal security deposit measures, set out at length above.

The issue is all the more problematical when it is understood that employee share schemes are designed by employers as retention strategies and apply to many employees not just the senior executives.

Ernst & Young would recommend a dismissal of this recommendation as part of this review.

7.6 Establishing an ATO Cell for Foreign Expatriates – Option 5.4

The current ATO administration of expatriate issues is disjointed due to the number of different sections involved.

An expatriate assignment changes virtually every aspect of an individual's tax treatment from FBT to superannuation, stock options and capital gains. While the ATO has units dedicated to each of these areas, there is no overarching unit with the authority to deal with expatriate issues that cross over the ATO's various service lines.

As such we would welcome the establishment of a specialist cell as a point of reference for all expatriate tax issues. This will help to alleviate some of the cross-jurisdictional issues expatriate currently face. Some common examples of this are:

- The inability of the superannuation group to recognise that non-resident international assignees may still receive Australian employer superannuation contributions. This has led to demands for tax returns to be lodged despite these foreign expatriates having no other taxable income.

- The taxation of stock options is currently split between the employment income unit and the CGT unit. Therefore the ATO has not been able to provide definitive guidance on the correct treatment of options under the current deemed disposal rules or the ability to claim foreign tax credits in double taxation cases.

8 Other Issues not addressed in the Consultation paper

There are a number of further issues that Ernst & Young believe the Board should be considering in their review of Australia's international tax regime. Many of these measures have been raised previously in the BCA discussion document.

8.1 Venture Capital Concessions to attract foreign equity capital

Ernst & Young consider that, apart from dividend imputation there are other factors that are also relevant in setting the attractiveness of Australian companies to investors.

Our unworkable environment for venture capital equity, certainly for emerging companies, hampers the supply of foreign equity funds in Australia.

One of the unattractive features of the Australian tax environment is the lack of truly viable venture capital concessions, notwithstanding the measures proposed in the RBT report and introduced in 1999.

Ernst & Young recognises here the Press Release of the Assistant Treasurer, Senator Helen Coonan, foreshadowing enhanced treatment of venture capital effective 1 July 2002, delivering on the Budget announcement in the May 2002 budget.

Ernst &Young would like to stress the real significance of the venture capital concession in the equity raising behaviour of Australian companies.

The following points are made:

1. Australia is recognised internationally for the quality of our knowledge and research skills.
2. However, it is unattractive for foreign private capital (which emanates largely nowadays from major foreign pension funds, educational funds and endowments such as charitable foundations and USA university foundations) to invest in Australia. The reason is that Australia imposes CGT on investments by foreigners in Australian private companies and in Australian public companies where the foreigner's investment exceeds 10% of the issued capital.
3. This taxation impost can be contrasted with carefully designed venture capital concessions which apply in many other countries, which are specifically tailored to enable long-term patient venture capital to be attracted into the local jurisdiction and used to grow local companies.
4. This issue was recognised in the RBT, in the venture capital concession recommended by the RBT, and in the concession introduced in 1999 by the Government in the *New Business Tax System (Capital Gains Tax) Bill 1999*.
5. Unfortunately, however, the venture capital concession then introduced was flawed in a number of critical respects:
6. The venture capital concession was limited only to investments by foreign superannuation funds. It did NOT apply to investments by foreign educational endowments (such as those of the major USA universities) and major charitable endowments (such as the Ford Foundation).
7. More importantly, the concession in relation to intermediaries was restricted so that only a foreign intermediary that was owned exclusively by superannuation funds exempt in their country of taxation was

eligible. Again, this meant that if any foreign intermediary who has any investment in it from a foreign charitable endowment educational foundation, or wealthy foreign individual, then – even if these investments were limited in extent – the foreign collective investment vehicle was ineligible for the Australian venture capital concessions.

The Government is urged to proceed with this measure with the greatest urgency.

It is noted that, unlike the optimistic times of 1999, when NASDAQ was booming, and global stock markets were strong, we now have a very muted international economic environment.

Further, since 1999 Singapore has expressly targeted the venture capital market with a concession designed to capture Singapore as a hub for venture capital investment.

It is disappointing that the initiative of the RBT, and the well-meaning initiative of the Government in 1999, has not been achieved due to flawed legislation that has not been remedied in the interval.

Australia needs a strong active and vibrant venture capital industry, bringing in foreign equity funds into Australian companies. Venture capital concessions provide a significant element of this attraction, particularly in relation to unlisted companies such as:

1. Early stage investments – in industries such as biotechnology, computer technology, but also engineering and other innovative production processes; and

2. Later stage venture capital investments such as leveraged buy-outs, and other mechanisms where existing Australian businesses can be acquired by new financial owners, with the involvement of foreign venture capital monies, and invigorated and grown to a global scale.

8.2 Australian Treatment of Intangibles and Intellectual Property: A Factor in Equity Raising Attractiveness

It is considered that, as well as the dividend imputation measures, and the venture capital measures, that Australia should address the significance of the treatment of intangibles and intellectual property in making for an attractive capital-raising environment.

There is a particular need for focus on two aspects that would make Australia more attractive as a location for the capital raising and holding of global intellectual property in Australia:

- the withholding tax environment, which applies to royalties under Australia's double-tax agreements. Australia should adopt a preference for negligible or nil royalty withholding tax rates in its double-tax agreements; and

- an enhanced process of achieving an appropriate tax recognition or tax write-off for the cost of intellectual property.

The withholding tax environment in relation to royalties and charges for intellectual property is important.

Australia in the past was a net payer of royalties to residents of other countries.

However, with the talent of Australia's business people and researchers, Australia is recognised as a viable research location. Unfortunately however, Australia's double-tax agreements do not strive for any advantageous treatment in relation to royalty withholding taxes, other than typically the generic 10% limitation on royalty withholding taxes.

As a result, Australia is not seen as an attractive location to use as a licensing hub for international business.

Ernst &Young and its members have seen Australian technology move to ownership in other countries that have better treaty networks, from which the technology is licensed.

Unfortunately, the other countries' treaty networks and licensing activities mean that there are flow-on activities which are then undertaken in those other countries – activities involving the intangibles management, professional services, and licensing headquarters activities of the relevant companies.

It is understood that there will no doubt be a concern about potential revenue costs in this regard. But it is thought that the opportunity cost of such a measure would be extremely low. That is, Australia is missing out on international licensing activity by virtue of Australian intellectual property being sold overseas. If Australia had a more attractive withholding tax environment fostering licensing through Australia, then Australia would be able to generate a higher level of licensing activity through Australia.

And, more importantly, if international intangibles were owned through Australia, and managed through Australia, it is submitted that the intangibles would then be more likely to remain in Australia within the Australian companies affiliated with global organisations.

8.3 Amortisation of Intangibles and Intellectual Property

It is noted that various elements of intangible property are currently eligible for amortisation under the uniform capital allowances (UCA) rules.

However these amortisations are limited in accordance with the following provision:

> *40-30 What a depreciating asset is*
>
> *……………*
>
> *(2) These intangible assets are depreciating assets if they are not trading stock:*
>
> *(a) mining, quarrying or prospecting rights;*
>
> *(b) mining, quarrying or prospecting information;*
>
> *(c) items of intellectual property;*
>
> *(d) in-house software;*
>
> *(e) IRUs;*
>
> *(f) spectrum licences;*
>
> *(g) datacasting transmitter licences*

Other countries such as the USA and more recently, in 2002, the UK, have mechanisms whereby a broader range of business intangibles is eligible for amortisation. It is suggested that these amortisation techniques make it more attractive for acquisitions to occur by companies located in those countries.

As a medium-term objective, Australia should consider an enhanced process for amortisation of business intangibles in the context of acquisitions.

Whilst it might be argued that this amortisation will create a revenue cost, the marginal revenue cost might in fact be quite low. Factors in determining the marginal revenue cost will include:

- increased attractiveness of Australian takeovers for Australian companies (that is, the economics for an Australian acquirer will improve, perhaps to the same level as the after-tax economics for a USA acquirer or now a UK acquirer of an Australian company); and
- the fact that there will be a higher propensity for Australian-based acquisitions rather than foreign takeovers might enhance the volume of headquarters activity in Australia, and the flow-on benefits for Australian businesses.

This priority measure would require some analysis and revenue costing.

For that reason Ernst & Young believe that this should be itemised by the Board and by the Government as a medium measure of significance for Australia's growth.

8.4 Exemption of Non-Australian workdays for temporary residents

We note the Treasury's concerns that allowing an exemption for non-Australian workdays of temporary residents will create a tax bias in favour of temporary residents over Australian residents.

However with respect to these views, Ernst & Young believes they are misplaced. The idea behind these measures is to increase Australia's international attractiveness as a home of regional head offices. The current Australian tax rules provide no incentive in this respect when compared to our neighbours such as Hong Kong, Singapore, Thailand and Malaysia, who all offer this type of exemption.

Therefore, it becomes a simple matter for a group of executives looking at where to locate an office to decide between paying 47% on all of their income or between 17% and 35% on only a part of their income.

Furthermore, these concerns do not reconcile fully with the treatment in TLAB7 of non-employment income.

Therefore we would reiterate the comments in part 10.3.1 and recommendation 21 of the BCA discussion paper that Australia must provide a mechanism for relief from tax of non-Australian source employment income received by temporary residents.

8.5 Introduction of an Objective residency test for inbound residents

The current "resides" definition of a resident for Australian tax purposes is out of date and out of step with Australia's desire to provide a more definitive tax environment. It is also inconsistent and provides different outcomes for people coming to and leaving from Australia on a temporary basis.

Basing a person's tax residency on where their mail is delivered and where they keep their goods is unlikely to be relevant to the type of expatriate that Australia is trying to encourage to come here with this review. As such, Ernst & Young would recommend that an objective test be developed. This could be based on days of physical presence and apply to both leaving and arriving international travellers.

Such a system would be consistent with the treatment adopted by our near neighbours and would provide greater certainty.

8.6 Superannuation

The Consultation Paper notes, and Ernst & Young recognises, the Government's moves to allow temporary residents to withdraw their superannuation contributions following their departure from Australia.

However, Australia still imposes additional non-recoverable costs on employers in terms of:

- The 30% Australian tax payable on contributions to the fund and the 30% payable on withdrawal of the balance (a total tax on the original contribution of 51%!)
- The time value of the money that may be recovered by agreement from the temporary resident following departure from Australia.
- The administrative cost of having the temporary resident join the Australian fund, while maintaining their home country superannuation fund, with the employer seeking to recover the contributions from the employee.

These issues result from the double coverage of employees under home and host country social security systems.

While Ernst & Young acknowledges the efforts of the Government in this area through negotiation of social security agreements, the exemptions allowed in these treaties do not always reflect the commercial substance for the arrangement.

For example, the recent Australia/USA agreement will only provide an exemption for an Australian resident in the USA from USA social security where an employee is "covered" by the Australian Superannuation Guarantee Charge (SGC) system. As SGC is only compulsory where a person remains a resident of Australia for tax purposes, the USA exemption is limited to a maximum period of two years (compared to five years for USA citizens coming to Australia).

Ernst & Young recommends that:

A. All temporary residents should be excluded from having to make contribution to Australia's compulsory superannuation charge in the same way that the "senior executive" exemption operates now. This proposal was outlined at recommendation 22 of the BCA discussion paper.

B. Alternatively, if a full exemption cannot be achieved, then an alternative is:

  1. to recognise contributions to foreign social security systems as being equivalent to Australian superannuation for the purposes of companies meeting their minimum support obligations.
  2. to allow Australian employers to claim deductions for contributions to foreign superannuation plans on account of temporary residents.

C. Australia should negotiate our treaties to reflect the commercial reality of superannuation contributions for Australian citizens rather than the minimum requirements dictated by the SGC law.

8.7 Foreign Personal Superannuation Funds – need for exemption from FIF difficulties

The consultative Paper recognises at Option 4.4 the need to provide concessions from the FIF rules for Australian complying superannuation funds.

A similar issue arises, however, in relation to foreign personal retirement funds.

8.7.1 What is the problem?

Foreign retirement plans

Australians who have worked in the USA and return to Australia, or Americans who come to Australia to work, will frequently have funds invested in Individual Retirement Accounts (IRA) (similar to Australian Retirement Savings Accounts). These are genuine retirement saving vehicles subject to substantial USA tax penalties if withdrawn prior to retirement. Often, these amounts will have been accumulated in an employer sponsored pension fund, but need to be transferred to an IRA when the individual returns or moves to Australia.

However, these accounts do not fall within the current FIF exemption, as they are not employer-sponsored funds. This creates two problems:

a) The FIF rules apply in Australia to the IRAs on a current basis. That is, the increase in benefits is taxable to the employee.

b) When the funds are withdrawn at retirement, no further tax will usually be payable due to the operation of the FIF attribution rules and section 27CAA. However, USA tax is payable at that time and cannot be claimed as a Foreign Tax Credit. As a result, double tax arises.

8.7.2 What solution should be considered?

These funds are clearly genuine retirement vehicles that should not fall within the FIF net. Accordingly, Ernst & Young recommends that they should be included within the list of FIF exemptions.

Appendix 1

As noted in section 2 of our submission, the impact that changing the imputation regime has on the cost of capital of Australian companies will depend on the efficiency with which capital markets operate.

If it is assumed that Australia is a small, open, net capital importing nation and that capital markets operate perfectly, then changes to the imputation regime are unlikely to alter the cost of capital of Australian companies. Under such assumptions, the rates of return on equity will be determined by the operation of world capital markets and Australian companies and their shareholders will be 'price takers'. That is, Australian companies will have to be prepared to pay the prevailing world pre-tax rates of return to attract the equity capital they need to finance their investments and Australian shareholders will have to accept those rates of return. Changes to the Australian imputation regime will affect the after-tax rates of return earned by Australian shareholders on their investments, but will not alter the cost of capital of Australian companies.

By contrast, if it is assumed that some Australian companies have difficulty accessing international capital due to the existence of capital market imperfections, then changes to the dividend imputation regime have the potential to affect the cost of capital of Australian companies. In particular, under such assumptions, options A, B and C have the potential to reduce the cost of capital of Australian companies that have difficulty accessing international capital.

This raises the question as to what assumptions should be made about the efficiency of capital markets for the purposes of determining the impact of the options for reforming the dividend imputation regime that were outlined in chapter 2 of the consultation paper.

Ideally, we would like to know how the Australian tax system, particularly the dividend imputation regime and changes to that regime, influence the cost of capital of Australian companies. In the absence of detailed empirical evidence, however, it will be necessary to make certain assumptions regarding capital market efficiency for the purposes of analysing the proposed options for reform of the imputation regime.

The assumption that capital markets operate efficiently certainly simplifies the analysis of those options for reform. However, as outlined below, available empirical evidence suggests that this may not be a realistic assumption. Rather, it may be more realistic to assume that there is still a significant 'home country' bias and that changes to the imputation regime may alter the cost of capital of those Australian companies with restricted access to international capital markets.

Although international capital markets have been deregulated over the last two decades, capital is still much less mobile internationally than expected. As noted by Gordon and Bovenberg (1994), empirical evidence suggests that capital is quite immobile internationally as indicated by the correlations between domestic savings and investment pointed out by Feldstein and Horioka (1980), real interest differentials across countries, and the lack of international portfolio diversification.

Despite this international immobility of capital, however, Gordon and Bovenberg note that many studies of the impact of capital taxation in an open economy still assume that capital is fully mobile internationally:

> In spite of this strong empirical evidence on the propensity of savers to invest at home, most theoretical papers studying capital income taxation in an open economy have assumed that capital is fully mobile internationally.

Gordon and Bovenberg discuss a variety of possible explanations for the immobility of capital that have appeared in the literature and their consistency with the empirical evidence and conclude that the existence of asymmetric information between investors in different countries is the most plausible explanation:

> The explanation that we find most convincing, and one that has been inadequately explored to date, is asymmetric information between investors in different countries. In particular, foreign investors are at a handicap relative to domestic investors due to their poorer knowledge of domestic markets.

Similarly, Stulz (1999) examines the impact of this process of globalisation on the cost of equity capital and concludes that although globalisation reduces the cost of equity capital, the effects are lower than theory leads us to suspect. As noted by Stulz, this is explained to some extent by the well documented home country bias (i.e. the bias in favour of domestic rather than foreign investment):

> The theoretical analyses make the assumption that a country liberalizes or a firm accesses global capital markets in such a way that they are immediately completely integrated in world markets. This is rarely the case. A well-documented empirical regularity in international finance is that investors are not as well-diversified internationally as predicted by the analysis of Section I and that they invest too much in their home country[24]. As an example,[25] in 1996, U.S. investors held 90% of the value of their stock portfolio in US stocks. At that time, however, US stocks represented less than half of the world market capitalisation of stocks. Consequently, if U.S investors had been holding the world market portfolio of stocks, their holdings of U.S. stocks would have represented less than 50% of their holdings of stocks.

Stulz notes that numerous reasons have been advanced for that home country bias including:

- remaining restrictions and additional costs associated with investment abroad;
- the benefits from international diversification can be obtained by holding foreign securities that are traded domestically;
- information asymmetries between domestic and foreign shareholders;
- the existence of different consumption baskets;
- political risk; and
- behavioural biases in favour of domestic assets.[26]

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24 See Cooper and Kaplanis (1994), French and Poterba (1991), Kang and Stulz (1997), and Tesar and Werner (1995).

25 See Tesar and Werner (1998) for these numbers.

26 See Kang and Stulz (1997) for a discussion of these various explanations.

Similarly, Karolyi and Stulz (2002) have reviewed the international finance literature to assess the extent to which international factors affect financial assets demand and prices and conclude that:

> The literature has provided clear evidence that national market risk premiums are determined internationally, but less clear evidence that international factors affect the cross-section of expected returns. … Models that rely on perfect financial markets do not explain important stylized facts in international finance, such as the home bias and the volatility of capital flows. Though introducing barriers to international investment, especially differences in information between local and foreign investors, helps in understanding these facts better, our understanding of these facts in quite incomplete.

In view of the international immobility of capital, the Australian imputation regime and changes to that regime have the potential to affect the cost of capital for those Australian companies with marginal investors who are Australian shareholders. As a result, the value of imputation credits to those shareholders can be an important factor influencing the cost of capital of those companies.

Much of the pioneering work in the valuation of imputation credits in Australia was undertaken by Hathaway and Officer (1992). They found that:

- 80% of company tax payments are distributed as imputation credits; and
- 60% of the distributed credits are redeemed by taxable investors.

Overall, this means that the statutory company tax rate is reduced by 48% (i.e. the effective company tax rate was substantially less than the 36% company tax rate and was much closer to an effective rate of 19%). They estimated the value of $1 of imputation credits to be between 77 and 82 cents.

In 1994, McKinsey & Company estimated that:

- franking credits have added $21 billion to the value of Australian companies – about 8 per cent of the market capitalisation of the Top 100 – and for many companies, around 15 per cent of their market value. In addition, they noted that dividend payout ratios had increased substantially, which they argued 'flies in the face of academic literature that suggests dividend policy does not matter'; and
- imputation has lowered after-tax hurdle rates of return by two to three percentage points.

In 1999, J B Were & Son estimated that the value of franking credits:

- in the industrial market was almost 40% (at a 90% confidence level); and
- for higher yielding stocks and Smaller Industrials was around 50% (at a 95% confidence level).

Overall, J.B Were considered that 60% was at the upper end of an acceptable valuation range for franking credits.

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Appendix 2 – List of Abbreviations

ALP	Australian Labor Party
ATO	Australian Taxation Office
BCA	Business Council of Australia
BCA paper	'Removing Tax Barriers to International Growth' December 2001
BELC	Broad-exemption listed country
CFC	Controlled foreign company
CGT	Capital Gains Tax
CHC	Conduit Holding Company
CM&C	Central management and control
DTA	Double Tax Agreements
FBT	Fringe Benefits Tax
FDA	Foreign Dividend Account
FIA	Foreign Investment Account
FIF	Foreign investment fund
GST	Goods and Services Tax
HS	Headquarter Services
IHC	International Headquarter Company
IRA	Individual Retirement Accounts
ITAA 1936	Income Tax Assessment Act 1936
ITAA 1997	Income Tax Assessment Act 1997
LOB	Limitation of benefits
n/a	Not applicable
OBU	Off-shore Banking Units
OECD	Organisation for Economic Cooperation and Development
R&D	Research and Development
RBT	The Review of Business Taxation – Ralph Review
RHQ	Regional Headquarters
RITA	A Review of International Tax Arrangements – Department of Treasury – August 2002
SGC	Superannuation Guarantee Charge
SME	Small or medium enterprises
The Board	The Board of Taxation
The paper	RITA Consultation Paper
TLAB 4	Taxation Laws Amendment Bill (No 4) 2002
TLAB7	Taxation Laws Amendment Bill (No 7) 2002
UCA	Uniform Capital Allowances
UK	United Kingdom
USA	United States of America